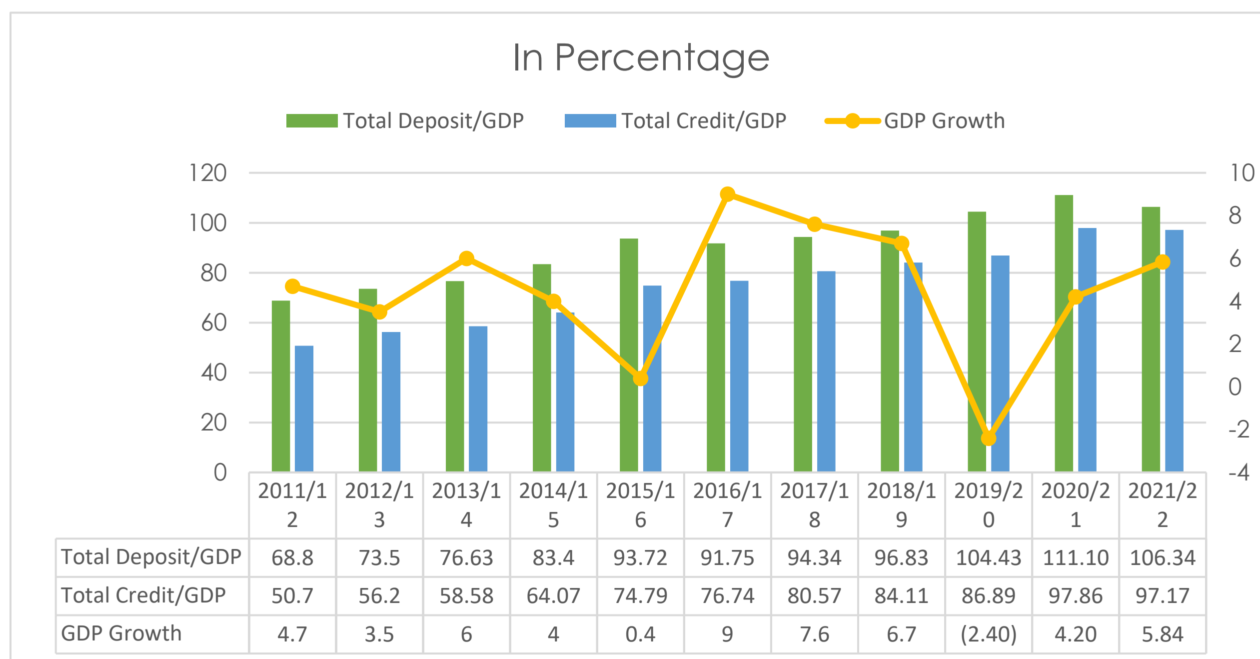
How is NPL so low in banks? Evergreening? Window dressing?

