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 focusses more on the major development in the banking industry between mid-April 2018 (Q3 FY2018) and mid-January 2020 (Q2 FY2020). The developments are analysed in the backdrop of changes brought about by the Monetary Policy of FY2016 that mandated the increment of a minimum paid up capital for all banks and financial institutions (BFIs). The Policy has been instrumental to the subsequent developments in the banking industry such as high banking sector credit growth since FY2015 and consolidation among the players in more recent period.

This updated note intends to be a continuation of the previous note published in July 2018 - the link to which is given here.

As of mid-January 2020, banking industry of Nepal comprised close to 73 players across Class A (commercial bank), Class B (Development Bank) and Class C (Finance Companies). However, with >85% share in the asset base of the banking industry, the commercial bank industry (comprising 27 players) have a much higher significance to the industry and hence remains paramount to this analysis.

Major Financial Indicators of Nepalese Banking Industry

Key Ratios	Q3FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
Total Deposit/GDP (%)	86.59	94.34	96.83	101.95	104.90	96.83	99.38	102.78
Total Credit/GDP (%)	76.79	80.57	86.39	91.21	94.23	84.11	87.69	91.36
Total Credit/ Total Deposit (%)	88.69	85.41	89.23	89.46	89.83	86.87	88.23	88.89
Fixed Deposit/Total Deposit (%)	43.7	43.4	45.1	47.0	46.5	45.5	46.9	48.3
Saving Deposit/Total Deposit (%)	34.80	33.38	33.74	32.04	32.35	31.62	31.89	30.80
Current Deposit/Total Deposit (%)	8.50	9.05	7.51	8.23	8.19	9.29	7.79	8.14
NPL/ Total Loan (%)	1.91	1.60	1.69	1.75	1.83	1.52	1.74	1.77
Total LLP/Total Loan (%)	2.44	2.27	2.36	2.34	2.41	2.17	2.21	2.35
Deprived Sector Loan/Total Loan (%)	6.15	6.28	6.63	6.61	6.65	6.56	6.72	7.00
Cash & Bank Balance/Total Deposit (%)	11.02	13.15	10.57	10.38	10.68	11.58	10.63	9.21
Investment in Gov. Securities/Total Deposit (%)	10.84	10.43	10.03	9.97	9.78	11.16	10.93	10.78
Total Liquid Assets/Total Deposit (%)	24.17	25.91	23.05	23.34	23.11	25.06	23.93	22.98
Core Capital/RWA (%)	13.48	13.89	13.39	12.62	12.58	12.77	12.49	12.15
Total Capital/RWA (%)	14.80	15.15	14.68	13.93	13.99	14.29	14.19	13.97

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

Although the history of the Nepalese banking industry goes as back as up to 1937, the industry was limited to a small number of players until the 1990s. Following the liberalisation of the Nepalese economy in the 1990s, banking sector was also opened for new investors. Many new banks started to come into existence from the mid-1990s with the process accelerating between 2000-2012. As a result, the number of banking sector players registered a strong growth until FY2012. The Nepal Rastra Bank (NRB) stopped issuing new licences for the BFI in FY2012 and since has been encouraging consolidation among the banking sector players through several regulatory relaxation and tax benefits. The process of merger between the BFIs gathered speed after the NRB rolled out higher paid-up capital requirement in July/August 2015.

The Nepalese banking industry credit has grown at a high pace during most of the last 12-15 years, especially when compared against the growth in the nominal GDP of the country. As can be seen from the table below, the ratio of the total bank credit outstanding to nominal GDP of the country has been on a steady rise since FY2012 as the YOY credit growth has generally outpaced the growth in the nominal GDP in most of the interim years. Most of the growth has taken place during the period of low to moderate interest rate environment and in the absence of strong countercyclical checks by the regulator. As a result, the credit growth during those periods has also fuelled the inflationary growth in asset prices, to some extent.

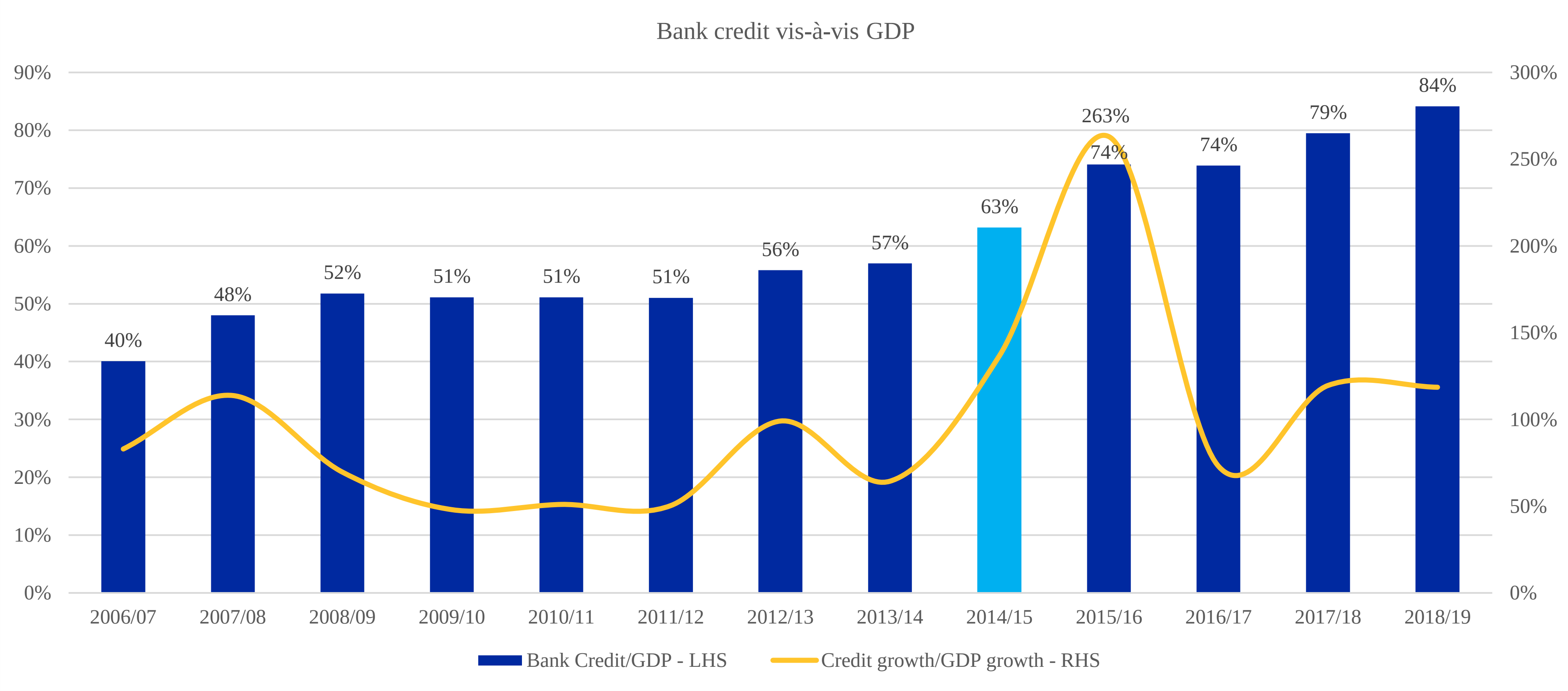
The historical trend of economic growth vis-à-vis banking sector growth has been tabulated below:

	No. of licensed BFIs		Growth Year-On-Year (YOY)			Closing Credit/ Nominal GDP	YoY Credit growth/ YOY nominal GDP growth	NEPSE market Capitalization/ GDP	NPA Banking sector
	Total	Class A	GDP[1]	Bank credit	Bank deposit				
FY08	161	25	12%	34%	30%	48%	114%	45%	5.69%
FY09	166	26	21%	31%	33%	52%	70%	52%	3.17%
FY10	185	27	21%	19%	16%	51%	48%	32%	2.20%
FY11	197	31	15%	15%	11%	51%	51%	24%	3.60%
FY12	189	32	12%	12%	23%	51%	50%	24%	3.60%
FY13	176	31	11%	21%	17%	56%	99%	30%	3.80%
FY14	167	30	16%	18%	18%	57%	64%	54%	3.76%
FY15	154	30	8%	20%	20%	63%	137%	46%	3.33%
FY16	137	28	6%	24%	19%	74%	263%	84%	2.19%
FY17	96	28	19%	18%	13%	74%	73%	69%	1.81%
FY18	86	28	14%	22%	19%	80%	120%	47%	1.60%
FY19	80	28	14%	20%	18%	84%	119%	45%	1.52%
Q2FY20	73	27		17%	12%				1.77%

[1] Gross value added by Industrial division at current (nominal) prices; FY2019 GDP is the revised estimate by Central Bureau of Statistics (revised in April 2020)

Leverage continues to build up in the financial system; as credit growth has picked up after a brief slowdown in FY2017:

Bank credit to the GDP is taken as an indication of the bank credit to the general productivity of the economy. As shown by the table above and the chart below, banking sector credit to GDP ratio has been rising steadily since FY2012. The growth has remained more pronounced in the year after FY2015 when the revised paid-up capital norms were introduced, triggering a high credit growth in the following years.



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

Note for graphs:

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

Leverage remains high across all major sectors financed by the banking industry:

The table below summarises the major credit segments of the banking sector, which accounted for ~75% of the banking sector credit as of mid-July 2019. As can be seen from the table below, the credit-to-GDP ratio for the top three sectors for bank financing (viz- trading, manufacturing and construction) are all above 100%, which indicates at a relatively high level of leverage in those sectors vis-à-vis the sectoral productivity. Leverage in these sectors have gradually increased in the last four to five years.

In addition, the leverage in sectors such as energy and tourism has grown at a very high pace in the interim. These sectors have received an increasing volume of bank credit in the last few years, because of their status as a "priority sector" as per the classification of the NRB (the banking sector regulator). As can be seen from the table below, the leverage in the sectors viz. Electricity, Gas & Water and Hotel & Restaurants has risen exponentially in the last four to five years. To a large extent, the rising credit-to-GDP ratio for these sectors are also partly explained by the fact that multiple large energy and tourism projects are under construction and are yet to generate economic value addition. The performance of such projects and the quality of credit extended to them, will depend on the long-term demand prospects for these sectors (viz. tourism and energy).

Ratio of outstanding bank credit to sectoral GDP of major sectors	FY15	FY16	FY17	FY18	FY19	% of credit in FY2019
Wholesaler & Retailer	102.7%	127.6%	131.8%	139.6%	140.4%	21.1%
Manufacturing	214.8%	244.8%	246.4%	273.5%	295.9%	17.5%
Construction	109.5%	129.4%	121.5%	122.8%	133.2%	10.6%
Finance, Insurance and Real Estate	41.5%	45.1%	41.3%	42.2%	42.8%	8.0%
Agricultural and Forest Related	10.0%	11.9%	12.3%	15.0%	19.2%	5.4%
Electricity, Gas and Water	156.6%	219.2%	207.5%	258.9%	345.9%	4.3%
Other Services (mainly health and education)	39.4%	41.2%	41.8%	44.1%	46.1%	4.2%
Hotel or Restaurant	108.8%	131.3%	140.2%	173.9%	217.0%	4.2%
Ratio of total bank credit to gross value addition across all sectors	**69.0%**	**81.0%**	**81.6%**	**88.2%**	**95.5%**	

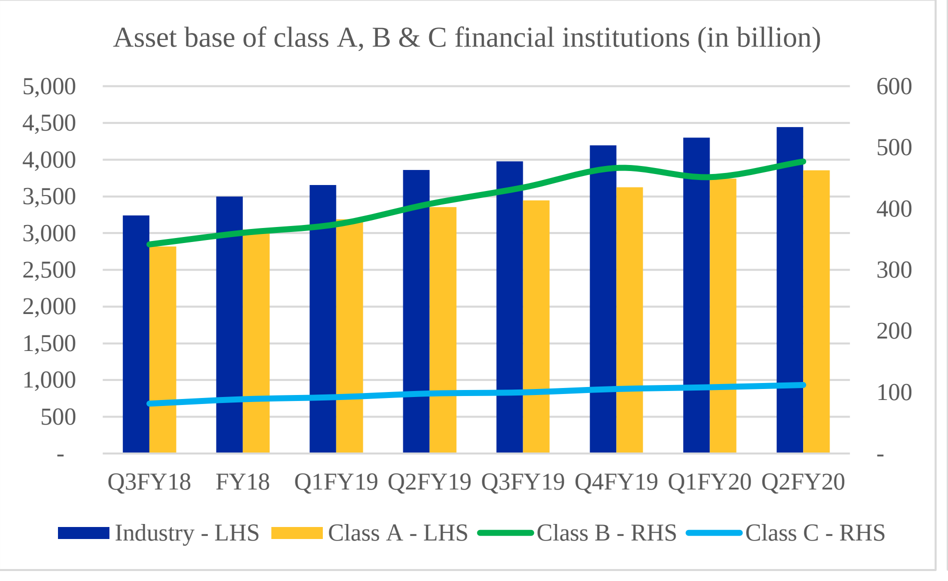
Source: NRB annual compilation of BFI's financials; ICRA Nepal research

