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# Nepal: Selected Issues

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NEPAL

**Selected Issues**

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## FINANCIAL SYSTEM CHALLENGES IN NEPAL

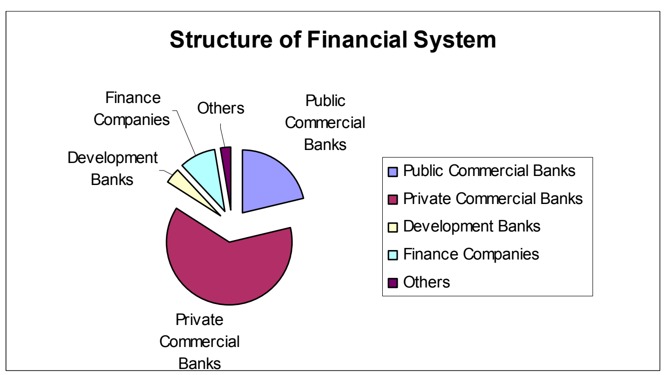
### I. INTRODUCTION

1. **The rapid growth of the financial system presents a number of challenges to maintaining financial stability in Nepal.** The recent proliferation of financial institutions and credit growth has coincided with a sharp rise in stock market and property prices, warranting an added focus on the risk mitigation framework. This paper discusses the structure and vulnerabilities of the financial system, describes the key risks to financial stability going forward, and recommends measures to mitigate these risks, including by:

- Strengthening bank supervision and regulatory enforcement;
- Improving liquidity management and forecasting in the central bank's conduct of monetary policy; and
- Addressing financial weaknesses of the large public banks.

### II. STRUCTURE OF THE FINANCIAL SYSTEM

2. **There has been a rapid growth of the banking sector over the last few years**. The financial system as of mid-January 2008 includes 23 licensed commercial banks (Class A institutions), 58 development banks (Class B institutions), 79 finance companies (Class C institutions), and other financial institutions including 12 micro-credit development banks.



Development banks and finance companies are not permitted to take demand deposits or undertake foreign currency business, but are otherwise treated similarly to commercial banks, and thus referred to as banks throughout this paper. Total assets of the banking sector stood at 81 percent of GDP in July 2007, increasing from 78 percent of GDP in July 2006 and 62 percent of GDP in July 2001.

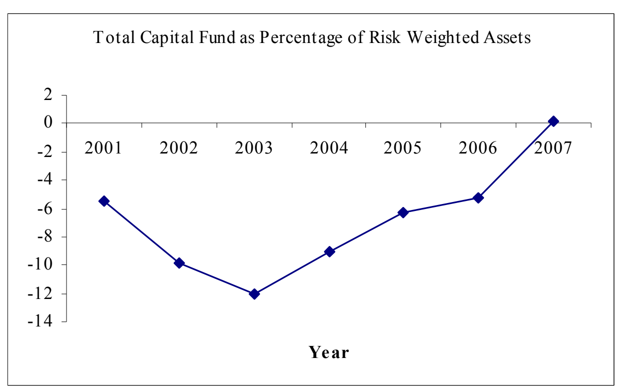
3. **State-owned institutions continue to dominate the banking system**. Despite a comprehensive restructuring process and the rapid entry of new private banks, state-owned banks still account for more than 30 percent of total banking sector assets. The state-owned banks also have the largest branch networks, representing more than half of total bank branches in the country. There are two large public commercial banks–Nepal Bank Ltd (NBL) and Rastriya Banijya Bank (RBB). Both banks have been under a restructuring program supported by the World Bank since 2000. The state also retains a stake of 65 percent of the capital of the Agriculture Development Bank Limited (ADBL), which was recently upgraded to a Class A institution and is under a restructuring program supported by the Asian Development Bank.

4. **Equity market capitalization has increased sharply while government debt markets remain underdeveloped**. Between end 2006 and 2007, the stock market boomed, with the Nepal share price index more than doubling, causing market capitalization to rise from 17 percent of GDP to about 40 percent of GDP at end 2007. Following a 20 percent correction early in 2008, market capitalization now stands at about 32 percent of GDP. The government debt market remains small with treasury bills and development bonds amounting to about 10 percent and 2 percent of GDP, respectively. About 25 percent of treasury bills are held by the Nepal Rastra Bank (NRB) with little or no secondary market trading activity.