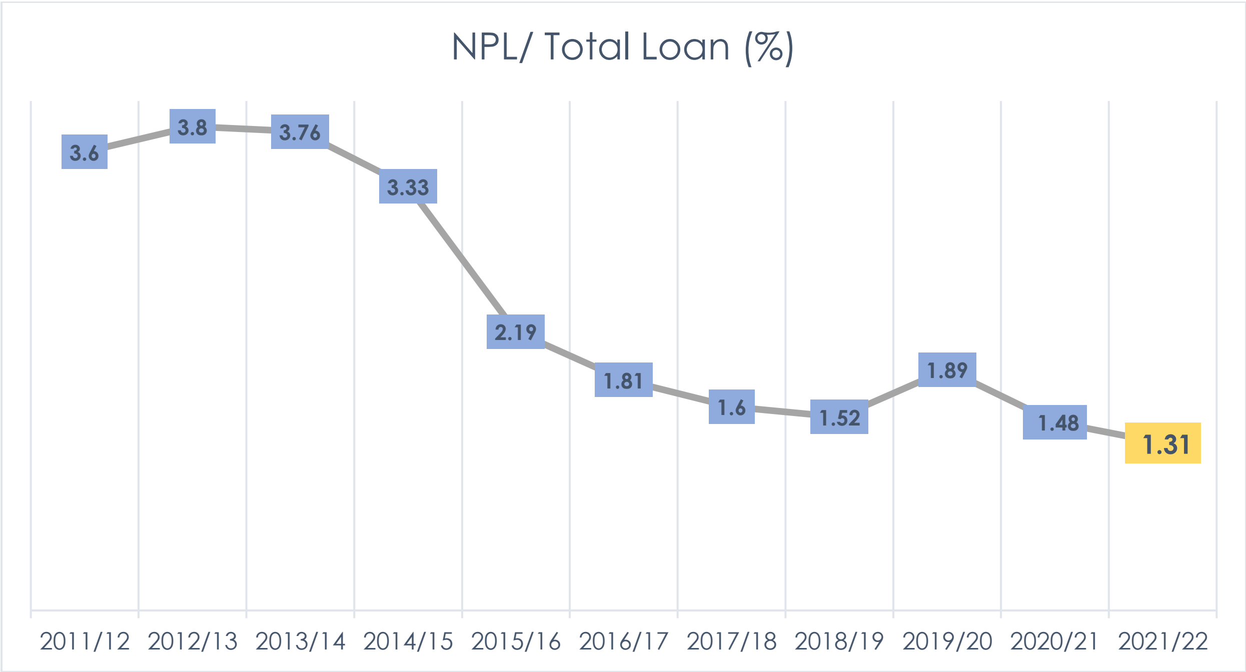
COVID-19, a black swan event impacted each and every sector of the economy, including the daily lives of the citizens. The manufacturing houses, service-oriented industries, schools, and government entities, all were brought down to their knees, jeopardizing the survival of the same, except the mammoth entity Banks. Despite all the turmoil created by COVID-19, banks posted profits, supported by resilient business growth. Even the devastating earthquake was not able to deter the bank's business. In the FY 2019/20, BFIs were able to increase the loans by 12%, while maintaining an industry average NPA of 1.89%, an increase of 24.34% from the previous FY. In the times when the public was fearful about the solvency of the banks due to unforeseen circumstances, the banks posted comfortable financials, along with a minuscule increase in Non-Performing Assets. From this, we can draw two hypotheses, i.e. "Are the banks being managed in such an efficient way that they were able to overcome testing time with flying colors", **or** "Are the banks deliberately hiding something so that the public trust is unfazed?"



	2011/12	2012/13	2013/14	2014/15	2015/16	2016/17	2017/18	2018/19	2019/20	2020/21	2021/22
Total Deposit/GDP	68.8	73.5	76.63	83.4	93.72	91.75	94.34	96.83	104.43	111.10	106.34
Total Credit/GDP	50.7	56.2	58.58	64.07	74.79	76.74	80.57	84.11	86.89	97.86	97.17
GDP Growth	4.7	3.5	6	4	0.4	9	7.6	6.7	(2.40)	4.20	5.84

BFIs credit growth has always been a matter of great interest which attracts scholars of all sorts, some speaking in the favor of above-average growth and some arguing against it as it is not yielding the required growth as it is supposed to. As of FY 2021/22, the credit to GDP stands at 97.17%, which is almost double where it was a decade ago, however, the economic growth remains at a similar level. In reference to the data provided by NRB, the total loan disbursed in FY 2011/12 was Rs. 789 Billion, which has swelled to Rs.470.9 Billion in FY 2021/22. Again, if we refer to the NPL data over the course of the same period, we can clearly see the downward journey of the NPL, with an exception of the COVID times. This raises the question of how the banks are able to halve the NPL while the credit expansion has increased sevenfold during the same course of time. IMF in one of the reports commented on the

suspiciously low level of NPA, warning that if not addressed timely, could snowball into a larger financial disaster. IMF states "despite a 29.7 percent increase in total loans, by October 2021 the NPL ratio had decreased to 1.4 percent (from 1.8 percent in January 2021 and 1.5 percent as of August 2021), reflecting the high level of masking effects of COVID-related forbearance measures."

