ICRA NEPAL COMMENTS ON MONETARY POLICY FOR 2018-19

CCD ratio for banks not increased and hence remains a positive in terms of curbing recent high credit growth in industry; easing out of CRR/SLR and reduction of interest rate spread could reduce lending rates to an extent

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Highlights of the NRB's Monetary Policy for FY2018-19 – July 2018

- In line with our expectations, NRB did not increase the CCD[1] cap for the banking sector (currently at 80%). Monetary policy has also highlighted the inclusion of long term debentures as a part of CCD which was earlier introduced in Unified Directives of FY17/18.
- NRB has reduced the CRR to 4% for all classes of BFIs (earlier 6% for commercial banks, 5% for development banks and 4% for finance companies). Additionally, SLR has also been reduced to 10%, 8% and 7% for class A, B and C BFIs respectively (earlier 12%, 9% and 8%).
- Interest rate spread for class A banks has been reduced by 50 bps to 4.50%, with further indication to bring it down gradually.
- Following the declaration in budget for FY18/19 to initiate Nepal's Country rating, Monetary Policy has also mandated all commercial banks to be rated by national/international rating agency on an annual basis. Large branches of the banks are also to be audited independently. Further, borrowers availing/renewing facilities equals to or more than NPR 500 million are also required to be externally rated. Additionally, borrowers availing working capital loan more than NPR 250 million must get their net current assets certified independently.
- Rates under interest rate corridor has further been constrained at 3.5% to 6.5% (earlier 4%-7%). Policy rate, i.e. the two week's repo rate has been kept constant at 5%.
- Banks can now borrow up to 25% of core capital from foreign banks in INR which is in addition to earlier regulations allowing up to 25% of core capital as FCY borrowings.
- Monetary policy has stated that merger of commercial banks would be facilitated. The policy also highlights on identification, regulation and supervision of systemically important banks (SIBs).
- Given the high variation seen in valuation norms for real estate property across BFIs, NRB has planned to introduce collateral valuation guidelines. Real estate price indexing is also planned to be started shortly.
- Monetary policy has removed the 18% cap on interest rate for MFIs and reduced the interest rate spread of MFIs to 6% vs. earlier 7% (spread is to be maintained over total of cost of funds and operating costs up to 3%[2]). Total borrowing of an individual from different MFIs cannot exceed regulatory cap (NPR 5 lacs for unsecured and NPR 7 lacs for secured) and MFIs are to compulsorily obtain membership of Credit Information Bureau; additional 2% provisioning required for non-compliance.
- Limit for personal OD has been reduced from NPR 7.5 million to NPR 5 million
- BFIs can now only add up to 1% on published FD rates (earlier up to 2% allowed) while bidding for deposits.
- Commercial banks would be required to establish provincial offices in all 7 provinces within FY18/19. Also, NRB approval is not required for opening branches in other than metropolitan and sub- metropolitan areas.

[1] Credit (LCY) to core capital and deposits (LCY)
[2] As clarified by Circular dated 18th July 2018.

- Broker license to be provided to subsidiary of commercial banks established solely for operating as share broker.
- Ceiling for deposit insurance from individuals to be increased to NPR 3 lacs from existing NPR 2 lacs.
- NFRS Implementation has been extended to class B and C BFIs as well; these BFIs are to prepare NFRS compliant financials from FY19.
- Mechanism to be devised to cross check financials submitted by borrowers to banks and to tax authorities; tax clearance/submission certificate mandatory in every approval/renewal of loans to firms and companies.

<u>Macroeconomic outlook and NRB forecasts:</u>

- NRB has reduced its baseline forecast for GDP growth for FY2018 at 5.9% (7.4% during FY2017) vs. 7.2% growth targets; this was impacted mainly by impact of floods in terai region leading to low growth in agriculture sector while other sectors witnessed better growth rates. Monetary policy targets to support 8% GDP growth targets for FY19 as envisaged by fiscal policy for the year.
- NRB forecasts CPI inflation to be within 6.5% for FY19 (4.5% for FY17 and 4.1% for 11MFY18). Earlier in its Monetary policy of FY2017/18, NRB had forecasted CPI inflation to be constrained within 7% which was revised to 6% in mid-term review of the policy. Given the growth targets set by fiscal policy, rising imports (dominated by vehicle/parts and petroleum) and devaluation of NPR with respect to USD, inflationary pressure is expected over medium term.
- Rising imports leading to massive trade deficit (~34% of GDP in 11MFY18) amid moderate growth in remittance inflow (7.3% YoY) has led to increasing current account deficit. BOP is also currently in deficit by ~NPR 4 bn in 11MFY18 (~NPR 82 bn surplus in FY17), hence presenting a weakening state of the economy.