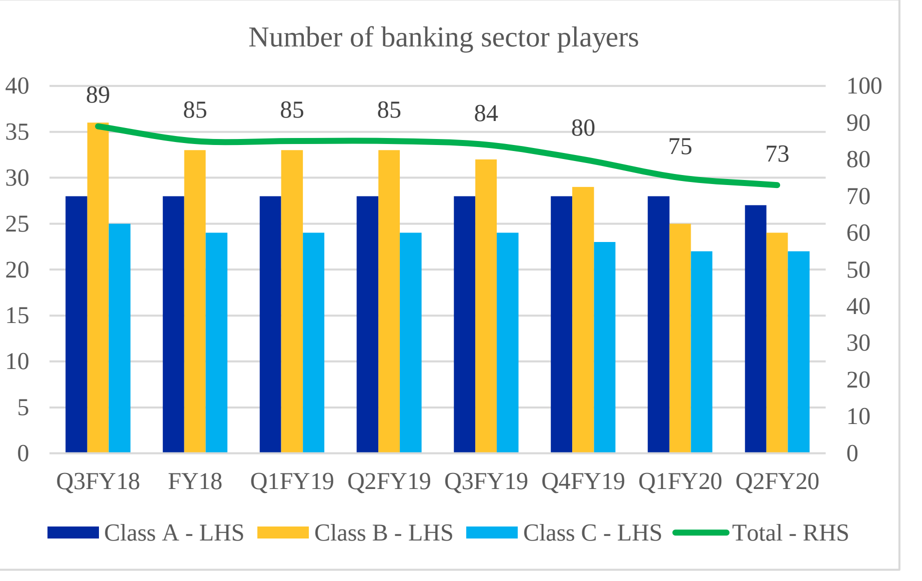
The bank credit to agriculture is relatively modest because of the unorganised agriculture sector and subsistence-based farming. This also partly explains the dichotomy between credit and GDP growth as agriculture remains the largest contributor to the Nepalese GDP. Bank credit to the health and the education sectors also remains low, partly aided by the cash-rich nature of these businesses.

Leverage in the real estate sector (represented under Finance, Insurance & Real Estate in the table above) has remained largely unchanged since FY2015 as the credit to this sector is subjected to closer scrutiny by the NRB - with a higher risk weight while calculating capitalisation ratios.

General banking industry update:

1. Number of banking sector players continue to decline, albeit at slower pace





**Two commercial banks (Global IME Bank Limited and Janata Bank Limited merged in Q2FY20. Notable class B banks acquired by class A banks include Kailash Bikash Bank Limited (acquired by Prime Commercial Bank), Om Development Bank Limited (acquired by NMB Bank), Tourism Development Bank (both acquired by Mega Bank Limited), Nepal Industrial & Development Corporation (acquired by Rastriya Banijya Bank), etc.*

- The Monetary Policy of FY2016 requiring the BFIs to increase their paid-up capital has been largely successful in encouraging consolidation among the banking sector players, especially the small regional and national level players in class B & class C universe. The total number of banking sector players has come down from 154 in FY2015 end to 73 by Q2 FY2020. However, the consolidation has happened mostly among the class B & C players.

- In a major development, the merger between two class A banks was completed in Q2 FY2020, the first since FY2016. Global IME Bank Limited & Janata Bank Limited merged to form the largest commercial bank in terms of asset base and net worth as of Q2 FY2020.

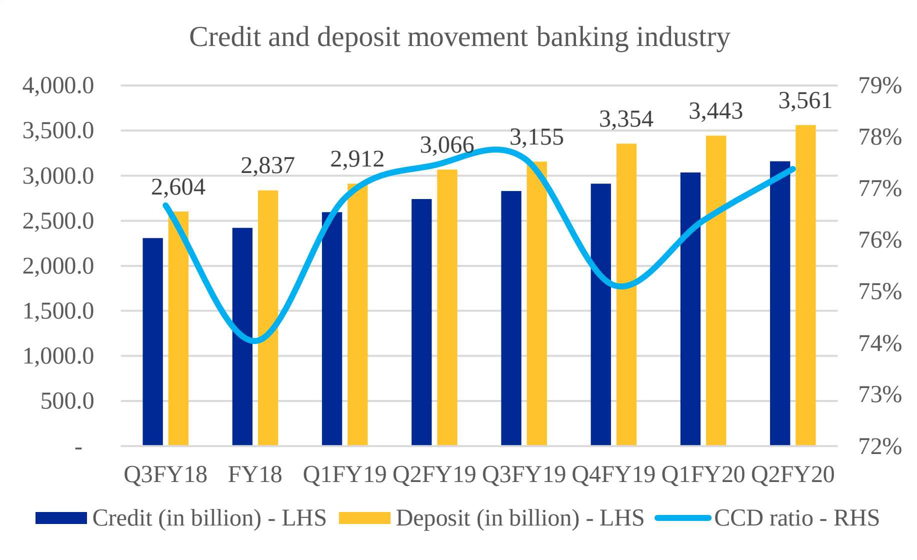
- Despite the NRB officials urging banks to consolidate, the NRB is unlikely to direct the class A banks to undergo a merger. However, regulatory measures such as gradual reduction in interest spread rate and increase in capital buffer are likely to be implemented that could affect the profitability of banks operating at a low scale. These, coupled with the rise in operating expenses amid increase in branch network and human resources, is likely to lead the banks towards consolidation, in a bid to improve scale economies and shareholder's return.

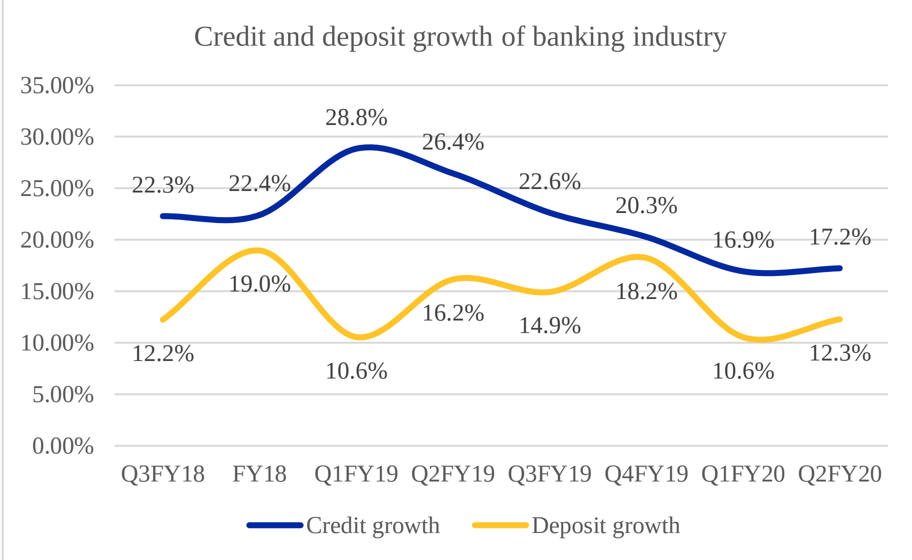
- In the last two-year period, a few established class B players have also been acquired by class A commercial banks. The aggressive branching out by commercial banks in the last few years has eroded the niche market of class B banks, which are mostly regional players. This, coupled with the implementation of the interest spread cap, and the inherent challenges for regional players to scale up and limited revenue diversification avenues have led the investors in these banks to seek out mergers with larger class A banks. This has also benefitted class A banks that are looking to expand in certain regions without much time and effort, while capitalising on the local traction gained by established class B players. The mutual benefit of such a merger is also reflected in the relatively healthy share swap consideration for such transactions. All these factors could play a part in further consolidation between class A and class B players in the near term.