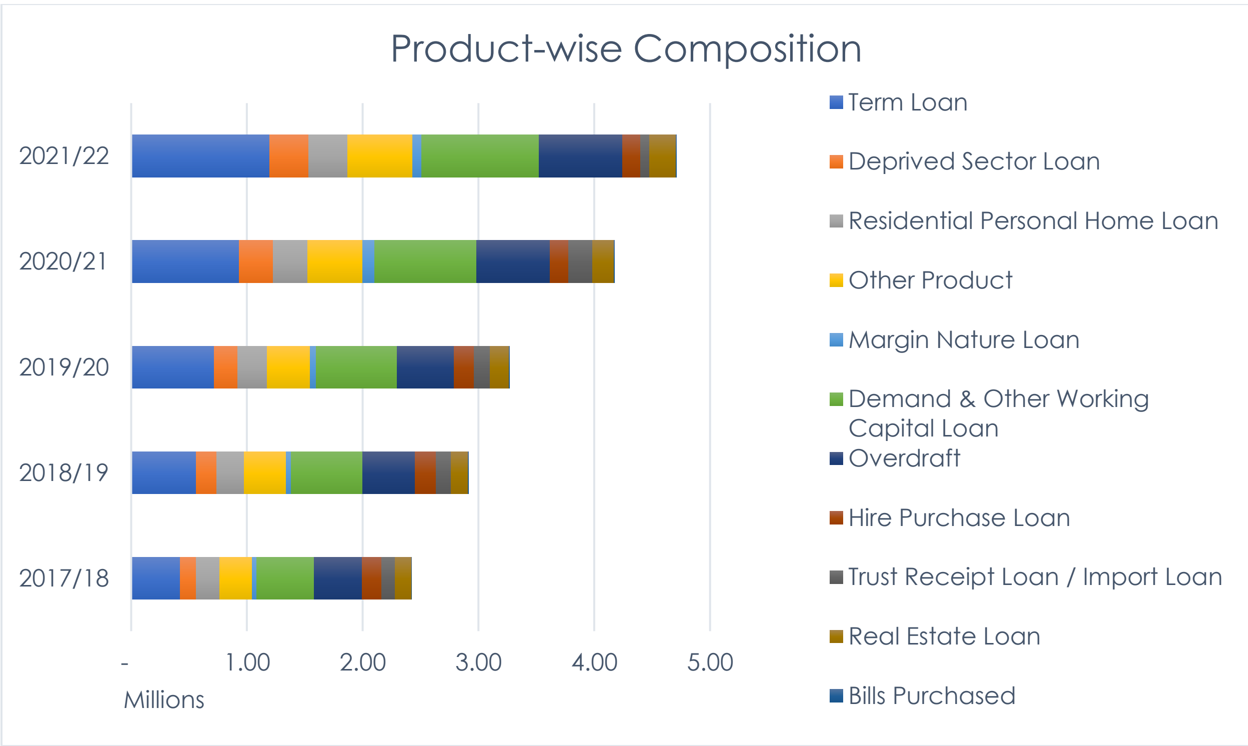


The low level of NPL has always been a matter of concern for national as well as international authorities. In the subsequent section, we try to dive deeper into the possible reasons behind the "impressive" level of NPL as published by the banks.

According to IMF, "the high share of revolving loans, evergreening practices, the difficulty in monitoring consolidated borrower exposures, unavailability of bank-level forbearance data, and insufficient level of COVID-19-related monitoring raise concerns that NPLs are understated, provisioning for loan losses is inadequate, and capital adequacy is overstated. At the same time, there are ongoing COVID-19-related borrower support and regulatory forbearance measures, which are likely to hide the vulnerabilities in asset quality. Asset classification in Nepal, including NPLs, is mostly defined in terms of the days past due and does not adequately incorporate qualitative factors that could affect borrowers' creditworthiness. Additionally, the current regulatory framework does not include clear definitions of forborne loans and NPLs, and guidance on how these loans should be treated in reclassifications. But statements suggest that Non-Performing Assets (NPAs) are also declining, indicating that some banks could be "ever-greening" loans to bring NPAs to minimum levels. They have used high volumes of revolving loans, overdrafts, and working capital loans to evergreen loans and understate the level of NPAs.