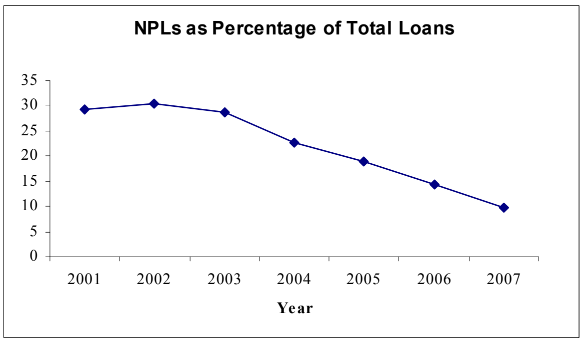
## III. Vulnerabilities of Financial Institutions

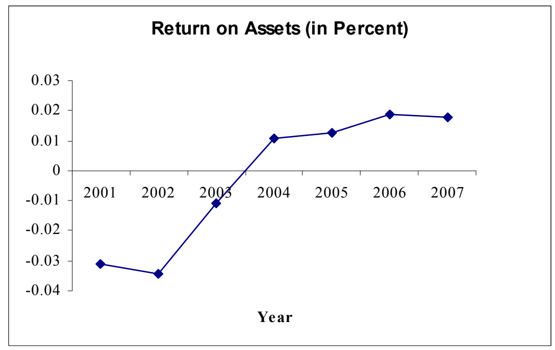
### A. Banking

5. **Despite a challenging macroeconomic environment, the financial performance of the banking system has improved**. The Financial Sector Reform Program of the government was launched in late 2000 to address the legacy of politically motivated lending by state-owned financial institutions and weak supervision that allowed the buildup of a high volume of non-performing loans (NPLs) and brought the banking system to near insolvency. Key financial soundness indicators (capital, asset quality, and profitability) improved steadily in recent years. Most commercial banks continued to maintain capital in excess of the minimum statutory capital adequacy

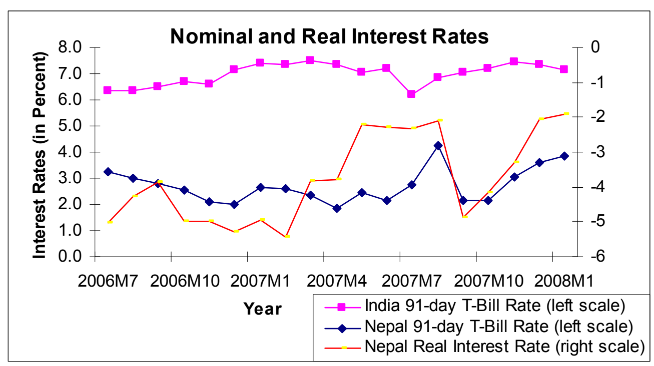


requirement (CAR) of 11 percent in January 2008, with the exception of the two large public banks, the ADBL and 3 other private commercial banks.[1] The ratio of NPL to total loans fell by more than half since 2003, due to aggressive write-downs of bad loans and improved supervision, though rapid credit expansion in recent years has also contributed. Recent data suggests a continuation of this positive trend with NPLs declining in the first half of 2007/08. Meanwhile, total loan loss provisions have also increased to about 150 percent of NPLs by January 2008.



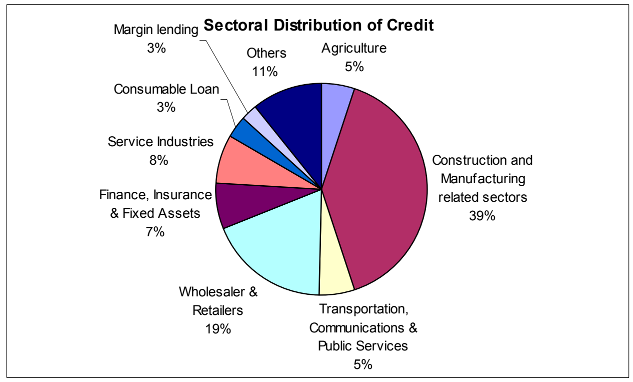




6. **Credit growth has been rapid, fueled by a number of factors.** Credit has grown by around 25 percent at end-2007—compared to a trend growth of 22½ percent over 2000/01–2006/07—, with a 36 percent increase in credit by private commercial banks more than offsetting a contraction of lending by the two large public banks as they undergo restructuring. While some of the growth reflects a natural deepening of the financial system, loose monetary conditions, intermediation of worker remittances to housing and consumer credit, and a proliferation of new institutions also played a role. The number of licensed commercial banks, development banks and finance companies at end-2007 reached 23, 58 and 79 (from 18, 38 and 34 the previous year, respectively). Minimum capital requirements have been raised as a response but demand for new licenses remains strong, in part because of the profitability of the sector.

