Nepalese Banking Sector: Performance Update and Outlook

ICRA NEPAL RESEARCH SERVICES

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This report analyses the general trend in the banking industry* of Nepal with a closer look at the performance of 28 commercial banks between FY14 and Q2FY18. The focus is on the change in banking industry after NRB introduced revised paid up capital regulations for BFIs in July 2015. The report also discusses on current trend in banking industry and near-term outlook.

**Banking industry of Nepal comprises of close to 100 players across Class A (commercial bank), Class B (Development Bank) and Class C (Finance Companies). However, with >85% share in the asset base of banking industry, the commercial bank industry (comprising of 28 players) have much higher significance to the industry.*

Historical trend of Banking sector growth vis-à-vis other economic parameters:

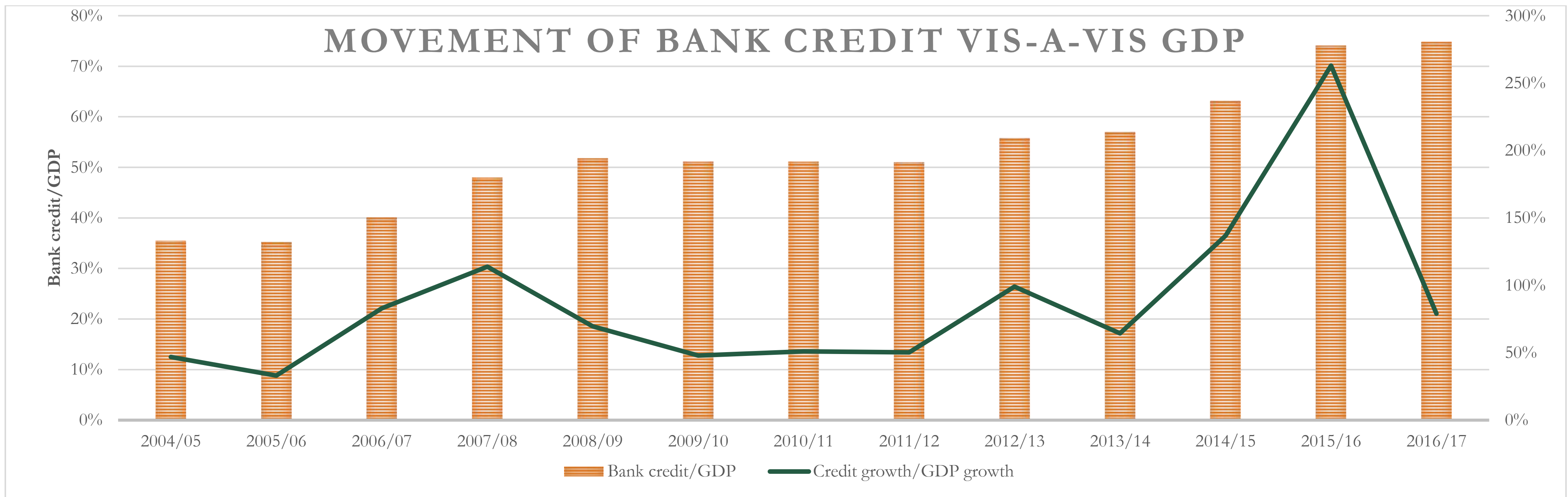
Nepalese banking sector growth during past 10-12 years has been characterized by increase in number of players and concomitant increase in the asset base of banking industry. However, barring marginal growth in penetration, the industry has remained mostly concentrated in the urban centers; in line with limited economic and political decentralization of the country. Sizeable addition to the number of industry players without commensurate increase in penetration and borrower/depositor base has led to intense competition among the players for limited business opportunity. With rapid expansion in the number of banking sector players, NRB stopped issuing new licenses for BFI from FY2012 and encouraged BFIs for merger through several regulatory relaxation and tax benefits. This move laid the foundation for the merger among BFIs in coming years. The process of merger between BFIs gathered speed after NRB rolled out revised paid up capital requirement in July/August 2015.

With most of the major business houses of Nepal involved directly in banking business, there is a lack of clear demarcation between borrowers (members of business community) and banks; which could give rise to potential conflict of interest situation.

