Nepalese Banking Sector: Performance Update and Outlook

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Financial Sector Ratings

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This report analyses the general trend in the banking industry* of Nepal and intends to be a continuation of the previous note published in December 2021- the link to which is given here.

As of mid-January 2023, the banking industry of Nepal comprised of 56 players across Class A (commercial bank), Class B (Development Bank) and Class C (Finance Companies). However, with ~89% share in the banking industry's asset base, the commercial bank industry (comprised of 22 players) has a much higher significance in the banking industry and hence remains central to this analysis.

Major Financial Indicators of Nepalese Banking Industry

Key Ratios	Q4FY21	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23	Q2FY23
	FY2021	FY2022				FY2023	
Total Deposit/GDP (%)	111.10	113.31	114.96	102.65	106.34	106.60	110.49
Total Credit/GDP (%)	97.86	105.42	109.71	97.72	97.17	98.45	99.85
Total Credit/ Total Deposit (%)	88.08	93.03	95.43	95.20	91.38	92.36	90.36
CD Ratio as per regulatory norms (%)	76.32*	88.51	89.64	90.06	86.22	86.90	86.61
Fixed Deposit/Total Deposit (%)	45.45	50.29	53.67	55.10	54.97	58.22	59.67
Saving Deposit/Total Deposit (%)	33.19	33.61	29.93	28.23	27.18	26.32	25.28
Current Deposit/Total Deposit (%)	12.18	7.60	8.63	8.90	9.02	7.78	8.08
Call Deposit/Total Deposit (%)	8.20	7.47	6.80	6.53	7.58	6.49	5.93
Gross NPL/ Total Loan (%)	1.48	1.37	1.31	1.44	1.31	1.98	2.63
Total LLP/Total Loan (%)	2.48	2.43	2.36	2.41	2.36	2.63	2.60
Deprived Sector Loan/Total Loan (%)	8.25	8.39	8.28	7.88	7.27	7.17	7.11
Cash & Bank Balance/Total Deposit (%)	9.51	7.92	7.81	7.36	8.03	7.80	7.93
Investment in Gov. Securities/Total Deposit (%)	15.22	14.32	13.99	15.48	17.63	15.73	15.14
Total Liquid Assets/Total Deposit (%)	26.18	23.13	23.00	24.43	27.52	25.02	24.29
Core Capital/RWA (%)	11.12	10.56	10.50	10.68	10.81	10.64	10.21
Total Capital/RWA (%)	14.19	13.53	13.43	13.58	13.58	13.46	13.06

**CCD ratio for FY2021; regulatory cap for CCD ratio was 80% and regulatory cap for CD ratio is 90%.*

Source: Nepal Rastra Bank/ ICRA Nepal Research

Nepalese Banking Sector: Performance Update

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Key commentary:

Commercial banks have entered a consolidation phase with accelerated mergers/acquisitions.

The number of class A commercial banks that reached to its highest level of 32 during FY2012 started to fall thereafter amid regulatory restriction in new license issuance and roll out of merger guidelines. In the early stages, commercial banks acquired several class B and class C entities which was followed by merger among commercial banks in the later stages. The pace of merger/acquisitions among class A banks has accelerated in recent quarters. Out of the 26 class A commercial banks in existence as of mid-October 2022, following 14 banks have entered into merger/acquisition agreement and are in various stages of the merger process.

- Nabil bank Limited (rated [ICRANP-IR] AA-) and Nepal Bangladesh Bank Limited (rated [ICRANP-IR] BBB+) (acquisition MOU signed in January 2022 and **combined operations commenced from July 2022**)
- Nepal Investment Bank Limited (rated [ICRANP-IR] A) and Mega Bank Nepal Limited (rated [ICRANP-IR] A-) (merger MOU signed in June 2022 and **combined operations commenced from January 2023**)
- Kumari bank Limited (rated [ICRANP-IR] BBB) and Nepal Credit and Commerce Bank Limited (rated [ICRANP-IR] BBB) (merger MOU signed in October 2022 and **combined operations commenced from January 2023**)
- Prabhu Bank Limited (rated [ICRANP-IR] BBB) and Century Commercial Bank Limited (acquisition MOU signed in August 2022 and **combined operations commenced from January 2023**)
- Global IME Bank Limited (rated [ICRANP-IR] A) and Bank of Kathmandu Limited (rated [ICRANP-IR] BBB+) (merger MOU signed in June 2022 and **combined operations commenced from January 2023**)
- Himalayan Bank Limited and Civil Bank Limited (acquisition MOU signed in July 2022)
- Laxmi Bank Limited (rated [ICRANP-IR] BBB+) and Sunrise Bank Limited (merger MOU signed in January 2023)

The completion of above mergers/acquisition will bring down the number of class A banks to 20. The number could decline further in the event of future mergers. Apart from the regulator's suasion, the possibilities of further mergers have also increased given the factors such as ceilings on interest spread and non-interest service income, increasing compliance cost and generally moderate profitability outlook for the industry amid asset quality concerns for the banks.

Credit growth has slowed down amid regulatory changes and high interest rates.

After forex reserve of the country declined to a level commensurate to merchandise/services import coverage of less than 7 months in December 2021 (amid rising commodity prices and weakening of Nepalese currency vis-à-vis major foreign currencies), creating risks of external imbalance to the import-based Nepalese economy, the regulator and central bank responded immediately by raising the LC margins on select goods to up to 50-100% of the import value from December 2021 and later on imposing a restriction on imports of items deemed "non-essential or luxury" that included cars, high-end motorbike, gold, cosmetics, liquors, high-end smartphones/television, etc from April 2022. This led to a slowdown in those sectors, affecting credit growth as well as scale and liquidity of the businesses dealing in such items.

This was followed by the roll out of working capital guidelines from NRB in August 2022, partially limiting the bank's discretion while sanctioning working capital facilities and pegging the fluctuating working capital facilities with the turnover reported by the business (20-25% of the turnover; up to 40% of turnover for select business with proper justification). The guidelines also introduced the concept permanent and fluctuating limits within the working capital credit lines. The working capital loans currently utilized by the businesses are all fluctuating and constitute a major portion of existing banking sector credit portfolio as well as fresh credit demand in the banking industry. Since a major portion of borrowers were availing a high proportion of working capital limits vis-à-vis the new ceilings, this led to a decline in eligibility of many borrowers for availing fresh working capital limits and affected the fresh credit demand.

Slowdown in credit growth is also partly contributed by high interest-rate environment in the banking industry, especially for fresh credit. The pressure on forex reserve also influenced the banking sector liquidity which has kept the interest rate at a high level on a sustained basis in the last 12-18 months, which was usually a seasonal affair (restricted to last 1-2 quarters of a FY) in the past. Since the central bank has prevented the banks from passing on the increased cost of fund to the existing borrowers on ad-hoc basis, the banks are compensating by passing on the cost to new borrowers which is discouraging the fresh credit growth to some extent.

The margin requirement and import restrictions were scrapped in January 2023 after forex reserve improved to a level commensurate to merchandise/services import coverage of ~9 months. Since the demand (for goods by consumers as well as bank credit by borrowers) during the festival season of September/October 2022 remained subdued on account of the import restrictions and generally inflationary environment; the impact of restrictions is likely to be seen in the financials of corporate borrowers as well as credit growth of banking industry for FY2023 (period between mid-July 2022 and mid-July 2023).

The commercial banks have reported an annualized private sector credit growth (claims on private sector) of ~7% during 5mFY2023 (vs. ~26% during 5mFY2022), vis-à-vis monetary policy targeted private sector credit growth of ~13% for FY2023 (vs. ~19% in FY2022).

Near to medium term credit growth could remain muted as banks could focus more on maintaining capital cushion amid rising asset quality concern

Although the average credit to deposit ratio of the banks have eased in recent months, the pace of credit growth continues to remain low. While this is partly contributed by the regulatory changes and high-interest rate environment, this can also be partly attributed to the banks' reluctance to further lower the capital cushion amid the increasing asset quality concerns. The central bank's intent of implementing counter cyclical buffers with effect from mid-July 2023 is also likely to deter the banks from growing their risk-assets. This is likely to stretch the liquidity profile of many borrowers that were used to easy credit creation from the banks in the past.

Recent tightening could test the resilience of borrower's liquidity, asset valuations, and bank's asset quality.

Between FY2016-FY2022, the commercial bank credit has grown by CAGR 20%, tripling from ~NPR 1,400 billion as of mid-July 2016 to ~NPR 4,200 billion as of mid-July 2022. As the credit growth was fuelled more by the bank's need to ensure optimal utilization of increased paid up capital requirement[1] rather than the change in underlying economic fundamentals or organic demand growth, it contributed to the easy availability of credit for the entire spectrum of borrowers and was used to finance debt-driven capacity expansion and liberal working capital practices of corporate/SME borrowers and sharp rise in consumer demand amid easy loan availability. This effectively increased the leverage across the universe of banking sector borrowers. This phase of credit growth was also supported by less restrictive and more accommodative policies from the regulators. The latest spurt of credit growth came in FY2021 after the NRB-mandated extension of ad-hoc loan in the form of liquidity support to all (covid-affected) borrowers; with the commercial bank industry registering 28% y-o-y growth, its highest in the last 6 years, and on an already-inflated base.

Following a long spell of accommodative policies, the banking industry seems to have entered into a new phase with relatively tighter regulatory regime. This is characterized by rolling back of NRB-mandated ad-hoc liquidity support during Covid-era, expiry of NRB-mandated Covid moratorium on principal/interest payments and discontinuation of low-cost NRB refinancing facilities (priced much lower than regular banking sector interest rate), introduction of relatively stringent working capital guidelines, as well as proposed introduction of counter cyclical buffer from FY2023 end. Tightening of local regulations intended to contain the risks of inflation and external imbalances, demand moderation amid inflationary environment and prevailing high-interest environment have created a difficult operating condition for the entire spectrum of borrowers, especially those with sizeable debt acquired during the credit growth phase. This could create strong headwinds for the growth and asset quality of banking industry going forward.