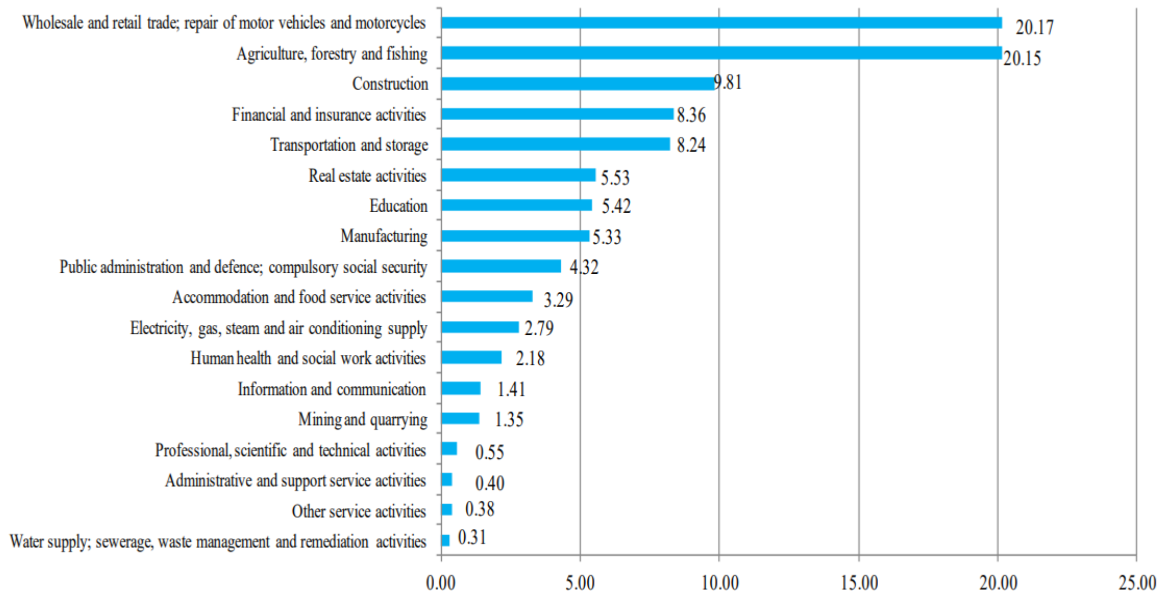
In the banking supervision report published by NRB, "every year it mentioned malpractices harbored by the banks to smoothen their earnings and publish too good-to-be-true

financials. “Instances were noted in some banks where banks have not properly assessed the need and repayment capacity of the borrower. Instances were noted where additional working capital loan provided as a COVID-19 relief measure has been used to pay overdue interest and principal of other loans. Most banks have developed and implemented Internal Credit Risk Grading (ICRG) for the risk assessment of all credit exposures. However, scores obtained through credit risk grading are not correlated with the probability of default by the customer and hence pricing (interest rate) of credit facilities provided”. All of these statements clearly mention evergreening practices adopted by banks to publish the desired level of NPL, when the actual scenario is more concerning than it looks. Each year, the chunk of overdraft and working capital loans dominates the loan portfolio of the banks as suggested by the figure below. Both Overdraft and working capital loan is issued for general purposes, attracting minimum monitoring or fund usage information, which is why it has been used for evergreening mostly, along with investment in stocks and real estate.