During past 12 years, Nepalese banking industry has witnessed 2 spells of high credit growth (between FY07-FY09 and FY15-FY17). Both these credit growths have taken place during very low interest rate regime; in absence of strong countercyclical checks by the regulator. As a result, the credit expansion during those periods has fueled asset price growth. The historical trend of economic growth vis-à-vis banking sector growth has been tabulated below:

	No. of licensed BFIs		Growth Year-On-Year (YOY)					NEPSE market	NPA Banking sector
	Total	Class A	GDP[1]	Bank credit	Bank deposit	Credit/GDP	Credit growth/ GDP growth	Capitalization/ GDP	
FY05	100	17	10%	13%	10%	35%	47%	10%	18.79%
FY06	116	18	11%	10%	15%	35%	33%	15%	13.11%
FY07	132	20	11%	27%	19%	40%	83%	26%	8.99%
FY08	161	25	12%	34%	30%	48%	114%	45%	5.69%
FY09	166	26	21%	31%	33%	52%	70%	52%	3.17%
FY10	185	27	21%	19%	16%	51%	48%	32%	2.20%
FY11	197	31	15%	15%	11%	51%	51%	24%	3.60%
FY12	189	32	12%	12%	23%	51%	50%	24%	3.60%
FY13	176	31	11%	21%	17%	56%	99%	30%	3.80%
FY14	167	30	16%	18%	18%	57%	64%	54%	3.76%
FY15	154	30	8%	20%	20%	63%	137%	46%	3.33%
FY16	137	28	6%	24%	19%	74%	263%	84%	2.19%
FY17	96	28	17%	18%	13%	75%	79%	70%	1.81%

[1] GDP (at current price) calculation by Expenditure Method

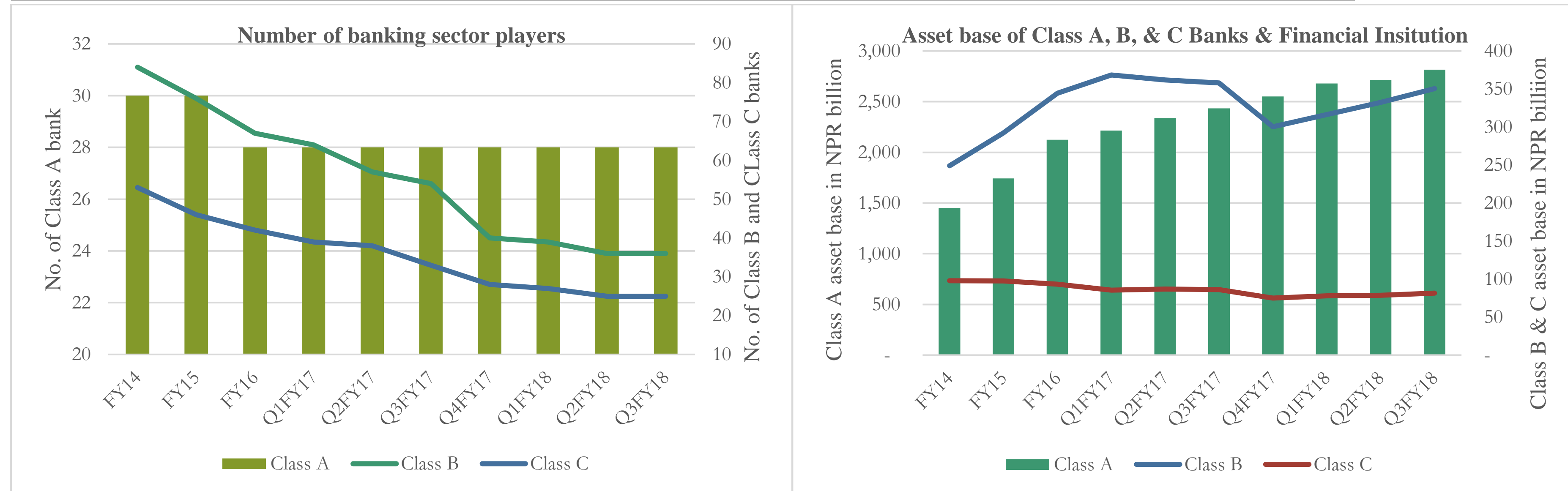


Source: Central Bureau of statistics, NRB, ICRA Nepal research

Note for graphs:
In case of combined graph, scale of bar diagram is to the left and scale for line diagram is to the right vertical axis.

