Unit 2

Challenges in Banking: A Nepalese Diaspora

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ABSTRACT

Nepal has become member of World Trade Organization (WTO) and has committed to open Financial Services Sector (FSS) especially banking services to the foreign banks and financial institutions by 2010. This could be threat as well as opportunities for banking sector of Nepal. The existing level of Non-Performing Assets (NPA) is not that much healthy sign for the smooth growth of banking sector. One should seriously need to re-think proper strategy for managing NPA. The predominance of rural economy urge bank and financial institutions of Nepal to peneterate in this sector with innovative products of microfinance as insurence, remittance, etc.so as to support poverty alleviation programme. Expansion of Small and Medium Sized Enterprises (SMEs) in rural sector could lured to banking sector to invest on it too. Managing inflow of remittances would yield fruitful outcome for Nepal. Public private partnership concept will be equally desirable for poverty alleviation, growth and expansion of banking service especially in the rural economy.

All branches of economic activity today are fundamentally dependent on access to financial services. In fact, it is the diversified intermediation and risk management services of the financial system which have made possible the development of modern economies. A healthy and stable financial system, underpinned by sound macroeconomic management and prudential regulation, is an essential ingredient for sustained growth. Conversely, macroeconomic instability emanating from weaknesses in the financial sector can undermine the process of development. The continuing globalization of economic activity, and the challenge of attracting productive investments in a competitive international environment, accentuates the need to maintain a healthy and efficient financial sector.

In almost all advanced economies, financial systems deliver a broad range of financial services and sophisticated products, and the efficiency of such well-developed systems has contributed to macroeconomic stability and sustained economic growth and prosperity. Increased availability of funding and more efficient allocation of capital for productive private sector investment is beneficial economy-wide, with particular benefits for SMEs that are often constrained in their financing options prior to effective banking reforms and non-bank financial sector development. Thus, robust growth and effective functioning of a full service financial system is essential for economic development and prosperity.

Over the years the importance of financial sectors development and its contribution to nations Gross Domestic Product (GDP) has been evident. FSS comprises over 9.91percent of the GDP in the Nepal. While impressive, the numbers belie the much larger role that this industry plays in the economy. Financial services firms provide the payment services and financial products that enable households and firms to participate in the broader economy. By offering vehicles for investment of savings, extension of credit, and risk management, they fuel the modern capitalistic society.

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Figure 1

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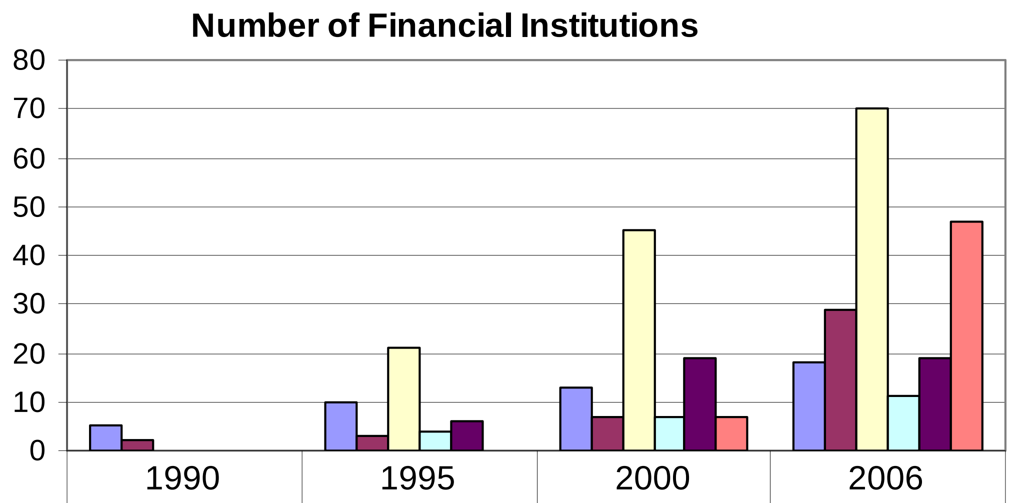


