Systemic Problems or a Problem of Trust: BFIs

Banks as a business bear a peculiar risk, they borrow short and lend long. Most of their assets (loans) are tied up in long term credits against short term deposit liabilities. As a result, banks themselves as well as regulations mandate that banks allocate a certain percentage of their total deposit liabilities to liquid assets. Central banks and regulations put certain structural safeguards through CD ratios, Liquidity Ratios and Capital Adequacy frameworks. So if people want to withdraw their funds, banks can cater to these daily requirements without much fuss. But what if everybody wants their deposits back at the same time. No financial institution in the world can comfortably withstand bank runs. No amount of structural safeguards can protect against lack of trust.

The fragility of any monetary system is as fragile as the trust of the masses. From the great depression of 1929, to the financial crisis of 2008; the failure of currencies of Weimar republic in the 1920s or Zimbabwean trillion denominated currency; whatever the crisis all of them were somehow a function of lack of trust of people on the financial and monetary system.

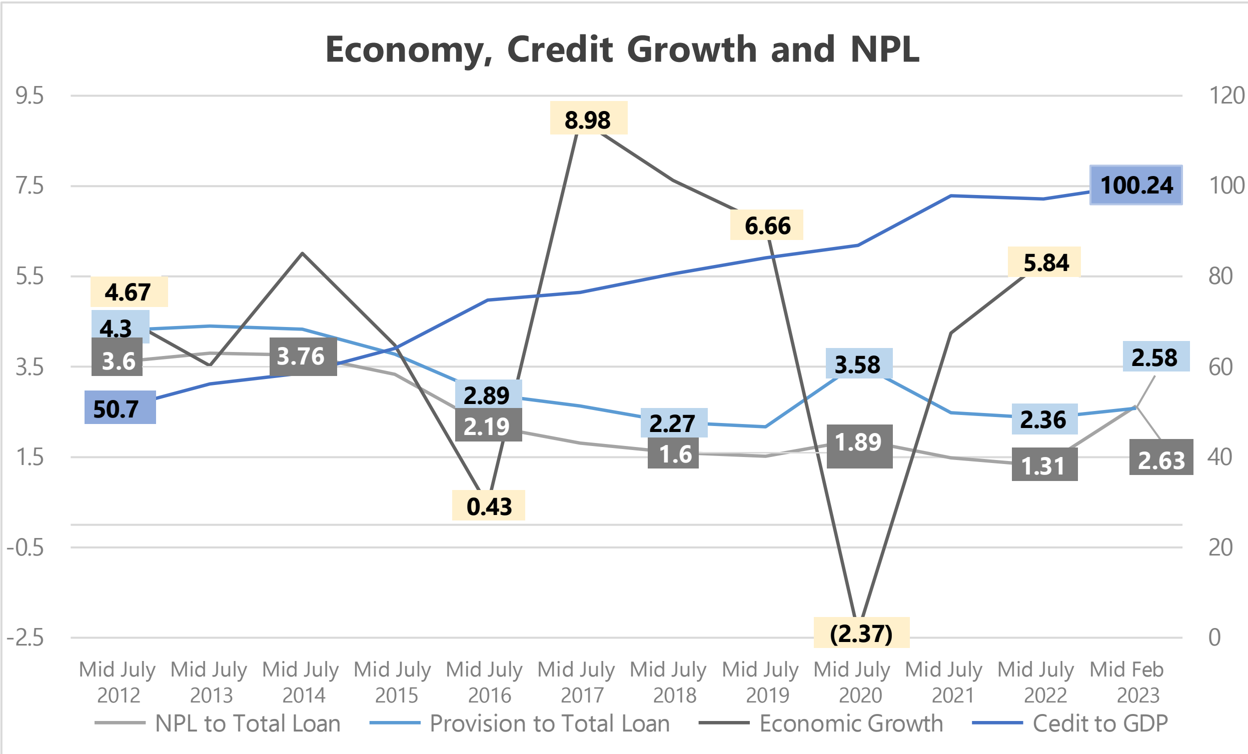
A globalized world order today coupled with information dissemination at the speed of light, incidents of bank runs in a couple of state based banks in the USA, has sparked fear among the depositors in Nepal. A fear that may have the potential to ensue bankruns in Nepal as well. But are people’s fears baseless? Is this simply mass hysteria triggered by an uncorrelated event or are there underlying systemic problems yet to be exposed in our banking system that justify the fears?