General banking industry update:

1. Revised paid up capital requirement prompted limited consolidation in the banking industry; albeit not among class A players:



**Only 4 commercial banks underwent merger after FY14 (Prabhu Bank Limited acquired Grand Bank Limited while Bank of Kathmandu merged with Lumbini Bank Limited). Out of these also Bank of Kathmandu and Lumbini Bank were merged to adhere the capital plan rolled out by Nepal Rastra Bank.*

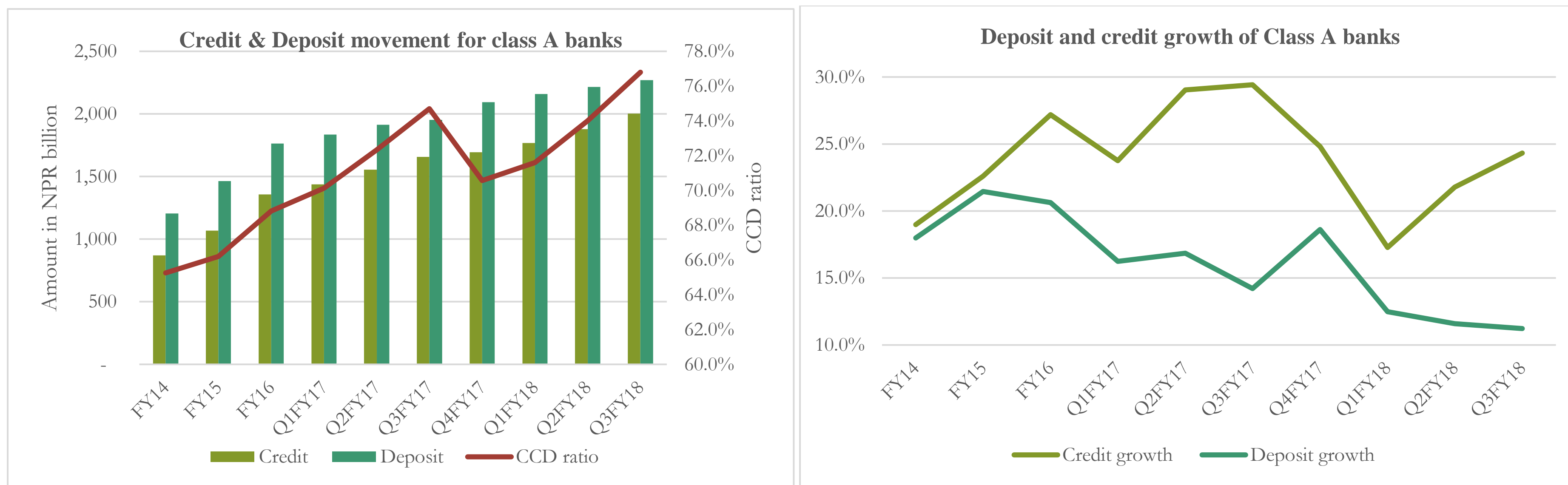
With the decline in number of class B and Class C players, asset base of the related industry also saw similar decline. During FY16, class A and Class B banks both acquired smaller entities and continued to grow. However, in FY17, few large development banks themselves got acquired by class A banks leading to the decline in the size of class B industry as well.

Industry outlook:

Some regulatory intervention is expected through upcoming monetary policy to curb (undirected) aggressive growth strategy of BFIs. Return pressure on increased capital has propelled high credit growth in past 2-3 years, without commensurate improvement in the fundamentals of the economy. This, if continued without any control measures, could lead to unwarranted impact on the assets quality of the banks as well as on the general economy.

2. Growth Update: After 3-year long spell of high credit growth, momentum has weakened amid shortage of lendable deposits:

In absence of regulatory checks, four-fold capital increment and low interest rate regime led to aggressive credit growth between FY15 and FY17:
Capital increment requirement rolled out by NRB through monetary policy in July 2015, was primarily aimed at reducing the number of BFIs through consolidation. However, only 2 commercial banks out of 31 (then) underwent merger while the rest resorted to equity infusion and/or acquisition of smaller BFIs (Class B and Class C) to meet the revised capital requirement. Increased capital base created return pressure on the bank management, setting a background for aggressive credit growth in the following years.



Credit growth of class A banks surpassed deposit growth from FY15. On the other hand, deposit growth rate tapered after FY15 backed by weak growth in inward remittance, a major contributor to industry deposits. Credit growth continued to rise while deposit growth rate weakened over next 18 months. This continued till Q3FY17, when the banks felt the first impact of tightening liquidity and pressure on CCD ratio. After Q3FY17, banks credit growth rate tempered over next 6 months. Credit growth rate has again picked up after Q1FY18, while deposit growth rate continues to decline. This is likely to given rise to another liquidity shock in near future.

