



Snowball Capital’s Memo on the Banking Sector Post Covid-19

Background

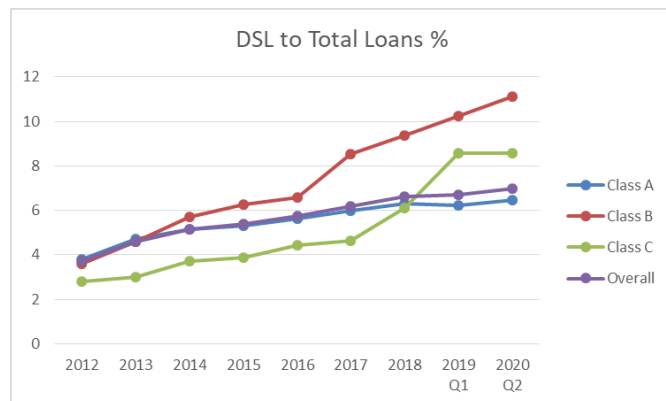
Even prior to the lockdown, banks had started experiencing decreased growth rates (single digits) after a run of at least 3 years with average growth nearing 20%.

Interest rates continue to be capped and reduced, resulting in continued high credit demand and preventing cut-throat competition for market share amongst banks based on 'price'. The fixed interest environment has created a sort of 'stagnancy' in the credit market with overall reduced deposit and credit growth (even though demand remains high).

While Q3 reports are yet to be published as of Baisakh 6, it is most likely to be weak given the lockdown in the last month. With squeezed growths of deposits and loans, the profitability is expected to stagnate or fall. Also, due to uncertainty in adherence to new circulars from NRB regarding the provisioning of loans and others, we will have to wait longer than usual for the third quarter reports.

As of Mid-Feb 2019/20, the growth in deposits of overall BFIs was 7% as compared to 9.2% in the same period last fiscal year. Similarly, loan growth was 9.36% up to mid Feb this year compare to 13.51% in the same period last year. NRB data post-Mid-March (not published yet) is most likely to show a clearer picture of the pandemic-hit Nepalese financial sector.

Fiscal Year	Deposit Growth	Credit Growth
11-12	23.10%	13.18%
12-13	16.71%	21.01%
13-14	18.24%	18.20%
14-15	19.89%	20.44%
15-16	18.91%	23.59%
16-17	13.19%	18.61%
17-18	18.95%	21.45%
18-19	18.22%	20.26%
Mid-Feb 19/20	6.29%	9.44%



CASA ratio stands at 38.30%, which is the least in since 2010. Similarly, the FD ratio is 49.05%, the highest ratio since 2010. This demonstrates the shift of investors from savings to fixed deposits.

DSL (Deprived Sector Lending) of BFIs stands at 7% as of 2nd Quarter 2019/20 which is the highest since 2012. DSL is the primary source of funding for micro-finance companies.

Covid-19

It is expected that the COVID-19 pandemic will bring an unprecedented crisis in the economic sector. According to the Nepal Economic Forum, the short-term and long term challenges of the pandemic are:

1. Asset Quality

NRB has brought some relief packages to stimulate the economic sector, which includes discounts in interest amount and extension of the penal date to next quarter. However, this extension might create further problems. How will a business be able to pay a lump sum



6months' interest during lockdown? Since hotels, industries, automobile businesses are in complete lockdown, it will be difficult for them to pay their debt. This will result in an increase in NPL and decrease in profitability. Therefore, it is a huge challenge for BFIs to maintain asset quality. NRB's relaxation of rules for NPA may help in the short term but long-term ramifications will remain.

'It's only when the tide goes out that you learn who has been swimming naked' as quoted by Buffet. During periods of uncertainty, BFIs which have poor Asset quality will be disproportionately affected by the pandemic. For instance, the lenders which are highly leveraged will have difficulty in paying interests and principle to the banks.

Sector-wise Outstanding Credit of Banks and Financial Institutions

<u>Heading</u>	<u>2020</u>	<u>%</u>
	<i>Feb (P)</i>	
<i>1. Agriculture*</i>	214,465.20	6.74%
<i>2. Mines</i>	6,917.40	0.22%
<i>3. Productions</i>	527,876.10	16.59%
<i>4. Construction</i>	341,029.60	10.72%
<i>5. Metal Productions, Machinery, and Electrical Tools and fitting</i>	40,525.40	1.27%
<i>6. Transportation Equipment Production and Fitting</i>	47,164.90	1.48%
<i>7. Transportation, Communications and Public Services</i>	194,775.90	6.12%
<i>8. Wholesaler and Retailers</i>	659,230.90	20.72%
<i>9. Finance, Insurance, and Fixed Assets</i>	248,555.00	7.81%
<i>10. Service Industries (including Tourism)</i>	273,953.60	8.61%
<i>11. Consumable Loan</i>	91,016.70	2.86%
<i>12. Local Government</i>	1,564.30	0.05%
<i>13. Others</i>	535,005.60	16.81%
Total (1 to 13)	3,182,080.50	100.00%

■	Directly/Heavily affected
■	Indirectly/Moderately affected
■	Low affected

As on Feb 2020, the outstanding credit of Banks and Financial Institution (BFI) stands at 3,182 Arba (3,18,200 crores). From the table above we can see the loan portfolio of BFIs is highest in the wholesaler and retailers sector (20.72%) and second in the production sector (16.59%).