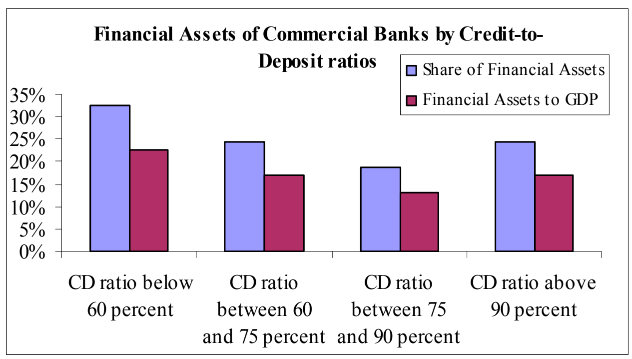



[1] However, two of the private commercial banks that have not yet met the new (higher) minimum capital requirements introduced in 2007 have been given until 2009 to do so while another private commercial bank is under the receivership of the NRB.

7. **The rapid increase in credit growth in recent years suggests growing credit risk**. The rapid proliferation of financial institutions and credit growth has coincided with a sharp rise in stock market and property prices. While the sectoral distribution of credit does not show a high exposure to the real estate and stock market, partly as a result of loan classification limitations, the indirect exposure could be quite large. Nearly 60 percent of bank loans are secured by real estate assets, thus making banks vulnerable to a sharp drop in real estate prices. In contrast to international best practice, Nepalese banks can lend against stocks as collateral. While this so-called margin lending remains small (about 3 percent of the loan portfolio of banks), its recent growth could be fueling the stock market boom. The lack of detailed bank-by-bank sectoral NPLs and collateral held precludes a stress testing of these risks.

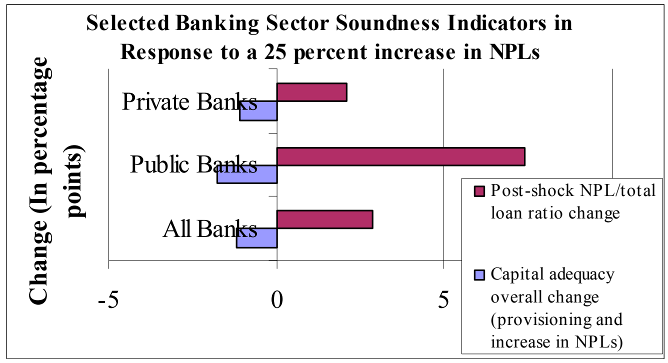



8. **Growing competitive pressures and an uneven distribution of liquidity could also weigh on the financial sector**. Banks have so far managed to increase profitability by maintaining relatively high spreads between deposit and lending rates but the recent proliferation of financial institutions, and thus increased competition, appear to have contributed to a narrowing of the spread. Liquidity management is also likely to be a growing challenge. The share of illiquid loans in bank assets is increasing throughout the system, and the average credit-to-deposit (CD) ratio for the banking system has increased from 60 percent over 2000–2006 to 78 percent by end-2007. Nearly 25 percent of banking assets and 17 percent of GDP are now held by small private banks with CD ratios exceeding 90 percent—very high by international standards.




9. **Stress tests suggest that banks are more vulnerable to asset quality and liquidity shocks than exchange rate and interest rate shocks**.[2]

[2] See Cihak (2007), "Introduction to Applied Stress Testing," IMF Working Paper 07/59 (Washington: International Monetary Fund) for the methodology and assumptions used. The audited financial statements as of mid-July 2007 were used as the base for the stress testing and covered 20 Class A institutions, more than 95 percent of banking sector assets.




- A 25 percent equiproportional increase in NPLs at all banks reduces the aggregate CAR by 1.2 percentage points, and more so at the large public banks (1.8 percentage points) as expected given their already large NPLs ratios. In this scenario, the capital of one additional private commercial bank would fall below the minimum CAR.