During the growth phase, liberal bank financing resulted in excess capacity creation and margin pressure in multiple sectors while liberal financing of working capital aided the rise in working capital intensity of corporate and SME businesses. Similarly, easy availability of money and relaxed underwriting practices during the growth phase have partially contributed to the monetization of real-estate at inflated prices (with the rise in general property prices mimicking the growth in banking sector loans). With the tapering of credit growth starting H2FY2022, many such sectors are facing liquidity pressures further exacerbated by falling demand and high interest rate on borrowings. This is also reflected in the gradual uptick in the delinquency levels of banks during Q1 and Q2 of FY2023. The balance sheet of corporates is also showing liquidity pressures on account of decline in their sales, delayed recovery from debtors/inventories and high debt obligations. Similarly, SME/retail segment are also affected by the inflationary environment and falling demand. Prevailing high-interest rate regime could further compromise their ability to maintain debt-servicing on a timely manner unless deleveraging is achieved.

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[1] *The paid-up capital of the bank was increased significantly from NPR 2,000 million to a minimum of NPR 8,000 million in the monetary policy for FY2015/16*

The impact of credit slowdown is also manifesting in the real estate market with slowdown in demand for commercial/residential units, growing numbers of sellers, etc. To a certain extent, this has also compromised the ability of borrowers to deleverage through disposal of assets owned by them. Prolonged stagnancy in credit growth could exacerbate the liquidity concerns for borrowers and asset quality concerns for the bank. A good proportion of banking sector credit are backed by real estate collateral, either as primary or secondary collateral. However, forced selling of the collateral by borrowers/banks in order to deleverage/ recover the credit exposure, could lead to a downward pressure on asset valuations; especially amid the ongoing liquidity and high-interest rate scenario.

Early signs of stress manifesting in the cooperative industry; could spill over to the banking industry

Few instances of irregularities and liquidity problems have surfaced in the cooperative industry; following slowdown in banking sector credit creation and its impact on the real estate sector since last one year. This remains a concern to the incremental asset quality of the bank as well. Cooperative societies as an industry (comprising around 30,000 players) mobilise sizeable credit (over NPR 400 billion). Of the total credit by cooperatives, over 60% was mobilised by savings and credit cooperatives (which have a riskier asset mix compared to the traditional cooperatives that have a limited member base and small ticket exposures).

Cooperative societies operate with much lesser scrutiny as compared to mainstream banking sector players despite being one of the sizeable players in the financial system of the country. A significant portion of loans from cooperatives (mostly savings and credit cooperatives) is loans against property with a much lower underwriting control in form of debt repayment capacity assessment through cashflow generation.

The cooperatives also share some borrowers with the banking industry (as evidenced by recent instance involving a former commercial bank chairman defaulting on his obligation towards one of the major cooperatives), raising the likelihood of overfinancing of those borrowers, as the credit availed from cooperatives are not captured in the credit information bureau reports.

Broader banking sector outlook to depend on the incremental regulatory stance on credit growth and capitalization.

The banking sector players, for the major portion of the last decade, have functioned under an “easy money” regime promoted by the central bank. This is reflected in the high credit growth reported by the banking sector, detailed above. Sustained high credit growth and regulatory forbearance during earthquake, blockade and Covid has masked many issues at borrowers as well as bank level. With the central bank adopting tighter stance in the last 12 months, the credit profile of the banks and borrowers are likely to get tested over the near to medium term. The profile of these banks/borrowers will depend on the stance of the regulator and its impact on financial sector liquidity. Regulatory policies favouring “phased and gradual tightening” could offer time for the banks and borrowers to deleverage themselves without significant erosion in their credit profile while “hard stop” approach could lead to liquidity freeze and could result in solvency issues for the borrowers and banks alike.

Central bank's stance on allowing equity raising plans by commercial banks will also remain important going forward. No commercial banks have floated fresh equity shares (rights issuance) in the last five years despite depleting tier I capital ratio, which can be partly attributed to the central bank's push for inorganic growth (mergers/acquisitions). As a regulator, central bank has a say on the capital raising plans of the BFIs. Going forward, the central bank's stance towards allowing/disallowing issuance of fresh equity will have a bearing on the tier I capitalization and solvency of banks. More so, amid the increasing asset quality concerns, high credit concentration among top borrowers and low capital cushion carried by the banks that could prove inadequate to withstand any major credit shocks. However, amid the falling profitability of BFIs and moderate to weak outlook over the medium term, the subscription prospects of the fresh equity (especially by the promoter shareholders, given the relatively less liquidity of promoter shares in stock exchange) could remain subdued. Any weakening in capitalization (on account of credit losses) and failure to raise the capital through share issuance could trigger another round of mergers/acquisitions among the banks.

Summary

Amid external and internal headwinds, the credit growth of Nepalese banking industry has moderated. The moderation follows a long period of continuous high credit growth and increased leverage across the spectrum of borrowers. The spike in delinquencies across the banking sector players shortly after the roll-back of covid-era forbearance, partly hints at the high dependence on borrower's credit profile and bank's asset quality on accommodative policies of regulator. Incremental asset quality and solvency of the banks over the medium term will remain dependent on the regulatory action. The probable deterioration in asset quality of banks in subsequent quarters could result in the need for recapitalization, given the moderate capital cushion of many banks. However, the ability of the banks to recapitalize through equity issuance could remain a challenge given the weak to moderate profitability outlook for the banking sector.

UPDATES:

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

Credit growth of Nepalese banking sector consistently outpaced the growth in gross domestic production (GDP) for almost all years since FY2015 that has moderated in FY2022 owing to the liquidity stress and lack of loanable fund in the banking channel amid low deposit growth.

The consistently higher credit growth, though, has not resulted in a similar GDP growth. While this could be partly attributed to the significant credit infusion towards the sectors of economy where the benefits are likely to accrue with a lag (such as infrastructures related to tourism, energy, etc), it is also because of the high growth of credit towards the non-GDP contributing sectors and limited underwriting/ regulatory control to check high credit growth.

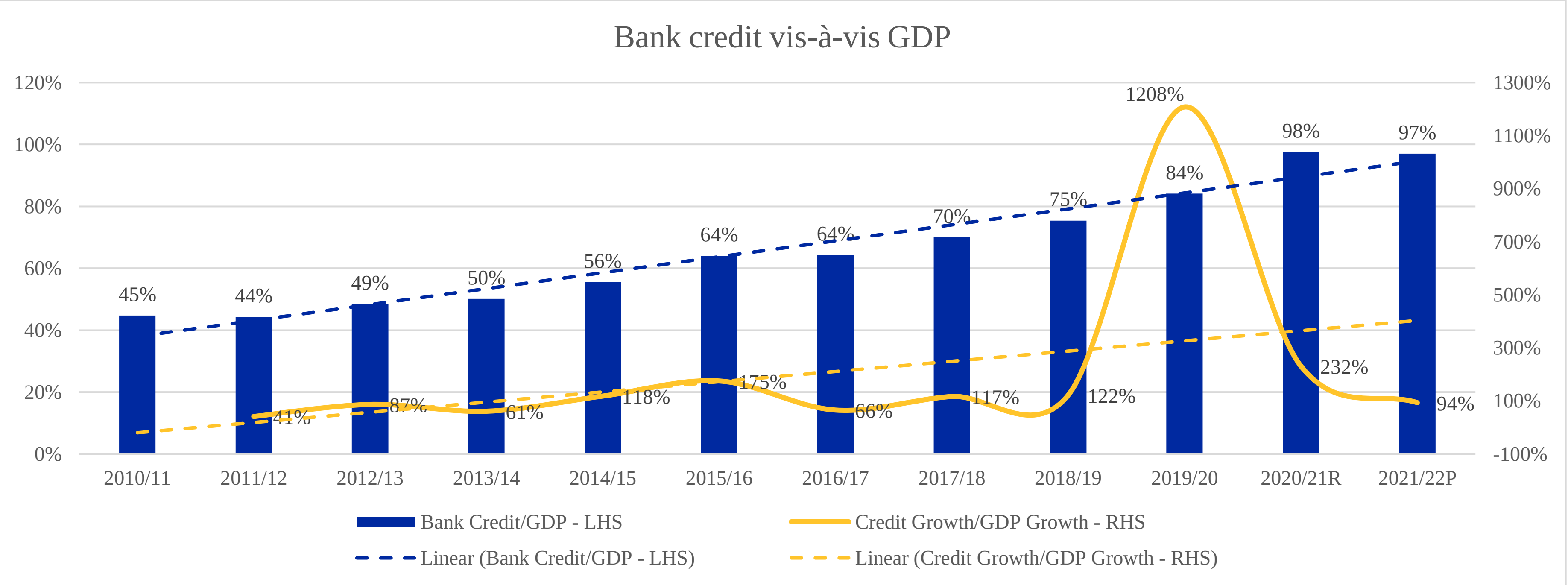
	No. of licensed BFIs		Growth Year-On-Year (YOY)			Closing Credit/ Nominal GDP	YoY Credit growth/ YOY nominal GDP growth	NEPSE market Capitalization/ GDP	NPA Banking sector
	Total	Class A	GDP[2]	Bank credit	Bank deposit				
FY12	189	32	12.5%	11.6%	23.2%	44.3%	41.3%	20.9%	3.60%
FY13	176	31	10.9%	21.3%	16.7%	48.5%	87.0%	26.4%	3.80%
FY14	167	30	14.5%	18.4%	18.2%	50.1%	61.3%	47.4%	3.76%
FY15	154	30	8.6%	20.2%	19.9%	55.5%	118.5%	40.8%	3.33%
FY16	137	28	7.6%	24.0%	18.9%	64.0%	175.3%	72.5%	2.19%
FY17	96	28	18.0%	18.4%	13.2%	64.2%	65.6%	60.3%	1.81%
FY18	86	28	12.3%	22.4%	19.0%	70.0%	116.9%	41.5%	1.60%
FY19	80	28	11.7%	20.3%	18.2%	75.4%	121.8%	40.6%	1.52%
FY20	69	27	0.8%	12.4%	17.3%	84.1%	1207.9%	46.1%	1.89%
FY21R	62	27	10.0%	27.5%	20.5%	97.5%	231.7%	93.8%	1.48%
FY22P	60	26	13.4%	12.9%	8.8%	97.1%	93.8%	59.1%	1.31%