	1990	1995	2000	2006
CB's	5	10	13	18
DB's	2	3	7	29
FC's	0	21	45	70
MCDB's	0	4	7	11
SACC's	0	6	19	19
NGO's	0	0	7	47

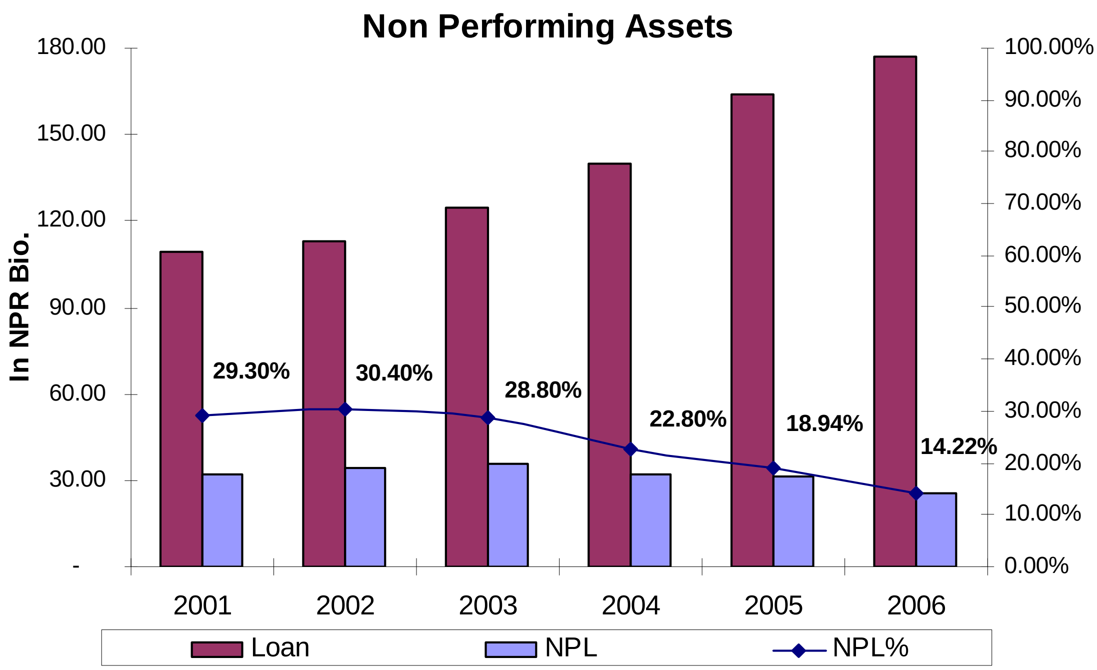
The essential functions performed by the organizations that make up the industry have remained relatively constant over the past several decades; however the structure of the industry has undergone dramatic change. Liberalized domestic regulation intensified international competition, rapid innovations in new financial instruments, and the explosive growth in information technology fuel this change. Competition has created a fast-paced industry where firms must change in order to survive. In addition, Nepal’s financial sector liberalization and commitments on the WTO forum further highlights the need for change.

The current financial institutions market in Nepal clearly delineates a developing market with tremendous potential. With two large economies growing at a massive speed Nepal has a lot to gain from its neighbors. In addition to this, the recent peace agreement and sign of political stability in the country has further paved a way for prosperous future ahead. Hence, in order to capitalize on the existing scenario Nepalese financial sector seriously needs focus its activities in attaining higher economic growth. Few areas where Nepalese financial sector should focus are**:**

PRUDENT MANAGEMENT OF NPA’S

For the past few years we have seen that some banks have not been able to properly manage their level of NPA. As a result there has been constant pressure in their capital base as well as their profitability.

