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NPA Management Conference Report

Jan 2025

Challenges in Managing NPAs: Current Trends and Challenges Way Forward

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01 Acknowledgement

Kathmandu FinteK expresses sincere gratitude to all stakeholders who participated in the NPA Management National Conference. The event was a valuable platform for discussion, knowledge sharing, and collaboration. We appreciate the contributions of all speakers, panelists, and participants in making this conference insightful and productive.

02 Executive Summary

The NPA Management Conference, held on January 26, 2025, served as a crucial platform for stakeholders in Nepal's banking and financial sector to address the growing challenge of Non-Performing Assets (NPAs), which remain at concerning levels. The event brought together esteemed speakers, industry experts, and regulatory authorities for meaningful discussions on innovative solutions and strategic approaches to effective NPA management.

Key discussions focused on the underlying factors driving the rise in NPAs, the role of technological advancements in credit risk mitigation, policy reforms to strengthen regulatory frameworks, and practical recovery strategies. This report captures the key insights, discussions, and recommendations from the conference, serving as a valuable resource for stakeholders and policymakers.

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03 Event Overview

Purpose

To address the challenges posed by rising NPAs in Nepal and explore the innovative solutions for effective management and recovery.

Participants

- Regulators,
- CXOs,
- Banking professionals, and
- Fintech experts.

Objectives

- Gain insights into the latest trends and challenges in managing Non-Performing Assets (NPAs) in Nepalese banking and financial sector.
- Explore the role of technology and fintech in enhancing credit management and overall asset management, including NPA mitigation.
- Discuss policy recommendations and regulatory reforms to strengthen the financial ecosystem.
- Foster collaboration among stakeholders to promote long-term financial stability of the nation.

04 Speakers

Mr. Rameshore Khanal

Former Secretary
Ministry of Finance

Mr. Guru Prasad Poudel

Executive Director , Banks and Financial Institutions Regulation Department, Nepal Rastra Bank

Mr. Upendra Poudyal

President , Confederation of Banks and Financial Institutions Nepal

Mr. Santosh Koirala

President, Nepal Bankers' Association

Mr. Ramesh Mahaliyan

Ex-Deputy General Manager (Legal & Recovery)
& Retd Judge DRT Aurangabad

Prabin Poudyal

Advocate/Managing Partner
K & G Advocates

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05 Panelists

Panel Discussion: Challenges in Managing NPAs: Current Trends and Way Forward

Mr. Ramu Paudel

Executive Director, Bank
Supervision Department
Nepal Rastra Bank

Mr. Pradyuman Pokharel

CEO
Muktinath Bikas Bank Ltd.

Mr. Ajay Shrestha

Former CEO
Bank of Kathmandu

Mr. Manoj Gyawali

Senior Deputy CEO
Nabil Bank Ltd.

06 Key Insights and Discussions

The conference focused on analyzing emerging trends, key challenges, and best practices for managing NPAs. The discussions covered the impact of poor credit governance, economic downturns, and the increasing reliance on real estate collateral for lending.

6.1 Reasons for NPA

- **Economic Slowdown and Real Estate Market Slump:** The sluggish real estate market and overall economic slowdown have made it difficult for borrowers to dispose of assets held as collateral, impacting their ability to repay loans.

- **Collateral-Based Lending and Overvaluation:** Excessive reliance on real estate collateral instead of assessing business cash flows and viability has led to unsustainable credit exposures. Inflated property valuations, coupled with high loan-to-value (LTV) ratios, have further increased credit risks by undermining the significance of distress value (DV).

- **Financial Misrepresentation and Lack of Transparency:** Some borrowers have engaged in financial misrepresentation, including window dressing, to present a stronger financial position than reality. Additionally, inaccurate financial reporting and the absence of variance analysis between projected and actual financials have limited banks' ability to adjust credit exposure based on borrowers' financial health.

- **Weak Governance and Credit Monitoring:** Inadequate credit assessments, repeated loan restructurings, and ineffective oversight mechanisms have contributed to rising NPAs. Weak governance within financial institutions has allowed high-risk lending practices to persist.

