

Nepal Bankers' Association

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The Way Forward for the Banking Sector: Opportunities and Challenges

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I. INTRODUCTION

Thank you for inviting me to speak at this conference. I have arrived not long ago in this beautiful and hospitable country, and I feel particularly fortunate to be here at this time, when such tremendous possibilities have opened before the whole nation.

The topic of today's conference is an important one. At this time in the history of Nepal there are many uncertainties, and it is difficult to glimpse through the fog that shrouds what lies ahead. However, we can say with confidence that the opportunities—as well as the challenges—loom large, not least in the realm of economics.

Economic prospects have improved; the government budget is providing for a large increase in much-needed development spending while containing domestic borrowing; and the central bank is appropriately steering monetary policy to maintain the stable peg with the Indian rupee. Remittances have increased and aid is expected to rise. So we have a good basis.

But the state and external actors can only do one part. For the economy to recover and the Nepali people to prosper, each and everyone must do their part as well: private entrepreneurs and employees, in the financial and in the industrial, service, and agricultural sectors.

The rewards can be substantial. Nepal has significant resources and advantages that wait to be brought to good use: its rivers can deliver energy, for use in domestic industry and for export; its natural beauty and cultural heritage attract hundreds of thousands of foreigners, who must be enticed to spend more money; its labor force is young; and the country is located between India and China, whose economies are both growing at a rapid pace.

Yes, there are risks and challenges: Political developments may not be supportive. There are the pressures of international competition and globalization, and external economic developments may not always be favorable. But these are challenges that have to and that can be overcome. And the banking sector can and needs to play an important role in this effort. In this regard, I would like to confine my remarks to a few issues that are in my view fundamental.

¹ The views expressed in this paper are those of the author and should not be attributed to the International Monetary Fund, its Executive Board, or its management.

II. THE PAST

But before we move forward, the past has to be resolved. The single largest issue that overshadows the future of the banking sector and, by extension, the public finances and the entire economy, is the issue of default on a large scale on bank loans that have been extended in the past. The two largest banks in the system are insolvent because some refuse to repay what they owe.

The consequences are staggering: the nonperforming assets of these two banks amount to about 15 billion rupees, or almost two-fifths of both banks' total loan portfolio. This is a sum equivalent to one-third of the government's entire development budget for this year. If the loans are not repaid, it would be a loss not only for the banks, but for the country as a whole. It is the general public—rich and poor alike—that would ultimately have to pay the price for the privileged treatment of a few. The deadline for defaulters set by the government is approaching, and decisive action is needed in the days ahead.

Some contend that the campaign against defaulters launched by the government and Parliament is one-sided and unfair. They say that the bank officers responsible for extending the loans should be punished also. While that may be desirable, it is beside the point. The obligation to repay a loan rests ultimately with the borrower.

Some also say that the difficult economic situation has made it impossible for some defaulters to repay. But many loans have not been serviced for a very long time, both in good years and bad. The total interest due is larger than the amount of principal due. At the very least, borrowers who cannot repay need to approach their creditors. They need to ask for forbearance, and present a credible plan how they will recover their financial health and eventually repay. Simply ignoring one's obligations will not do. Ultimately, it seems to me not to be not an issue of ability to pay, but an issue of willingness to pay.

Beyond the financial loss for the general public of not repaying one's debt, there is a wider damage that occurs if people can with impunity escape their obligations. The culture of honoring one's commitments, of responsibility, of accountability, is undermined. This goes to the very heart of the social fabric of the nation. Tremendous damage has already been done in the long years when it was thought that credit from state-owned banks was free. This has to end. The Nepali people deserve better.

III. LOOKING AHEAD

Now, let me turn to look forward. The financial sector's function to collect and mobilize the savings of Nepalis at home and abroad, and to channel those savings into productive investments that drive forward the development of the nation, is fundamental. To be able to fulfill this role well, the financial sector and the government need to work together, and strive for the highest standards of professional excellence and accountability. Again, each needs to do their part.

I have mentioned earlier that the obligation to repay a loan rests ultimately with the borrower. But this does not absolve the creditor from doing everything in his power to ensure that loans are brought to good use, that they are only extended for viable projects, and only to responsible borrowers that can repay. This—to protect themselves—is the duty of financial institutions vis-à-vis the public, and vis-à-vis their shareholders and depositors.

Banks must persevere in this effort, in spite of increasing competition. They must find the right balance between risks and rewards. The public deserves financial institutions that behave responsibly, institutions to which they can entrust their savings, institutions that provide the services they need at reasonable cost. Market share and profits should be the reward of attractive yet prudent loan and deposit packages. Trying to expand market share at all costs is not a prudent course. Care must be taken that, as longstanding nonperforming assets of the largest two banks are being addressed, the same problem is not created again, this time through the imprudence of other banks.

The banks must do their part, by designing sound deposit and lending strategies. But, they also need help. This brings me to the guardian of the financial system, the Nepal Rastra Bank, and its two core functions, supervision and regulation. In these key areas, let me paint with a broad brush what I see as the crucial issues.

The NRB's supervisors should be respected and feared. Otherwise temptations for banks may be too great. However, respect from the financial sector does not come automatically; it must be hard-earned. The supervisors should become an elite corps in the NRB and the financial sector. Their capability must be of the highest standards. There needs to be a sufficient number of them, and they must produce timely and accurate assessments. And finally, they must be held accountable for their actions, including their omissions.

On the regulatory side, an urgent issue is the needed consolidation of the banking sector. There are too many financial institutions in Nepal. This stretches the supervisory capacity of the NRB, and it leads to smaller and weaker banks instead of bigger and stronger ones. Ultimately, it hampers the banks' ability to compete, and could endanger the stability of the system. Therefore, strong action needs to be taken to ensure that the financial system consolidates.

If banks that are unable to compete do not merge voluntarily, they must be forced. First, capital requirements need to be raised and enforced with an even hand. This would also deter applications for new licenses. Second, it must be made clear that banks are allowed to fail. There can be no exceptions. Pressures—from whichever side—to save a bank must be firmly resisted. Small depositors who are unable to assess a bank's health should be protected, but shareholders must be made to bear the full risk inherent in their investments. There can be no reward without risk.

This brings me back to the issue I mentioned before, and which has run like a thread through all of what I have said. This is the issue responsibility and accountability. It is, in

my view, fundamental. To prepare well for what lies ahead, to use the opportunities and meet the challenges that are arising, it is crucial that people—bankers, borrowers, and the public servants who guard the system—are facing the consequences of their actions.

This is not a stick; it also promotes professional excellence, and instills pride and confidence. And there is no greater service that can be done to the nation.