Figure 2



Any kind of lending involves the following three stages where discretion needs to be exercised (a) Evaluation and assessment of the proposal (b) Timely monitoring and evaluation and (c) Proper assessment of exit decision and modality. Some of the commercial banks exhibit extremes of behaviors at each of the above stages. A rule-based approach precludes reasonable application of mind. Evaluation of project idea and the management is something that most of the banks are least equipped for. This has lead to the bank acting too liberal on all projects insisting on collaterals without taking into consideration any other competencies of the project and the entrepreneur's capability. Further constant monitoring of major economic indicators which bears direct impact on the business is a must. Many of these banks have not been able to properly assess the impact of economic indicators on the growth and sustainability of the business. In addition to this, incompetence to properly assess the exit modality as and when necessary resulted in major disasters in terms of lending. These were the internal factors which resulted in the increase in the level of NPA of these commercial banks. Besides these, there are some major external factors that bear direct impact on the level of NPA of commercial banks. Commercial banks due to the ascendancy of these factors have not been able to pin down the willful defaulters and downsize the level of NPA. These external factors are:

a) Legal impediments and time consuming nature of asset disposal process.

b) Manipulation by the debtors using political influence and the weak corporate governance has been a cause for industrial bad debt being so high in case of government owned banks.

c) Bankruptcy laws favor borrowers and law courts are not reliable enforcement vehicles.

d) Legal mechanisms to dispose bad loans were time consuming and expensive and NPAs remained on the balance sheet.

If we look at our Asian counterparts, few years ago their financial system was following the same trail as ours. Till the year 2000 China had a NPA level of around 28 percent, Japan was also suffering from high NPA levels of 16 percent and India before 2000 had around 15 percent NPA levels. Prudently assessing the peril ahead they quickly acted upon and created environment which supported and uplifted the effort to reduce high levels of NPA.

<u>China</u>

a) Reducing risk by strengthening banks, raising disclosure standards and spearheading reforms of the state owned enterprises by reducing their level of debt.

b) Laws were passed allowing the creation of asset management companies, foreign equity participation in securitization and asset backed securitization.

c) The government which bore the financial loss of debt ‘discounting’. Debt/equity swaps were allowed in case a growth opportunity existed.

d) Incentives like tax breaks, exemption from administration fees and clear-cut asset evaluation norms were implemented.

<u>Japan</u>

a) Amendment of foreign exchange control law (l997) and the threat of suspension of banking business in case of failure to satisfy the capital adequacy ratio prescribed.

b) Legislation to improve information flow has been passed.

c) Accounting standards with the major business groups established a private standard setting vehicle for Japanese accounting standards (2001) in line with international standards.

d) Government support at the government’s committed public funds to deal with banking sector weakness.

<u>India</u>

a) Strengthening of legal norms aligning of prudential norms with international standards.

b) Legal mechanisms including creation of Assets Recovery Companies (ARCs).

c) Strengthening of the capital markets.

Hence, looking at the current scenario in Figure 2 we seriously need to rethink our strategies in terms of managing NPA. Commercial banks along with the central bank and the government need to devise a mechanism to keep the increasing level of NPA at bay. Though it seems that the industry is putting efforts to recover the bad loans, in reality the reduction is mainly due to increase in the total debt and huge write offs by commercial banks having higher NPA levels. If this problem is left unmanaged the overall health of our financial system may suffer a serious batter.

RESTRUCTURING FOR BETTER FUTURE

No economy can afford abnormality in the banking sector; a failure of a bank can lead to a systemic failure. The need of restructuring is vital when the NPA level is higher, further justified by the following:

a) The current picture of the balance sheets of some financial institutions needs to be restructured as expeditiously as possible not only to revitalize the institutions but also to aid economic growth. Hence, it has become necessary that the financial regulator take the initiative in assessing the true value of the loan portfolio of such banks and take the necessary remedial actions for banks with insufficient capital.

b) Financial institutions should initiate and expand the process of establishment of Assets Management Companies (AMCs) who help collect loans repayment. These steps would help the process of debt restructuring. The functions of AMC should be explicitly focused on purchase, restructure and sell the assets and receivables of financial institutions. Setting up AMC makes the loan recovery business professional and competitive. In addition, government should hence grant such companies generous tax perks when acquiring bad assets from financial institutions and selling them onto the third parties.