Assets quality update: Gross NPA level which declined amid high credit growth; could go up with credit slowdown and interest rate rise:

Commercial banks	FY13	FY14	FY15	FY16	FY17	Q3FY18
Gross Credit (NPR billion)	736.10	873.86	1069.56	1363.70	1694.27	2,003.50
Gross NPA (NPR billion)	19.13	25.51	28.12	24.81	26.09	33.25
Gross NPA %	2.60%	2.92%	2.63%	1.82%	1.54%	1.66%

Source: NRB quarterly/annual compilation of BFI's financials; ICRA Nepal Research

Gross NPA level for commercial banks continues to decline, partly masked by high credit growth:

Gross NPA level of commercial bank has declined since FY14, backed by high credit growth of the industry players. Commercial bank average gross NPA halved from ~3% in FY14 to ~1.5% in FY17. Commercial bank's average credit growth stood at 27% and 25% during FY16 and FY17, the two years following the announcement of revised capital requirement by NRB. Before that, the credit growth stood at 15% (FY14) and 23% (FY15), on much smaller credit base.

Competition among players for business and large borrowers using multiple lines of credit makes it hard to assess true stress on borrower:

Decline in NPA level over the years has been characterized by high credit expansion and growth in number of BFIs. Intense competition among the industry players to rope in large borrowers has given rise to instances of overfinancing to large borrowers. At the same time, stress on these accounts often go unnoticed due to revolving nature of loan and multiple lines of credit being availed by these borrowers from different banks.

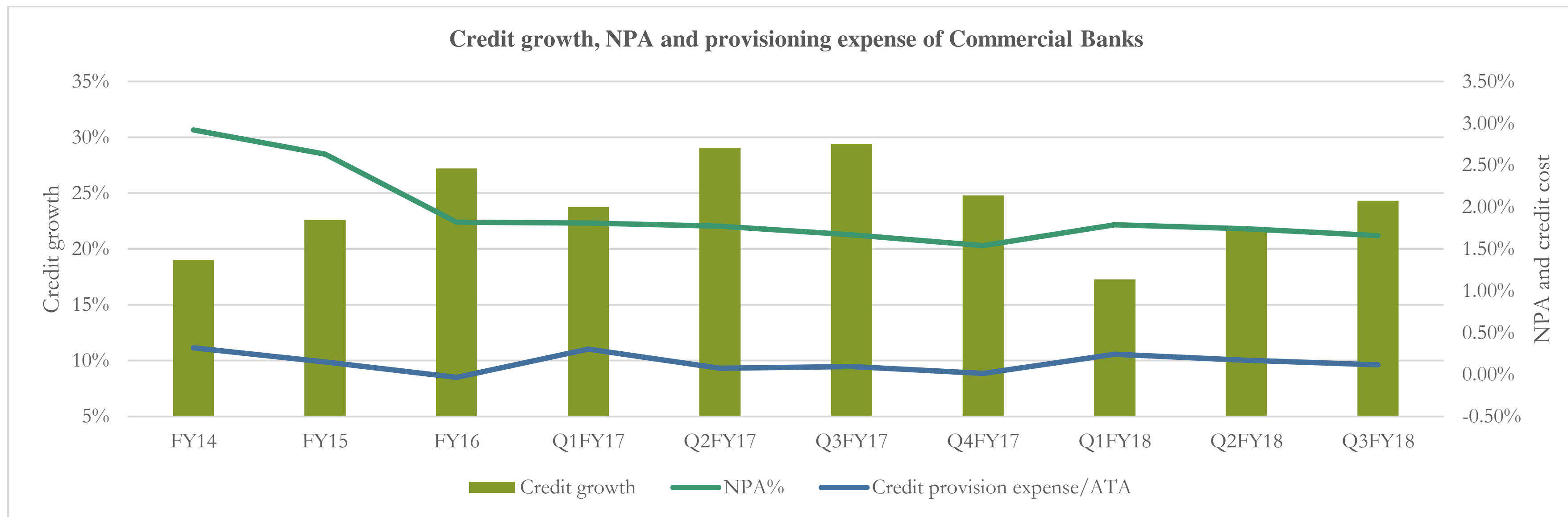
Sizeable proportion of revolving lines of credit also prevents true test of borrower's repayment capacity:

~70% of the total credit books of class A banks comprises of renewable credit facilities which only entails periodic interest payment and the credit lines gets renewed on maturity. Most of the large borrowers in Nepal are involved in trading business and utilize revolving line of credit for working capital financing. As highlighted above, intense competition among the lenders for credit growth has led to overfinancing of most of the large borrower groups. Coupled with moderate quality of accounting adopted by most of the large borrowers, this creates a challenge in effective tracking of exposures by the bank.