Can this fear shapeshift to loss of trust in our banking system? How shock resistant is our financial system? How safe are our deposits in our financial institutions?

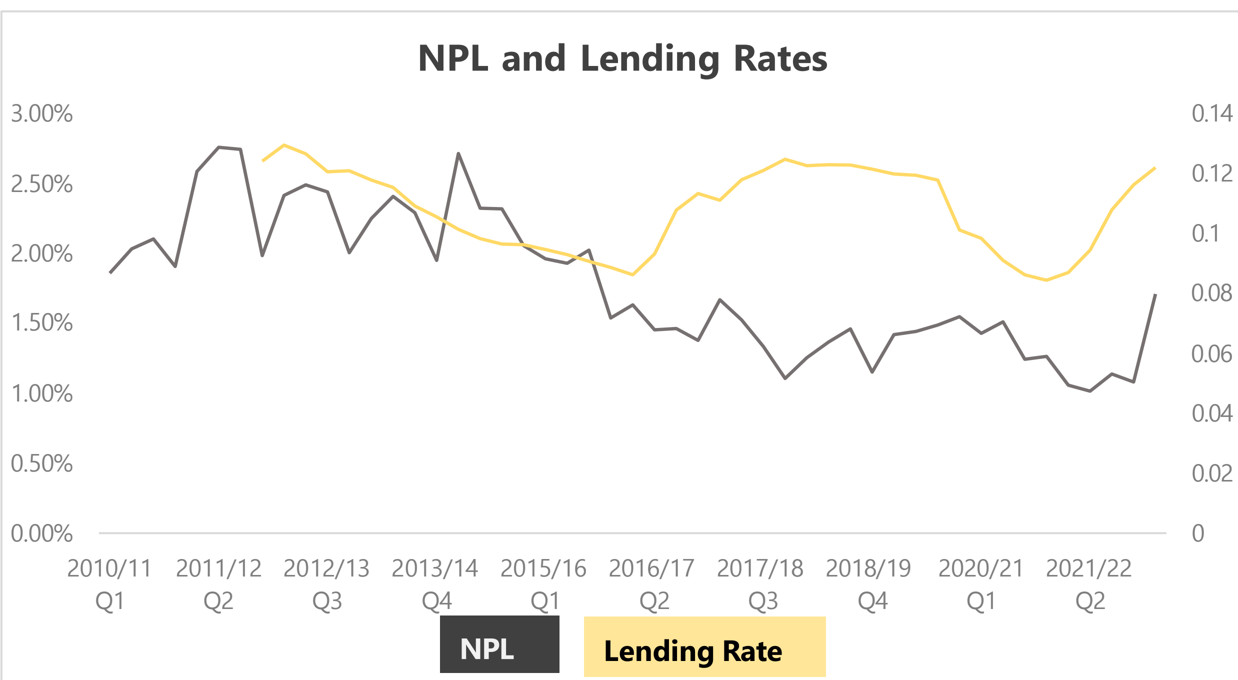
The Diagnosis

Credit is the foundation of economic growth, but too much causes inflation (both CPI and asset inflation), misuse of credit, aggressive lending motivation masquerading as growth and lax risk management. All of which leads to high NPLs. Theoretically. Yes! But historical trends in credit cycles in Nepal paint a different picture. As governments of the past decade have set out to achieve very high GDP growth targets, private sector credit extension has grown rapidly. With such high growth in credit expansion, NPAs should have risen proportionately, but they didn’t. Since 2012 we can see NPA on the decline, and almost stagnating around 2% since 2016. Couple of reasonings to explain such anomaly can either be the banks were really prudent and stringent in loan disbursement and credit recovery or credits might have also been used to evergreen the Non Performing Loans.