- **Diversion of Funds** – In the case of business loans, funds have often been utilized for purposes other than the intended business activities, leading to financial strain and loan defaults.

- **Unusual Liquidity Swings and External Factors :**The credit cycle has been disrupted by liberal credit terms before COVID-19, which encouraged excessive borrowing. Abuse of NRB's forbearance policies during the pandemic, delaying the recognition of financial distress. Post-COVID liquidity constraints, leading to rising interest rates and business closures.

- **Economic Distress and Government Payment Delays:** COVID-19 impacts, delays in government payments - especially in the construction sector, where NPAs exceed 10% - and broader macroeconomic instability have further aggravated loan repayment challenges.

- **Lack of Market Research Before Lending**: Inadequate market analysis before lending, such as failing to assess industry and market size before financing new ventures (e.g., lending to cement industry).

06 Key Insights and Discussions

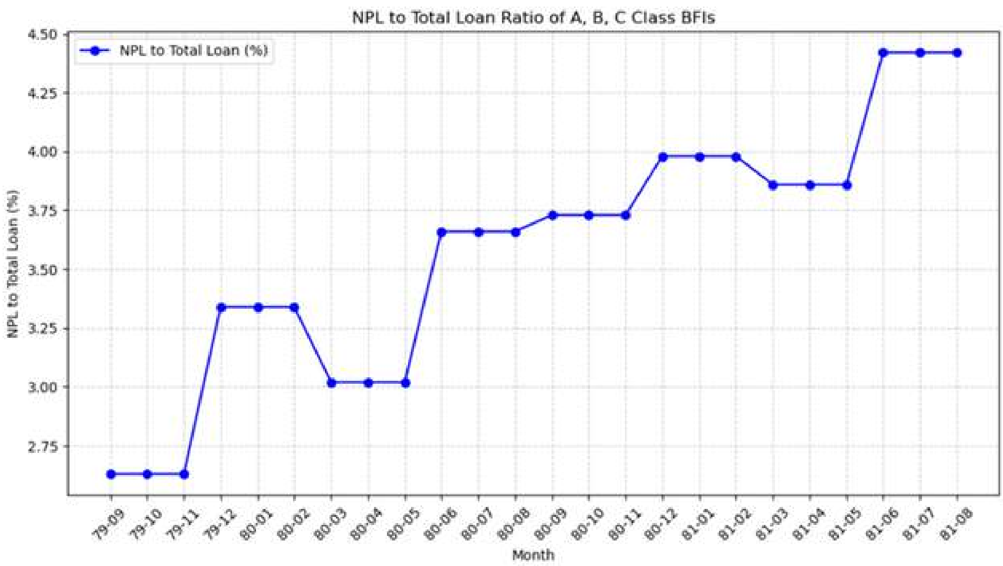
NPA in Mangsir 2081

4.9%

6.2 Current NPA Trends

1. NPA levels in Nepal's banking sector rose from 3.4% to 4.9% in just eleven months (Poush 2080 and Mangsir 2081), with some institutions exceeding 5%. (Figure 1 & Figure 2).