Recently, the central bank has hinted at lowering the ceiling for the percentage of revolving lines of credit offered by BFIs to its borrowers. This is likely to be addressed at the upcoming monetary policy announcement.

Slowdown in credit growth and uptick in interest rate could affect future assets quality:

Major portion of the credit portfolio added after FY14 has been underwritten under low interest rate regime. Recent uptick in the interest rates across industry could lead to increased delinquencies in the portfolio that were underwritten during low interest rate regime. Credit books of mid-tier banks, that have reported high growth in past 2-3 years could witness increased delinquencies over next 12-18 months.



<u>Outlook on Asset Quality:</u>

<u>Increased delinquency and NPA level likely over next 12-18 months as credit growth slows down:</u>
Decline in industrywide NPA from FY14 has been characterized by high credit growth in low interest rate regime. Low interest rate regime eases out assets quality pressure since BFIs find buyers for mortgaged properties more easily. Also, the rise in assets prices (land, stocks, etc) during excess liquidity allows stressed borrowers to liquidate those assets and repay bank loans. This apart, reduced interest rates in surplus liquidity scenario and high share of revolving loans also lowered the debt servicing obligation.

Euphoric growth in real estate prices between FY15-FY17 hints at a portion of banking sector funds being utilised in real estate transactions (directly through housing loans whereas indirect use cannot be ruled out). Real estate prices have appeared to peak towards FY17 end and is in correction mode due to increase in interest rates. Government intervention in real estate market (restriction of division of land through plotting, etc) is likely to trigger further correction in prices. With the low interest rate regime coming to an end since H1FY17, some (speculative) borrowers are likely to be left with inflated assets. Also, high interest rate regime attracts money from property and stock market to banks. This results in stressed borrower's inability to liquidate their assets to repay banks as well as bank's inability to liquidate the mortgaged collateral to recover its exposure.

Large common borrowers across most of the BFIs can have some spill over effect across all banks:

Given the industry competition, many of the large borrowers in corporate and SME segments tend to be common across multiple banks. Therefore, the impact on any of these top borrowers could trigger assets quality concern for multiple lender banks.

Sizeable funds are being mobilised through non-banking channels; assets quality impact will be first seen in those channels before being passed on to the banking channels:

As of FY17, co-operative societies as an industry mobilise assets worth NPR 273 billion in credit (more than class B banks' credit portfolio of NPR 205 billion on same date). Of the total credit of NPR 273 billion by cooperative societies, ~NPR 180 billion is mobilized by Savings and Credit cooperatives (which have more risker asset mix as compared to traditional cooperatives that have limited member base and small ticket exposures).

Cooperative society operates without any major regulatory oversight despite being one of the sizeable players in the financial system of the country. Major portfolio of cooperatives (mostly savings and credit cooperatives) are in loans against property and share loans.

Cooperatives also share some of the borrowers with banking industry which could result in overfinancing of those borrowers, as the credit availed from cooperatives are not captured in the credit information bureau reports.

3. Update on Profitability: Profit level could come under pressure from rising cost of fund, increase in credit and other operating cost:

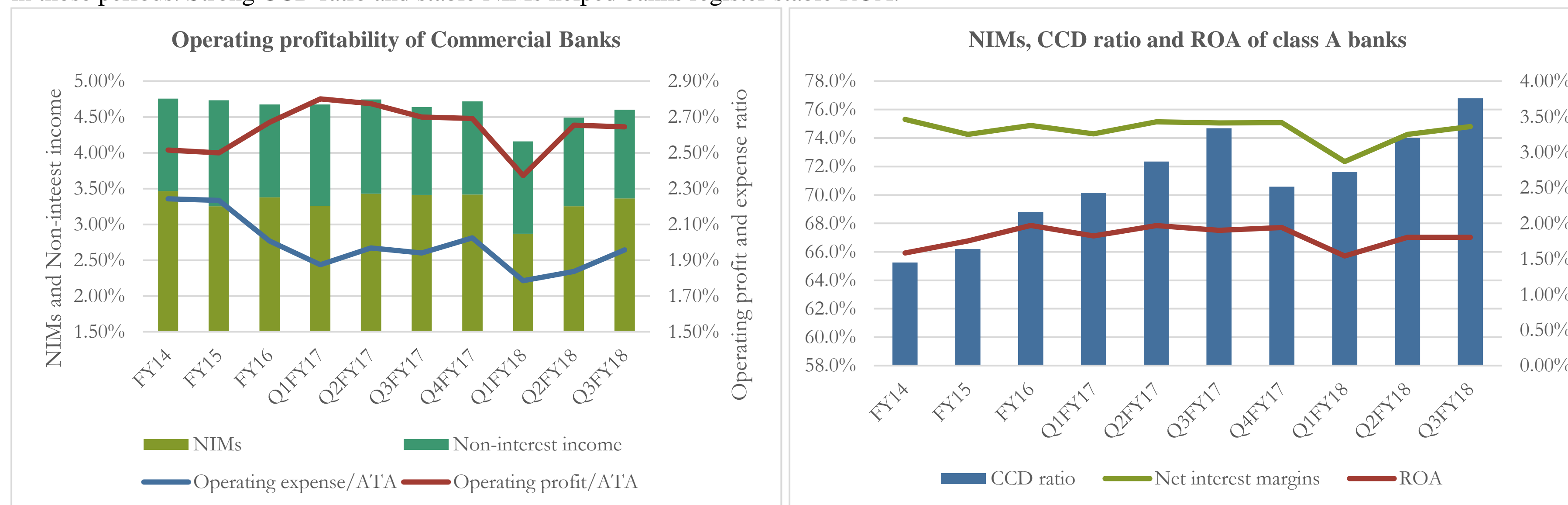
Banking sector profit improves on the heel of high credit growth and resulting scale economies:

High credit growth seen in the banking industry in recent years has had positive impact on the profit levels of the banks. Between FY15 and Q2FY17, ROA of commercial bank improved. This was backed by steady net interest margins (NIMs) on rising asset base and decline in operating expenses due to scale economies. Higher rate of credit mobilization (as evidenced by rising CCD ratio between FY15 and Q3FY17), also helped maintain the NIMs and prevent dilution effect created from capital infusion and retention of profit accruals.

Credit portfolio with floating rate helps maintain stable NIMs; despite interest rate volatility:

During past 3 years ending FY17, net interest income (NII) accounted for ~75% of total operating income of Class A banks while rest comprise of non-interest income (mostly credit linked activities like loan processing fees, Letter of credit/ guarantee commission, etc.).

Despite sharp fluctuation in interest rate, industry average NIMs remained largely stable (due to floating rate on entire loan book of Nepalese banks). Moderation in cost of deposits and increased rate of credit mobilization (as evidenced by rising CCD ratio) supported the NIMs; offsetting the impact of low lending yields in those periods. Strong CCD ratio and stable NIMs helped banks register stable ROA.



Limited investment avenues offer little scope for earnings on surplus fund:

Class A Commercial Banks	FY14	FY15	FY16	Q1FY17	Q2FY17	Q3FY17	Q4FY17	Q1FY18	Q2FY18	Q3FY18
Average Yield on advances	11.36%	10.07%	8.91%	8.47%	8.86%	9.26%	10.01%	11.45%	11.56%	11.52%
Average Yield on investment	1.49%	0.81%	1.02%	1.43%	1.51%	1.64%	1.39%	2.10%	2.52%	2.65%

Source: ICRA Nepal Research

Apart from credit activities, banks in Nepal usually invest their surplus funds in government securities (treasury bill and bonds) (60-70% of total investment in past 1-2 years), local and foreign bank accounts (~5%) and long-term investment in equity shares of listed companies (~30-35%). *Under prevailing regulations, the banks are not allowed to invest outside of the country, except as required by their business.*

Government's appetite for money has remained low in past 4-5 years, given the limited ability of government machinery to spend the budgets on capital expenditure. This is reflected in very low government treasury and bond yield. Similarly, shallow equity market in Nepal offers limited scope for large players

like BFIs to benefit from trading activities. Hence the average yield on investment for BFIs has remained low over the years. This has put pressure on the profitability of the banks and has encouraged risky lending practices to some extent.