- The largest negative shock would arise from the default of the banks' single largest borrowers. In this case, nearly all banks would cease to meet their minimum CAR, while a significant number of institutions would go insolvent if their largest 3 to 5 borrowers default.[3]

- Banks' liquidity positions are not able to withstand standard shocks to deposits (e.g., 15 percent of demand deposit withdrawn a day) under standard assumptions for market discounts on liquid assets.[4]

- The sensitivity tests confirm that banks' balance sheets are relatively resilient to the direct effects of an exchange rate shock (vis-à-vis the US dollar) due to stringent open-position limits and low level of dollarization. Likewise, the impact of interest shocks would be limited. The impact of a 1.5 percentage point increase in interest rates on the CAR of all banks is only -0.3 percentage points (-1.2 percentage points for public banks) due to its modest effect on the net interest income on private banks given their profile of interest sensitive assets/liabilities.

10. **Weaknesses in the two largest public banks affect the performance and soundness of the banking system as a whole**. The government has dropped earlier plans to privatize the largest two public banks and, instead, has opted for operational and financial restructuring, which has yielded some improvements over the past few years under a World Bank financial sector restructuring project. The operational autonomy provided to NBL and RBB has for the most part shielded the two institutions from politically motivated lending. The two banks are now showing an operating profit that has helped reduced their negative net worth, though they still maintain a significant negative CAR. While loan recovery and

[3] Limits on large exposures are relatively lax, which leaves the banks more vulnerable to credit concentration risk and to defaults by their largest borrowers.

[4] Tests could have also been undertaken using "liquidity contagion" models but was not attempted here partly due to lack of data on bank-by-bank interbank exposure.

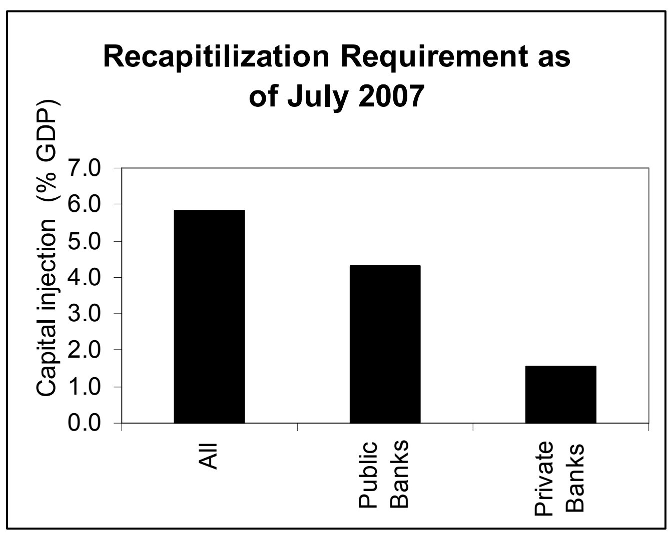
write-offs have reduced the level of NPLs in these two banks and in the banking sector as a whole, loan classification is based only on aging of arrears and not on creditworthiness, possibly underestimating potential problem loans. The overhead expenses of the two public banks—driven by high salaries and pension costs, reflecting difficult relations with the labor unions—continue to weigh heavily on their financial position. The management and governance of the two banks also suffer from uncertainty regarding the status of external management contracts put in place under the restructuring program, and from gaps in expertise in finance and risk management. Overall, state involvement in the financial sector continues to risk undermining its efficiency and development by increasing the cost of finance due to weak operational efficiency of public banks, by weakening regulatory credibility, and by stifling financial innovation.

**Annual Performance Indicators of NBL and RBB (in Percent, unless otherwise stated)**

| | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|
| NBL | | | | | |
| NPLs as Percentage of Gross Loans | 41.7 | 34.2 | 31.8 | 25.1 | 15.2 |
| Net Interest Margin | 2.5 | 0.6 | 1.7 | 1.5 | 1.1 |
| Return on Assets | -0.6 | 1.8 | 3.0 | 2.0 | 1.0 |
| Staff Expense to Income | 38.0 | 27.0 | 28.0 | 29.0 | 35.0 |
| Net Worth (Rs. Millions) | -9830.0 | -9015.0 | -7757.0 | -6698.0 | -6056.0 |
| RBB | | | | | |
| NPLs as Percentage of Gross Loans | 60.0 | 52.0 | 51.0 | 37.0 | 29.0 |
| Net Interest Margin | -0.2 | 2.4 | 4.2 | 4.1 | 3.9 |
| Return on Assets | -11.0 | 2.5 | 2.8 | 2.9 | 2.9 |
| Staff Expense to Income | 138.0 | 23.0 | 27.0 | 27.0 | 27.0 |
| Net Worth (Rs. Millions) | -22392.0 | -21382.0 | -20199.0 | -18719.0 | -17213.0 |

