NRB's Decision to Hike Paid-up Capital by Multifold : More of Tyranny Less of Foresight

Nepal Rastra Bank (NRB) in its 2072/73 monetary policy announced on 23 July 2015 has decided to hike the minimum paid up capital of commercial bank, development bank and finance company by multifold to be met within next two fiscal year i.e., by the end of Asad 2074. The decision was so dramatic that it sent shockwaves to the country's banking sector, causing banks and Financial Institutions (FIs) to scramble for partners for merger and acquisition (M&A). It is particularly interesting to note that it is the first monetary policy of the new Governor. In view of that many believe that he wants to take a very bold decision to leave a legacy of being one of the most resolute and effective Governors in the history of country's central bank. On the contrary, there are also other sections of people who are of the opinion that it is indeed the bureaucracy of NRB who took the advantage of new Governor's inexperience to make him agree on measures which they believe is long overdue, despite being very unpopular. Whatever may be the true intention, the decision does not seem to be based on the proper analysis of ground realities and therefore doesn't echo the concerns of stakeholders. Ideally, such measures are taken during the period of crisis and the banking sector is nowhere near that. The central bank being the apex body of banking sector must broaden its view in foreseeing the implication of such decision which is likely to do more harm than good to the country's economy. The manner in which decision was taken is extremely *ad hoc* as no consultation was carried out with stakeholders on the one hand and on the other hand no analysis of the likely consequences of such decision seems to be undertaken. Though the sole objective of the policy appears to be the consolidation of the banking sector through aggressive M&A, but even in the best-case scenario, the implication of the policy to the overall economy looks blatantly adverse. The economy of the country cannot simply absorb the extent of capital flight into banking sector leading to a crowding out effect in the real sector of the economy. As the country is reeling under the consequences of massive earthquake followed by Indian blockade, what is needed is the huge investment in real sector of the economy to uplift its overall productive capacity. On the contrary, the policy will only aggravate the situation by channeling more resources to already outsized banking sector leaving other sectors of the economy to suffer from continued underinvestment.

The central bank has cited few reasons in support of its unilateral decision and I would like to argue how each of them is based on misplaced beliefs and wrongful judgment:

1. It has been made to believe that the paid-up capital of our banking sector is the lowest in South Asia. On the contrary, the data in table 1 depicts a completely different picture. The minimum paid up capital of a commercial bank in Bhutan and Maldives are much lower than ours while those of Afghanistan and Bangladesh are marginally higher despite latter's economy being almost ten times bigger than the size of Nepal. The highest minimum paid up capital in South Asia is that of Pakistan followed by India and Sri Lanka. As none of these countries are planning to increase the minimum paid up capital anytime soon, Nepal within two years will become the country with the second highest minimum paid-up capital in the region along with

India surpassing both Sri Lanka and Bangladesh. Let us not forget that the economy of India is 104 times bigger while Sri Lanka is about 4 times bigger than the economy of Nepal. In addition, our bank's minimum paid up capital will become more than 3 times larger than that of a bank in Afghanistan though the economies of these two countries are almost equal in size. Similarly, the minimum paid up capital for commercial banks in Uganda, Tanzania and Kenya which are equal, two and half times and three times the size of our economy in that order and are sharing similar human development indices and development challenges are Rs. 70 crore, 23 crore and Rs. 1 billion respectively – much lower than our existing requirement. Measured by percentage of nominal Gross Domestic Product (GDP), even the current paid up capital of Rs. 2 billion for a commercial bank in Nepal is indeed one of the highest in the world.

Minimum paid up capital of commercial banks in SAARC countries — Table 1

	AFG	BAN	BHU	IND	MLD	NEP	PAK	SRI
Minimum Paid up capital in local currencies in billion	1.35	2.0	0.30	5.0	0.03	2.0	10.0	5.0
In USD equivalent in million	23.5	26.67	4.5	80.0	2.0	20.0	100.0	40.0
Size of economy compared to Nepal	1.03	9.44	0.11	104.37	0.15		12.65	3.8
No. of commercial banks	16	60	5	90	7	30	36	25