- Class C players have largely not been a valuable proposition for acquisition by class A banks because of their very low scale of operations and relatively evolving business practices. However, some of the established players are still operating in the industry by acquiring other class C players and scaling up their operations.

- Independent existence of class B and class C players over 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 set of customers as the large class A banks could be untenable for class B & C players over the longer time frame.

2. Banking credit continues to maintain a robust growth rate, albeit below the deposit growth rate





- After a brief lull in credit growth in FY2017 (because of the slowdown in deposit formation), banking sector credit growth has picked up from FY2018. Reduced deposit formation in FY2017 was partly aided by a sudden weakening of the current account position (which turned negative for the first time in the past five years), thus affecting the short-term liquidity and interest rates. This followed significant investment by the banking sector in the import and trading sector (for both consumption goods and capex goods) resulting in a widening trade deficit.

- The current account position of Nepal has remained consistently negative since FY2017 till 8M FY2020, eroding the government's forex reserve as well as liquidity of the financial system. The Covid-19 impact could slow the inward remittance and exacerbate the situation. Although the deteriorating reserve has put a pressure on the financial sector liquidity, the deposit rates have not risen because of the uniform rate agreement among the banking sector players. The banking sector interest rates are also being curbed to stimulate credit growth in the post-Covid era to prevent a prolonged economic slowdown. However, continuous credit growth in the import-dominated Nepalese economy, without providing checks against the further depletion in foreign reserves could deepen the external imbalances with a greater impact on the banking sector liquidity and asset quality.

- With a dichotomy between deposit and credit growth, the pressure on the CCD ratio remains obvious with the gradual rise in the industrywide CCD ratio.

Industry outlook and way forward:

- NRB and the banking community, on the demand from borrower community, are contemplating ways to further reduce the borrowing rates to increase the borrowing, investing, and spending capacity of firms and households. This remains a positive to jumpstart the economy that has come to a standstill because of the pandemic. The bankers' association has already moved to reduce the deposit rates which will increase their ability to lend at a cheaper rate. The NRB has also increased the budget for refinancing through its latest circulars to enable the bank to lend to the borrowers in priority sectors at low rates.

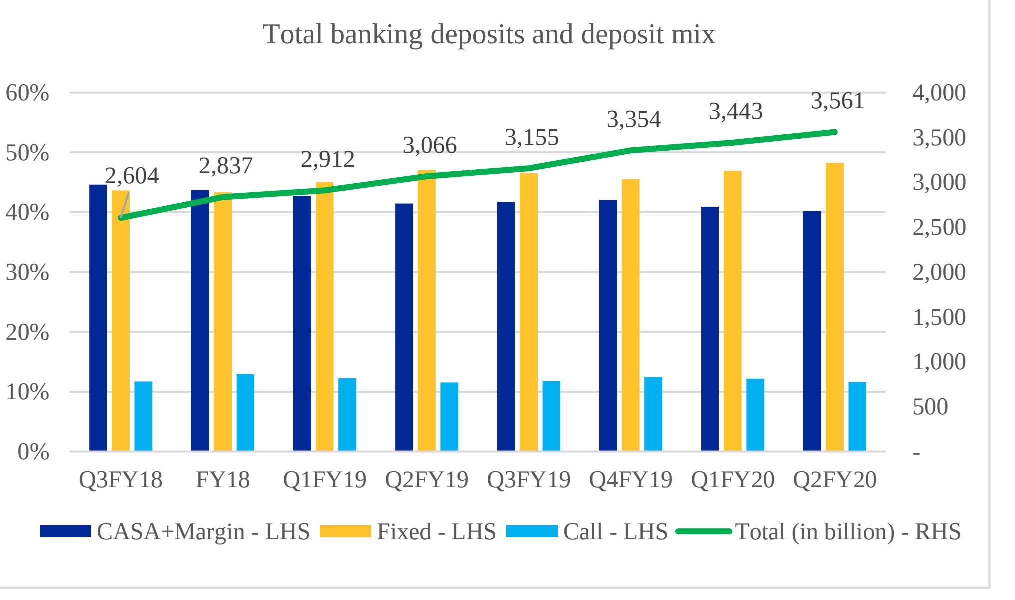
- However, given the already high leverage in the financial system and the level of debt currently being carried on, especially by corporate borrowers, any increase in debt will need to be closely monitored by the bank and will require an adherence to a strict discipline by the borrowers to ensure sustainability. A tight monitoring over large accounts as well as sizeable SME credit underwritten in the last three to four years will be required, to reduce the default risks.

3. Funding profile: rising proportion of term deposits and tier II debentures could stabilise the deposit profile, albeit with cost implications

The funding profile of the Nepalese banking industry comprises largely customer deposits (~97-98%) while borrowings account for a nominal portion of the overall funding profile. Within the external borrowings, ~50-60% comprises long-term instruments such as NRB financing and long-term bonds while the rest consists of short-term inter-bank borrowings.

- The deposit growth of the banking sector has ranged between 10-15% in the last two-year period, trailing below the credit growth, which stood between 15-20% over the same period.

- The deposit mix has remained largely unchanged in the last two-year period, except for a marginal growth in the term deposit at the expense of CASA proportion. During this period, the CASA deposits ranged between 40-45% while term deposits ranged between 45-50%. The proportion of call deposits remains largely stable at slightly above 10% in the interim.



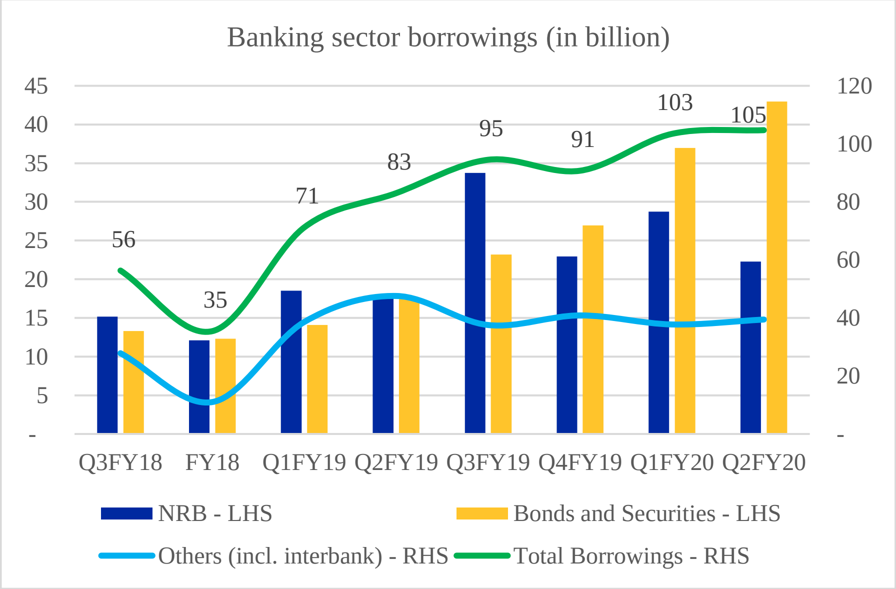
- Interest rates registered a marked increase from January 2017, on the heels of a weakening current account position of Nepal. Interest rates remained on higher side between 2017 and 2018. A series of deposit interest rate agreements between the banking sector players arrested the rise and then gradually reduced it to lower levels, despite a consistent deficit in the current account in each year since FY2017, putting pressure on the deposit formation and the CCD ratio. As of FY2019 end, the current account deficit stood at ~8% of the GDP, which is an unprecedented level in the last 10-12 years.