Outlook

Inflation risks related to commodities and perishables have escalated in recent months given the highly import reliant economy and devaluation of NPR w.r.t USD (~5% decline in last three months ending mid-Jul-18 reaching to ~NPR 110/USD). One of the major imports viz. petroleum has witnessed sizeable price hike in international market in recent periods. Additionally, there are concerns related to inflationary pressures arising from fiscal policies of the central and state governments. Nonetheless, the agriculture output is expected to remain good compared to last year given the normal monsoon this year. The CPI is heavily weighted toward food items (~44%), the prices of which tend to be quite sensitive to small changes in supply-demand dynamics. Therefore, volatility in the monthly CPI inflation readings would continue, imparting a cautious bias to monetary policy setting in Nepal, in our view.

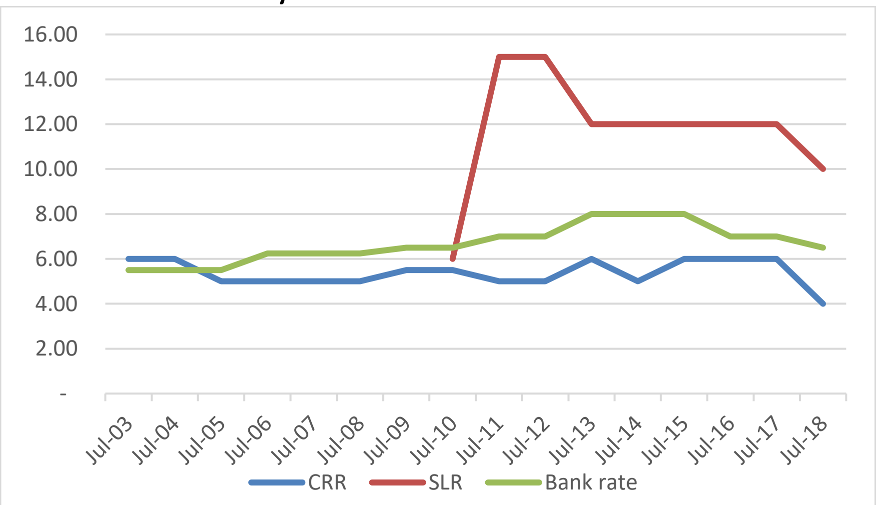
No change in existing CCD Norms:

In line with our expectations, NRB did not increase the CCD cap for the banking sector (currently at 80%) hence inducing banks to grow their credit portfolio based on deposit growth in the industry. CCD ratio of commercial banks was ~77% as of mid-Apr-18 (~69% in Jul-16), leaving minimal room for further credit growth as deposit growth is expected to be limited amid slowing remittances. In case of continued lower growth trend of deposits as seen in recent years, banks would need to consolidate the portfolio grown during last 2-3 years and maintain a cautious portfolio growth approach going forward.

CRR and SLR reduced:

NRB has reduced the CRR to 4% for all classes of BFIs (earlier 6% for commercial banks, 5% for development banks and 4% for finance companies). Minimum 70% of CRR must be deposited at NRB on daily basis as clarified by circular dated 18^{th} July 2018. Additionally, SLR has also been reduced to 10%, 8% and 7% for class A, B and C BFIs respectively (earlier 12%, 9% and 8%). This would free ~NPR 48 billion (as per NRB estimates) and hence result in lower cost of CRR/SLR leading to slightly reduced base rate, provided the banks are able to curtail further increment in cost of deposits. Though CRR and SLR requirement remains relatively lower among South Asian Economies, CCD ratio cap of 80% is expected to mitigate the concerns emanating from lower CRR/SLR ratios.

Chart 1: Movement of key rates



Additionally, CRR and SLR is not required to be maintained for 3 years on deposits to be garnered from local level branches (these branch openings were mandated by NRB to facilitate banking transaction under provincial system). Hence, effective CRR and SLR could be lower if sizeable deposits are raised from these branches (mainly the budget of related local level).