Sources: Central Banks websites

2. The highly ambitious scenario of more than halving current number of banks and FIs in next two years considering the sole objective of reducing the number of banks and FI will help us in understanding overall implication of the decision in the economy of resource strap country like ours. In the most likely situation, the existence of non-national level finance companies will come to an end in the light of extremely harsh capital requirement imposed upon them. Similarly, as there is no difference in capital requirement between 1 district and 3 district development banks, development bank with one district coverage will migrate to 3 district development banks. Moreover, these FIs will probably merge either among themselves or with a higher graded institution to meet the capital requirement. Likewise, most of the national level development banks by either merging with each other or with one or more regional development banks or finance companies can meet their capital requirement. In the similar fashion, 20 out of 30 commercial banks will find it difficult to meet the capital on their own, so they will resort to merger with suitable FIs including their counterparts as well. It is however highly unlikely that commercial banks will merge with each other for the sake of meeting capital requirement. Nonetheless for our analytical purpose we have assumed that 8 commercial banks will merge with another bank as a highly optimistic scenario. These commercial banks include those having problems amid persistent financial and governance issues as well as those which have received their operating license after the imposition of moratorium in 2009 finding it difficult to secure reasonable market share amid excessive competition among a large number of banks and FIs. We are assuming that under the best case scenario, we will end up having 22 commercial banks, 15 national level development

banks, 10 regional banks with ten district coverage, 15 regional banks with 3 district coverage and 10 national level finance companies – in total 72 from existing 154 institutions as exhibited in the following table:

Best case merger scenario in two years Table: 2

	Commercial Banks	Development Banks				Finance Companies		Total
	National	National	4-10 dist.	3 dist.	1 dist.	National	1-3 dist.	
Current paid up capital	2 billion	640 million	200 million	100 Million		200 million	100 million	
No. of Institutions	30	24	13	27	12	42	6	154
New paid up capital	8 billion	2.50 billion	1.20 billion	500 Million		800 million	400 million	
Best case merger scenario	22	15	10	15	0	10	0	72
Paid up Capital 71/72 (No.)	98.3 billion (30)	27.535 billion (76)				15.764 billion (48)		141 billion (154)
Paid up Capital 73/74 (No.)	176 billion (22)	57 billion (40)				8 billion (10)		241 billion (72)

Sources: NRB Monetary Policy 2072/73, NRB Current Macroeconomic situation of Nepal 2014/15, NRB circulars and NRB website

Going by NRB's new minimum paid up capital, the banking sector will have a paid-up capital close to Rs. 241 billion within two years against Rs. 141 billion as of last financial year, an increase of 71% in just about two years. Imperatives of injecting additional Rs. 100 billion within two years in comparison to Rs. 141 billion paid up capital built over the entire history of Nepal's banking sector can have massive impact in our economy that the policy maker and central bank has to contemplate since more than 90% of the investment has to be raised from within the country given very small foreign holding in our banking sector (Standard Chartered, Nepal SBI, Everest Bank and Nepal Bangladesh Bank). The situation will be worse if the best-case scenario of reducing the total no. of banks and FIs from 154 to 72 will not be achieved in two years because the banking sector will be inundated with even higher capital.

3 Analysis of the monetary aggregates: The shortcoming of the decision can be better understood from the analysis of monetary aggregates. The following table highlights comparison of the monetary aggregates among some of the countries in the region as well as those economies which are comparable to Nepal such as Uganda and Kenya:

Analysis of Monetary Aggregates Table 3

(In percentage)

	BAN	IND	NEP	PAK	SRI	Uganda	Kenya
Paid up Capital /GDP			6.66	2.12	1.46		
Capital & Reserves /GDP	4.83	7.10	10.47	5.53	5.02	4.54	9.37
Capital Adequacy Ratio	11.35	13	12.70	15.10	16.70		
Reserve Money	9.58	15.38	23		5.91	5.95	
Narrow Money (M1/GDP)	10.46		65	35.62	6.26	9.40	17.48
Broad Money (M2/GDP)	51.83		88.4	43.97	35.37	15.80	36.99

Broad Money (M3/GDP		85.13	93	55.88	39.61	23.38	43.49
Total Deposit/GDP	49.04	72.92	82.61		40.64	20.22	41.74
Loan & Advance/GDP	46.72	52.10	75.98		50.88	21.16	39.98
Claims on Private Sector/GDP	37.57		64.65		36.44	14.22	36.08
NPL	9.69	3.80	3.80	12.80	4.20		
Profitability (ROE)	8.09	10.70	14.40	23.50	16.50		
Profitability (ROA)	0.60	0.80	1.50	2.10	2.00		

Sources: Based on central banks' statistics, SAARCFIN e-bulletin, financial year considered is 2014 except for Nepal for which 2014/15 is used for monetary aggregates.