Figure.1 Combined NPA to Loan Ratio of A,B,C Class BFIs



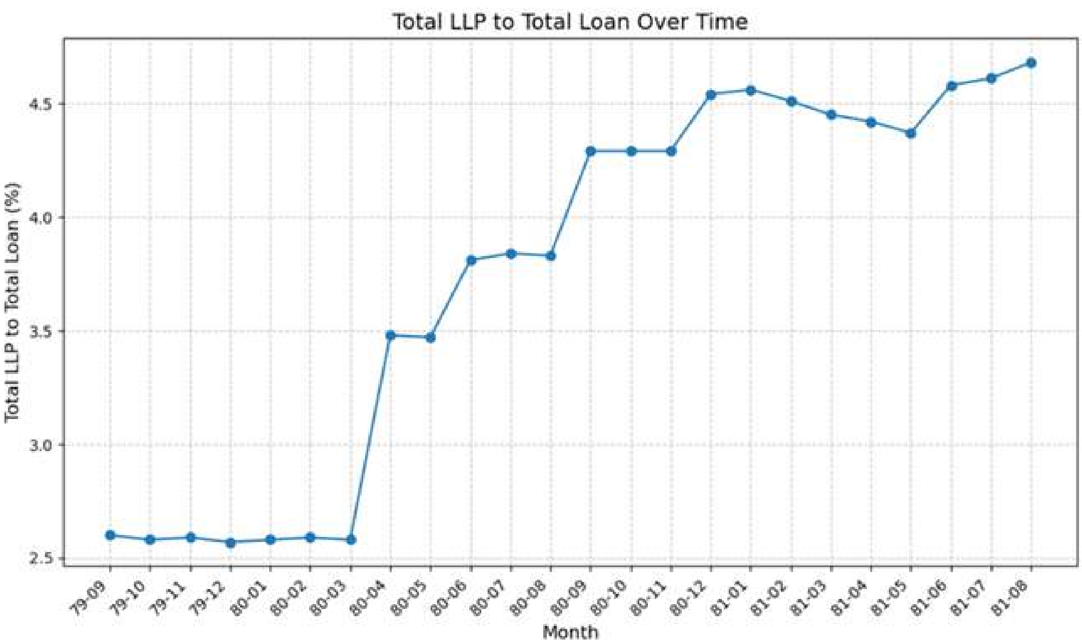


Figure.2 Total LLP to Total Loan Over Time

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06 Key Insights and Discussions

Total NPA and NBA in Mangsir 2081

Rs. 250 Billion and Rs. 39 Billion

6.2. Current NPA Trends

2. The total size of NPAs has surged to nearly Rs. 250 Billion in Mangsir 2081, highlighting the growing strain on the financial system (Figure 3)

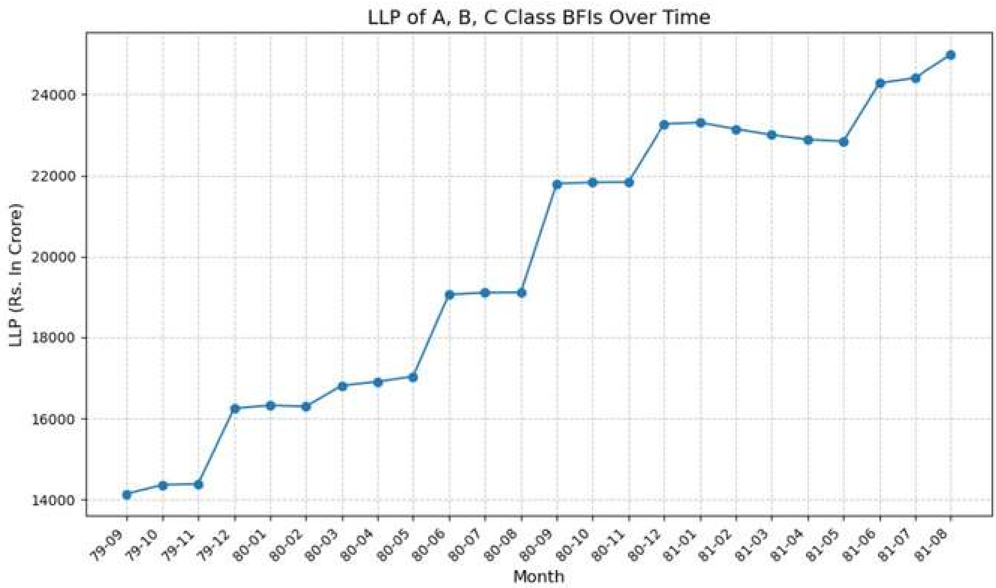

Figure.3 Combined LLP of A,B,C Class BFIs

3. NBAs more than doubled in a year, rising from Rs. 19 Billion to Rs. 39 Billion (Poush 2080 and Mangsir 2081), highlighting growing asset management challenges in Nepal (Figure 4).

