by Binam Raj Ghimire

Credit Sector Reform & NRB

Although the circumstances leading to financial problem or crisis in many Nepali banks differ in many respects, what is common across most of the banks is the increased size of Non Performing Assets (NPAs). To resolve the problem of the losses or likely losses of this nature facing the industry, Nepal Rastra Bank (NRB) has, as the central bank, amended several old directives and issued many new circulars in recent years. In many of these reform actions, NRB has been playing supportive and participative role.

On 15 May 2003, Bankers Training Center (BTC) of NRB was both supportive and participative by holding a workshop among the Chief Executives and Chiefs of Credit Departments of all banks on the theme "Overview of The New Basel Capital Accord." The workshop highlighted the New Accord of Bank For International Settlements (BIS) and requested feedback of the participants to help study how the new accord can best fit in Nepali context. The New Accord will undoubtedly have important ramifications for a country like ours, not only for capital flows and management of credit risk but also for the nature of the supervisory regimes NRB will need to operate. To the bankers, the workshop has become a notice in advance to prepare for the changes in regulations that are going to take place in the future. It has provided time to plan, discuss and prepare. However, in the past, NRB was not able to inspire similar confidence.

The Basel Committee report on Capital Accord, which sets standard and framework mainly for credit risk, has been in existence since 1988. This Accord was originally issued and agreed upon by the G-10 central banks in December 1987 to achieve common minimum capital standards by end-year 1992. The Accord has been conceptualized by many central banks around the globe. NRB could have followed the maxim "If you can't beat the team, join the team" and copied and pasted the recommendations as appropriate to fit in the scenario of our financial market long time back. While it dilly-dallied in the past, it is hastening with it now. As a result, the banks find it difficult to comply with the new directive/s of NRB. The examples in this connection are the directives changing the basis for classification of loans and making the provisioning.

As per NRB circular number Bai. Le 61 Karja 1165 dated March 22, 1991

Now & Then

New Loan Classification and Provision System Compared with Loan Loss Provisioning as per Old System

Effective from 2058/4/1 i.e. July 16, 2001					Effective March 22, 1991 to July 15, 2001 (10 years)
Classification	For FY 2059/60 (2002/03)	For FY 2060/61 (2003/04)	For FY 2061/62 onwards (2004/05)	Loan Loss Provision	Loan Loss Provision
Pass	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	1 %	0%
Sub-Standard	Loans and advances past due for a period of over 3 months to 1 year	Loans and advances past due for a period of over 3 months to 9 months	Loans and advances past due for a period of over 3 months to 6 months	25 %	5 %
Doubtful	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 9 months to 2 years	Loans and advances past due for a period of over 6 months to 1 year	50 %	25 %
Loss	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 2 years	Loans and advances past due for a period of over 1 year	100 %	50 % (For 100 % provisioning the overdue to exceed 5 years)

[The last column of the table shows what the Loan Loss Provisioning Percentage would be if the old directive followed is for provisioning figures but the new directive is followed for loan classification.]

which remained in force for 10 years (with some adjustments in 1992 and 1995), the classification of Large Loans was to be made in six categories on the basis of some clearly defined and some not so clearly defined parameters. The directive was not clear where the borrower had wide fluctuations with respect to some indicators. In such case the borrower would qualify for different ratings under each indicator. Besides, since all large borrowers were not incorporated under the Companies Act they could not be forced to maintain audited statement of accounts. But the classification of assets in the case of small loans was simple and easy. Therefore, after some pressure from banks, NRB soon agreed upon the categorization of all loans and provisioning in a manner that was applicable in the case of small loans. The new loan loss classification and provisioning rule came in effect from July 16, 2001. So, for several years, NRB accepted the classification of assets and provisioning which were not in accordance with the norms of its own directives. As a result, for all loans, banks followed classification of loan and provisioning that was originally meant only for loans amounting less than Rs. 100,000.

The table in the previous page presents new loan classification system and a comparison of the new provision with old provisioning requirement.

If we assume the same loan amount (say Rs. 100,000) in each category, then in the new arrangement the loan loss provision amount would be higher by 120 % over the previous arrangement. Since the majority of the loans of most of the commercial banks of the country at present falls under sub-standard, doubtful and even loss categories, loan loss provisioning now compared to under the previous arrangement would be dramatically higher. The new classification and provisioning norms are very laudable as they help to strengthen banks financially. But we also must remember that the old system remained in force from 1991 to 2001 and this was probably the most volatile decade for business operation in this country as there were frequent boom and bust cycles.