Source: World Bank

11. **Addressing the capital deficiency of the public banks and improving debt recovery from willful defaulters constitute key policy priorities**. Capital adequacy is the pre-eminent anchor of banking regulation, and the continued inability of public banks to maintain adequate capital undermines both the credibility of banking supervision and the soundness of the banking system. Coupled with regulatory forbearance, it clouds the existence of a level playing field among banks. As the current owner, the government should recapitalize NBL and RBB and ensure sound management practices given the past history of politically motivated lending and large stock of NPLs. ADBL has recently received a capital injection of US$58 million under a Rural Finance Sector Development Cluster Program funded by the Asian Development

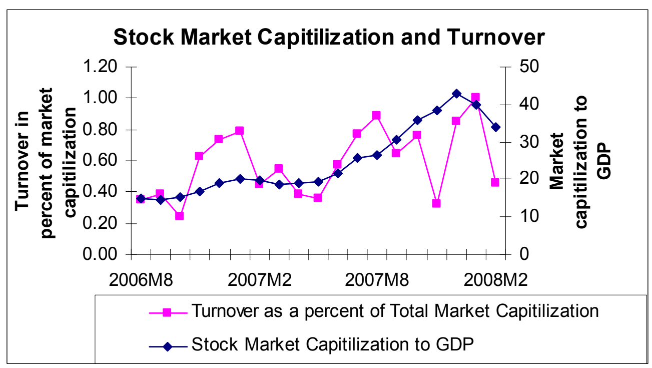


Bank, allowing its CAR to reach 9.8 percent at end January 2008.[5] The ADBL could thus meet the minimum CAR of 11 percent when the government further reduces its shareholding as envisaged in its strategic plan approved in November 2007. In addition, improving debt collection from willful defaulters, including through efforts by the Debt Recovery Tribunal, should remain a policy priority to maximize recoveries and instill credit discipline among borrowers. However, legislation aimed at setting up an additional bench at the DRT to expedite the large number of outstanding cases has been put on hold, delaying the timely disposal of pending cases.

## IV. Capital Market Developments

12. **A number of impediments have held back capital market development.** A central depository system and a scriptless trading platform are prerequisites for an efficient capital market system but have been held up by the lack of an adequate legal framework. Current disclosure levels for listed companies are also weak and need to be supported by the development of a comprehensive set of accounting standards by the Institute of Chartered Accountants of Nepal. The nascent state of the insurance and pension sectors, and more generally, a limited investor and issuer base are also impediments to the development of the private securities markets.

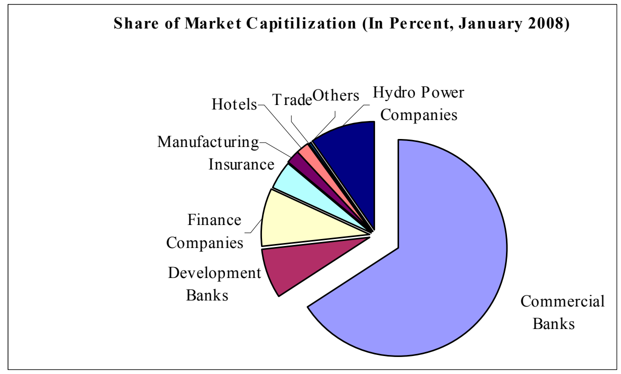
13. **Nonetheless, the Nepalese stock market experienced an unprecedented boom over the last few years, which reached its climax at end-December 2007.** The NEPSE Index rose by some 265 percent between mid-July 2006 and mid-December 2007, before falling by about 20 percent in January-February 2008. The surge in stock prices was accompanied by an increase in the number of listed companies, from 134 at mid-July 2006 to 145 as of February 2008. As a result, total stock market capitalization went up from 15 percent of GDP at mid-July 2006 to a peak of 40 percent of GDP at mid-December 2007. Monthly stock trading volumes, however, remain small, representing less than 1 percent of total stock market capitalization, partly due to transitory restrictions on sales of promoters shares.[6]




[5] The capital injection required in the chart does not reflect the recent recapitalization of ADBL and thus overestimates the capital injection for private banks at present.

[6] Restriction on sales of promoters' shares of bank and financial institutions is in place for at least an initial 5-year period.