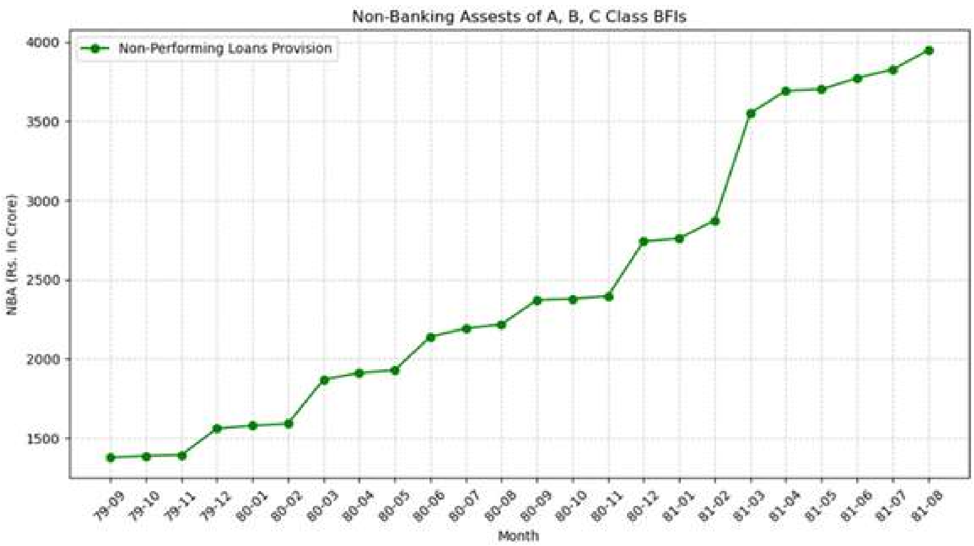

Figure.4 Combined Non Banking Assets of A,B,C Class BFIs.

06 Key Insights and Discussions

Private Sector Credit to GDP Ratio

93%

6.2 Current NPA Trends

4. The private sector credit-to-GDP ratio has risen from 63% to 93% over the past 10 years, indicating significant credit expansion and high leverage. However, this credit growth does not appear to have translated into proportional GDP growth, suggesting that much of the credit flow has been directed toward consumption rather than the productive sector - one of the key factors contributing to the current economic crisis.

The following chart illustrates that, except for a few months in the past 24 months, the ratio has remained in excess of 90 % (Figure 5).