- The NRB, in mid-2017, to calm the deposit rate volatility and liquidity shocks, pegged the deposit interest rates on call deposits (deemed the most volatile and interest rate sensitive deposits) with the savings rate. This has, to a large extent, helped lower the deposit rate volatility in the industry. However, the conversion of a major portion of such deposits into term deposits has increased the cost of deposits across the industry.

Borrowings:

- Largest portion of borrowings comprises short-term interbank borrowings, which are used for maintaining regulatory liquidity and reserve ratios. Mostly, these have a tenure of up to seven days and can be rolled over. The weighted average interbank rate for commercial bank was ~3.5% for FY2018 and ~4.2% for FY2019 against the Policy rate (fixed repo rate) of 5%. .

- Lately borrowings from the NRB has seen a surge as the central bank has increased its refinancing limit from NPR 20 billion in FY2018 to NPR 50 billion in FY2019. It was increased to NPR 60 billion through a mid-term assessment for FY2020. Recently, the NRB has announced the further increment in limit to NPR 100 billion, in the light of the Covid-19 impact. The interest rate on general refinance was 4% during FY2018 and FY2019 which was reduced to 3% in early FY2020. Similarly, the special refinance rate was 1% throughout these years. Refinance is a tool used by the NRB to provide cheap lending to certain priority sectors by paying to the banks the amount (or portion thereof) lent by the banks to such sectors.



- The Monetary Policy for FY2020 has mandated all class A banks to maintain tier II debentures equal to at least 25% of their paid-up capital. This has resulted in many banks floating tier II debentures in the market in the last two-year period, priced between 10-11% per annum. The debentures have met with generally positive response from the subscribers, despite the inherent illiquidity of the bonds as a capital market instrument in Nepal. Nonetheless, with the banks now agreeing to further subdue the deposit rates across all deposits (including long term deposits) to boost the credit-demand in post-Covid era, the investor attraction for these bonds is expected to increase further.

- The NRB has also opened the avenues for borrowing money from foreign banks in convertible foreign currency. Few banks have raised the money through such borrowings and some others are in the process. However, the amount raised so far remains miniscule in comparison. As of FY2019 end, ~3% of total borrowings of banking industry comprised the borrowings from foreign banks.

- The average price of the aggregate bank borrowings remains like the average deposit cost for the banking industry, as evident in the table below.

Operating Ratios	Q3FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
Yield on Average Advances	11.93%	12.32%	12.33%	12.50%	12.68%	12.84%	12.29%	11.98%
Cost of Average Deposits	6.37%	6.33%	6.78%	6.75%	6.76%	6.73%	6.87%	6.61%
Cost of Average Interest-Bearing Funds	6.36%	6.35%	6.76%	6.69%	6.72%	6.72%	6.83%	6.57%

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

Industry outlook and way forward:

- Rising proportion of term deposits within the deposit portfolio and growing proportion of debenture within the borrowings have introduced a semblance of stability to the funding profile of the bank, despite the higher cost implications. However, despite the rise in the proportion of term deposits, most of these deposits are in short term maturity bucket. As of FY2019 end, >60% of total fixed deposits in the banking industry had a maturity period of one year or less[2]. In case of interest rate volatility, these amounts can be withdrawn and could invite liquidity challenges for the BFIs concerned.

- Amid the recent development (post covid-19 pandemic) talks among the banking sector players and the NRB, of reducing the deposit and lending rates across the industry, ~200 bps decline in interest rate is likely over the medium term.

[2] *Based on the interest expense data published in NRB's monthly statistics for month ending mid-July 2019.*

4. Asset quality remains good across the industry, partly benefited by robust growth in fresh credit:

Non-performing assets	Q3FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
Gross Credit (NPR billion)	2,307	2,419	2,594	2,739	2,830	2,910	3,033	3,161
Gross NPA (Industry)	1.91%	1.60%	1.69%	1.75%	1.83%	1.52%	1.74%	1.77%
Gross NPA (NPR billion)	43	38	43	47	51	43	52	55
Gross NPA (Class A)	1.66%	1.41%	1.48%	1.60%	1.71%	1.40%	1.61%	1.71%

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

Reported gross NPA levels for industry remains low amid robust credit growth; even as the sector-wise and borrower-wise leverage continues to grow: Partly aided by the high pace of credit growth in the last five to six years, the Nepalese banking industry continues to report low NPA levels. This, to some extent, stems from the banking sector practice of obtaining good collaterals as well as banking regulations allowing relatively hassle-free liquidation of such collaterals to recover the loans. Low banking industry NPA can also be attributed to the concentration of credit to sectors such as trading and household consumptions, which entail a short gestation period and relatively low credit risk. The fact that major borrower groups of the banking system have a reasonably diversified and uncorrelated portfolio (across manufacturing, trading and financial sector) also adds to the resilience of these groups against the slumps in the different sectors at different periods.

However, as discussed in the section above, these sectors are also witnessing a growing leverage build-up over many years. Activities such as growing reliance on bank borrowing for capex and working capital, consistent dividend pay-out to shareholders despite high leverage, aggressive rates being offered in retail lending, etc. are contributing to the growing leverage. This lowers the resilience of borrowing firms and households and makes the borrower's repayment capacity vulnerable to any decline in their revenue profile or a spike in the interest rates.

On the other hand, the risk is also gradually increasing in the banking sector credit with a growing proportion of bank financing being made in capital intensive sectors such as hotels, hydropower, cement, steels, etc., mostly as a part of the priority-sector lending mandated by the NRB. Because of the increased lending and additional capacity creation in recent years, sectors such as hotels, cement, steels, etc. are demonstrating early signs of a supply glut. This could mean a reduction in the revenue potential of the borrowers in these sectors, vis-à-vis the original projections. This could lead to a diminished repayment capacity of the industry, eventually giving rise to asset quality concerns.

Competition among players for business; large borrowers using multiple lines of credit makes it hard to assess true stress on borrower: Decline in NPA level over the years has been characterised by high credit expansion and growth in the number of BFIs. Intense competition among the industry players to rope in large borrowers has given rise to instances of overfinancing to large borrowers. At the same time, 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, however, the extent of oversight in case of a non-consortium arrangement (such as pari-passu multiple banking arrangement), is lesser.

Sizeable proportion of revolving lines of credit also prevent true test of borrower's repayment capacity:
Despite a decline over the last few years with a growing instances of long-term project financing, ~60% of the average credit books of the banking industry still comprise short-term renewable credit facilities, which only entails periodic interest payment and the credit lines get renewed on maturity. This is in line with the trading-heavy GDP of our country, which is also reflected in the banking sector credit mix.