Cap on Interest rate spread reduced:

Interest rate spread for class A banks has been reduced by 50 bps to 4.50%, with further indication to bring it down gradually. This is expected to have a limited impact on bank profitability as most banks currently operate within this margin. Given this decrease and the possible incremental investment yields from the amount to be freed from lowered CRR/SLR requirements, slight reduction in lending rates can be expected to ensure lending spread cap. However, regulations are still unclear regarding the modality of passing on base rate to borrowers; base rate currently being calculated taking on cost of fund of recent month while passed on to borrowers quarterly. Hence, interest spread of commercial banks could witness erratic movement, especially at times of volatile interest rate scenario like now. Class B and C BFIs are to cap interest spread within 5%; this might impact their profitability to an extent as the spreads for these BFIs are usually higher than 5%.

Bank loan ratings to be started; tax payments on income shown by borrowers to banks also to be ensured while loan sanctions/renewals:

Borrowers availing/renewing facilities equals to or in excess of NPR 500 million will be required to be externally rated by credit rating agencies. Although rating of lines of credit (borrower) is not linked with risk weight under BASEL for current time, this is expected to improve financial reporting transparency of large borrowers over the medium term. Additionally, borrowers availing working capital loan in excess of NPR 250 million have to get their net current assets certified independently. SME borrower's financial transparency could also improve as cross-checking mechanism of financials submitted to bank and to tax authorities is also being prepared. Monetary policy also requires tax clearance /submission certificate to be compulsorily obtained for sanction/renewal of loans to firms and companies.

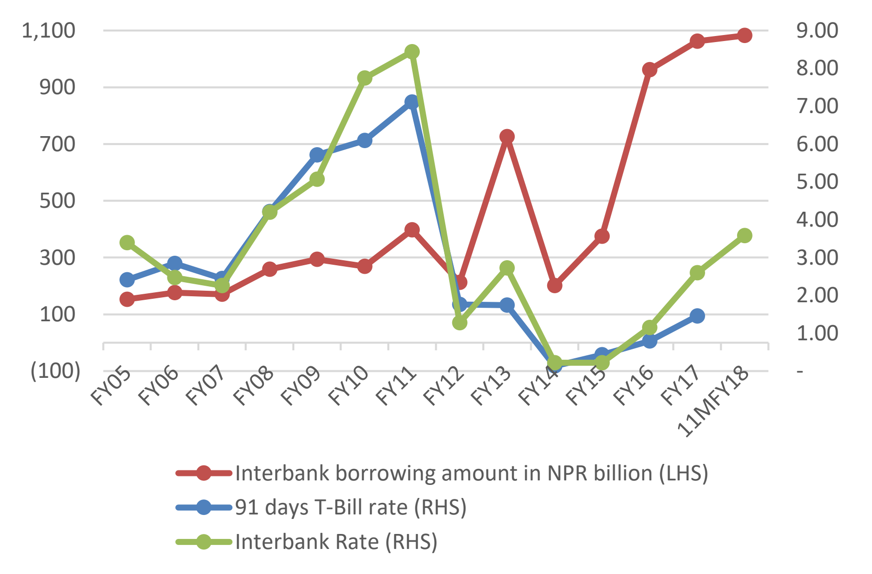
Promotion to debt market:

The policy has also highlighted the inclusion of long term debentures as a part of CCD which was earlier introduced in Unified Directives of FY17/18. Till now, most of the banks are comfortable on capitalisation front given the sizeable equity enhancement in last two years as well as retention of most of the internal accruals. However, cash dividend is expected to witness major boost from FY17 profits and hence capitalisation would have to be supported by tier-II bond issuance from banking sector. Given the low composition of debt instruments in overall capitalisation so far, bond/debenture issuance is expected to witness increment over medium term. This is also expected to provide some avenues to minimize long term liquidity mismatch in banking sector as well as provide much needed breadth to debt market.

Gaps in policy rate corridor reduced:

Rates under interest rate corridor has further been constrained to 3.5% to 6.5% (earlier 4%-7%) with means to provide more stability to short term interest rates; upper bound rate in the corridor is standing liquidity facility rate while lower bound rate is two weeks' deposit collection rate. Policy rate has been kept constant at 5% which is two weeks' repo rate.