INCREASE COMPETENCIES FOR 2010 AND BEYOND

As evident FSS of Nepal will be completely open for foreign participation after 2010 as per the commitments of FSS liberalization. Further it is evident that liberalization coupled with inadequate strengthening of regulatory and supervisory framework, is an open invitation for financial crisis. Hence, the opportunities and threats of liberalization of the financial sector need to be properly accessed. The budding stage of Nepalese financial sector is in no way ready for competing hand in hand with our foreign counterparts. Hence, banking sector seriously needs to focus on:

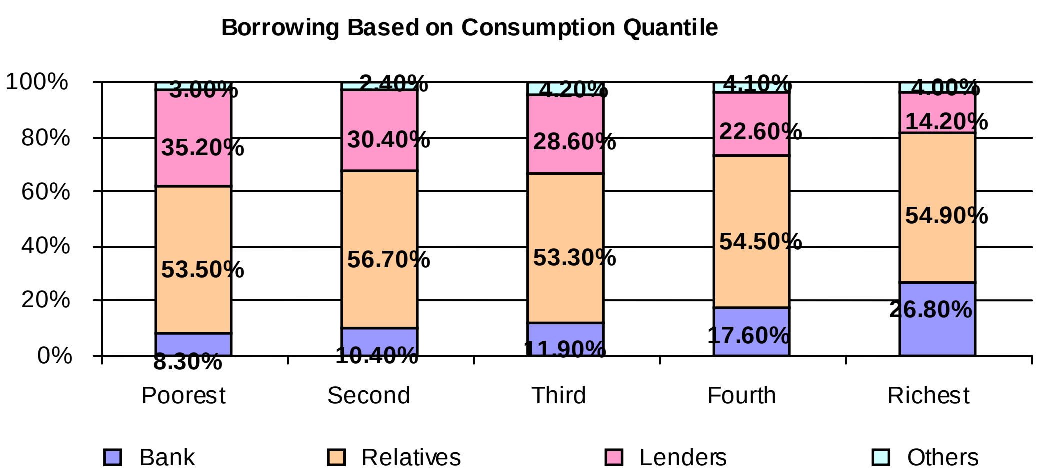
a) By the year 2010, Nepalese financial sector will be completely open to foreign investors and organization. Any financial institutions (as permitted in the commitments) will be allowed to open up branches or even a subsidiary in Nepal. Foreseeing these Nepalese financial institutions must act quickly, before 2010. In order to develop competitiveness, and compete in par with foreign financial institutions Nepalese financial institutions not only needs to develop in terms of skills but also in terms of size and reach. Advancement in communication and technology is rapidly changing the way business is being conducted. The ability to tap right technology becomes increasingly important to meet the more sophisticated demands. As such financial services entities will require large amounts of capital investments to remain competitive and be able to assume higher risks. To provide for stronger capitalization of the domestic institutions, the financial institutions (more so banking institutions) will have to embark on a merger program. The merger of institutions will not only promote the financial capability but will also promote domestic reach and competitiveness through shared skills.

