

The Role of Banking in National Economy: Opportunity in Productive Sector

Presented by:

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Outline

1. **Current economic situation of Nepal**
2. **The role banks have played in national economy**
3. **Contemporary challenges**
4. **Opportunities banks have to increase their role**

Current economic situation of Nepal

Economic growth and Inflation

- Economic growth has been 6.7% on average during the last three years. Inflation has been below 5%.
- Nepal is aspiring for a near double digit growth.

Table1: Economic growth and inflation

| | Economic growth | Inflation |
|---------|-----------------|-----------|
| 2014/15 | 3.0 | 7.2 |
| 2015/16 | 0.2 | 9.9 |
| 2016/17 | 7.4 | 4.5 |
| 2017/18 | 5.9 | 4.2 |
| 2018/19 | 6.8 | 4.5 |

External sector

- Recently, external position has deteriorated.
- BOP is in deficit and import coverage ratio has fallen to 7.7 months' import of goods and services.
- Stabilizing the external sector is a challenge.

Table 2: External Position (Rs in billion)

| | Trade A/C | Current A/C | Remittance | BOP | Forex |
|---------|-----------|-------------|------------|-----|-------|
| 2014/15 | -689. | 108. | 617. | 145 | 824 |
| 2015/16 | -703 | 140 | 665 | 189 | 1039 |
| 2016/17 | -917 | -10 | 695 | 82 | 1079 |
| 2017/18 | -1161 | -245 | 755 | 1 | 1102 |
| 2018/19 | -1321 | -248 | 799 | -91 | 1030 |

Public debt and fiscal space

- Nepal's total public debt stood at Rs 905.3 billion, consisting of external debt at Rs.519.5 billion and domestic debt at Rs.390.9 billion in 2017/18.
- While the world average public debt to GDP ratio was at 82 % in 2018, Nepal's was low at 30.1 % in 2018 , reflecting fiscal space which could be used for creating infrastructure, reducing poverty and narrowing regional disparities.

Table 3: Public debt

| F.Y. | Domestic | Foreign | Total |
|---------|----------|---------|-------|
| 1990/91 | 17.3 | 49.4 | 66.8 |
| 2000/01 | 13.6 | 45.7 | 59.3 |
| 2010/11 | 13.1 | 19.0 | 32.1 |
| 2015/16 | 10.4 | 17.0 | 27.4 |
| 2017/18 | 12.9 | 15.2 | 28.1 |

Budgetary position

- Budget has been under executed in Nepal.
- GON is maintaining cash balances with NRB.

Table 4: Federal budget (Rs in billion)

| | 2016/17 | 2017/18 | 2018/19 | Target |
|-------------------|---------|---------|---------|--------|
| Total expenditure | 815.7 | 1066.1 | 1015.5 | 1315 |
| Recurrent | 513.6 | 693.5 | 694.5 | 845 |
| Capital | 199.2 | 263.5 | 202.2 | 314 |
| Financial | 102.8 | 109.1 | 118.7 | 156 |
| Revenue | 609.1 | 726.7 | 861.6 | 945 |
| Grants | 14.5 | 28.4 | 14.6 | |
| Others | 3.9 | 5.5 | -- | |
| Deficit | -188.7 | -305.5 | -139.2 | |
| Treasury position | 106.2 | 89.5 | 107 | |

Employment

- Third Labor Force Survey shows that the working age population is 20.7 million.
- Out of this employed is 7.1 million and unemployed is 908 thousand.

Table 5: Employed population

| | |
|-------------------------------|---------------------|
| Working age population | 20.7 million |
| Employed | 7.1 million |
| Unemployed | 908 thousand |

- According to the GON, 1.7 million (17 lakhs) are registered as unemployed.
- Total number of Nepalese working abroad is estimated at 43 lakhs.
- Developing entrepreneurship is key for creating job opportunities.

The role banks have played in national economy

Credit growth

- Credit growth is exceeding nominal GDP and deposit growths in recent years.
- This reflects a role banks have played in supporting economic growth.