ROA of the banks could witness some moderation due to rising cost of funds and credit cost:

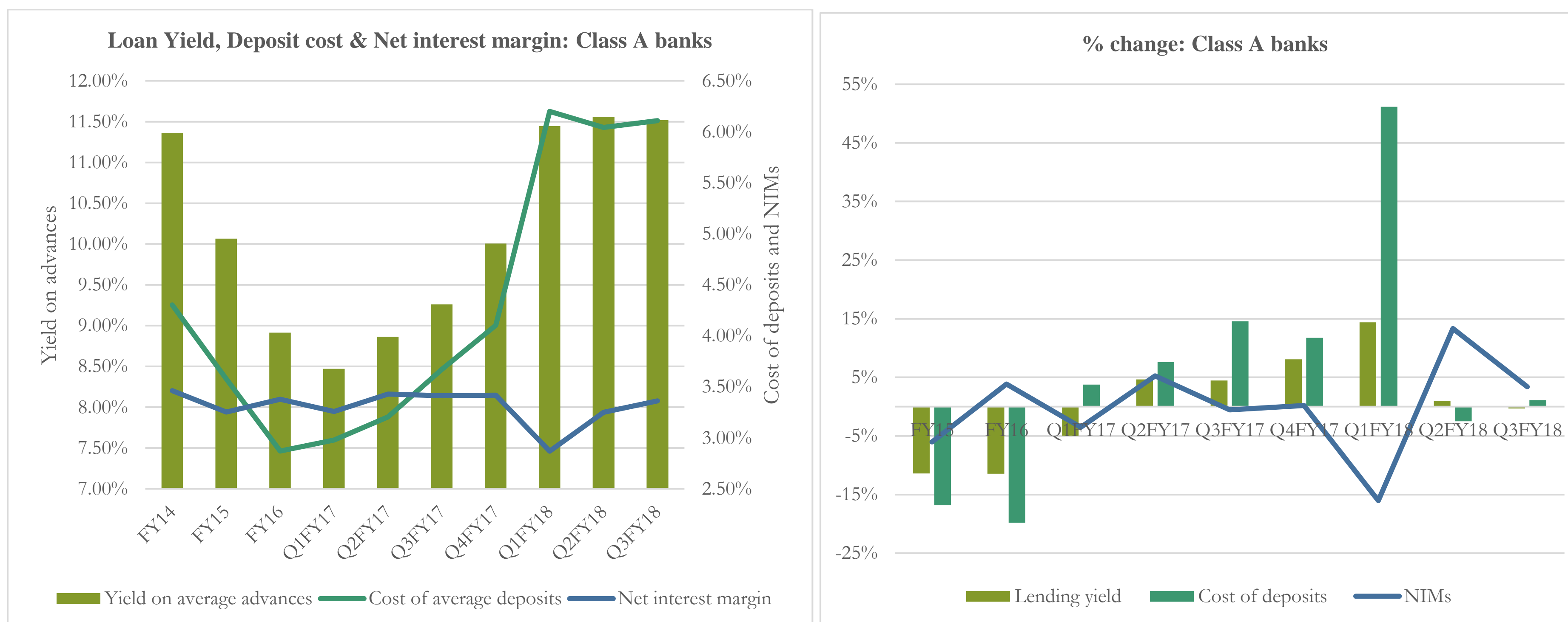
ROA came under pressure from shortage of lendable deposits starting Q2FY17. Shortage of lendable deposits pushed up the cost of funds, slowed down credit growth and hence affected NIMs and ROA. Moderation in ROA was also due to the dilution effect created from equity injection, as many players completed their last round of equity injection/capital retention towards FY17 end. However, the pressure is expected to be short-lived as the banks are likely to eventually pass on the increased cost to the borrowers.

With the general rise in interest rates, some stress is expected on the credit books added during the low interest rate regime of FY15-FY17. Increased provisioning cover required towards those assets is also likely to affect the ROA margin for industry players.

4. Deposit, Liquidity and interest rate update: Acute shortage of lendable fund mainly due to high credit growth compared to deposit in last two years push interest rate at highest level, however liquidity seems to be adequate.