In comparison to these countries, the monetary aggregate of Nepal as a percentage of GDP is quite high suggesting overstretched banking sector. Higher level of credit compared to GDP signals that beyond a certain point further credit expansion could be counterproductive to the financial stability of the country. Credit is indeed the means of increasing money supply in the economy through the creation of new deposits which will again be used to provide additional credit and the process keeps on repeating itself. With sizable increase in paid up capital in a very short span of time, there will be a pressure on scaling up business to maintain similar level of return - which can lead to the instances of moral hazards on the part of both the Management and Board. As these institutions will transform into behemoth organizations, each of them can pose systemic risk to the economy because of "too big to fail" phenomenon. Considering an optimum commercial bank with a paid-up equity of 8 billion, deposit of 80 billion and credit of 70 billion; the total assets of a single commercial bank alone will be over 4 to 5 % of GDP posing significant challenges in the management and supervision of these companies in the wake of systemic risk associated with its size and nature. Moreover, the total paid up capital as well as Capital & Reserves (C&R) of our banking sector as a whole as a percentage of GDP is already the highest in the region and any further attempt to increase it substantially within a period of two years as envisaged in our current monetary policy would only invite more problems than would help in fostering stability and economic development. The banking sector currently has a combined Capital & Reserves (which includes undistributed profit of 2071/72) of Rs. 220 billion and using a rule of thumb, it will be sufficient to support a total credit equivalent to ten times the C&R, i.e., Rs. 2,200 billion compared to total credit of Rs. 1,614 billion based on the consolidated financials of last financial year published by NRB. Hence, with no additional capital we still have a room for credit expansion of additional Rs. 586 billion representing 36% growth from current level which will be difficult to achieve in next two years – a sign of excess capacity in our banking sector. Moreover, at this pace and scale, the total credit is going to exceed the size of our GDP signaling already outsized banking sector and some underlying structural anomalies of our economy. In addition, considering the best-case scenario presented in the above table, if the banking sector has to inject Rs. 100 billion in a matter of two years to meet NRB's minimum paid up capital requirement, it will provide additional credit space of Rs. 1,000 billion accounting for 50% of our GDP. When the country has been facing excess liquidity for last several months and NRB has been taking unprecedented measures to address the matter, forcing banks and FIs to inject substantial capital in the form of minimum paid up equity is simply superfluous and arbitrary.

4 Opening branches in other countries in South Asia: A Central Bank sets minimum paid up capital requirement for banks and FIs by considering host of factors related to country's needs and its economy. As far as opening an offshore branch or subsidiary is concerned, the decision is personal and the concerned bank shall accordingly satisfy all the conditions required by the regulatory authorities of the concerned country. Hence, in the process of facilitating one or two domestic banks to expand abroad, it is preposterous to impose a capital requirement of a foreign country to the whole domestic banking sector. Moreover, not all the banks in a country will be opening branches in the other countries. Insofar, when none of the banks in Nepal including fully government owned bank has made any intention of expanding abroad in more than 75 years of its banking history, slapping capital prescription based on this assumption is quite untenable and counterproductive.