Table 6: Credit growth (%)

| | Nominal GDP | Private credit | Deposit |
|---------|-------------|----------------|---------|
| 2014/15 | 8.4 | 19.4 | 20.0 |
| 2015/16 | 5.8 | 23.2 | 19.4 |
| 2016/17 | 18.7 | 18.0 | 14.0 |
| 2017/18 | 13.3 | 22.3 | 19.2 |
| 2018/19 | 14.3 | 20.6 | 19.0 |

Job creation in the financial sector

- ▶ Financial sector is currently providing jobs to 118 thousand people.
- ▶ For young college graduates, banks are only hope for getting jobs.

Table 7: Employment in financial

| | Employment | % share |
|------------------|---------------|---------|
| Total employment | 7086 thousand | 100 |
| Financial sector | 118 thousand | 1.7 |

Entrepreneurship development in the financial sector

- ▶ The market share of state-owned banks has declined and that of private banks has gone up.
- ▶ The structure is the just opposite in India.

Table 8: Market share of private banks in deposit (%)

| | 2001 | 2018 |
|-------------------|------|------|
| State-owned banks | 51 | 15 |
| Private banks | 49 | 85 |

This shows how quickly private entrepreneurship developed in banking industry once it was opened for them.

There is opportunity in other areas of financial sector which are not developed yet in Nepal.

The role of finance in saving mobilization

- ▶ The other associated role of financial deepening is the churning of savings for capital formation,

Table 9: Gross domestic saving rate

| | Wt. avg. DR (%) | GDS /GDP (%) | GNS/GDP (%) | Remittance/ GDP |
|---------|-----------------|--------------|-------------|-----------------|
| 2015/16 | 3.28 | 4.08 | 40.12 | 29.52 |
| 2016/17 | 6.15 | 13.43 | 46.45 | 26.00 |
| 2017/18 | 6.49 | 17.82 | 47.10 | 24.91 |
| 2018/19 | 6.67# | 20.46 | 52.35 | 26.24 |

weighted average rate as of mid-May 2019.

- ▶ Rising gross domestic and national saving rates indicate potential for entrepreneurship development in Nepal.

The role of banking sector in capital formation

Table 10: Gross fixed capital formation as % of GDP

| | 2000/01 | 2018/19 |
|------------|---------|---------|
| GFCF | 19.2 | 36.9 |
| Government | 4.1 | 7.9 |
| Private | 15.1 | 29 |

- ▶ The good news is that the gross fixed capital formation ratio has increased to 36.9 % in 2018/19 from 19.2 % in 2000/01.
- ▶ Capital formation by the private sector has increased to 29.0% in 2018/19 from 15.1% in 2000/01.
- ▶ This reflects the role of finance for capital formation and entrepreneurship development.

Bank loans to the productive sectors

- ▶ The priority sector lending requirement (PSLR) is currently set at least a 25 % of loan portfolio in Nepal.
- ▶ Of this, the requirement for agriculture is at least 10% and energy and tourism combined is 15%.
- ▶ Actual loans provided under this scheme is just 17.2%
- ▶ In India, the PSLR is 40%, of which target for agriculture is 18%, microenterprises 7.5% and weaker sections 10%.
- ▶ **This offers opportunities for entrepreneurship development in Nepal.**
- ▶ **Such credit should be above 40%.**

The role of banks for private sector development

Financial deepening measured by M2, bank credit and deposit-to-GDP ratio reflects the role of banking sector for the private sector development in Nepal.

Table 11: Financial deepening in terms of GDP (%)

| | 2000 | 2018 |
|-------------------------------|------|-------|
| M2 | 56.5 | 102.9 |
| Domestic credit | 41.6 | 90.4 |
| Bank credit to private sector | 28.6 | 81.2 |
| Total deposit | 40.7 | 91.2 |

The **size of the financial sector** has exceeded the size of the national economy.

Table 12: Size of financial sector

| | As % of GDP (mid-July 2018) |
|----------------------------------|-----------------------------|
| Deposit taking incl. D | 122.9 |
| Contractual saving Organizations | 22.3 |
| Market capitalization of equity | 47.7 |

- **The size of financial sector holds the key for further entrepreneurship development in Nepal.**

NRB emerging as a strong regulator

- ▶ NRB has earned a fame of a strong regulator in Nepal.
- ▶ Adoption of global best regulatory and supervisory practices has made NRB a strong regulator.
- ▶ Professionalism in NRB has also played a role for it.
- ▶ This is positive aspect for entrepreneurship development.