b) Another greatest challenge facing the domestic institutions is their ability to compete effectively in a more liberalized environment due to skill gaps which are still lacking in critical areas, particularly in the area of credit and treasury risk management. In the banking sector, it was acknowledged by the Basel Committee on Banking Supervision on the New Capital Accord that the emerging economies in Asian do face difficulties in implementing the BASEL requirements due to the lack of skills. For safeguarding the Nepalese banking sector provisions has been made in the specific schedules of commitments such that financial institutions will not be permitted to deal in derivative products under sub-sector and settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments until Nepal Government determines what types of entities can conduct these services, the related laws and regulations are established and such business is authorized by the government or other designated authority. As the provision made is only intended for safeguarding and not for restricting it is necessary to identify that sooner or later Nepalese financial sector will have to develop its skills in order to compete with foreign financial institutions. Hence, keeping this in mind policies regarding settlement of and clearing services for financial assets, including securities, derivative products, and other negotiable instruments should be prepared at the earliest such that the Nepalese banking sector can gain enough know how before 2010.

BANKING WITH THE NON-BANKABLE

In almost all the developing country, for a common, banking is mere a simple deposit and lending centre. This is mainly due to the large gap between the rich and the poor where the poverty amongst the poor never lets them to be facilitated with the banking as a whole. Basically two factors governs it, first is the banks had limited vision to innovate the need in the areas that suits the need for the common; at the second place nor did the customer had knowledge how could s/he bank upon his needs. Apart from this, the banks vision was to target the big which provides a logical sense to serve and earn. Except few banks in all the economy which were established with a prior objective to promote a specific philosophy like agriculture, health care, community development and/or others, financial institutions financed by government or private sector could not came out of the box to cache the financing need of poor, and even if they did the reach was far. This led the poor to rely on the traditional money lenders to manage their financial needs by pledging all their assets which has a market value.

Figure 3



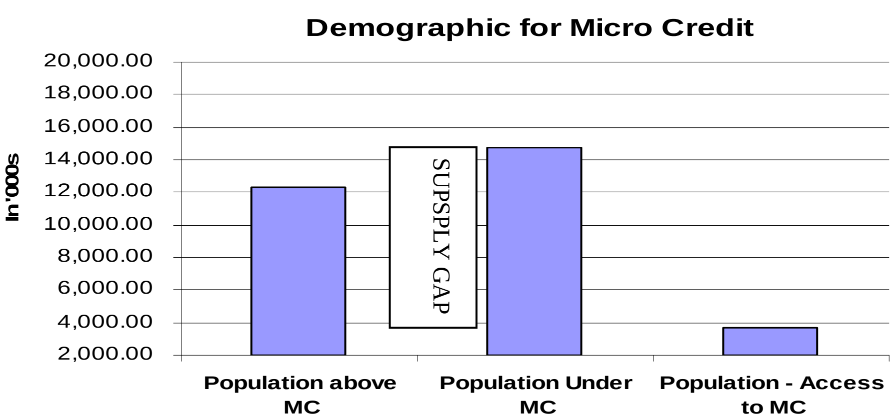
Cashing the needs and a practiced mechanism since early times, the money lenders had every opportunity to charge high costs of finance or interest on such finances which ranges from 30 percent to over 60 percent at times. At the end, the burden of repayment of principal itself, the additional interest on it forced to forgo the assets or collateral offered to the money lender ultimately leaving them much poorer.

The structured micro financing came in the year since 1990 with the establishment of Grameen Bikas Bank (GBB) in the regional level. Since then the micro financing movement has been intensified with the involvement of Financial Intermediary NGOs (FINGOs), Credit Unions, private and state owned Micro Finance Development Banks (MFDBs). Collectively known as microfinance, these financial services include loans for business and personal use, savings and other deposit products, remittances and transfers, payment services, insurance, and potentially any financial product or service a bank can offer to this market segment. The market segments include micro-enterprises, small farmers, low-income salaried employees, day laborers, pensioners, and poor households, which have historically been un-served or underserved by banks. The products and services can be targeted to meet the financial needs of the households as well as their income generating activities.