Similarly high lending rate environments should also have a positive correlation with NPLs. Again, theoretically! Yes! But then again through the years 2017-2020 despite high interest rates the NPL seems to be low. Probable cause again, can be evergreening of the loans and refinancing facility to COVID hit priority



sectors. Until recently, in 2022, as interest rates went up and COVID relief refinancing was taken back, NPL in BFIs have started to increase. Also the provisions that seemed to be sufficient cover the NPLs previously, as seen comparing the NPL to Total Loan and Provision to Total Loan trend lines above, the gap however has been converging and the allocated provisions are just enough to cover the current NPL levels as of now. If the trend is to continue on this course, there might be a need of higher provision requirements, but this bringing insolvency risk for them will depend upon BFI's having adequate equity to bear such contingencies.



Some smaller financial institutions especially cooperatives were unable to return deposits to their depositors, some limiting withdrawals to only a couple of thousand at a time. The withdrawal limits were set at 5% for cooperative depositors. There were obvious issues, deposits were tied to illiquid real estate assets, and the real estate sector was suffering from regulatory restrictions and liquidity issues.

Microfinance companies, which had previously been untethered and had disbursed credit at high interest rates to their low income clientele, were seeing their Non Performing Assets go up as incidents of loan defaults surfaced. Moreover, microfinances are accused of operating like predatory loan sharks, and protests have started against them.

Class A, B and C BFIs have problems of their own. With signs of recession showing and slowing down economic activity plaguing businesses throughout the nation, banks too have seen their NPAs go up in the past few quarters.

The trust in financial institutions appears to be waning as all tiers of financial institutions are struggling in some way, the foundations of trust in the banking system itself seem to be eroding.

Currently the credit to GDP ratio of Nepal stands at 100.24%. Credit outflow greater than GDP indicates that the multiplier effect of credit seems to be completely ineffective in the Nepalese economy. Yet, another evidence of credit misutilization. The Non Performing Loans of BFIs as of February 2023 stand at 2.63%. The total amount stands at 86.08 billion, almost a threefold increase from 2017 July when the total NPL was at 28.8 billion. Some of the class A BFIs i.e. Commercial Banks have seen their NPL climb as high as 4.5%. The Central bank deems NPL within the 5% threshold as a safe zone for BFIs. As of now the industry average seems to be within the safe limits, but in case any of the institutions show regulatory red flags, trust in the overall banking sector could falter.

The Prognosis

Amidst all the fear and uncertainty, it was only prudent to analyze the worst case scenarios regarding banks' ability to withstand increasing NPL and liquidity position to assess their ability to return deposits to the depositors and assess how vulnerable they are incase of bank runs.

Commercial Banks

Currently commercial banks cater to NPR 4744 billion in deposits, out of which NPR 354 billion are liquid assets and NPR 748 billion investment in securities such as government securities that may be made liquid at a short notice that provide a healthy cushion of 24% deposit refund capacity in case of bank runs in the commercial banks.

Commercial Banks		Use of Funds					
Deposits		Liquid Funds	Investment in Securities	Loans & Advances	Total Liquid Assets		Deposit Refund Ability
4744 Bn		354 Bn	748 Bn	4310 Bn	1102 Bn		24%

Assessing the severity of increasing NPLs in the commercial banks we can see that the banks have adequate provision

Loan Loss Provision	NPL %	NPL Amount
119 Bn	2.40%	107 Bn

Even if the NPL doubles in the coming quarters the total provision requirement would be Rs 248 billion, an additional 129 billion to be covered for which commercial banks look to be adequately capitalized. However, the additional provision would result in the average book value of commercial banks to come down from current Rs 163.65 to Rs 130.79. Despite the chances of taking hits on profits and the reserves in the near term, the commercial banks have adequate capitalisation to withstand a significant rise in NPL.

Development Banks

Currently development banks cater to 533 billion in deposits, out of which 52.5 billion are liquid assets and 76.91 billion investment in securities such as government securities that may be made liquid at a short notice that provides a healthy cushion of 30% deposit refund capacity in case of bank runs in the development banks.

Development Banks		Use of Funds					
Deposits		Liquid Funds	Investment in Securities	Loans & Advances	Total Liquid Assets		Deposit Refund Ability
533 Bn		52.5 Bn	76.91 Bn	458.51 Bn	129.41 Bn		24%

However, assessing the severity of increasing NPLs in the development banks we can see that the banks have inadequate provision with only Rs 13.08 Billion provision for 14.65 Billion in NPLs. Also the NPL stands at 3.19%.