Our conjectures and thinking with regard to the impact of COVID-19 on the individual sectors of the BFIs loan portfolio are as per the table above. Most of the sectors lie on Indirectly/moderately affected sector. Whereas Service Industry which includes Tourism, hotel, educational services, entertainment, recreation, films are classified under directly/ heavily affected. We believe agriculture will not be affected in a meaningful manner. We will be talking in more detail about the impact on the hotel industry in another article.

Despite the classification of the loan portfolio to its inherent risks, we must keep in mind that anything that affects the economy will have an impact on the banking sector. Banks sit at the heart of the economy and provide funding to corporates and individuals. Their stability is crucial to keep the system up and running. **Currently, the sector seems to be in a strong, well-capitalized position to withstand the expected economic slowdown/crisis.**

2. Interest Rates



Commercial Banks have started decreasing both the savings and fixed deposit rates. FD rates have decreased to 8.25% and 7% for individuals and institutions which was 9.25% and 8.5% respectively before. The lending rates are also expected to fall soon.



Figure 1 United States Fed Funds Rate

In response to the Corona, the US has cut the FED rates on 2 occasions. 1st on 2020-03-03 from 1.75% to 1.25%. & 2nd from 1.25% to 0.25% points (a negative real interest rate). The FED has cut rates by 7X for the same. India has cut its interest rate from 5.15% to 4.4%.

We can expect further deductions in Nepal’s interest rate as well (FNCCI has proposed reducing maximum FD rate to 7% from 8.25% right now).

3. Liquidity

BFI’s have been through the issue of liquidity or the shortage of loanable funds for the past few years. With uncertainty in the amount of remittance flow (over 26% of GDP in 2018/19). Global remittances are projected to decline sharply by about 20 percent in 2020 due to the economic crisis induced by the COVID-19 pandemic and shutdown (World Bank, 2020). As Nepal’s economy and BOP depend on remittance, this will have a serious negative impact. It has been Nepal’s main source of foreign currency earning. As it is also one of the major sources of deposit for BFI’s, a decrease in the remittance will contribute to a decrease in BFI’s deposit as well.

The growth of demand for the loan in the coming days will most likely be higher than the growth in the growth in deposits, which will stress the CCD ratio. With local businesses in a standstill, there could be a huge shortage of funds in the economy. In the month of Chaitra, Banks were only able to recoup 60% of interest and principal payments according to Bhuvan Dahal, CEO of Sanima Bank.

Banks are now looking to capitalize the interest payments. Capitalization of interest means when the businesses fail to pay the interest amount it will be added to the principal balance of the loan. The demand for working capital loans will also increase as there will be delay turning inventory into cash and delay in receiving payments as well.

According to Anuj Agarwal of Vishal Group, the low interest rate environment will be coupled with ‘tight’ liquidity despite additional liquidity from fiscal spending, relaxation of CCD and other ratios. We echo this view.

4. CCD Ratio relaxation

If the situation goes out of hand and there is a shortage of loanable funds in the market, then the NRB has the power to relax the CCD ratio. “CCD ratio stands for the credit to core capital plus deposit ratio. It is the limit until which the banks are allowed to issue the loans and advances. If a bank has Rs 100 as a sum of core capital and deposit, then it can provide a loan only up to Rs 80, and remaining Rs 20 should be held as liquidity.”



According to Bhuvan Dahal- Chairman of Nepal Banker's Association and CEO of Sanima Bank, "BFIs have about 100 Arba of loanable funds available as of April 25, 2020. If there is a shortage of loanable funds in the market, NRB can relax the CCD ratio by 5% which will free up ~150 Arba of the loanable fund, making a total of 250 Arba (Rs. 25,000 crores). Furthermore, the total refinances fund of 60 Arba out of which 20 Arba is utilized and 40 Arba is still freed up. So, a total of ~290 Arba will be available."

5. Funding to business houses

It is unsure how the BFIs will ensure funding to the SMEs if they fail to meet their current debt obligations. NRB is expected to come up with economic relief packages to help uplift the businesses but this remains a vulnerable area. Bigger business houses, due to their relationships with banks and credit history should fare better when it comes to restructuring or refinancing their loans.

6. Impact on the return of shareholders

With everything in a standstill, it is obvious the shareholders' return will get squeezed this fiscal year. The financial performance of BFIs is expected to stagnate or decline moderately amid the coronavirus pandemic – the exact extent is impossible to predict.

The issue of shareholder vs community is surfacing at this time and banks are at the center of it. The management and regulators may feel that the main focus for the BFIs should not be to maximize their profits in the period of coronavirus pandemic but to survive and provide capital to other businesses to help them survive as well. The owners may put profit first and foremost. This tension was witnessed from the recent dispute between the NBA (Association of the CEOs) and CBFIN (Association of the Directors and Promoters).

We believe that all else equal, in the long term, banks will be just fine and remain profit making machines. We don't see ourselves in any rush to sell bank stocks at the moment.

7. Future of Digitalization

Due to lockdown and ban in people's movement without emergency has surely promoted the use of online banking amid Nepalese customers. The lockdown can prove to be a catalyst for the advancements in the adaptation of digital technology in Nepal. Customer's adoption will increase because of the lack of options and obligatory use of the technology.

NRB has also increased the daily and monthly limits of online transactions. However, security and safety come first and must be ensured by NRB and BFIs. We are still a few years behind the world, hopefully this crisis will accelerate the move towards digital.

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