Contemporary challenges

Retaining existing banking business models is the challenge

Existing models: There are three types of banking business models in Nepal.

1. Collateral-based:
 - ▶ Commercial banks: A class
 - ▶ Development banks: B class
 - ▶ Finance companies: C class
2. Group guarantee-based: D class
3. Membership-based: Cooperatives

Purposes of these models

- ▶ Commercial banks are meant for trade and corporate financing.
- ▶ Development banks are for SME financing.
- ▶ Finance companies are for consumer financing.
- ▶ Recently, Infrastructure Development Bank has come into operation.

Table 13: BFIs (as of June 2019)

| BFIs | No. | Branches |
|--|------------|-----------------|
| Commercial banks (collateral-based) | 28 | 3539 |
| Development banks (collateral-based) | 32 | 1250 |
| Finance companies (collateral-based) | 24 | 205 |
| Micro credit institutions (group guarantee based) | 91 | 3570 |
| Infrastructure development bank (collateral-based) | 1 | - |
| Total | 176 | 8564 |
| SACCOs (membership-based) | 14000 | |

Market share of these models

Table 14: The Market Share (Rs in billion)

| | Deposit | Loans | % of deposit | % of loans |
|----------------------------|----------------|--------------|---------------------|-------------------|
| Commercial banks | 2676 | 2405 | 76.4 | 71.8 |
| Development banks | 341 | 342 | 9.7 | 10.2 |
| Finance Companies | 69 | 65 | 1.9 | 1.9 |
| Micro Finance Institutions | 72 | 205 | 2.1 | 6.1 |
| Cooperatives | 346 | 333 | 9.9 | 9.9 |
| Total | 3504 | 3350 | 100 | 100 |

► Evolution of the banking structure

Table 15: Evolution of BFIs

| Mid-July/BFIs | A | B | C | D | Total | GDP (Rs billion) |
|---------------|----|----|----|----|-------|------------------|
| 2007 | 20 | 38 | 24 | 12 | 94 | 727 |
| 2010 | 27 | 79 | 79 | 18 | 203 | 1192 |
| 2012 | 32 | 88 | 70 | 24 | 214 | 1527 |
| 2016 | 28 | 67 | 42 | 42 | 179 | 2253 |
| 2018 | 28 | 33 | 25 | 65 | 151 | 3030 |
| 2019 June | 28 | 32 | 24 | 91 | 175 | 3465 |

- While cooperatives serve their 6.5 million clients, micro finance institutions 2.6 million.
- The mandatory deprived sector lending requirement of 6% amounting to Rs 174 million has contributed to the business of micro finance institutions.

Developing Alternative Investment Funds (AIF) is the challenge

- ▶ Some alternative investment funds (AIF) such as private equity (investment made in private companies not listed at stock exchange and investment made a later- expansionary phase, large investment) and venture capital (is the investment in early stage, small investment) are coming up to finance SMEs in Nepal.
- ▶ BO2 of IFC, Dolma with the support of DFID and Hydroelectric Investment and Development Company Ltd. are examples.
- ▶ These are at infancy stage. The challenge is to expand their operations further.

Raising the share of financial intermediation in GVA

- ▶ The share of financial intermediation in GDP is currently at 6.3%.
- ▶ While the GVA of national economy grew by 6.8 %, the GVA of financial intermediation expanded by 6.18%.

Table 16: Growth in financial intermediation

| | 2015/16 | 2016/17 | 2017/18 | 2018/19 |
|------------------------------|---------|---------|---------|---------|
| Real GDP (%) | 0.26 | 7.74 | 6.30 | 6.81 |
| Financial intermediation (%) | 8.55 | 9.09 | 6.38 | 6.18 |

Maintaining the health of financial institutions is the challenge

- Currently, the financial soundness indicators of banks are in good shape.
- ▶ The regulatory capital is 14%, above the threshold of 11%. NPA level is below 2%. Banks do not have a negative net worth.
- ▶ Most of BFIs are earning a reasonable level of profits.