Chart 2: Movement of T-Bill rates, interbank rates and interbank volumes

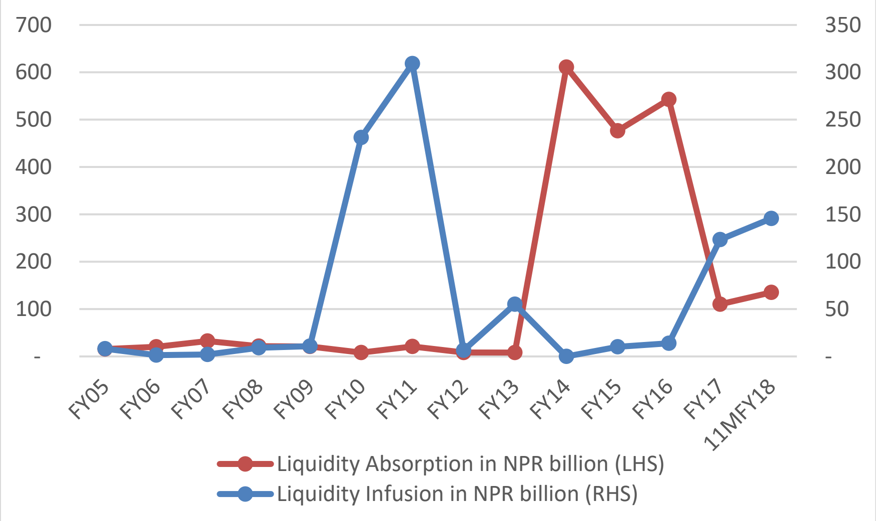


Interbank lending volumes has witnessed upsurge in recent years. However, interbank rates, despite the related upswing, remains at 3.58% for 11MFY18. This was partly due to introduction of interest rate corridor as well as banks facing acute shortage of lendable funds, rather than core liquidity. Earlier, in absence of CCD caps (this was introduced only in FY12), interbank lending (even among commercial banks) were used to finance advances which is not the case now.

Liquidity across banking sector

NRB reiterated its stance to maintain neutral liquidity conditions with minimal fluctuation in short term interest rates. Liquidity in banking sector has been seen comfortable towards year end (mostly Jul-Sept) in last two years which has gradually tightened in following months, as evident from liquidity infusion and absorption trend. The daily average liquidity infusion increased progressively during FY17 and 11MFY18 from NPR 338 million to NPR 437 million vs. minimal infusion in earlier 2-3 years. Liquidity absorption which used to be in the range of NPR 1.3-1.7 billion per day in FY14-FY16 has declined to NPR 300-400 million in FY17 and 11MFY18. With reducing liquidity surpluses, the interbank lending rate (across commercial banks) stood at 3.58% for 11MFY18 as against 2.60% for FY17 and 1.15% for FY16.

Chart 3: Trend of liquidity absorption and infusion by NRB



As can be seen above, volume of liquidity absorption has significantly reduced in recent periods while the volume of liquidity infusion is following a gradual increasing trend. Liquidity infusion includes all monetary measures including repo, standing liquidity facility and outright purchase while absorption includes reverse repo, deposit auction etc.

Increased FCY borrowing avenues:

Banks can now borrow up to 25% of core capital from foreign banks in INR which is in addition to earlier regulations allowing up to 25% of core capital as FCY borrowings. This could help raise borrowings at lower cost (as INR borrowings entails no hedging costs) and hence supports bank's credit growth over near term. Bank's with international presence/backing could remain more benefitted by this provision.

Promotion of merger of banks as well as tighter supervision of SIBs:

Monetary policy has stated that merger of commercial banks would be facilitated and hence this could remain a positive for stability in banking sector which is characterized by too many players in a niche market. The policy also highlights on identification, regulation and supervision of systemically important banks (SIBs). This is also a positive with regards to close regulatory supervision of large banks. Supervisory additions to capitalization ratios are expected for SIBs once the same are identified and pace of growth of these banks are expected to be moderated vs. non-SIBs.

Tightening in real estate valuation norms:

Given the high variation seen in valuation norms across BFIs, NRB has planned to introduce collateral valuation guidelines to make the practices uniform. Real estate price indexing is also planned to be started shortly. However, overall cap on real estate sector prevails at 25% of total portfolio (including 10% cap for core real estate including land purchase and plotting) despite significant increase in asset base of banks in last few years.

Changes in norms related to loan against shares

BFIs can now lend only up to 25% of core capital towards this segment as against 40% earlier. Given the sizeable increase in capital base of banks in last two years, this decline was expected. Nonetheless, this is not expected to impact BFIs to a large extent as the overall industry's exposure to this segment remains low so far (~11% of capital fund of BFIs as of mid-May-18). However, some BFIs having relatively higher exposure would have to downsize these loans to an extent.

In addition to above, margin call on such loans is not required until 20% decline in share price of pledged shares (earlier margin call had to be started after 10% decline in prices). This would provide some respite to investors in the current declining market scenario. Further, circular following the monetary policy has stated that margin call is not required until the value of shares is 1.6 times of the outstanding loan amount.