14. **The nexus between the stock market and financial institutions has been a source of concern.** With banking and finance companies stocks dominating stock market capitalization, this nexus could give them incentives to encourage margin lending and inflate stock prices to the benefit of their stockholding. Sooner or later, stock prices would experience a correction and bad debts mount, with a risk that depositors or the government bear the ultimate costs. Margin lending grew rapidly during 2007 and represented a larger share of lending for development banks and finance companies (about 5-10 percent of credit) than for commercial banks. As distinctions between commercial banks and other bank-like financial intermediaries are unlikely to be fully appreciated by the average depositor, an additional risk was that a wave of failure by these institutions might impact the standing of category A banks. These concerns prompted the NRB, in consultation with the Securities Board of Nepal, to introduce a number of prudential measures in January 2008 including limiting margin lending to below 50 percent of the average closing prices of the shares held as collateral. These measures appear to have helped curtail speculative pressures.

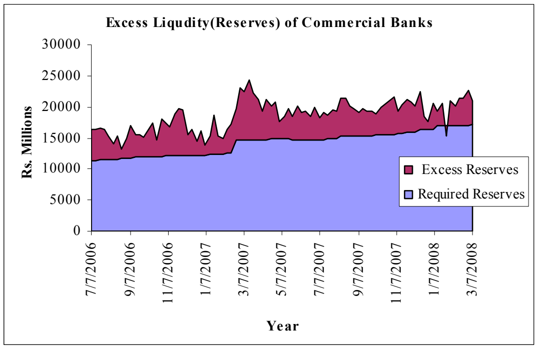


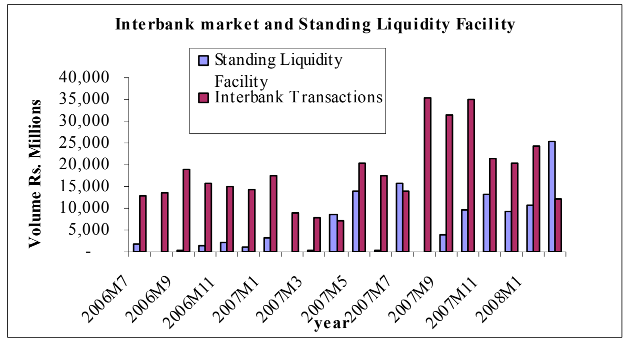

## V. Risk Mitigation in the Financial System

### A. Systemic Liquidity Management Framework

15. **The NRB has the standard set of tools to manage liquidity, including reserve requirements, standing facilities, and open-market operations.** Nonetheless, the relatively passive liquidity management conducted by the NRB in recent years has allowed foreseeable exogenous events, such as changes in government spending, to lead to potentially disruptive swings in liquidity conditions, with an overall bias toward excess liquidity and negative real interest rates. Against a background of high and rising CD ratios at banks, temporary exogenous liquidity shocks, such as funds withdrawn from the system during the ADBL Initial Public Offering and advance tax payments by banks, can cause a temporary liquidity squeeze, as happened recently, forcing the hand of the central bank to provide additional liquidity to the system through the Statutory Liquidity Facility (SLF) and Repo facility. Access to the SLF is highly skewed to a few banks with high CD ratios and is relatively large compared to the total amount interbank transactions, highlighting the limited role of the interbank market in redistributing liquidity. This complicates monetary management and stifles the development of a liquid interbank bank, by making the central bank the lender of first rather than last resort. Higher penalty rates for the SLF and

supervisory measures could be used effectively to deal with repeated access by a small number of banks.




16. **Monetary operations would benefit from better liquidity management and forecasting by the central bank and steps to deepen the interbank market.** This will require a separation of the formulation and execution of monetary policy from public debt management. In particular, the NRB should discontinue its practice of playing the role of buyer of last resort of treasury bills and the use of cut-off interest rates in the primary treasury bill market. Liquidity forecasts should be strengthened, including with improved projections of government cash flows, and they should be used in a timely manner to guide monetary operations. Lack of trust and collateral has hampered the development of a liquidity interbank market. The introduction of a Master Repurchase Agreement (MRA) for interbank repos (inspired by the repo MRA signed between commercial banks and the NRB) would help smooth credit limit constraints and allow for more trading between banks belonging to the various tiers of the market.