Source: ICRA Nepal Working

[2] Gross value added by Industrial division at current (nominal) prices; GDP from FY11 to FY20 as per rebased National Account Series from the base year 2000/01 to the base year 2010/11

Leveraged domestic economy, reflected in high bank credit to GDP ratio

Despite the lower credit growth in FY2022, the economy continues to remain highly leveraged with the bank credit to GDP ratio of ~97.1% in FY2022, a marginal improvement from ~97.5% in FY2021. Bank credit to GDP is taken as an indicator of the participation of the banking sector in the economy. A high bank credit to GDP ratio in a developed economy with robust production capacity and minimal threat of external imbalances, remains desirable as it signifies a developed financial system with easy access to credit. However, overleveraging in an import-dependent, infrastructure-deficit, emerging economy could add to the external imbalance as well as create systemic credit risk. The credit growth has exceeded the GDP growth throughout the last decade except for FY2022. Steadily increasing bank credit to GDP ratio signifies lower economic value addition in real sector compared to the credit consumption and hints at untenable rise in leverage level across the economy.



**R-revised; P-provisional*

Note for graphs:

In the case of combined graphs across the report, the scale of the bar diagram is to the left-hand side (LHS), and the scale for the line diagram is to the right-hand side (RHS).

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

Leverage remains high across all major sectors of the economy

The table below summarises the major credit segments of the banking sector, which accounted for ~65% of the banking sector credit as of mid-July 2022. As can be seen from the table below, the credit-to-GDP ratio across major sectors is above 100%, indicating a relatively high level of leverage in those sectors vis-à-vis the sectoral output.

In addition, the leverage in sectors such as energy and tourism has also grown sharply as these sectors have received an increasing volume of bank credit in the last few years because of their importance to the economy and their status as a "priority sector" as per the classification of the NRB (the banking sector regulator). To a large extent, the rising credit-to-GDP ratio for these sectors is also partly explained by the fact that multiple large energy and tourism projects are under construction and are yet to generate economic value. While the priority sector lending norms remains a positive from the standpoint of investing in the sectors that offers competitive edge to the economy or helps in sustainable economic growth, rapid expansion of credit to these sectors without addressing the fundamental bottlenecks in these sector (example-availability of seeds, fertilizers and rising land prices for agriculture, lack of transmission and power trading infrastructure for energy sector and rising land prices and supporting infrastructure for tourism, etc) could lead to credit concerns in future.

Ratio of O/s credit to nominal sectoral GDP	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	% of FY22 credit
Wholesaler & Retailer	87.2%	106.7%	108.7%	112.3%	113.3%	128.7%	143.3%	140.8%	20.1%
Manufacturing	196.9%	232.2%	220.7%	245.1%	265.3%	324.1%	344.0%	316.6%	15.6%
Finance, Insurance and Real Estate	35.9%	39.2%	41.4%	45.0%	46.5%	44.7%	57.2%	58.4%	8.0%
Agricultural and Forest Related	10.1%	11.8%	12.4%	15.3%	19.5%	22.7%	31.0%	35.5%	7.4%
Electricity, Gas and Water	90.5%	124.6%	133.1%	172.1%	236.3%	267.7%	333.0%	319.0%	5.2%
Hotel or Restaurant	95.9%	117.6%	119.1%	135.4%	161.4%	294.8%	312.9%	295.1%	4.3%
Construction	110.3%	120.5%	116.4%	116.3%	132.1%	162.7%	190.0%	75.0%*	4.0%
Total bank credit to gross value addition across all sectors (before taxes and subsidies)	62.3%	71.8%	73.3%	80.5%	87.1%	95.3%	113.9%	114.7%	

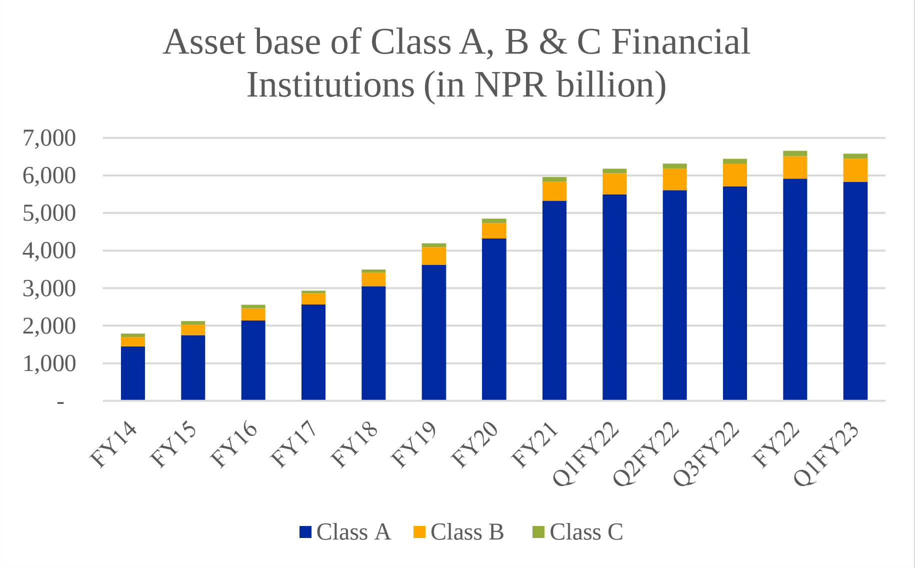
**Central bank has reclassified the residential home loans from construction loans to consumption loan from FY2022 resulting in declined proportion of construction loans*

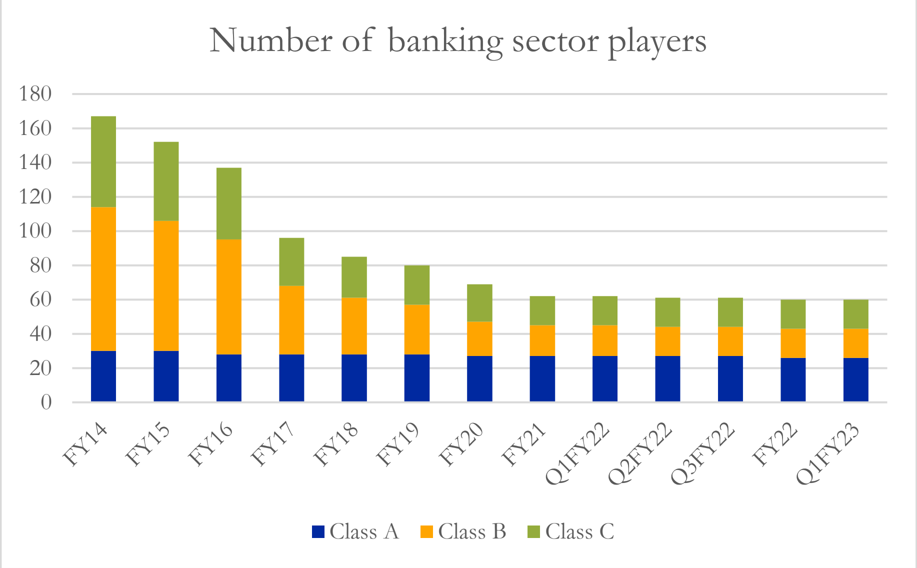
Source: NRB annual compilation of BFI's financials; ICRA Nepal research

The bank credit to agriculture is relatively modest because of the unorganised agriculture sector and subsistence-based farming. This also partly explains the dichotomy between credit and GDP growth as agriculture remains the largest contributor to the Nepalese GDP. Leverage in the real estate sector (represented under Finance, Insurance & Real Estate in the table above) has remained on the lower side as the credit to this sector is subjected to closer scrutiny by the NRB with a higher risk weight and stringent loan to value ratio. However, between the fast pace of credit growth, commensurate laxity in underwriting control and sharp appreciation of real estate prices across the country, diversion of some of the credit towards the monetization of real estate cannot be ruled out.

General banking industry update:

1. **Accelerated consolidation among class A commercial Banks**





- The number of banks and financial institutions have continued to decrease after the regulator stopped issuing new BFI license and rolled out the merger guidelines about a decade ago. The suspension/restriction on issuing a new license for commercial banks, development banks and financial institutions along with the substantial increment in minimum capital requirement in FY2016/17 contributed the consolidation process. The total number of banking sector players have come down to 60 players in FY2022 from 167 players in FY2014.

- The merger/acquisition of BFIs remained a focal point in the monetary policy for FY2021 and FY2022 as well. Further, the entities that have entered into the merger agreement till mid-July 2022 with commencement of joint operation by mid-January 2023 will be eligible for some forbearances/incentives/ concessions on the regulatory norms for one year from the date of joint operation. Specifically, the forbearances include relaxation the cash reserve ratio (CRR), interest spreads, waiver for CD ratio and priority sector loan norms, relaxation in norms regarding tenure of board members and senior management personnel, etc.