Table 17: Net profit of commercial banks

| FY ending mid-July | Net profit (Rs in billion) |
|--------------------|----------------------------|
| 2014 | 21.3 |
| 2015 | 28.4 |
| 2016 | 38.1 |
| 2017 | 45.4 |
| 2018 | 53.6 |

Expanding the access to finance (A2F)

- ▶ The global financial inclusion (findex) data base developed by World Bank since 2011 is now popularly used for measuring financial inclusion.
- ▶ The key metric of financial inclusion is the proportion of adults having bank accounts.
- ▶ According to Findex, the percentage of adult having bank account at the global level is 69% on average.

Table 18: Adults having bank accounts at the global level and Nepal

| Year | Global (%) | Nepal (%) |
|------|------------|-----------|
| 2011 | 51 | 25.3 |
| 2014 | 62 | 33.8 |
| 2017 | 69 | 45.0 |

- ▶ The percentage of adult having bank account in Nepal is 45 %.
- ▶ India improved financial inclusion from 35% in 2011 to 80% in 2017 on account of JAM trinity -Jandhan Yojana account, Aadhaar (biometric identification) card and mobile connectivity announced on August 15, 2014.
- ▶ **Expanding financial access to that of India's level offers opportunities for entrepreneurship development in Nepal.**

Applying the appropriate theory of banking

- There are three theories of banking, namely:
 - i. Fractional reserve theory of banking
 - ii. Credit creation theory and
 - iii. The financial intermediation theory/loanable funds theory
- Because of low level of CRR, fractional reserve theory is not that relevant. Credit creation theory has empirical issues.
- For policy purposes, loanable funds theory is more relevant.
- Designing appropriate policies on interest rate, regulatory capital and CCD ratio are challenging for securing stability and promoting growth.

Deciding on appropriate banking structure

- Nepal needs to decide on monopoly or competitive banking structure.
- Significant reduction in the number of commercial banks through forceful mergers will likely lead to the monopoly power in the hands of few banks.
- A regulatory capture like situation will develop.
- The collusive behavior of banks will further accentuate, making monetary policy ineffective.
- Banks are unlikely to decrease lending rates with a decrease in the policy rates.
- The customer reaction hypothesis is not workable in Nepal because of collusive behavior of banks, suggesting upward biasness of lending rates.
- Search and switching costs for borrowers also make the customer reaction hypothesis ineffective.

Opportunities

Growing economy

- ▶ During the last three years, the Nepalese economy grew by more than 6.5%.
- ▶ The GON is aiming at the double digit economic growth.
- ▶ The commitment to transform the economy into middle income country by 2030 provides business opportunity for banking industry.

Overcoming the resource gap

- ▶ Currently, Nepal faces resource gap of about Rs 300 billion, 9.9% of GDP.

Table 19: Resource gap

| Year | GCF/GDP (%) | GNS/GDP (%) | Resource gap/GDP (%) |
|---------|-------------|-------------|----------------------|
| 2015/16 | 33.87 | 40.12 | 6.23 |
| 2016/17 | 46.82 | 46.45 | -0.38 |
| 2017/18 | 55.18 | 47.10 | -8.09 |
| 2018/19 | 62.25 | 52.35 | -9.89 |

- ▶ Once the problem of resource gap is surmounted, banks will have opportunities to expand credit including the productive sector.
- ▶ Raising domestic saving and mobilizing external capital are key for bridging the resource gap.

Scaling up of investment

- ▶ Nepal's plan to transit to the lower middle income country by 2030 and higher middle income country by 2043 calls for the average annual investment required is about US dollar 20 billion (more than Rs 20 trillion).
- ▶ The current gross fixed capital formation (Rs 1279 billion) is 36.9% of GDP.
- ▶ Clearly, there is a need for a huge scaling up of investment up to 55% of GDP.
- ▶ Mobilization of this scale of investment has potential for further growth of banking industry in Nepal.

Reducing the size of shadow economy

- ▶ According to the World Bank, the size of shadow economy is 37% of GDP.
- ▶ The way forward is the government playing an active role for financial sector development.