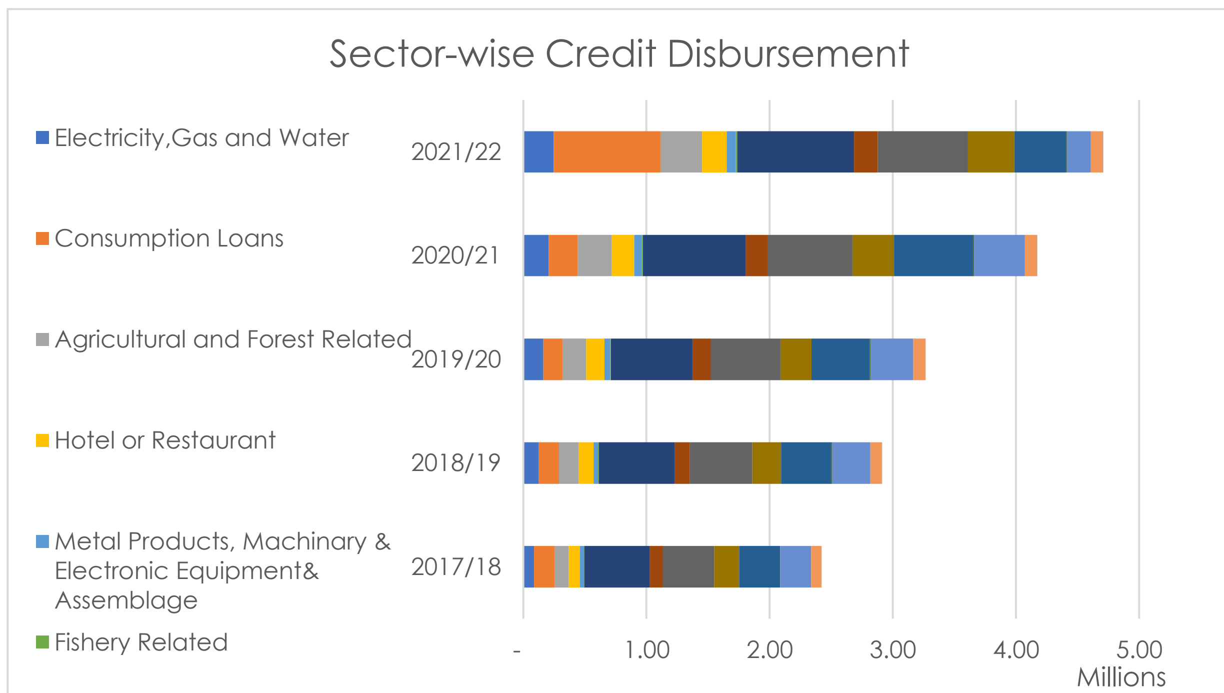


Again, lets us provide a benefit of the doubt to these categories of loans, due to its convenience, it is usually used by business houses and manufacturing companies which is usually capital intensive. Let’s examine how efficient its utilization has been. In reference to GDP data for 2020/21, wholesale and retail trade accounts for 20.17% of the GDP, i.e Rs.863 Billion, while the loan amount disbursed to the sector amounts to Rs. 838 Billion. Similarly, manufacturing contributes 5.33% of Rs. 228Billion, while the loan amount disbursed to the sector amounts to Rs. 687 Billion, which accounts for 16.45% of the credit portfolio of the banks. Similarly, the contribution of the agriculture sector to GDP is declining every year, where it has reached 21% in FY 2020/21 from 31% in FY 2010/11, but the share of agricultural loans has increased from 2.62% in FY 2010/11 to 6.56% in 2020/21. Therefore, we can even raise the question of why the banks are increasing their loan portfolio in the

agriculture sector while its contribution to GDP is in the declining phase. Is the loan issued for the agriculture sector put to good use? If it were so, why is the agriculture sector not been able to increase its contribution despite banks increasing its funding throughout the year? There is a possibility that the working capital and overdraft loan usually utilized by manufacturing entities is not being utilized prudently and loan issued in the name of agriculture is just used for buying agricultural land for real estate investment purpose.



Source: Central Bureau of Statistics, 2020/21 *Provisional



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With this presented scenario, the big question of where we are headed is if we continue to proceed with the same tendency. Until when will the banking industry be able to continue evergreening without its outburst? In case of an external audit by entities such as IMFs, what horrifying figure of NPL and profits will the safest institution publish? Hence, the threat of an outburst looms casting a dark shadow on the most trusted institutions in the country. At present, the NRB has been actively trying its best to untangle the complicated scene woven by the banking industry in pursuit of profits and maintaining its "leading" position. Tightened working capital policy, overdraft policy, and restrictions on investment in real estate and stocks are some of the popular weapons used by NRB with the hope to curb the practices. However, it has led to widespread panic in all the sectors of the economy such as hotels, manufacturing, and trading houses. Voices are being raised from all the sectors citing that NRB's policies will lead to seemingly a halt in Economy. Currently, banks are not even in a position to extend further credit, which translates to not being able to provide additional loans to pay off existing loans. So, will we see a rise in NPL in the upcoming days? Or, is there any other trump card in the hands of the banking industry?