As estimated, of the total population of Nepal, more than 2.1M households live below poverty line and are in need of the microfinance services. Though the Micro Finance Institutions (MFIs) are expanding their bases to reach the maximum, they have been able to reach only around 0.7M households, the rest two third of the needy are still deprived of the services catered. Amongst the deprived 1.4M, more than 70 percent reside at the hilly region where the Micro Finance (MF) plan and access to them is the toughest. The reach of MF towards the low land has been higher and effective than the hills; the eastern terai belt is privileged than the tougher topography of western belt.

Contribution of MFI especially GBB in reaching the poor for their uplift and self- sustenance is high, however the costs involved for the same cannot be neglected. The self-sustenance of the MFI without the government funding, grants, aid or support from a donor agency is a question due to their mounting losses. The operating and service delivery costs are the highest for MFI operations where the number of clientele base is larger and the size of the credit ranges from minimum of Rs. 500 to maximum of Rs. 30,000. Due to the service cost to individual relationships are higher, income generated through such relationships make a weak credit sense. Further, financing the poorest of the poor without a collateral and performance of credit not generating income directly confers to the recovery of principal itself adding higher losses than the expected income to substantiate.

Figure 4



Considering the above, the philosophy of micro finance adopted in Nepal might get criticism and a logical view for its self-sustenance. This however if studied at the neighbors land, we see MF as huge potential business with varied opportunities to tap. The Grameen Bank of Bangladesh initiated and directed by Dr.

Mohammed Yusuf, the Nobel Laureate of 2006 and SKS Bank, India MF has been a profitable venture targeting the similar poorest of the poor who share lot in common in the context of stricken poverty with Nepal. The interesting facts of these banks are they work without the state support and grants, charge interest rate from 18 percent to 28 percent on their credit and have managed to be profitable with a handsome recovery rate, advocating micro-credit, arguing that it is only through collateral-free credit, made available in particular to poor, and that poverty can be alleviated.

However, despite the size of the microfinance market and cases of demonstrated commercial success in delivering microfinance, most commercial banks remain hesitant to enter this market, even though they are often in the best institutional position to service it. In large part, commercial banks misjudge the risk of microfinance: they overestimate the costs and underestimate the potential returns.

It can wisely be said that except one or two in contradiction, private sector banks in Nepal have achieved more efficient and sound performance than the state owned banks. This was mainly due to the aggress to perform, thrive to compete and grow. These were achieved from the quality manpower, proper risk management and innovate to lead approach. However, this achievement has always come from targeting the same rich who has easy access to the banking and with focused operation at urban cities targeting the primes. As every business, banking also needs constant innovation in its products and service delivery. With the space to play within the regulatory framework and customers banking needs that can be provided, all the banks offer similar products and services with minor deviations in the delivery process. The products are innovated to suite the customers need however by restricting in a certain capsule.

80 percent of the Nepalese population are concentrated in the semi urban and rural areas. Further classifying the population into class strata, over half of the population falls below the middle class segment. The upper middle class, upper class and upper upper class segment hardly occupy 25 percent of the bracket. The segmentation is primarily based on the recent census considering the reach of people to education, health, sanitation, and employment; no quantifiable study has been found to mark the differentiating line for stratification of class.