5 Funding capital intensive projects: Time and again, it is heard especially in relation to investment in hydroelectric project that even if whole banking sector of the country comes together it will not be able to finance a project of 250 MW. For instance, consortium must be organized for funding small to medium projects of 5 to 25 MW. I find this argument a reason for increasing the paid-up capital very naïve and irrational. We have to understand that banking sector doesn't operate in vacuum and it has to anchor around real sector of the economy. When the size of our economy is just USD 20 billion, the banking sector can only generate resources commensurate with its size and its income (GNP). Potential (which is not yet harnessed) of a country's economy cannot alone determine the amount of financial resources that a banking sector of country can generate. The size of the economy along with multitude of factors such as depth, credibility, openness of our financial market will determine it. Nepal has 100,000 MW of technically feasible hydroelectric potential which requires total investment of USD 200 billion, equal to ten times the size of our own GDP. Even for a country like India, it needs funding from foreign market to exploit potential of this magnitude and scale, let alone a small economy like Nepal. World Bank has estimated an investment need of 13 to 18 billion US dollar in Infrastructure over a period of 2011 to 2020 for Nepal to graduate from LDC to developing one. It is quite irrational to expect mobilizing this resource entirely from domestic market when the size of our economy is too insignificant compared to our needs and our financial market is too shallow and narrow. Increasing paid up capital with a view to address these concerns seems totally misplaced and undesirable.

6 Consolidation of banking sector by removing categorization and keeping commercial bank only: The "Financial Sector Development Strategy" envisions the removal of various categories of FIs to eventually have only commercial bank. The policy to create different categories of FIs was initiated with good intension when commercial banks were hesitant to reach out to the mass and were conduits of only few privileged and well-off individuals and corporates. So, finance companies came into being from early nineties to promote retail financing followed by development banks from late nineties and beginning of the millennium to extend banking services to areas outside capital in small towns and district headquarters with the concomitant aim of channeling funds towards development sector. Their establishments have helped promoting competition and expanding banking services to areas and places hitherto not reached out by commercial banks. However, during the whole process,

what seemed to be totally overlooked was the importance of creating differentiation and complementarity among different categories leading to stiff competition among large number of FIs crowding together in the same market. As a result they ended up doing essentially the same thing defeating the very purpose of creating different categories of FIs. Regulatory authorities and management alike could not act proactively and innovatively to promote differentiation in creating niche for each category of institution, rather convergence in scope and areas of operations got reinforced in the process. All the categories of FIs have been financing vehicle loan as well as providing consortium loan to hydroelectric projects in the same market. The central bank that has created these categories and issued licenses after following due process cannot eliminate them simply because the original goals were either not served or because the numbers of these institutions are just too many. Who is to blame for it and who created it in the first place? The central bank must take due share of its responsibility and come up with exit strategy that is gradual and calibrated. It is premature to envisage that these challenges can be fully resolved in a matter of two year or during one Governor's term. Trying to initiate sweeping reform without properly assessing its broader macroeconomic implication can cost the economy severely. There is still merit in creating differentiation, for example, introduction of Non-Banking Financial Companies (NBFC) specializing in special products or line of credit. Once the consolidation phase is over, the central bank can promulgate new laws relating to the establishment of NBFC and as a part of exit strategy, the existing finance company can be incentivized to opt out to be transformed into NBFC. Similarly, the development banks can be allowed to make equity investment in infrastructure projects such as hydroelectric ventures, toll roads, power transmission lines etc. so that overtime it can build niche in this area and play complementary role vis-à-vis commercial banks thereby promoting both scale of investment and transparency in the infrastructure funding. Reserve Bank of India has introduced the concept of differentiated banks by rolling out Payment Bank and Small Finance Bank and recently issued 6 and 11 licenses, respectively. These are some of the things we can try to emulate from other countries for the development and stability of our banking sector. Furthermore, once the moratorium is lifted, both the development banks and finance companies can be allowed to compete for the license of a commercial bank, similar to what has been practiced in many countries as opposed to automatic upgrading followed in the past.

7 Basel III implementation: Nepal has been ahead of Basel's requirement for the most of its banking history. Even as of now, all the commercial banks are BASEL III compliant as far as capital requirement is concerned though it is yet to be enforced officially. BASEL III provides norms for capital adequacy, leverage position and liquidity requirement from risk management perspectives. Our capital adequacy guidelines have been stricter than those contained in BASEL II and III frameworks to which our banking sector in general have always conformed. Increasing paid up capital by four times in a matter of just two years does not augur well in the pretext of BASEL III compliance.