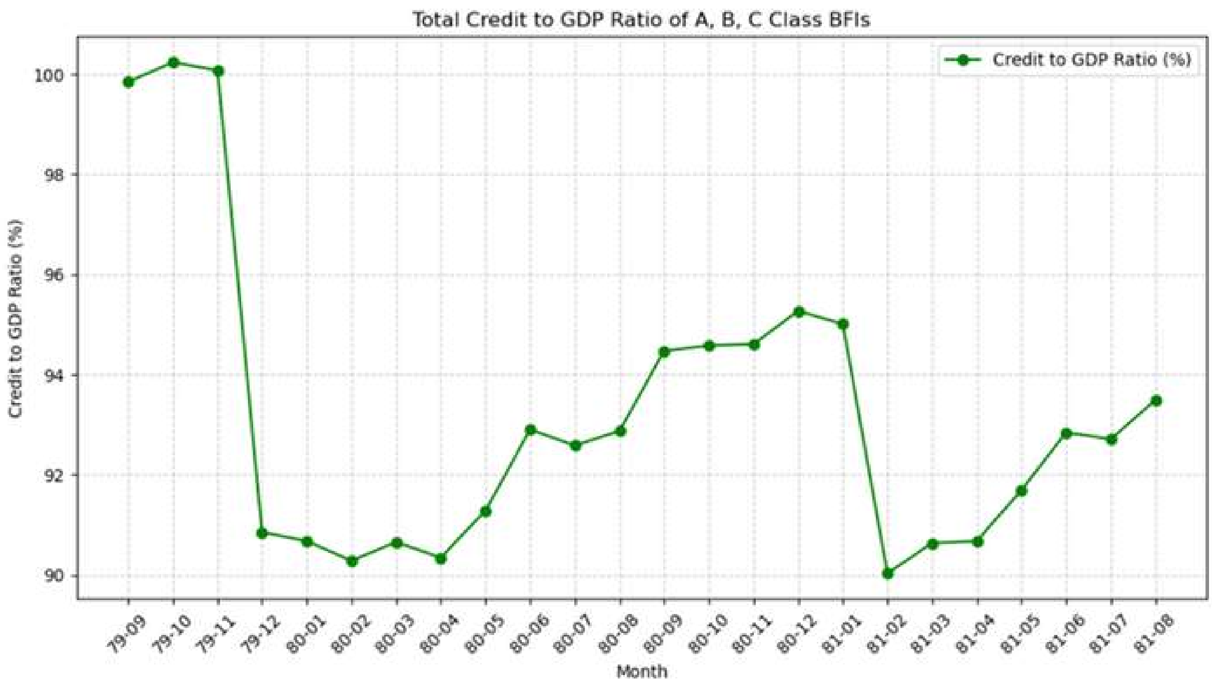

Figure.5 Combined Credit to GDP Ratio of A,B,C Class BFIs.

06 Key Insights and Discussions

6.3 Challenges in Recovery

- **Legal and political barriers**: Complex legal procedures and political interference delay recovery efforts.
- **Liquidity Constraints in the Real Estate Sector**: The real estate sector is facing a severe liquidity crunch, making it difficult for borrowers and businesses to generate funds through asset transactions.
- **Limited Access to Informal Funding Sources**: Borrowers who previously relied on informal funding sources, such as cooperatives, are struggling with fund management due to the ongoing crisis in the cooperative sector. This has restricted their ability to refinance or manage existing debt.
- **Economic Distress and Declining Asset Liquidity**: Previously, borrowers in financial distress could sell assets to prospective buyers to settle their loans. However, due to the deteriorating economic situation, finding buyers has become increasingly challenging, further complicating loan recovery efforts.
- **Collateral auction difficulties:** Borrower protests, branch lockdowns, and weak asset management frameworks in Nepal hinder effective auctioning of collateral to recover the credit.
- **Employee safety concerns:** Bank staff face risks during recovery efforts, often lacking administrative and political support.
- **Lack of separation between business and recovery units:** Business and Recovery units are not separate in most of the bank branches in Nepal leading borrowers getting familiar with the business unit which in turn makes the recovery effort more challenging.
- **Absence of structured asset management mechanisms:** Nepal lacks a robust framework to manage distressed assets effectively

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06 Key Insights and Discussions

6.4 Role of Technology in NPA Management

- **Early Warning Systems (EWS)**: Automated alerts and data-driven monitoring mechanism to detect potential defaults early.
- **Enhanced risk assessment**: AI-driven credit analysis, real-time data tracking, and predictive modeling to strengthen decision-making related to credit life-cycle.
- **Efficiency**: Automation of documentation and credit monitoring to free up staff for strategic and proactive decision-making.
- **Proactive credit management**: AI-powered tools identify red flags that may go unnoticed, preventing loans from turning into NPAs.

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06 Key Insights and Discussions

6.5 The Indian Story

- **Dedicated recovery teams**: Indian banks separate recovery from business units, ensuring objectivity in NPA management.
- **Net-worth verification**: Borrowers submit a net-worth statement with supporting documents at loan sanctioning, which later serves as a recovery tool for banks.
- **Legal action against misuse**: Borrowers in India face "Breach of Trust" cases if they divert loan funds or violate covenants.
- **Robust valuation and auction systems**: Minimum bid amounts are disclosed, ensuring transparency in asset disposal during the auctioning of the collateral.
- **Stringent credit inspections**: Regular stock audits by third-party firms (e.g., Chartered Accountants) prevent financial misrepresentation including Quarterly Information System (QIS) reporting where the borrowers furnishes major financial highlights of each quarter to the banks.
- **Proactive legal enforcement**: Indian banks do not hesitate to initiate legal proceedings, a practice recommended for Nepalese institutions. Further, the recovery team is provided with the latest legal updates and guidance to ensure that the recovery process is efficient and compliant.