NRB should review the fact that our country's government has used the banking system as an instrument to further the national development strategy. The government chooses those industries which it believes will contribute to overall economic development of the country. It then directs credit to these "winners", often by encouraging commercial lenders to favor those industries. This policy undermines the growth of a sound banking system as it prevents banks from assessing loan applications on the basis of such prudent criteria as likelihood of repayment and availability of sufficient collateral. For example, when Himalayan Bank Ltd. provided loan to Gorakhkali Rubber Udyog Ltd. (GRUL) in mid 1990s, the government backed the loan by providing its indemnity to repay the loan. But the repayment was delayed for years. How many of such loans have been sanctioned by NBL and RBB, the government owned banks,

Effects of Sudden NRB Strictures

Figures in Million Rupees

Bank	Chaitra End 2059 (April 13, 2003)			Chaitra End 2057 (April 12, 2001)			
	Total Credit (C2)	Loan Loss Provisioning (P2)	% of provision to credit P2/C2(A)	Total Credit (C1)	Loan Loss Provisioning (P1)	% of Provision to credit P1/C1 (B)	Increment % of Provision to Credit (A-B) %
Standard Chartered Bank	6,162.00	307.00	4.98	5,520.60	122.00	2.21	125.45
Nabil Bank	7,537.00	438.00	5.81	8,138.00	360.00	4.42	31.37
Himalayan Bank	10,029.00	747.00	7.45	9,089.60	244.00	2.68	177.47
Nepal Bangladesh Bank	8,655.58	705.49	8.15	6,856.50	86.90	1.27	543.10
Bank of Kathmandu	4,920.58	424.55	8.63	3,750.30	70.90	1.89	356.39
Everest Bank	4,789.42	112.32	2.35	3,527.00	16.80	0.48	392.35
Nepal Investment Bank	5,409.22	172.00	3.18	2,301.40	80.20	3.48	(8.75)
Nepal SBI Bank	4,696.00	285.15	6.07	3,686.70	102.00	2.77	119.47
Nepal Ind. & Commer. Bank	2,514.63	113.77	4.52	2,721.30	NA	-	-
Lumbini Bank	2,667.70	149.76	5.61	1,532.30	NA	-	-
Nepal Credit & Comm. Bank	3,401.29	558.01	16.41	3,002.80	23.30	0.78	2,014.31
Kumari Bank	1,878.00	29.00	1.54	NA	NA	-	-
Macchapuchhre Bank	1,125.14	30.66	2.72	477.30	NA	-	-
Laxmi Bank	650.51	6.51	1.00	1,532.30	NA	-	-
Siddhartha Bank	347.33	3.47	1.00	NA	NA	-	-
Nepal Bank Ltd.	18,515.10	11,238.22	60.70	23,185.70	2,886.60	12.45	387.53
Total	83,298.50	15,320.91		75,321.80	3,992.70		

Source (for figures of April 13, 2003): Unaudited Financial Statements published by banks. Source (for figure of April 12, 2001): NRB
Notes: The new loan loss classification rule is in effect from 2058/4/1 (16 July 2001). Figures of Rastriya Banijya Bank Not Available (NA). Kumari Bank Ltd., Laxmi Bank Ltd. and Siddhartha Bank Ltd. are new banks and in their case the loan loss provision were Not Applicable (NA) as of April 12, 2001.