8 Opening license for new bank with a capital of 10 – 15 billion and removing moratorium: It is at the sole discretion of the Central bank of the sovereign country to decide on when to lift moratorium based on its assessment of the situation. When the paramount objective of NRB

in increasing paid up capital is to force M&A activities so that the number of existing banks and FI are reduced considerably, reopening license goes against its own overriding goal. The NRB's policy and implementation plan are contradicting with each other, and it doesn't convey unified and consistent message to the public at large raising doubts over its intention and integrity.

9 Opening foreign banks branches to do retail banking: Currently foreign banks are permitted to do only wholesale banking in the country. Accordingly, thresholds have been imposed on the minimum amount of deposit they can mobilize from a single party and credit they can provide to a single party. Due to this restrictiveness, foreign banks will not find it feasible to operate their branch in the country. Once such restrictions are lifted, foreign banks with global ambition will not find capital requirement of a small country like ours a major stumbling block for their international expansion.

10 In the medium to longer term, the capital market may face a brunt of the decision as it pushes back our secondary market to a similar state when the banking sector alone constituted more than 80% of total market capitalization (two third at the time of decision) thereby amplifying the overall risk in the capital market in the light of overconcentration in one sector. In the short run, it looks as if the capital market has responded positively to the decision of the central bank, but it is very unlikely that the momentum will be sustained over a longer period. While it may be money making opportunity to the shareholders of only handful of banks which are able to meet the new capital threshold on their own, for the majority of the other banks and FIs the bullish sentiment can very quickly turn into bearish run. Similarly, most of these banks including those who have fared extremely well will in no circumstance be able to sustain the same rate of return that they have been reaping for the last several years. Moreover, flooding of capital market with the shares of only one sector within a very short span of time will result into excessive portfolio concentration thereby sharply heightening the vulnerabilities in the financial market.

11 There are host of areas where central bank can initiate reforms in the banking sector including its own management. Professionalizing of its departments and skilling of its staff are crucial in taking forward the reform process. Plethora of *ad hoc* directives that either do not conform to professional standards and international practices such as accounting and auditing standards or are impractical; unwarranted focus on witch hunting in the past; embroiling on petty issues; and excessive interference in the internal management of banks undermines the larger role of the central bank in streamlining and steering the country's banking sector into more advanced and risk based management system. By any standard, the operational efficiency of Nepal's banking system is probably one of the best in the world. The banking sector has contributed immensely to whatever has been achieved so far and is one of the bright spots of our economy. However, there are ample of negative vibes fueled by the very ones who are at the helm of affairs which will not be conducive in creating healthy and robust banking system in the country. In every sector there are few rogues who deserve to be identified and prosecuted in a timely manner and Nepal banking sector is no exception. But due care must be exercised while addressing these issues so that honest people don't feel intimidated to take rightful decision in a free and fair manner, else it will be difficult to uphold and maintain the moral

standard and professional integrity necessary to revitalize the most promising and transparent sector of our economy.

While sustained capital increment is good for every prospering sector and institutions, any abrupt and aggressive increase could be equally destabilizing and counterproductive. Both the timeframe and scale of increment are unreasonable and hence, the central bank must revisit its decision and come up with more practical framework. The central bank's objective of reducing the number of banks and FI- probably the highest in the world in comparison to the size of our GDP on the back of no differentiation among different categories of FIs is well appreciated and shall indeed be pursued with vigor and tenacity for the overall development and consolidation of banking sector. But putting whole onus of achieving this objective in a single factor –minimum paid up capital is unwarranted and can be damaging. It must be supplemented by host of other policy measures such as incentivizing differentiation among different categories, introduction of NBFC to which existing finance companies would have the option of migration, tax rebate, concessional terms for branch expansion and time extension for meeting minimum paid up capital, among others.

Based on the analysis of financials and the prospects of country's banking sector, it is hard to contemplate that any rational investors either domestic or foreign would be in favor of NRB's decision. This is because there is no economic sense and business logic to increase paid up capital by at least four times in a span of merely two years given that there is no possibility of achieving similar rate of return for many years to come under the weight of massive paid-up capital amid very little prospects of commensurate business growth and economic development. NRB shall pay heed to the genuine concerns of stakeholders to avoid the ramifications of failure of its policy on the overall economy of the country. In the economy in which the share of the banking sector is already outsized and overstretched, NRB's unilateral decision could be counterproductive from the point of view of misallocation of the resources.

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