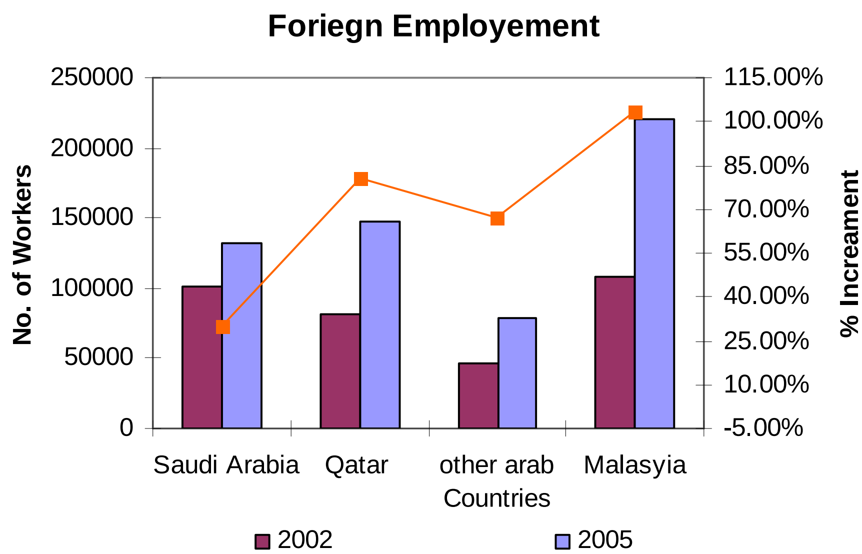
The focus of entire banking industry since past few years is growing to expand in the mid market. Due to the small size of bigger corporate market and higher concentration risk, mid market has turned as a potential growth provider with higher yield and less complexity. In the context of country’s demography, the size of the mid market is huge however due to the absence of reach and expertise in designing the ease products, there lies an enormous untapped opportunities.

Generally classified as a SMEs, the banking industry is in aggression to target the mid market in both deposit and lending products. SMEs have been lucrative for banking due to few basic factors like; easy monitoring, simple products, better yield, and comfortable tangible securities to cover the exposure and in some cases customized needs to be catered. Banks should specialize in mechanism to cater the needs of SMEs, this shall enhance self entrepreneurship, employment generation and sustainable growth in banking, economy and other areas of development.

MANAGING REMITTANCES

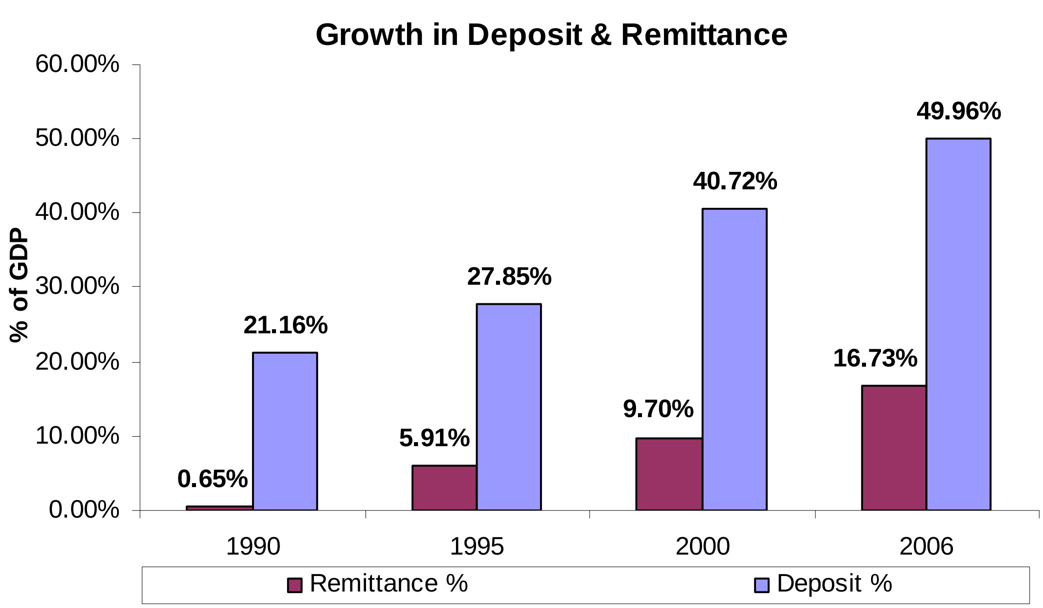
Remittance through foreign employment has been a significant contributor in savings of the banks in the Nepalese economy. The number of migrating population for employment is growing year to year see Figure 5.