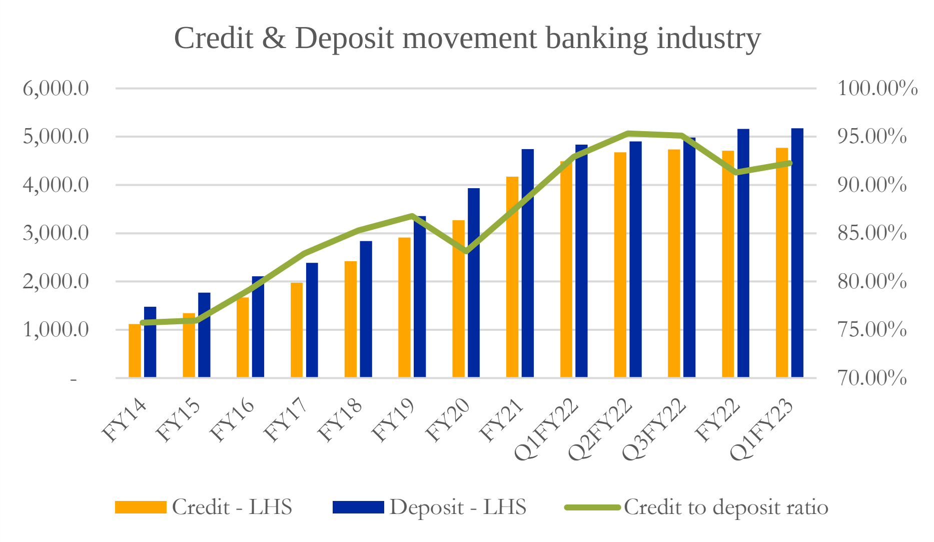
- Commercial banks (Class A) in the first round, undertook strategic acquisition of class B development banks, that benefitted class A banks looking to expand in specific geography in a short-time, capitalising on the local traction gained by established class B players. The number of class B players have remained relatively stable in the recent periods following the prolonged merger/acquisition phase. While the acquisition of class B players may still remain a value proposition for branch expansion and market penetration, the acquisition may not add significant operational scale considering the substantially higher business volume of present-day commercial banks.

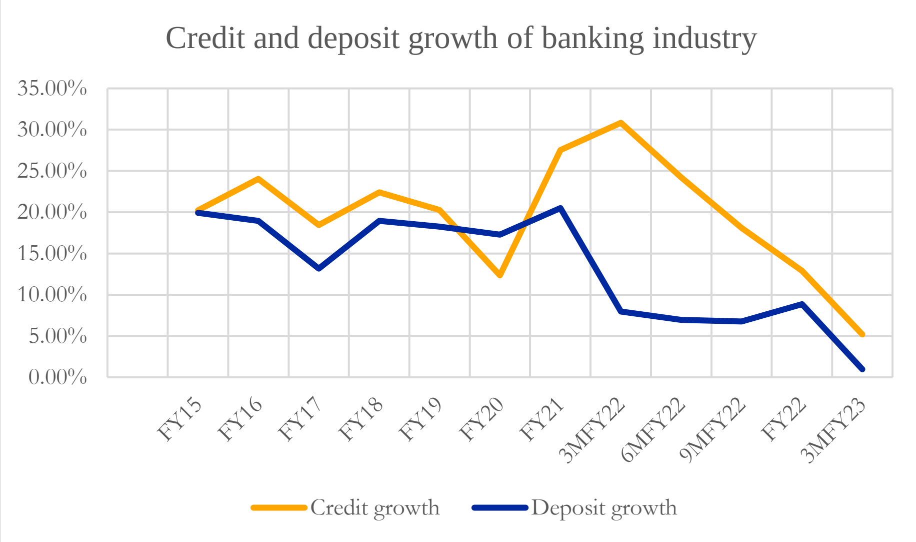
- Mergers/acquisitions among class A banks have intensified in the last 12 months as discussed in the earlier sections.

- Class C players have largely not been a value proposition for acquisition by class A banks because of their meagre scale of operations and relatively evolving business and control practices.

- The independent existence of class B and class C players over a longer term will largely depend on the regulatory demarcation of their area of operations vis-à-vis the class A banks. Operating in the same market with the same customers as the large class A banks could be untenable for class B & C players over the longer time frame.

2. Lower deposit growth slowed down the pace of credit growth for the banking industry:





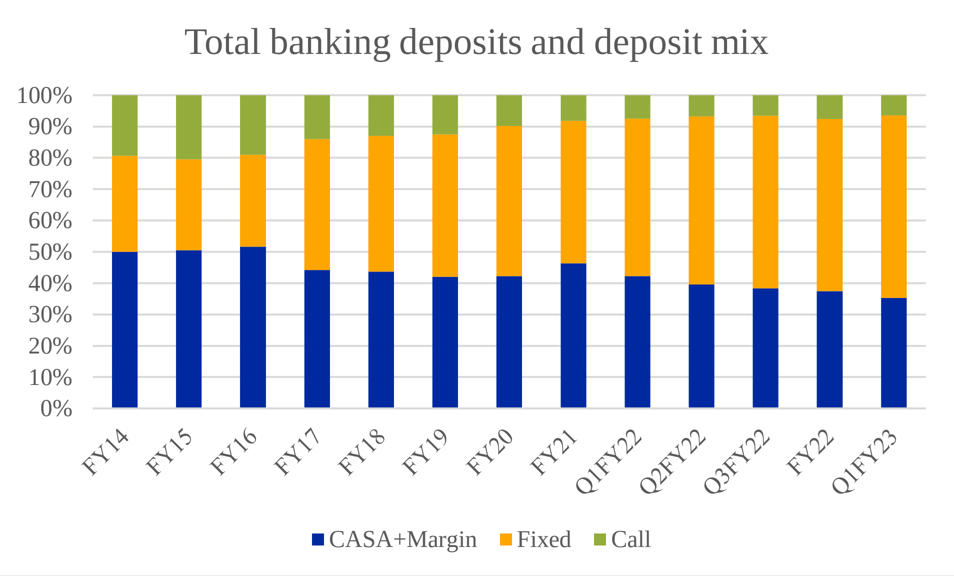
- The economy witnessed a recovery from the global pandemic with relative normalisation of business operation and uptick in the credit demand and. The credit growth for FY2020 dipped to ~12.4% with the pandemic taking a toll on the overall economy. The credit growth picked up with the restoration of normal economic activities, pent-up import demand and provision of NRB mandated ad-hoc liquidity support to Covid-affected borrowers in FY2021. However, from mid-FY2022, the credit growth has started to falter amid the reasons such as import restrictions and other regulatory reasons discussed above.

- The high trade deficit and pressure on forex reserve amid inflationary environment has subdued the deposit formation in the industry. After a marginal improvement in deposit growth during FY2020 and FY2021 amid import disruption, the deposit growth rate has come down steadily in the recent period.

- Most of the banks are currently operating close to the regulatory CD ceiling of 90% which will limit their ability to expand credit till deposit pressure exists. The regulator is gradually rolling back the inclusion of certain items in deposits for calculation of CD ratio (such as debentures, local government's deposit, etc), which could keep the CD ratio elevated over the near term, curbing the bank's ability to expand credit and preventing sharp moderation in deposit rate.

3. Funding profile: high proportion of high-cost term deposits, tight CD ratio and inflationary environment likely to keep cost of funds high

The Nepalese banking industry's funding profile comprises mainly of customer deposits, while borrowings accounts for a nominal portion of the overall funding profile. Though minimal in amount, international borrowings have been increasing in the recent periods (*borrowing from foreign banks and financial institutions constitutes ~12% of total borrowings as of mid-July 2022 vs ~9% as of mid-July 2021*). The extension of refinancing and concessional loans from the central bank led to the rise of borrowings from NRB in the funding profile in FY2021 and FY2022. However, the borrowing from the central bank is likely to decline with the recently announced discontinuation of Covid-related refinancing facilities by NRB.



- Except for FY2020, the deposit growth of the banking sector has consistently lagged the credit growth with deposit CAGR of ~17% in the last 5 years ending FY2022 vs credit CAGR ~19% during the same period.

- The deposit mix has reported major change with the shift of CASA deposits to term deposits, as banks looked to stabilize their deposits amid tightening CD ratios. Banking sector CASA deposits have declined to ~35% as of mid-October 2022 from ~46% as of mid-July 2021 while the term deposits have increased to ~58% from ~45% over the same period.

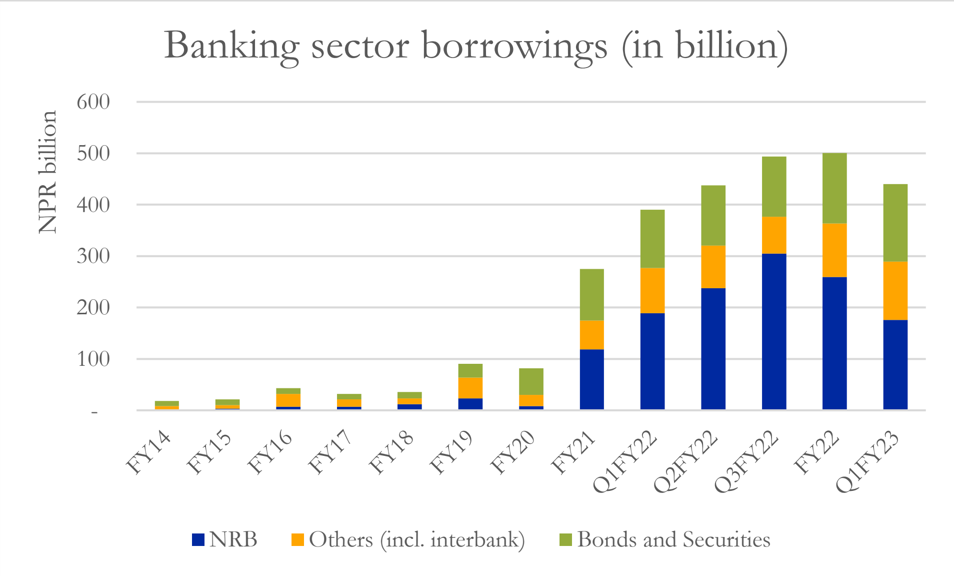
- Further, the call deposits have also declined over the period. The banks have priced their call deposits at half of the minimum saving interest rates offered by them, as per the central bank's directive. This has discouraged the call account depositors.