Impact on Micro Finance (MF) sector

MFI sector would be benefitted mainly by withdrawal of 18% cap on lending rates. With no upper cap on lending rates, monetary policy has now stated that only the interest rate spread of MFIs to be within 6% vs. earlier 7%; spread is considered over total of cost of fund and operating costs up to 3% (earlier 4% allowed). Operating costs for large players are in the range of 4-5% while the same for new age and smaller MFIs are in the range of 5-7%. Cost of funds for the MFIs are currently in range of 9-11%. Hence, large MFIs with better cost of funds are expected to be benefitted by this provision while smaller MFIs would need to develop scale economies. Nonetheless, even the smaller MFIs with higher operating costs would be enjoying 2-3% net spreads now vs. negligible spreads for these MFIs so far. Additionally, fee-based income could provide further respite.

Though deprived sector lending targets for Class B and C have been increased by 50 bps and 100 bps to 5% for both, exposure of these are already above 5% and hence no major benefit is expected from this front. As BFIs can directly foray into deprived sector lending given the increased ticket size that qualify as deprived sector (up to 10 lacs; 15 lacs for women run business), this could result in lower funding source of MFI sector over medium term.

In addition, MFIs are to become members of Credit Information Bureau compulsorily and failure to regularly submit information to the bureau would attract 2% additional loan loss provisioning. Further, total exposure of a borrower across multiple MFIs cannot exceed the regulatory cap for MFI lending (NPR 5 lacs for unsecured and NPR 7 lacs for secured as of now). Licensing of new MFIs has been kept on halt and mergers of MFIs is being promoted which remains a positive given the presence of large number of players in the industry (62 as of mid-May-18).

Current macroeconomic indicators:

Rising trade deficit in recent years has led to BOP deficit in 11MFY18 by ~NPR 4 billion vs. NPR 82 billion surplus in FY17. Remittance inflow remains a major support in this front. However, the growth rate of the same seems lowering in recent years which remains a concern in lack of other major foreign income inflow sources.

Chart 4: Trend across major macroeconomic indicators (Data in NPR billion)

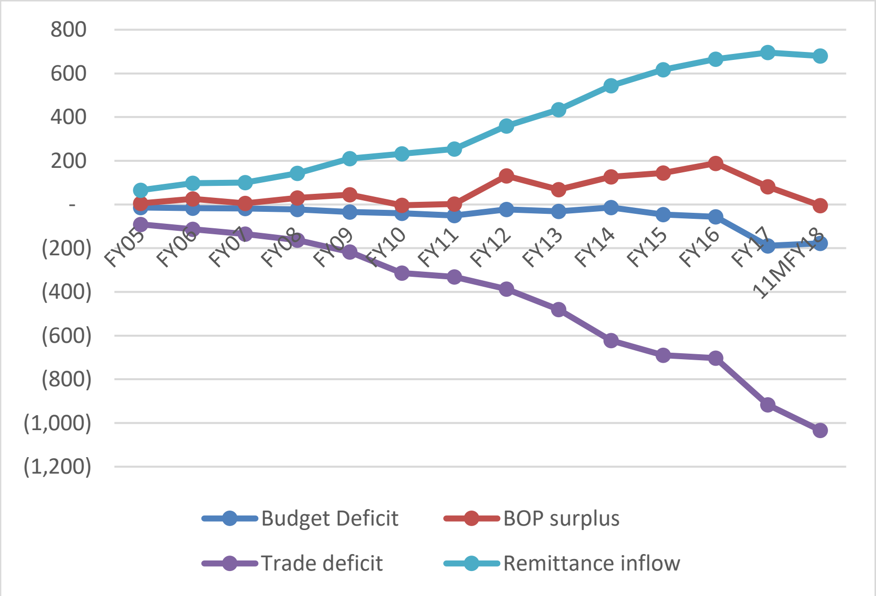
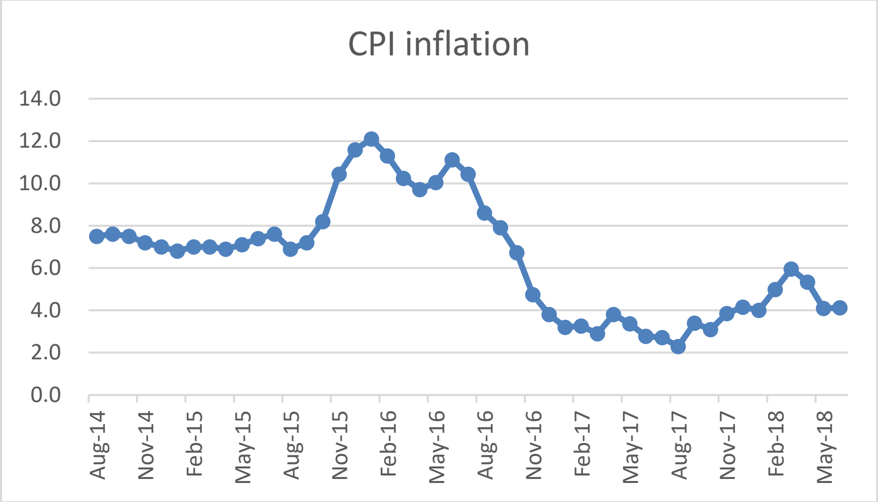