Loan Loss Provision	NPL %	NPL Amount	Doubled NPL	Additional Provision Requirement
13.08 Bn	3.19 %	14.65 Bn	29.3 Bn	16.22 Bn

In case of a scenario where the NPL doubles in the coming quarters the total provision requirement would jump to Rs 26.11 billion an additional 11.47 billion to be covered for which development banks lack adequate capitalisation. The additional provision would result in the average book value of development banks to come down from current Rs 124.7 to Rs 96.14. The development banks will struggle with adequate capitalisation to withstand a significant rise in NPL and will take huge hits on profits in the upcoming quarters. Similar is the case with finance companies whose liquid assets cushion in case of bank runs looks to be adequate, but the problem again lies in the rising NPLs and capital adequacy to cover for the provisions.

Although for the BFIs the near term risk in credit default look eminent and increasing NPLs are a concern however, most large cap BFIs are adequately capitalized to absorb credit default shocks.

Non-performing loans (NPLs) ratio of selected commercial banks over the study period

S.N.	Bank	2015/2016	2016/2017	2017/2018	2018/2019	2019/2020	Av-NPL
1	ADBL	4.36	4.6	3.5	3.29	2.84	3.718
2	BOKL	2.51	1.29	3.04	1.54	2.28	2.132
3	CCBL	0.22	1.15	0.5	1.14	2.11	1.024
4	CZBIL	1.38	2.02	1.48	1.19	1.55	1.524
5	CBL	4.49	3.96	2.63	2.37	1.9	3.07
6	EBL	0.38	0.25	0.2	0.16	0.22	0.242
7	HBL	0.85	0.85	1.4	1.12	1.01	1.046
8	KBL	1.15	1.86	1.05	1.01	1.39	1.292
9	LBL	0.8	0.93	1.29	1.11	1.04	1.034
10	MBL	0.55	0.38	0.44	0.37	0.52	0.452
11	MEGHA	1.74	0.83	0.82	0.98	1.15	1.104
12	NABIL	1.14	0.79	0.55	0.74	0.98	0.84
13	NBB	0.71	0.76	1.27	1.74	2.89	1.474
14	NBL	3.11	3.32	3.37	2.64	2.47	2.982
15	NCCB	7.44	9.32	11.92	10.23	9.03	9.588
16	NIBL	0.68	0.83	1.36	2.78	2.91	1.712
17	SBI	0.14	0.1	0.2	0.2	0.23	0.174
18	NICA	1.79	2.03	1.1	2	1.76	1.736
19	NMB	0.41	0.11	0.04	0.01	0.01	0.116
20	PRVU	8.83	4.55	3.98	3.76	3.15	4.854
21	PCBL	1.23	0.88	0.85	1	1.48	1.088
22	SANIMA	0.019	0.01	0.03	0.08	0.45	0.1178
23	SBL	1.47	1.03	1.09	0.95	1.38	1.184
24	SCBL	0.32	0.19	0.18	0.15	0.44	0.256
25	SRBL	1.22	1.37	1.24	1.03	1.86	1.344

Source: Banks' annual report

Historical data shows banks have been able to cope with NPLs well over 5% and have recovered well from past crises owing to central banks' stringent policies.

The problem with our banking and financial institutions is not asset liability mismatches or the inability to refund deposits that will put the deposits of general public at risk. However, despite the risk tolerance capability ensured by the appropriate regulatory measures, even if a couple of small financial institutions fail, it could create a narrative that the BFIs are not safe enough to entrust them with our hard earned deposits.

As for now our deposits look to be safe, but then again in spite of this the predicament that our banks face today isn't the problem of a systemic risk but a problem of keeping the trust in the financial and banking system intact.

A disclaimer however might be due here and the NPL data disclosed by the BFIs, could come into question as them being understated and the NPL bubble is larger than what it seems. As the economic growth in the future will demand even larger credit extentions, requiring large sized financial institutions, with huge capital requirements and large ticket size loans, that will create "too big to fail" entities. If the suspected evergreening of the loans continues unhindered the bubble burst in the future might prove to be fatal for the overall economy. As for now, the ligetimacy of the data published under the supervision of a stong central bank as a regulator can be give a benefit of doubt. With great power comes great responsibility; hence the role of the central bank will be vital if we are to keep the trust in the banking system intact."