Increasing financial access

- ▶ It is still low at 45% according to the World Bank Findex report.
- ▶ Financial sector development has the potential to mobilize resources needed for federal Nepal

Attracting FDI. It is very low

- Globally, FDI (around \$1.5 trillion) is the largest flow followed by remittances (around \$600 billion) and ODA (around \$130 billion).
- In the case of Nepal, remittances (Rs 755 billion) are the largest followed by ODA (Rs 131 billion) and FDI (Rs 17.5 billion).

Table 20: Flow of financial resources

| Sr. | Resource | Global | Nepal (2018) |
|-----|------------|-------------------|-----------------|
| 1 | FDI | US \$1.5 trillion | Rs 17.5 billion |
| 2 | Remittance | US \$ 600 billion | Rs 755 billion |
| 3 | ODA | US \$ 130 billion | Rs 131 billion |

► The way forward for attracting FDI is initiating governance reforms.

- ▶ The government, the central bank and banks must collaborate for improving governance structure.
- ▶ This is needed because, Nepal ranks low in Transparency International's corruption perception index and the World Bank's the ease of doing business index.

Table 21: Nepal's rank in CPI and ease of doing business index

| | Nepal | India |
|------------------------------|-------|-------|
| Corruption perception index | 124 | 78 |
| Ease of doing business index | 110 | 77 |

- ▶ The way forward is improving Nepal's rank at the par with India's.

Changing the banking business model to the differentiated one.

- ▶ This is important to integrate the financial sector with the national economy.
- ▶ The new model is also needed for increasing bank credit to the productive sector to 40%.
- ▶ India has varied BFIs for integrating the system with the national economy.
 - i. NABARD for rural financing
 - ii. EXIM bank for integrating trade, investment, MSMEs and growth
 - iii. NHB and HDFC for housing development
 - iv. IDBI, SIDBI, IFCI, IIBI, and ICICI for industrial development
 - v. Infrastructural Development Finance for Infrastructural development

► Improving efficiency of banking industry

- a. Allocative efficiency: resources should be allocated to high yielding sectors.
 - b. Operational efficiency: should be competitive with a lower financial intermediation cost and
 - c. Dynamic efficiency: it should further the financial deepening and cater consumers with well diversified financial services.
- The way forward is allowing market forces to function.
- Interest rates should play an equilibrating role.

- ▶ **Modernizing the banking industry: The way forward is:**
 - using fintech on a massive scale.
 - using internet banking, mobile banking and branchless banking for reducing cost and increasing financial inclusion.
 - utilizing smart phone technology to a fuller extent.
- ▶ India has revolutionized the Indian banking industry through the introduction of biometric ID (Aaadhar) card.
- ▶ The Government of India played a key role in introducing such innovations.
- ▶ We expect GoN to do the same.

Separating bankers and borrowers

- ▶ Once this issue is settled, there will be transformative changes in Nepalese banking industry.
- ▶ Uses of financial resources will get diversified.
- ▶ Banks are also likely to be innovative

Replacement of CCD ratio will bring about transformative changes

- ▶ Currently, CCD ratio acts as the nominal anchor for banking sector stability.
- ▶ Once we introduce LCR and NSFR, there is no need to keep CCD ratio.
- ▶ Interest rate structure will be also rationalized as CCD ratio has distorted the market interest rate structure.
- ▶ Banks will get competitive rates on treasury bills including development bonds.

Regulatory reforms

- ▶ Many countries have recently introduced regulatory reforms aimed at boosting credit to the productive sectors.
- ▶ For example, USA has increased the SIFI threshold of assets from US dollar 50 billion to US dollar 250 billion.
- ▶ Because of this reform, the regulatory burden has eased. As a result of this, credit flow to the economy has increased.
- ▶ India has classified SIFIs as those having assets more than 2% of GDP.
- ▶ Accordingly, SBI, ICICI and HDFC are categorized as SIFIs.
- ▶ Nepal will have to classify BFIs according to that line to ease regulatory burden.
- ▶ There is no point applying stress testing for micro finance.
- ▶ Now time has come to apply proportionality principle for regulation and supervision.

THANK YOU!