- A deposit growth of ~20% against the credit growth of ~28% in FY2021, followed by the deposit growth of ~9% against credit growth of ~13% in FY2022 shows the pressure on the system's ability to retain the funds within the internal economy, amid the unfavourable balance of trade. The pace of deposit formation has even worsened during Q1FY2023.

Borrowings:

- Borrowings of Nepalese banks comprises of loans from NRB, short-term interbank borrowings, offshore borrowings, and bonds & securities.

- The borrowings from NRB remained generally minimal in the past that increased significantly with the Covid-era refinancing loans from NRB. The refinancing loans had outstanding balance of NPR 112 billion as of mid-July 2022 vs. NPR 123 billion as of mid-July 2021. Similarly, the standing liquidity facility (SLF) borrowings by banks from central bank increased from to NPR 158 billion as of mid-July 2022 from negligible level as of mid-July 2021. The commercial banks borrowed in SLF during FY2022 to invest in fresh T-bills due to the arbitrage opportunity (SLF was then priced at 5% while treasury bills were issued at higher prices). This practice persists albeit with reduced intensity after NRB raised the SLF rate from 5% till mid-February 2022 to 7% till mid-July 2022 and then to 8.5%, bridging the gap between SLF rate and T-bill rate. Also, the central bank capped SLF limit to 1% of the bank's local currency deposit which has discouraged the banks to borrow under SLF. However, this has also lowered the bank's appetite for subscribing fresh T-bill, which the banks pledge to borrow under SLF window. The continuation of cap on SLF borrowings raises challenges to the subscription of future securities issuance by the government/central banks.



The monetary policy has mandated all class A banks to maintain tier-II debentures equal to 25% of their paid-up capital. This has resulted in many banks floating tier-II debentures in the market in the last two to three-year period. The bond issuance flourished in the last couple of years due to the regulatory directive and better interest rates as compared to bank deposit, despite the inherent illiquidity of the bonds in Nepalese capital market. However, the bond issuance program has slowed down in recent period with uptick in bank interest rates as well as moderation in risk asset growth.

- The borrowings from foreign agencies/financial institutions have increased after the central bank opened avenues for borrowing money for borrowings in convertible foreign currencies. Nonetheless, this remains minimal in the funding composition and comprised of ~12% of the total borrowings as of mid-July 2022. Since BFIs have a foreign currency-based lending portfolio with the onus of forex risk/hedging passed on to the borrowers, this keeps the BFIs less vulnerable to the forex risk.

4. Reported assets quality remains good across the major industry players despite recent moderation; however, outlook remains negative

Non-performing assets	FY20	FY21	Q1FY22	Q2FY22	Q3FY22	Q4FY22	Q1FY23
Gross Credit (NPR billion)	3,270	4,171	4,492	4,676	4,737	4,709	4,770
Gross NPA (Industry)	1.89%	1.48%	1.37%	1.31%	1.44%	1.31%	1.98%
Gross NPA (NPR billion)	62	62	61	61	68	62	94
Gross NPA (Class A)	1.81%	1.41%	1.23%	1.18%	1.32%	1.20%	1.83%

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

Low NPLs supported by regulatory forbearance during Covid-era; NPLs could rise going forward given the expiry of these relaxations in FY2022 end

Despite the pandemic having major impact on the borrowers' repayment capacity, the bank's financials remained relatively unaffected. The regulatory relaxation in the NPA recognition and provisioning norms, NRB mandated extension of ad-hoc credit facilities as liquidity support/ business continuity loans, refinancing facilities at low interest rates, rescheduling/restructuring of existing loans, the extension of moratorium period, et al. aided the banks' lower NPA and provisioning expense level. Further, the robust credit growth in FY2021 and initial quarters of FY2022 diluted the NPA percentage to some extent.

With the expiry of regulatory relaxation after mid-July 2022 (FY2022 end), the banking sector NPLs have registered an uptick. The gross NPA of the industry has increased from 1.31% as of mid-July 2022 to 1.98% on mid-October 2022 and further to 2.63% on mid-January 2023. While the rise in NPA during the first half of the financial year can be partly attributed to the industry seasonality, the ongoing challenges led by increased interest rates, erosion in credit profile of the borrowers as discussed in earlier sections, inability of the banks to extend credit facilities under new regulatory regime, etc have exacerbated the liquidity concerns and weakened the debt-servicing ability of the borrowers; which could continue the pressure on banking sector asset quality going forward.

Traditionally, the banking system in Nepal fares well in terms of NPA level because of following reasons:

- Major loans in trading businesses with no domestic substitutes and local manufacturing industries protected through high import barriers against import,
- Presence of major business houses in diversified and generally uncorrelated sectors,
- Domestic businesses catering mostly to domestic demand; very limited export-based businesses where long-term loss of business is a real possibility,
- Domestic demand supported by the steady flow of inward remittances,
- Sizeable proportion of revolving lines of credit that doesn't require principal repayment on periodic basis,
- Relatively hassle-free regulations supporting the recovery of loans through liquidation of collateral assets.

However, with the steady build-up of leverage in the economy, the borrowers/bank's resilience towards major credit/liquidity shocks have eroded significantly. The recently introduced stringency in regulations, triggered by the global inflationary phenomenon putting pressure on external stability, is likely to persist for some time. This will test the business and financial health of the borrowers and banks alike. The need for deleveraging among the corporates and banks has increased significantly, in order to prevent major deterioration in their credit profile and solvency prospects. The risk remains even more heightened in the long-tailed, capital-intensive and infrastructure related sectors like hotel, hydropower, cement, steels, etc.

Large borrowers using multiple lines of credit from multiple BFIs makes it hard to assess actual stress on these borrowers:

Intense competition among the industry players to rope in large borrowers has given rise to overfinancing to large borrowers. Early signs of stress on these accounts often go unnoticed due to the revolving nature of the loan and multiple lines of credit being availed by these borrowers. Although the credit disbursal through a consortium of banks is often subjected to tighter oversight by the consortium of lenders as required by the regulations, the extent of surveillance in case of a non-consortium arrangement (such as pari-passu multiple banking arrangements) is lesser. The recent regulation change increasing the loan cap for compulsory consortium loan from NPR 1 billion to NPR 2 billion, is a continuation of liberal regulatory policies supporting the credit growth.

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

Many large borrowers in the corporate and SME segments tend to be common across multiple banks. Therefore, the impact on any of these top borrowers could trigger assets quality and liquidity concerns for multiple lender banks.

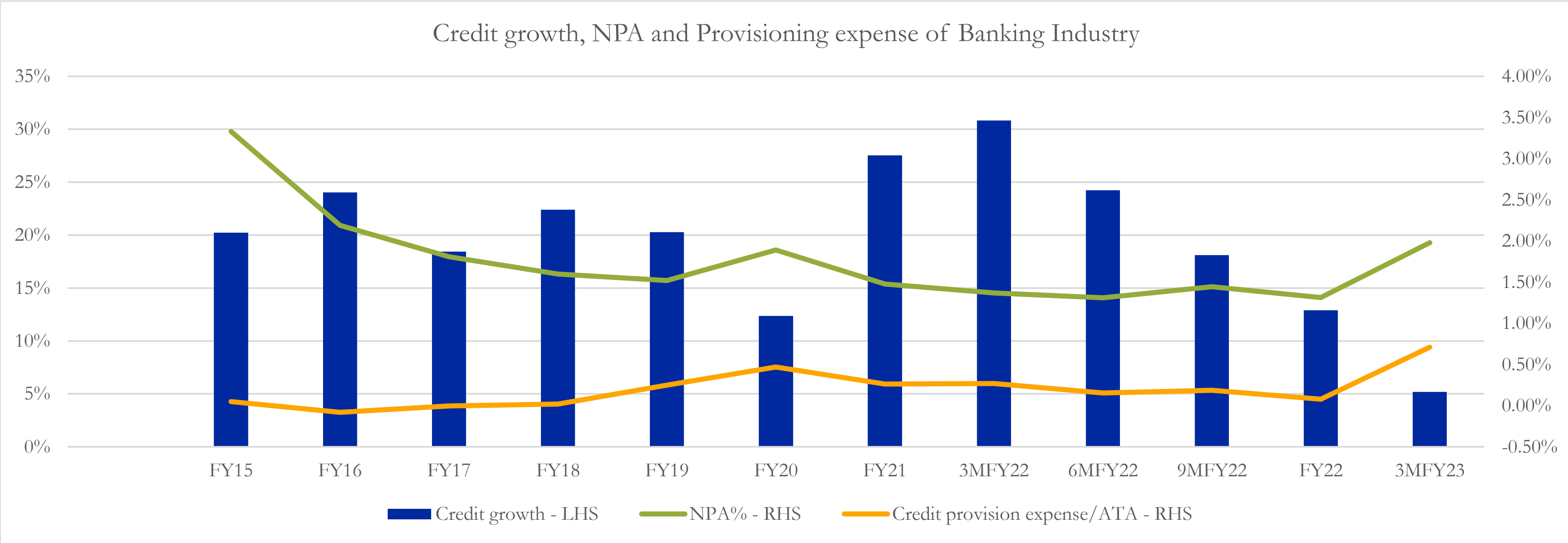
Sizeable proportion of revolving lines of credit; the recent implementation of working capital guidelines could test borrower's repayment capacity

The credit books of banking industry continue to remain dominated by the short-term renewable credit facilities that entail periodic interest payment and renewal-at-maturity. As there is no requirement for principal repayment, these borrowers remain untested for their repayment capacity. This phenomenon concurs with the trading-based Nepalese country, that requires constant and repetitive investment in debtor/inventory by the business. Nonetheless, the disconnect between the working capital financing need and the actual bank financing is increasing, with liberal financing by banks even for aged debtors and delinquent inventory in many instances. The recent introduction of working capital financing guidelines by the central bank aims at addressing those concerns, by limiting lender's discretion in working capital financing.