07 Recommendations

For Banks

Improving credit appraisal processes through data-driven analysis, industry risk assessments, and borrower cash flow evaluations.

Enhancing post-disbursement monitoring via site visits, financial reviews, and digital tracking tools.

Leverage AI-powered fintech solutions for automated credit monitoring and documentation.

Establishing specialized recovery units staffed with legal and financial experts.

Enhancing the use of net-worth statement and supporting documents as a strong credit assessment and recovery tool.

Diversifying loan portfolios to minimize overexposure to high-risk sectors like real estate.

Implementing real-time monitoring dashboards to track key credit risk parameters of the borrowers, sectors, portfolio, etc.

Developing a Knowledge Management System (KMS) to document past recovery cases for future learning.

Enforcing liability-asset matching i.e., short-term liabilities should finance short-term loans, and long-term liabilities should fund long-term credit.

Reviewing and revising credit policies to incorporate external risk factors and economic cycles, ensuring that lending practices consider macroeconomic conditions and liquidity risks.

07 Recommendations

For Regulators

Developing a comprehensive AMC framework, including funding mechanisms, oversight structures, and operational guidelines.

Strengthening debt recovery laws and introduce a dedicated Debt Recovery Tribunal.

Enforcing stricter prudential norms for high-risk lending sectors like real estate and agriculture.

Mandating the adoption of Early Warning Systems (EWS) for all financial institutions.

Mandating timely disbursement of government dues to contractors and vendors. This will prevent liquidity bottlenecks and ensure that businesses reliant on government payments remain financially stable.

Taking immediate steps to ensure that liquidity accumulated within the banking sector flows into the broader market. This will help restore economic confidence and facilitate a smoother recovery.

Introducing valuation standards for banking-sector collateral assessments that is uniform across all banks thereby reducing the possibilities of over-valuation.

Requiring banks to appoint a Chief Economic Officer to lead research and development efforts specially related to industry, local and global economy, and various other economic parameters.

07 Recommendations

For Government

Clearing pending payments to contractors and industries to ease liquidity constraints and reduce the outstanding loans of banks in such sectors.

Fostering collaboration between banks and government bodies to promote responsible lending.

Investing in infrastructure projects to boost economic growth and create productive credit demand.

Encouraging IT and BPO sector growth by creating favorable policies to attract foreign outsourcing opportunities which will not only help the employment generation but will also help in knowledge transfer.

Supporting local industries through tax incentives or subsidies, particularly for SMEs.

Consider borrowing funds for productive capital expenditure. Effective investment in infrastructure and development projects will stimulate economic activity, generate employment, and enhance overall liquidity in the market.

08 Conclusion

The conference highlighted the urgent need for proactive strategies, technological innovation, and collaborative efforts to tackle the growing NPA crisis in Nepal's banking sector. Key solutions included:

- Establishing Asset Management Company (AMC) for effective NPA management.
- Adopting fintech solutions to improve credit monitoring and risk assessment.
- Strengthening governance and regulatory frameworks to prevent loan defaults.
- Enhancing early warning systems to identify distressed assets before they become NPAs.

By implementing these measures, stakeholders can build a more resilient and sustainable financial ecosystem, ensuring long-term financial stability supporting the stableg growth of the Nepalese economy.

We extend our special thanks to Mr. B.N. Gharti, banking expert, for his valuable contribution.

We extend our sincere gratitude to Aadiswan Pvt Ltd. (www.aadiswan.com) for their support during the event. We would also like to thank Mr. Shashi Prakash, Principal Consultant from Aadiswan for his insightful presentation on NPA management automation.

Reference

Monthly Statistics published by Banking and Financial Institution Regulation Department of Nepal Rastra Bank (https://www.nrb.org.np/category/monthly-statistics/?department=bfr)