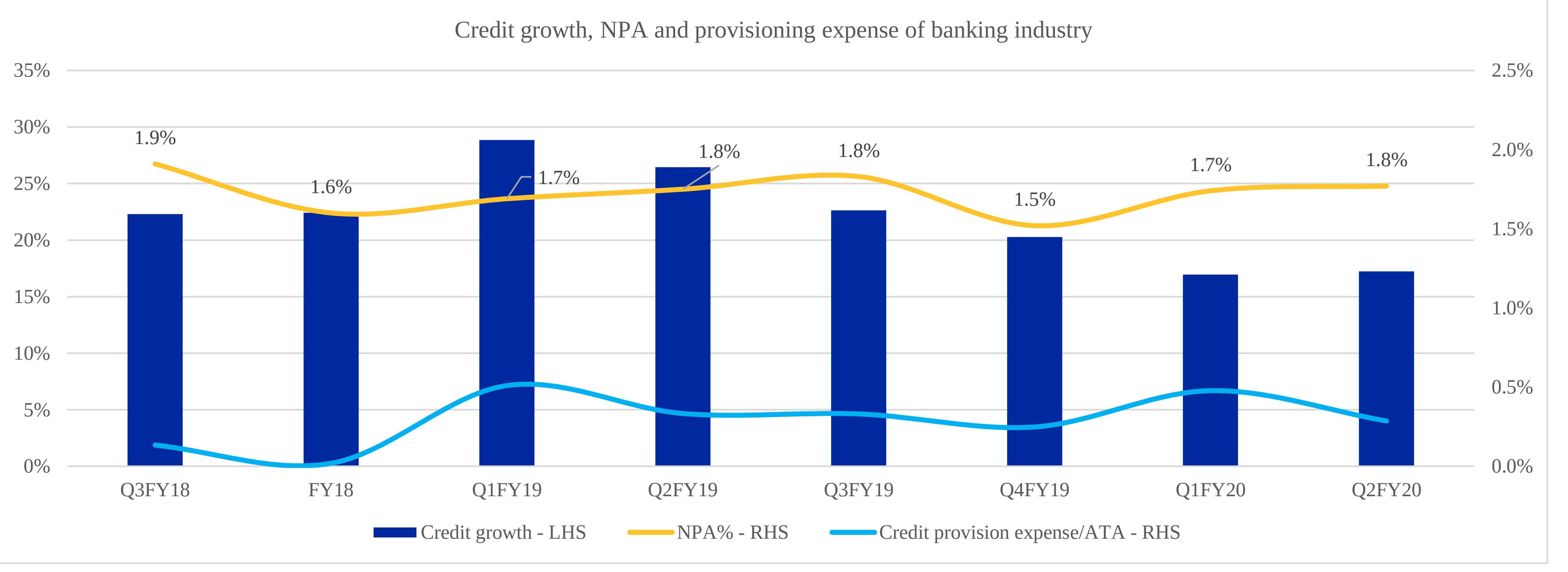
Intense competition among the lenders for credit growth has led to overfinancing of most of the large borrower groups. Moderate quality of financial reporting in many medium-to-large borrowers, coupled with the lack of proper sectoral database in public domain, creates problems in effective tracking of the quality of their exposures by the bank.

Large common borrowers across most of the BFIs can have some spill-over effect across all banks:
Given the industry competition, many of the large borrowers in the corporate and the SME segments tend to be common across multiple banks. Therefore, the impact on any of these top borrowers could trigger assets quality and liquidity concern for multiple lender banks.

Sizeable funds mobilised through non-banking channels; asset quality impact to be first seen in those channels before being passed on to the banking channels:
As of mid-April 2019 (latest available statistics), co-operative societies as an industry (comprising over 34,500 players including over 13,900 saving and credit cooperatives) mobilised assets worth NPR 332 billion in credit (vs. 273 billion in FY2017 end). This is larger than the credit portfolio of class B banks' as of mid-April 2019 (NPR 326 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 limited member base and small ticket exposures).

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

The cooperatives also share some of the borrowers with the banking industry raising a likelihood of overfinancing of those borrowers, especially at the SME and the retail segment, as the credit availed from cooperatives are not captured in the credit information bureau reports.

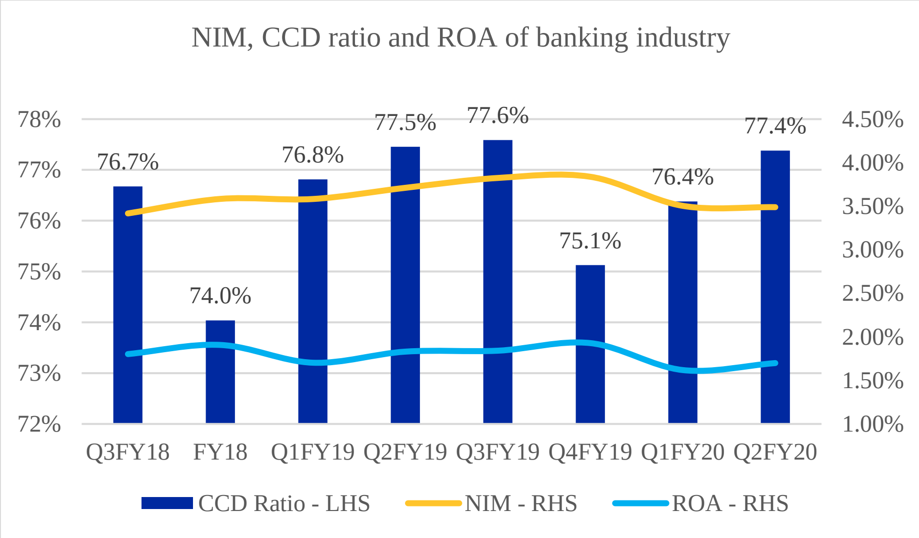


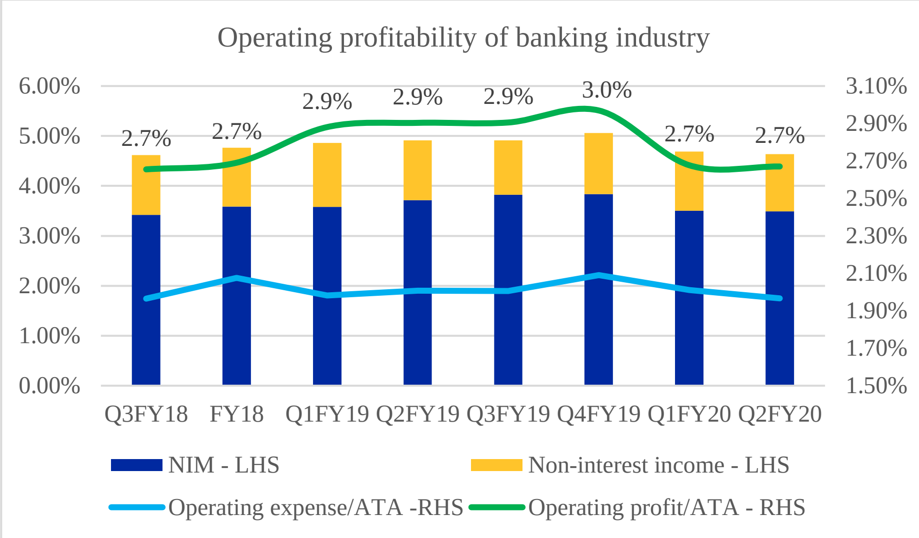
Outlook on Asset Quality:

Future assets quality remains on shaky ground because of the increasing leverage among borrowers:

Given the high leverage built-up in the financial system and among the borrowers, the vulnerability of the overall banking system to business shocks as well as interest rate shocks have increased significantly in the recent years. Continuation of external imbalance (i.e. Current account deficit) will put an upward pressure on liquidity and interest rates. Supressing the interest rates and further increasing the leverage in the system through the creation of cheaper credit, without insisting on the improvement in underlying business fundamental and discipline of the borrowers and/or without improvement in the external imbalances in government account could be untenable over the longer run. An eventual upward correction in interest rates could erode the repayment capacity of leveraged firms and retail borrowers and high interest rates could have a supressing effect on the valuation of the collaterals, which could ultimately increase the probability of credit losses for the banks.

5. **Update on Profitability: ROA continues to remain stable supported by stable NIMs and scale growth; operating expense, however, a drag to profitability; future profits to depend on the regulatory decision on interest rate spread**





Banking sector profit improved after a brief moderation towards late FY2017 and early FY2018, on the heels of credit growth

The sudden slowdown in deposit formation by the end of H1 FY2017 due to current account imbalances, the resulting spike in the banking sector interest rates, the slowdown in credit growth and the delay in transmission of the same to the borrowers led to a decline in NIMs towards the second half of FY2017 and the first half of FY2018. However, with the resumption of normal credit growth in the industry in later months and floating interest rate on credit portfolio, which allows the transmission of increased cost of funds to the borrowers, the profitability level has improved and has remained relatively stable in the last two years with the ROA between 1.7% to 2.0% of the industry average total assets.

High operating expense ratio remains a dampener to the profitability levels:

Players in the banking industry has branched out aggressively in the last few years in line with the nation's entry into the federal structure and the government's directive to ensure the presence of the banking sector in all local electoral regions of the country. This has resulted in the setting up of new branches and recruitment of new staff which has increased the costs for the banks in the interim. As a result, despite the growth in the scale of operations and a stable interest margins, the bank's operating expense ratio has remained largely stable, resulting in a similarly stable or marginally moderate ROA levels.

Non-interest income level keeps pace with the growth in net interest income level to support banking sector profitability:

For the past two years, the share of net interest income (NII) accounted for ~75% of the total operating income of Class A banks, while the rest consists of non-interest income (mostly credit linked activities like loan processing fees, Letter of credit/ guarantee commission, etc.). The proportion of non-interest income in the total banking sector has kept up with the growth in NII, given the sizeable growth in non-funded businesses, especially guarantees and bonds related to the construction sector in addition to the regular LC businesses.

Low investment yield affects profitability:

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

The investment portfolio of the Nepalese banking industry comprises largely of government securities (forming ~2/3rd of the investment portfolio in the last two years) while the rest comprises other investments including long-term equity holding in subsidiaries and to some extent, equity investment through the secondary market. The yield on 91 days T-bill issued during different months of FY2018 and FY2019 ranged between 0.5-5.8% and between 0.8-5.5% respectively, while a similar yield for 364 days T-bill issued during FY2018 and FY2019 was between 1.3-5.8% and 2-5.8% respectively.

Banking industry	Q3FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
Yield on average investments	2.67%	2.71%	3.10%	2.86%	2.73%	2.64%	3.12%	2.92%
Yield on G-Securities	1.52%	1.62%	2.16%	1.99%	1.91%	1.74%	2.20%	2.05%

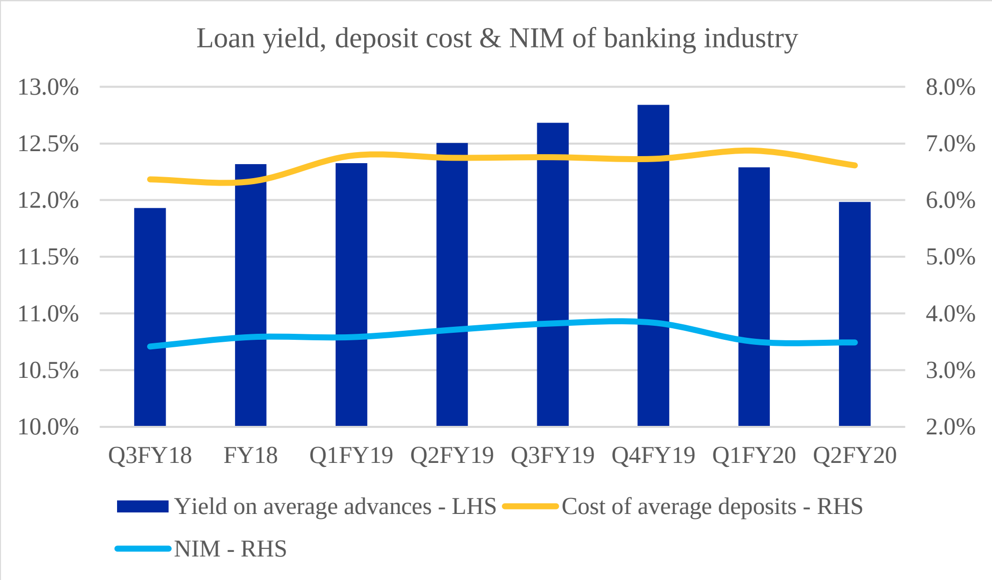
Source: NRB quarterly/annual compilation of BFI's financials; ICRA Nepal research