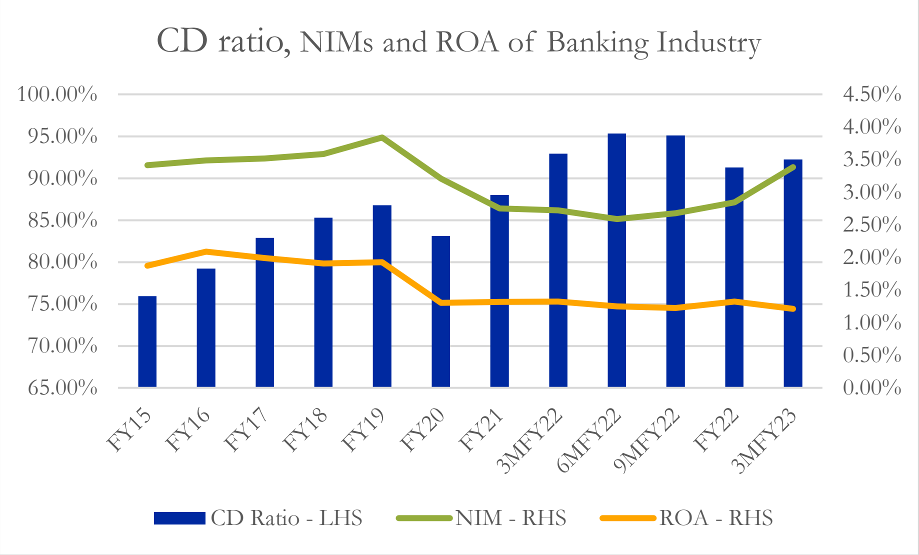
Sizeable funds mobilised by less-regulated cooperatives; series of issues in co-operatives in recent time remains a red-flag for the banking sector:

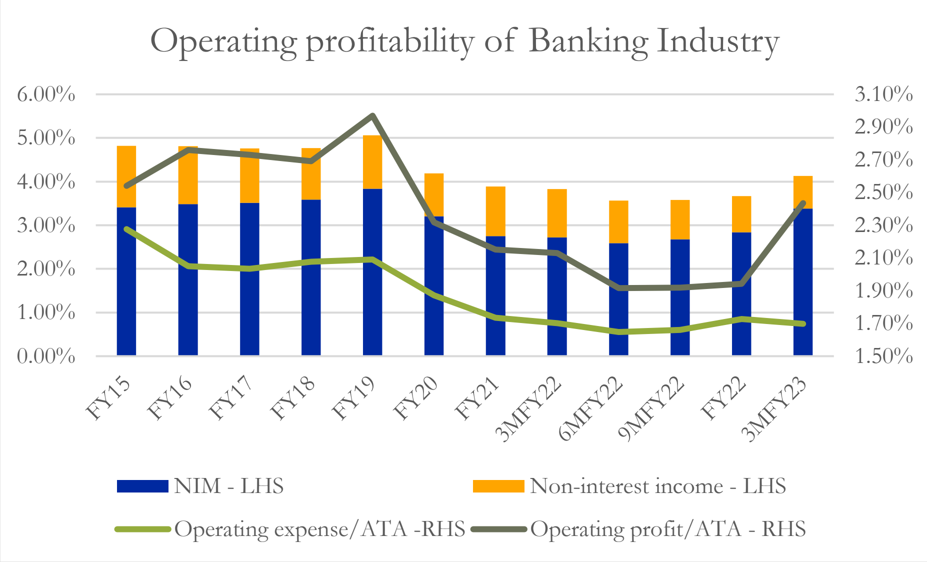
A major proportion of asset base in the Co-operative industry are mobilised by saving-and-credit cooperatives (SACCOS), which functions in the model of regular banking entities, instead of the traditional principal of cooperatives focussing on its members in the local, marginalised and vulnerable sections of the economy. This leaves a scope for borrowers to access fund without conforming to the regulatory framework as set for the traditional banking sector players. As the borrowers in the cooperative industry are not captured in the credit information bureau, this remains a risk from the perspective of still-more overleveraging of banking-sector borrowers. Recent instance concerning the default on the repayment of cooperative loan by a major banking-sector borrower shows the extent of overlapping between the corporate borrowers of banking sector and cooperative industry, which remains a risk.

The lending portfolio of cooperatives have a greater composition of loans towards speculative investments, especially the real estate sector. This is also corroborated by the increasing instances of liquidity stress in cooperative industry in the last 12-18 months, coinciding with the slowdown in banking sector credit and relative decline in the liquidity in the real estate sector.



5. Update on profitability: Central bank continues to lower interest spread cap curbing the profitability prospects of bank; however increasing consolidation in the banking industry could support the margin for the players due to decline in competitive intensity





Uptick in lending rates, increasing yield on G-secs and increased consolidation has supported profitability for banks in recent quarters.

The high liquidity and stiff competition during the Covid-era supressed the lending yield of banks and affected profitability. With the subsequent uptick in interest rates (driven by the upward revision in policy rates), decline in competition due to increasing consolidation and increasing yield on G-secs for fresh issuance/renewals have enhanced the bank's profit margins in recent quarters.

Nonetheless, the central bank has revised the ceiling of interest spreads as a measure to lower the impact of increasing rates on the borrowers. The first quarter review of monetary policy 2023 has reduced the interest spread to 4.0% for class A banks and 4.6% for class B banks & class C financial institutions (from earlier cap of 4.4% and 5.0% respectively) to be maintained by mid-July 2023. Although majority of the banks were operating well below the earlier cap amid competitive pressure, the reduction in spread cap will nonetheless curb the profit potential of banks in coming days.

Central bank has limited bank's discretion to reprice floating-rate loans, outside the terms of loan agreement.

The banks that sizeably expanded their credit books at low rates during the low-interest rate environment of Covid-era were prevented from repricing their floating interest-rate-based credit portfolio (no repricing for revolving short-term working capital loans before renewal and no repricing at all for long-term project loans), unless the provision were clearly spelled out in the loan agreement. This is likely to subdue the margins for the banks that have grown at high pace during the low-interest rate era, over the near to medium term.

This central bank's action put an end to the earlier practice where upward revision in lending rate was within the bank's prerogative. This action led to the refund of excess interest charged by many banks to the borrowers in FY2022 in the following quarters; with adjustments given effect in the audited financials of FY2022. On the positive side, this is likely to promote a more planned credit expansion by the banks during the period of comfortable liquidity, going forward.

Limited investment avenues; however, rising yield on treasury securities have supported investment earnings:

Apart from credit activities, banks in Nepal usually invest significant surplus funds in government securities (~80-85%). Apart from the current high yield on government securities, banks subscribe the securities given its eligibility for inclusion in the statutory liquidity ratio (SLR). Given the recent increase in treasury yield, banks have subscribed the treasury securities well in excess of their SLR requirement. However, with the implementation of cap on SLF borrowings to 1% of the local currency deposits, the banks' appetite for incremental government securities issuance is likely to remain low. Equity investment and other investments remains minimal and mostly concentrated in the equities of subsidiaries/associate company. The investment in listed equity instruments have further declined with the restrictions imposed by the central bank in short-term trading of equities in the secondary market.

The yield on 91 days T-bill issued during different months of FY2021 and FY2022 ranged between 0.13-4.55% and between 0.66-10.66% respectively, while a similar yield for 364 days T-bill issued during FY2021, and FY2022 was between 1.25-4.22% and between 4.02-10.19% respectively. The yield on treasury securities have sharply increased after the increase in policy rate by the central bank.

Nepalese Banking Sector: Performance Update

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Weighted average rates:

Mid-of	91-days T-bill			364 days T-bill			Class A bank interbank rate			SLF rate/Bank rate			Monthly Weighted average deposit rates of class A banks	
	2020/21	2021/22	2022/23	2020/21	2021/22	2022/23	2020/21	2021/22	2022/23	2020/21	2021/22#	2022/23	2021/22	2022/23
August	0.21	0.66	10.64	-	-	10.40	0.02	2.13	8.02	5	5	8.5	4.76	7.64
September	0.13	3.98	9.09	1.25	4.02	9.03	0.08	4.75	8.50	5	5	8.5	4.92	7.81
October	0.63	4.86	10.14	2.00	4.72	10.37	0.11	4.95	8.50	5	5	8.5	5.43	8.16
November	0.79	4.81	10.88	2.40	4.97	11.64	0.14	4.96	8.50	5	5	8.5	5.80	8.32
December	0.60	5.04	10.67	1.95	4.97	11.76	0.10	4.96	7.96	5	5	8.5	6.24	8.46
January	0.87	5.07	10.89	1.73	4.99	11.56	0.14	4.76	7.48	5	5	8.5	6.37	8.51
February	1.13	5.32		1.98	5.29		0.58	4.78		5	5		6.49	
March	2.03	6.82		-	-		1.26	6.56		5	7		6.93	
April	2.76	7.58		3.34	7.35		2.03	6.99		5	7		7.11	
May	2.28	8.30		3.72	8.23		4.12	6.99		5	7		7.25	
June	3.79	9.90		4.22	9.50		3.21	7.01		5	7		7.34	
July	4.55	10.66		4.16	10.19		4.12	6.99		5	7		7.41	