## B. Regulatory and Supervisory Framework

17. **The legal framework for banking supervision has been subject to a major overhaul, and, in principle, provides the NRB with sufficient powers.** Since the self-assessment of the Basel Core Principles was completed in January 2007, a new Banking and Financial Institutions Act has been approved by Cabinet, and now awaits consideration by Parliament. Assuming it is passed as drafted, many of the legal deficiencies noted in the self-assessment would be remedied. In addition, the NRB issued in April 2007 a revised licensing policy that also addresses some of the deficiencies noted in the self-assessment. Finally, the NRB has expanded the role of external auditors by requiring them to include in their 'long-form' report an assessment of compliance with the NRB's directives.

18. **While the legal framework and supervision have improved, risk management remains weak.** The Regulation and Supervision Group of the NRB, which is responsible for supervising all bank and non-bank financial institutions, has substantially enhanced its monitoring capacities and is moving from a compliance-based to a more risk-focused supervisory approach. However, risk-management systems and processes are unevenly

implemented across banks, and supervisory guidance in this regard has yet to be issued. In addition to overall risk management guidance, specific guidance could be prepared and issued on major risks, including credit, market, liquidity, and operational risk.

19. **Enforcement of prudential regulations is crucial to the soundness of the banking system.** The new Prompt Corrective Action rules, outlined in the Basel II paper, will, if properly applied, allow a speedier enforcement of minimum capital requirements and avoid the existence of 'zombie' banks operating in an insolvent or barely solvent state (Box 1). This said, the political will to use these powers has yet to be tested in Nepal. The recent central bank interventions in problem banks have not only been late but have also bailed out bank promoters and other shareholders. Regulatory forbearance was exacerbated by the decision to allow these banks to continue to operate with negative capital. Regarding licensing, the stricter policy approved in April 2007 has been undermined by the recent proliferation of licenses granted to banking and financial institutions whose applications had been pending under the old licensing regime. If it proves impossible to strengthen the supervisory hurdle by enforcing a more demanding policy on defining and applying "fit and proper" tests, serious consideration needs to be given to raising further the minimum capital required. This would mitigate the increased risk being borne by depositors in these new institutions. Finally, the process of strengthening banking system soundness will only be complete when the government recapitalizes the public banks and moves forward on a credible restructuring strategy.

20. **The implementation of risk-based supervision and strengthened enforcement can be a solution to the problems described above by helping to identify problem banks at an early stage.** The NRB is developing risk-based supervision methodology and guidelines with the help of IMF technical assistance. These efforts may well require further capacity building and restructuring, in particular a further integration of on-site and enforcement with off-site work. The enforcement of the supervisory adjustments to risk weighted assets and capital contemplated in the Basel II paper[7] would be important in the Nepali context, and could be extended to all Class B and C institutions as well. Banks in Nepal are permitted to invest in any activity "not inconsistent with the business of banking and the provision of finance," allowing them to own not just financial institutions but also nonfinancial businesses, such as property development companies. For these reasons, the framework for consolidated supervision will be also enhanced with the passage of the BAFIA which calls for exchange of information with other supervisors, both in Nepal, such as the securities regulator (SEBON) and supervisory agencies abroad, particularly India.

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[7] In particular, to add 10 percent of the excess over single obligor limits to the risk weighted exposure to credit risk and a risk weight of 0.5 percent of total deposits when the bank's liquid assets (inclusive of investment in government securities) to total deposit ratio is less than 20 percent

**Box 1. Basel II Implementation in Nepal**

**Commercial banks and all “national” class B institutions in Nepal will be required to move to the Basel II framework by July 2008**. A major step forward has been the issuance of a Capital Adequacy Framework paper outlining the proposed method of adopting a simplified version of the Basel II capital adequacy regime. Trial reporting under the new system in parallel to the old has been initiated and the new system is slated to be implemented in July 2008. The NRB has adopted a very pragmatic approach, using a simplified calculation of capital charge which reflects the banks’ lack of capability to undertake internal ratings-based approaches and the absence of rating agencies which could provide the basis for an external ratings-based approach. The credit risk charge is therefore not very different from the present system. But the NRB has also adopted the basic indicator approach for operational risks which can be significant in Nepal, raising effective capital requirements. In addition, the NRB has also taken the opportunity of introducing a capital charge for market risks, based on the 1996 amendment to the Basel I standard. Market risks are at present basically confined to foreign exchange position risk but the system would allow inclusion of other forms of market risk as they may develop in Nepal.

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