Figure 5



The nature of labor force migrating are mostly the unskilled one rather than technical and the skilled. Looking at the trend, the migrating force falls under the bracket of population of below middle class level. Targeting this population, the prime focus of banks has been to route the remittance volume to Nepal and earn some fee and exchange income on their savings for the service offered. Following the same, some banks even have opened their counters for routing remittance in the foreign cities where the migrant population is larger.

Figure 6



The major portion of remittance received is mainly consumed as a household expenditure and some portion as savings. The banks should strategize the products based on remittance which should not only finance the consumer loans under real state buying but also to the area of self employment and entrepreneurship. Considering the level of knowledge of such people for better utilization of their resources, banks have to effort more on identifying small projects that are feasible to finance under entrepreneurship development. This further needs to be deciphered by the banks to the potential consuming class as an advisory role together with monitoring and evaluations. With the growing migrating population as labor force, the volumes of foreign remittance are expected to rise. Designing the sustainable product targeting this population is a great challenge; ability to crack the nut shall stretch the demand for banking with sound profitability.

PUBLIC PRIVATE PARTNERSHIPS FOR SUCCESS

Economic development brings opportunities for the people raising living standards with access to the minimum basic needs, this propels economic growth too. Nepalese terrain is dominated by hills and mountains. The accesses to a sound market from these areas are weaker due to the absence of proper infrastructure. Only 61 out of 75 district head quarters have road accesses, and not even one third of the total road length are black topped, and almost half the length rely on fair weather. The cost of air transport is beyond reach for the poor. Similar is the case in terms of health, education, safe drinking water, electricity, telecom, information technology – in totality the basic needs for today.

Access to poor and facilitate them in raising their living standard in sustenance can only be reached if they have stable income sources and easy reach to the basic services. The projects under poverty alleviation, micro finance, entrepreneur development, self sustenance and alike can only attain targeted vision if their beneficiaries have better market reach. Probable Public Private Partnerships (PPPs) projects needs to be identified, introduced and supported by government with flexible modalities. Banks, private sector, donor agencies, government and public should be involved in such projects for funding. This shall encourage knowledge sharing and effective monitoring and evaluation of projects from the pre – study phase to the completion of the projects, with a sense of belongingness amongst all the counterparts of the economy.

Further, banking sector has already shown their confidence in the infrastructure projects that are economically viable. Lending to small hydropower projects (upto 5 MW) where there is certainty for sale of produce can be taken as an example. Learning from small ones, the banks shall be interested in bigger projects as well that supports financial sense with expected repayment plan for their lending. At the other hand, the projects where financial sense of lending is weaker, however that adds higher value of social returns, the banks can still lend with soft interest rates as a corporate social responsibility, whereby the government takes the risks of default.

PPP projects directly supports development, catering the needs of common, insuring their future with new opportunities. The outcome of such partnerships shall be decentralized infrastructure development for equalized parity leading to a sustainable economic growth in the long run.

THE WAY AHEAD

The banking sector of Nepal since last one decade is going through a rapid metamorphosis. The need for sustainable growth through competition and prudent management has been the matter of prime importance. The challenges for 2010 and beyond as discussed above are evident, banks needs to refocus their strategy on strengthening their balance sheets and secure there specialized markets. The recent change in economic climate of the country is expected to bring peace and stability, promoting the overall growth of the nation by focusing on industrialization and infrastructure development. The banking should also prioritize their risk management on the aspect of credit management and treasury operations, proactive approach in creating specialized manpower in these areas shall enhance the efficient management. The banking shall face more challenges in future as we are in a transformation phase to a modernized banking from a traditional approach; It is clear that Nepalese will prove that they are productive managers in managing the same.

ENDNOTE:

1 **CB's** - Commercial Banks,
DB's– Development Banks,
FC's– Finance Companies,
MCDB's– Micro Credit Development Banks,
SACC's– Saving and Credit Cooperatives, and
NGO's - Non Government Organizations performing limited banking activities.

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