When & What
NRB Directives (on Credit Sector Reform) since April 2001

Directives	Circular No & Issue Date	New Arrangement Effective Date
Classification of Loan Loss and Provisioning	Circular No. Bai. Bya. Pa. 66/057/58 dated April 26, 2001	Beginning of FY 2001/2002
Capital Adequacy Norms	Circular No. Bai. Bya. Pa. Pa 66/057 dated April 26. 2001	Beginning of FY 2001/2002
Minimum capital requirements, capital adjustment fund and capital plan	Circular No. Bai. Bya 2/058/59 dated May 14, 2002 and decision dated 2059/11/29 (13 March 2003) circulated to banks by letter dated 2059/12/14 (28 March 2003)	Decision Dated 2059/11/29 (13 March 2003)
Single Borrowers Limit	Circular No. Bai. Bya. Pa. Pa. 66/057 dated April 26, 2001	Beginning of Fiscal Year 2001/2002
Credit concentration to single sector of the economy	Circular No. Bai. Bya. Pa. Pa. 66/057 dated April 26, 2001	Beginning of Fiscal Year 2001/2002
Provision of capital charge to minimize concentration risk	Circular No. Bai. Bya. Pa. Pa. 66/057 dated April 26, 2001	Beginning of Fiscal Year 2001/2002
Rescheduling and Restructuring of loans and provisioning	Circular No. Bai. Bya. Pa. 66/057/58 dated April 26, 200 and dated Bai. Bya. Pa. Pa. /91/059 dated November 28, 2002	Beginning of Fiscal Year 2001/2002
Swap Loans and Provisioning	Circular No. Bai. Bya. Pa. 66/057/58 dated April 26, 2001	Beginning of Fiscal Year 2001/2002

is anybody's guess. Loan assessments by the professional staff of the banks were based on economic and business criteria that include financial viability. But those crucial analyses were neglected and many of the sanctioning decisions were made at the instruction of the political powers of the respective period. Such a system has produced more bad loans and losses. The need of the hour is to recover the loans that have gone bad; just provisioning adequately will not be enough.

If we look at it from the side of the fresh and young banking professionals who work till late evening in private sector commercial banks, NRB's provisioning requirement have significantly reduced their bonus income. They lament that their income is being reduced to create provision for a loan that has gone bad for no fault of theirs. If a bank fails to adequately provide the provision amount, there are various serious penalties. One such provision says that NRB will issue orders requiring termination of the service of the staff. Because of such threats and the decreasing incentives, many young professionals have quit banking sector jobs and joined other industries while many others are looking for such alternatives. This can result in a manpower crisis in banking sector in the near future. Similarly from the sentiment of the shareholders of banks, they have been deprived from the dividend income which has not only affected their income but also the Market Value of Shares (MVS).

According to the table in the previous page, total loan loss provisioning as a percentage of total credit as of April 12, 2001 comes to 5.30 % (P1/C1%). As of April 13, 2003 it has jumped up to 18.39 % (P2/C2%). If we exclude Nepal Bank Ltd. and consider only private sector banks then the provision to credit is 2.12% as of April 12, 2001 whereas it is 6.30% as of April 13, 2003. NRB has chastised banks for the non-compliance of Directives no. 2 of loan loss provision while granting approval to publish the Annual Reports. If provision is made as per the NRB instructions, the total provision to total credit amount would be significantly higher than 6.30 %. Total increment in loan loss provision in the period is Rs. 11,328.11 million (Rs. 15,320.91 million -Rs. 3,992.7 million) whereas the growth of credit in the period is only 7,976.70 million. (Rs. 83,298.50 million - Rs. 75,321.80 million).

It is true that tightening provisioning requirements on non-performing loans is essential to ensure that banks remain liquid even during economic downturns. As has been reflected by the management handover of two large banks of the country last year, along with introduction of risk based Inspection and Supervision Manual of International Standard, onsite and offsite supervision, bank restructuring, introduction of NRB Act 2058 and several other new measures, 'the last 2-3 years have seen tremendous work in reforming the Nepali financial system' as NRB governor was saying on the occasion of the 48th anniversary of the central bank. It is again true that in the recent years NRB has worked for the management and reform of credit of the financial institutions more seriously than in the past. In many of these plans, NRB has started to figure prominently as a regulator promoting sound banking practices. NRB has adopted reforms aimed not just at dealing with problem banks but also, and which is more important, at strengthening banking supervision to reduce the likelihood of future crises. With respect to credit sector management NRB has firmed up new/revised prudential guidelines. Some of the major guidelines related with credit sector reforms are outlined in the accompanying table.

The table above clarifies the fact that all prudential directives of NRB in connection to credit sector reform have been made/revised on or after April 2001. More importantly, the previous circulars were in force for quite many years. To adapt to such a sudden change, there can be some difficulties. For a better and harmonized reform, NRB should continue to be supportive, proactive and also participative to take opinions of bankers for a change in regulation/ policy taking place in the future. Let us hope, the May 15 spirit continues.

(Ghimire is associated with Bank of Kathmandu Ltd. but the ideas expressed in this article are his personal.)