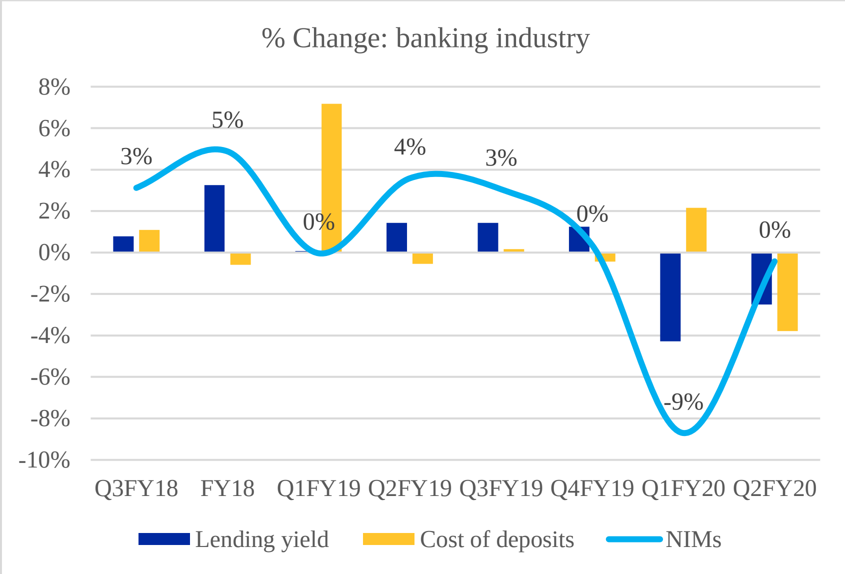
Although the government has been running budget deficits for the last few fiscals, its appetite for money has remained low given the limited spending ability of the government machinery, especially on the capital expenditure. This is reflected in very low government treasury and bond yield. Similarly, a shallow equity market in Nepal offers limited scope for large players like the BFIs to benefit from trading activities. Hence the average yield on investment for the BFIs has remained low over the years. To some extent, this is addressed by the NRB's decision to factor in the low investment yield while implementing the regulatory interest spread cap of 4.5% for commercial banks. However, the recent regulatory changes of calculating the interest rate spread without factoring in the low investment yield could reduce the lending yield considerably to conform to the new method of calculating the interest spread. This could impact the profitability of the BFIs.

Outlook on Profitability:

Notwithstanding any deterioration in the asset quality, the profitability outlook of the banking industry remains good. This, however, will remain dependent on the clarification and implementation of the regulatory interest spread cap by the NRB. A major contraction in the interest rate spread cap (by downward revision in the interest rate cap or change in the method of calculating interest spread) could erode the profitability profile of the banking industry.

6. Deposit, liquidity, and interest rate update:



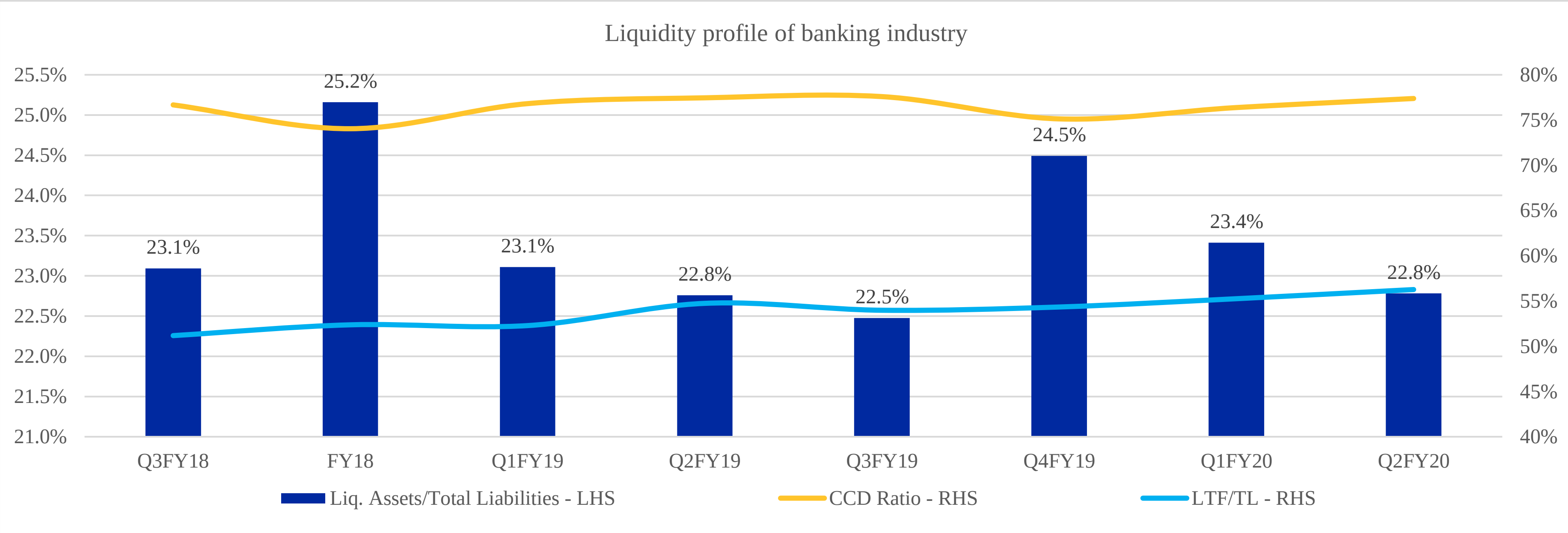


The lending yield picked up from late FY2018 transmitting increased cost of fund to borrowers, resulting in an improvement in NIMs:

As can be seen from the charts above, the average yield on banking industry reported a marked increase during the last quarter of FY2018. The impact of a spike in deposit rates across the industry from January 2017 was effectively passed on to the borrowers, thereby normalising NIMs. At the same time, the growth in deposit rate was arrested by the agreement between the banking sector players. Any contraction in the difference between lending yield and the cost of deposits was met by an increase in the CCD ratio, thereby smoothing the NIMs curve as seen in the chart above.

Rising proportion of long-term fund in banking industry:

The proportion of term deposits has been rising in the banking industry since the first price war of January 2017. As a result, the term deposit proportion of the industry increased from ~30% in FY2016 end to ~48% by Q2 FY2020. At the same time, the banking sector has been raising tier II bonds, prompted by the regulatory directive. The process of tier II bond-raising continues to go on strongly till date which could further increase the proportion of the long-term fund. All this is leading to a rising proportion of long-term funds in the industry, which could offset the liquidity and interest rate volatility in the industry.



Banking Industry	Q3FY18	FY18	Q1FY19	Q2FY19	Q3FY19	Q4FY19	Q1FY20	Q2FY20
Average cost of deposits	6.37%	6.33%	6.78%	6.75%	6.76%	6.73%	6.87%	6.61%
Average cost of borrowings	5.73%	8.07%	5.43%	4.03%	5.02%	6.11%	5.14%	5.04%
Term deposits (NPR million)	1,136,480	1,229,731	1,312,075	1,441,042	1,468,290	1,526,497	1,615,908	1,718,228
Term deposits as % of total deposits	44%	43%	45%	47%	47%	46%	47%	48%
Bonds and Securities (NPR million)	13,313	12,312	14,082	17,600	23,207	26,935	36,954	42,973
Bonds as % of total borrowing	24%	35%	20%	21%	25%	30%	36%	41%

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

7. Capital adequacy update: Capitalisation level remains comfortable; backed almost entirely by tier I equity capital; penetration of tier II capital instrument remains low despite recent improvement:

Capitalisation ratio of banking sector peaked in FY2018-end when almost all banks met the revised paid up capital requirement through equity injection (and retention of profits). A subsequent growth in risk asset (credit growth) has since moderated the capitalisation ratio. Nonetheless, the average capitalisation ratio continues to remain comfortable vis-à-vis the regulatory minimum. The NRB's impetus to further the credit growth in the coming period, to combat the Covid-19 pandemic effect, is likely to erode the capital cushion further.