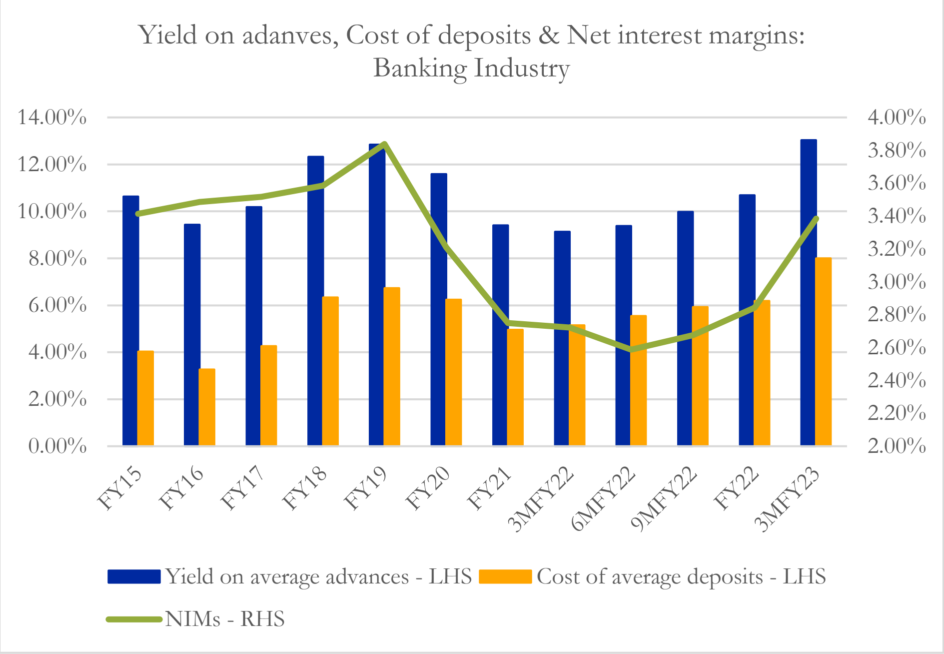
**source-NRB reports*

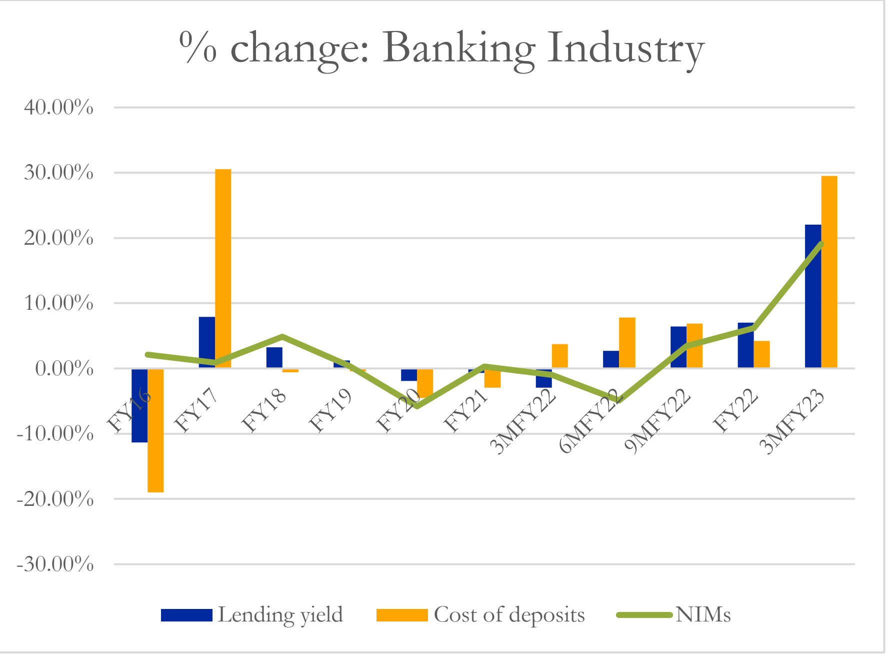
 # SLF rate/bank rate has been revised to 8.5% from mid-August 2022.

Banking industry	12M FY20	12M FY21	3M FY22	6M FY22	9M FY22	12M FY22	3M FY23
Yield on average investments	3.00%	3.14%	3.67%	3.70%	3.67%	3.75%	5.57%
Yield on Government securities	3.88%	3.72%	4.33%	4.23%	4.18%	4.29%	6.36%

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

6. Deposit, liquidity, and interest rate update; liquidity ratio continues to remain comfortable for the banking industry despite recent moderation





Volatile operating environment with steep rise in interest rates:

The average cost of deposits reported a steep rise during the review period with the continued upward revision in interest rates on deposits by the banking industry. The need to maintain CD ratio within the regulatory limits necessitated the banks to increase their deposit base within the limited period resulting in higher rates to attract fresh deposits. Further the lower deposit formation, increase in policy rate by NRB and higher inflation remained among the major reasons for incline in the deposit rates. The yield on advances have also reported a similar increment as the increased cost of funds are passed on to the borrowers through the adjustment in base rates.

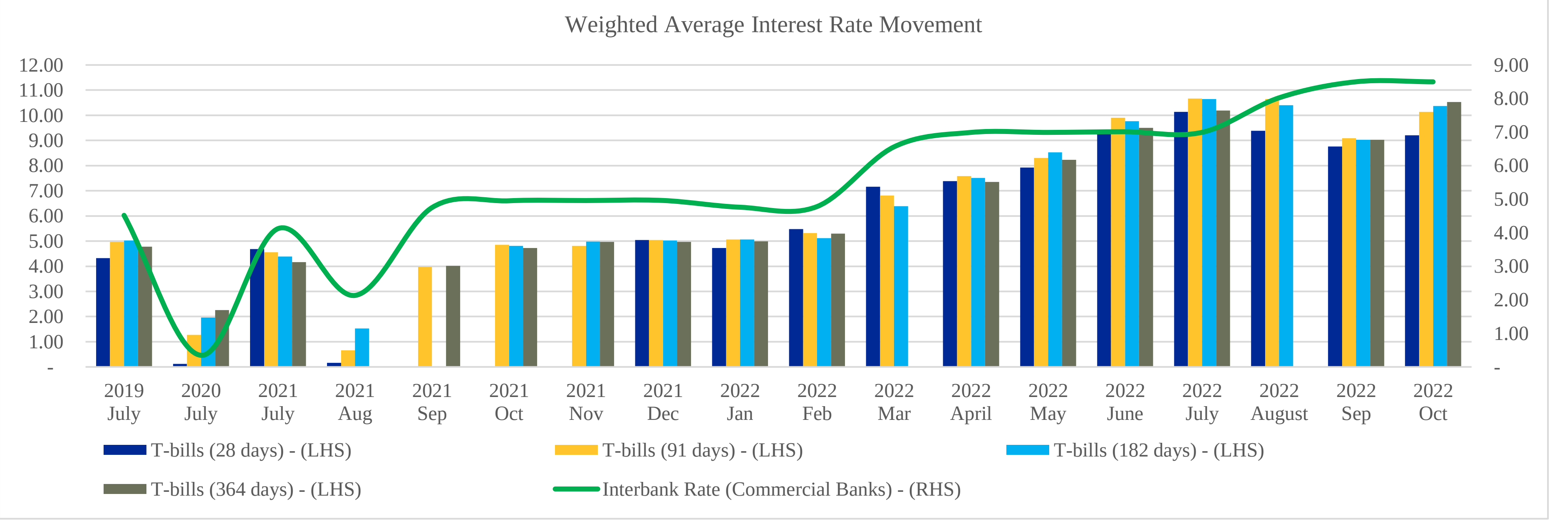
The central bank has made efforts to minimize the volatility in interest rates by making policy level changes. Considering the frequent and erratic interest rate changes by the banks, the central bank has allowed for interest rate revision only on a monthly basis. Further, the impact of the change in interest rates can only be adjusted on a quarterly basis on the existing borrowers. This is expected to smoothen the movement in interest rate for the borrowers.

The lag in adjustment of the revised interest rates onto the borrowers also impacts the net interest margins for the bank. As evident from the above charts, the interest margins declined in Q2FY2022 with the increase in cost of deposit that has been reflected in the yield on advances only from Q3FY2022 onwards.

Volatile interest rate:

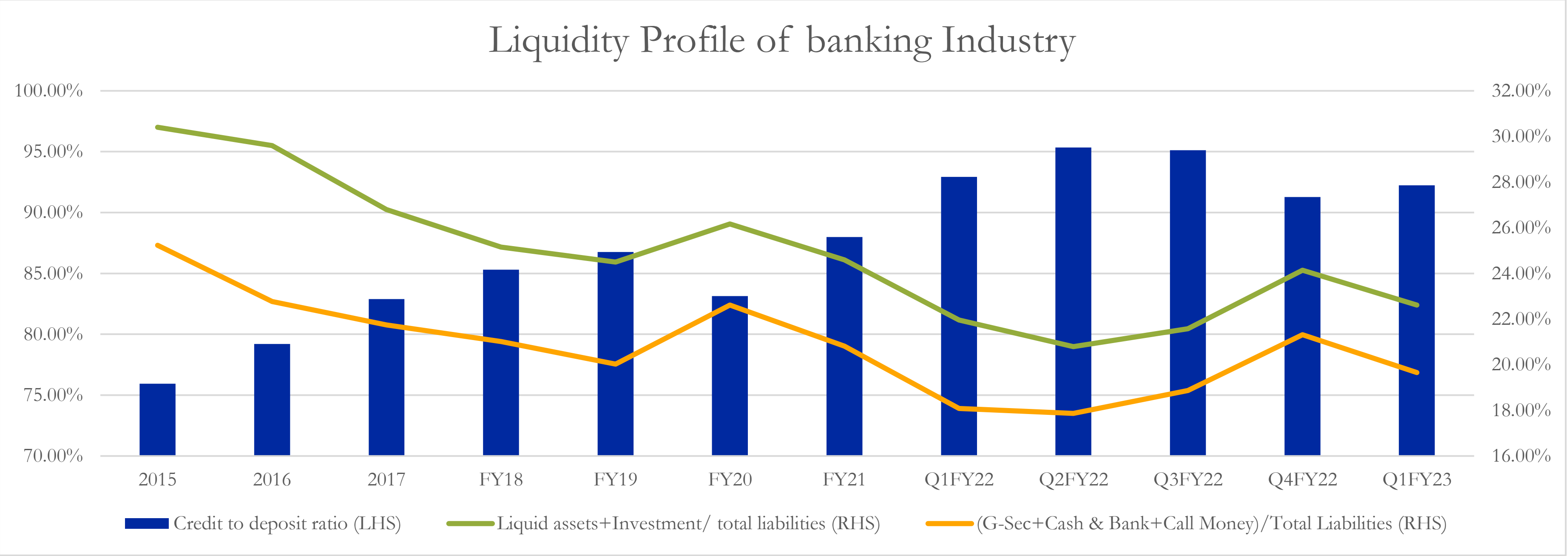
The interest rate volatility has been a pertinent characteristic of the Nepalese economy. The higher dependence on remittance and the import-based consumption/capex has resulted in the tie-up of the liquidity position with the trade statistics. Any disruption in import or demand slowdown results in shoring up of forex reserve and comfortable liquidity as seen during the pandemic period. Immediately upon the ebbing of pandemic waves, the resumption of economic activities, pent up import demand and increase in credit growth led to the immediate pressure on forex reserve and impacted the liquidity position of the banking sector. Further, the stress on the forex reserve was also exacerbated by the weakening of Nepalese currency vis-à-vis major world currencies and increased commodity and fuel prices. Amid the global rise in commodity prices, the remittance inflow was insufficient to finance the incremental import depleting the forex reserve as well as leading to low deposit formation within the economy.

The high-interest rate environment is also reflected in the T-bills rates, following the upward revision in policy rates by NRB.



Liquidity Management:

The liquidity management has been challenging given the short-term liquidity fluctuation. The central bank provided the liquidity worth of NPR 9,702 billion in FY2022 through open market operations compared to NPR 438 billion in FY2021. Furthermore, the central bank has provided liquidity worth NPR 2,355 till mid-October 2022 (vs NPR 1,008 billion till mid-October 2021). The commercial banks have been consistently utilising the SLF limits to maintain liquidity position as well to profit from the arbitrage given the difference between the SLF rate and rates of fresh T-bill issuance/renewals.



Nepalese Banking Sector: Performance Update

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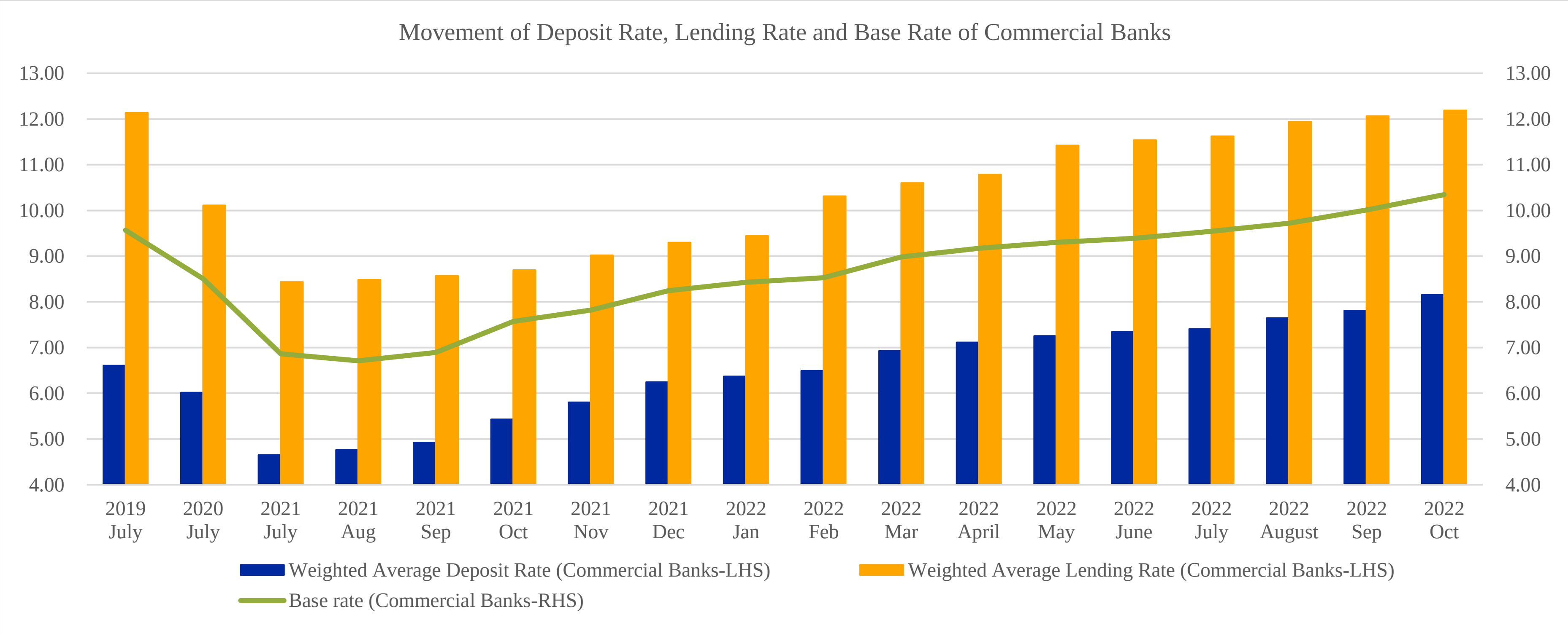
Banking Industry	FY20	FY21	3M FY22	6M FY22	9M FY22	12M FY22	3M FY23
Average cost of deposits	6.23%	4.96%	5.15%	5.55%	5.93%	6.18%	8.00%
Average cost of borrowings	6.67%	5.14%	5.13%	5.53%	5.90%	6.18%	7.95%
Term deposits (NPR million)	1,884,402	2,154,533	2,431,003	2,632,161	2,744,015	2,835,817	3,010,841
Term deposits as % of total deposits	48%	45%	50%	54%	55%	55%	58%
Bonds and Securities (NPR million)	51,679	100,435	113,245	117,154	117,119	136,986	150,441
Bonds as % of total borrowing	63%	37%	29%	27%	24%	27%	34%

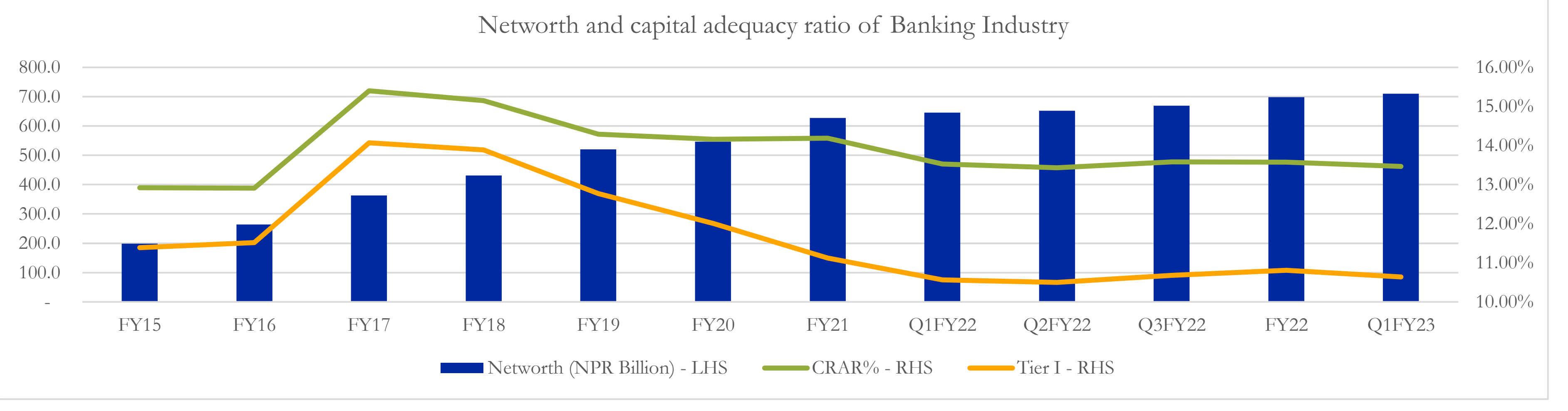
Source: NRB quarterly/annual compilation of BFI's financials; ICRA Nepal research



7. Capital adequacy update: tier I capitalization will remain a key monitorable amid the probable asset quality concerns.

The comfortable tier I capital adequacy position following the upward revision in regulatory minimum capital has reported a sustained decline since 2017, with a continuous high growth in risk assets of the industry. The tier-I capital cushion has eroded continuously through significant growth in risk assets (mainly credit growth) and relatively lower internal profit generation compared to credit growth. The inability of the banks to issue additional equity shares, given the central bank's focus on merger/acquisition necessitated the banks to maintain capital position through issue of tier-II debentures. As such, the overall capital adequacy position has remained adequate through tier-II debentures despite the sharp decline in tier-I capital. The capital position of the banks is expected to get a breather considering the stalled credit growth in recent times. Nonetheless, this will also remain dependent on the future dividend policy and incremental asset quality amid recent deterioration. Given the thin cushion at tier I level, recapitalization of more than a few banks could be necessary in the event of major credit slippages.

Further, the central bank has planned to enforce the countercyclical buffer from FY2023-24 that had been deferred since few years. This will also necessitate the banks to maintain adequate buffer over the current minimum capital requirement to ensure smooth transition.



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