Months	**12**	**12**	**12**	**3**	**6**	**9**	**12**	**3**	**6**	**9**
	FY14	**FY15**	**FY16**	**Q1FY17**	**Q2FY17**	**Q3FY17**	**Q4FY17**	**Q1FY18**	**Q2FY18**	**Q3FY18**
Class A banks	**Jul-14**	**Jul-15**	**Jul-16**	**Oct-16**	**Jan-17**	**Apr-17**	**Jul-17**	**Oct-17**	**Jan-18**	**Apr-18**
Deposit growth rate	18%	21%	21%	16%	17%	14%	19%	12%	12%	11%
Credit growth rate	19%	23%	27%	24%	29%	29%	25%	17%	22%	24%
CCD ratio	65.3%	66.2%	68.8%	70.1%	72.3%	74.7%	70.6%	71.6%	74.0%	76.8%
Average cost of deposits	**4.30%**	**3.58%**	**2.87%**	**2.98%**	**3.20%**	**3.67%**	**4.10%**	**6.20%**	**6.04%**	**6.11%**
Average lending yield	**11.36%**	**10.07%**	**8.91%**	**8.47%**	**8.86%**	**9.26%**	**10.01%**	**11.45%**	**11.56%**	**11.52%**

Source: ICRA Nepal Research



Continuous high growth in credit with slow growth in deposit led to tight CCD ratio; which manifested from Q2FY17 restricting further credit growth: Between FY13 and FY16, banks enjoyed comfortable liquidity position. Banks credit growth rate improved steadily during the low interest regime rising from 15% in FY14 to upwards of 20% in each of next 3 years. Credit growth rate surpassed the growth rate in deposit in those period, with the gap reaching its maximum in Q3FY17.

Due to the disparity in credit and deposit growth, banks' CCD ratio and liquidity position came under pressure by the first half of FY17. Second half of FY17 was characterized by banks focusing on attracting incremental deposits by offering better rates. This was done to support credit growth and prevent the breach of CCD ratio. This price war led swift rise in industry cost of deposits from 3.67% in Q3FY17 to 6.20% in Q1FY18; almost 70% increase within 6 months.

Recent rise in deposit rates follows change in deposit mix in favor of costlier term deposits:

Deposit mix	Jul-14	Jul-15	Jul-16	Oct-16	Jan-17	Apr-17	Jul-17	Oct-17	Jan-18	Apr-18
CASA+ margin deposits	49%	50%	51%	51%	49%	44%	44%	45%	45%	45%
Call Deposits	21%	21%	19%	19%	19%	16%	14%	14%	13%	11%
Term deposits	30%	29%	30%	29%	32%	40%	42%	41%	42%	44%
Total	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**	**100%**
Total deposit of Commercial bank (in NPR billion)	**1,204**	**1,463**	**1,765**	**1,836**	**1,913**	**1,953**	**2,093**	**2,159**	**2,215**	**2,270**

Bank's interest towards term deposits increased sharply after H1FY17 (mid-Jan 2017) as continuous increase in credit vis-à-vis deposits led to pressure on CCD ratio and many banks came close to breaching the regulatory ceiling of 80%. This led to competition in the industry for fresh deposits by offering high rates. The price war led to quick rise in proportion of term deposits as well as cost of deposits for players.

Historical rate of deposit growth and recent slowdown in flow of worker's remittance indicates that incremental deposit growth will fall short to support increased credit appetite of banks:

Between FY01 to FY15, banking sector credit has grown by CAGR 19%, backed by CAGR 18% growth in deposits. *After the announcement of revised capital requirement by NRB, banking sector deposit has grown by CAGR 16% while credit has grown by CAGR 21%.* Coupled with recent slowdown in the rate of inward remittance flow (which was a major contributor to the domestic money supply and source of bank deposits), near term deposit growth is unlikely to support the credit growth ambitions of the banks.

5. **Capital adequacy update:**

Capitalization level remains comfortable; backed almost entirely by tier I equity capital; penetration of tier II capital instrument remains very low:

Capitalization level of class A banks increased steadily from FY15 till FY17, as an impact of the monetary policy rolled out towards the end of FY15. After FY15, banks resorted to retention of capital accruals and infusion of fresh equity to meet revised paid up capital requirement of NPR 8 billion. Revised capital plan did not usher in the consolidation of class A banks through merger; as most of the players met the requirement through equity injection and acquisition of smaller entities from Class B and Class C banking industry.

Between FY15 and FY17, industry average CRAR increased from 11.69% to 14.72%, against prevailing regulatory minimum requirement of 11%. The increase in CRAR was driven by growth in tier I capital from 10.10% to 13.35% over the same period.