Chart 5: Monthly CPI Inflation (Y-O-Y)



CPI inflation has eased out in last two years. However, expected to increase to an extent given the expansionary fiscal and monetary policies to facilitate higher GDP growth vs. earlier years.

Other Key Developments

Priority sector lending requirement modified

Commercial banks were required to lend 25% of their credit portfolio towards priority sector comprising of agriculture, energy, tourism and others (export oriented, SME, pharmacy, cement and garment industries). Within the overall cap, minimum 10% was to be met towards agriculture and 5% each for energy and tourism; rest could have been towards other sectors. This has been modified to minimum 10% for agriculture and 15% for energy and tourism sector combined. The combined limit for two sectors may lead to banks prioritizing one of the sectors among these two. Banks had ~24% exposure to current definition of priority sector as of mid-June-18. After removing the "others" category as priority sector for commercial banks, the banks would remain largely short of the minimum requirements to be met. Given the deadline for this set at mid-Jan-19, this would remain a key challenge for commercial banks.

Priority sector lending requirement for class B and C BFIs has been kept unchanged at 15% and 10% respectively with no sectoral demarcation of overall lending requirement. Definition of priority sector for these BFIs has also been kept the same. Hence, these would remain in comfortable position regarding this lending requirement.

Refinance budget of NRB enhanced

NRB is also increasing its refinancing budget to NPR 35 billion (NPR 20 billion last year). This is expected to provide some support to borrowers from priority sectors through lower interest rates. Banks get this facility at 4% for general refinancing and 1% for special and import refinancing. Lending rates to borrowers in this case cannot exceed 9% and 4.5% respectively. Owing to low volume of exports from the country, export refinancing remains minimal compared to general refinancing; most of these are towards hydropower entities so far.

NFRS implementation extended to Class B and C BFIs as well

As per NFRS implementation timeline of Institute of Chartered Accountants of Nepal, Class A commercial banks were supposed to prepare the NFRS compliant financials from FY15/16 onwards while other classes of BFIs were supposed to implement the same from FY16/17 onwards. However, the format of financial statement specified under current banking regulations was not compatible with NFRS. Additionally, the level of preparedness among the banks was also not up to desired level. Hence, most of the BFIs (even commercial banks) were yet to prepare NFRS compliant financials. Monetary policy has now indicated that NFRS implementation will be made mandatory for class B and C BFI as well from FY19 onwards. Shortly after the policy announcement, NRB has issued NFRS compliant model financial statements for commercial banks. Similar developments for other classes of BFIs are expected soon.

Cap on deposit from sole depositor reduced; max. 1% can be added to published FD rates

NRB has reduced cap on deposit collection from sole institutional depositor from 20% to 15%. This however still remains on a higher side. Further, only 1% can be added on published FD rates while bidding for deposits (earlier this was 2%). This remains a positive in terms of helping banks in avoiding high spike in cost of funds.

Broker license can be provided to subsidiaries of commercial banks; positive move for development of capital market

Monetary policy has stated that share broker's license can be provided to subsidiary of commercial banks established for the purpose of acting as share broker. This remains positive in terms of development of capital market as reach of the market could increase to far corners of the country utilising the franchise strength of commercial banks.

Limits on personal overdraft reduced

NRB has further reduced limits on personal overdraft from NPR 7.5 million to NPR 5 million. This is a good move as this product is largely unmonitored with no track of end uses in general and hence could have been utilised towards speculative sectors. Borrower's ability to repay a part of loans to comply within the said regulations remains to be seen.

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