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Improving Banks' Credit Risk Management: Focus To Sustainable Banking in Nepal

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Background

When we look into the global scenario of banking industry, it has been noticed that few years back the entire global banking and financial system was unfortunate to experience the bitter taste of financial and economic crises. In the period of financial instability, it has been acknowledged that the success/sustainability or failure of banks or financial institutions largely depends on how well various risk are managed under a highly competitive, challenging and fast changing business environment. A number of financial institutions have been collapsed or experienced financial problems due to inefficient credit risk management system.

A banking crisis may also take place because, in first place, banks can be under pressure with liquidity problem caused by the increase of bad or nonperforming loans (NPL) in their balance sheets. So, the concentration to the driver of banking credit risk rather than looking at the cause of banking crisis. Credit risk is one of the most important areas of risk management. It is bank's exposure towards loan to its clients. It increases when the clients failed to repay the principle and interest amount of borrowed loan at the specified time schedules. Generally speaking, credit risk is the largest source of risk facing banking institutions. For these institutions, sound management involves measuring the credit risk at portfolio level to determine the amount of capital they need

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to hold as a cushion against potentially extreme losses. It plays an important role mainly for banking institution, which try to develop their own credit risk models in order to increase bank portfolio quality.

Many studies and researches have been conducted since past related to the financial performances of Nepalese Banking Industry which are largely based on improving the performance of existing banking industry in Nepal and has led down various suggestions and solutions to solve the issues related to liquidity, bad loans or non performing loans, security, poor corporate governance, operational risks, market risk, interest rate risk, foreign exchange risk etc. However it has been observed that the study requires focusing on the key issue of the bank which basically leads any bank or financial institution to bear losses and analyze various methods and techniques that need to be adopted to manage such risk. Hence the recent research entitled as "A study on Credit Risk Management in Century Commercial Bank Limited" is focused on analysing the practices adopted by newly commenced commercial banks in Nepal to cope with ever increasing challenges and threats of credit risks in the dynamic financial environment. The study has found every bank seek to develop their own credit policies and models to deal with credit risk and follow each and every regulatory norms and standard set by Central Bank of Nepal and Basel Committee. It identifies that new commercial banks in Nepal are strictly regulated by Nepal Rastra Bank (NRB), Central Bank of Nepal which make annual supervision to the banking performance in Nepal.

NRB publishes Annual Supervision Report of Banking and Financial Institutions in Nepal which helps to show the trend of growth of banking industry in Nepal with respect to number, capital base, profit, technology, security, deposit mobilization or investment, credit quality and control etc. According to the survey, In Nepal there are 31 commercial banks, 89 development banks, 75 finance companies and 22 micro-finance institutions. It is apparent that Nepali banking space is crowded by the existing number of banks and financial institutions. For this reason, implementation of major changes affecting the industry becomes challenging and at times smaller players find it difficult to cope with such changes. It is also observed that the changes that are easily absorbed by the bigger players become bottle necks for new and smaller entities.

Deposit and Lending market are different for big and small player in the same industry. The deposit trend for the big player seem stable and consistently growing with the increase in economic activities but the situation of small and newly commenced commercial bank such as century commercial bank, janata bank, mega bank and civil bank is different. These banks are facing the competitive market to raise the deposit and have difficulties to find the good and profitable sector for lending. The deposit collection is tough for the new banks but it is manageable by attracting big deposit from other banks. Most of the banks have to share the proportion of the deposit of any big institution clients. Similarly these banks compete to attract deposit of others. But the bank cannot be run profitably unless it makes lending. The lending market in Nepal is quite unpredictable. It is depend on the economic and political situation of Nepal. Since there doesn't exist big manufacturing industries and plants, hence the bank has to extend credit to small and medium scale enterprises. The new commercial bank such as Century Commercial Bank has very difficult to find appropriate sector to extend loan.

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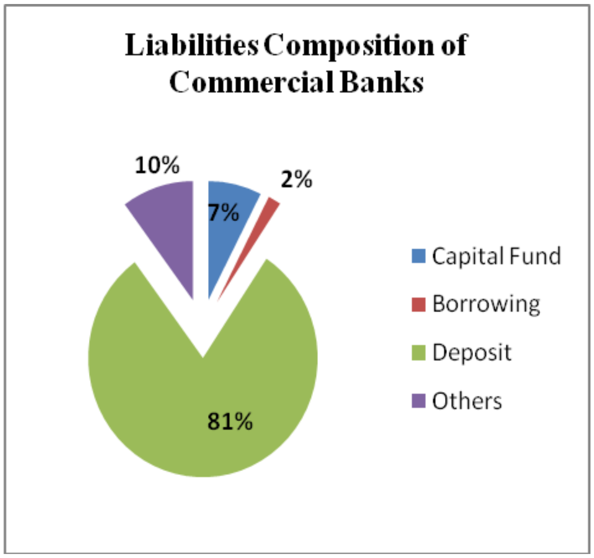
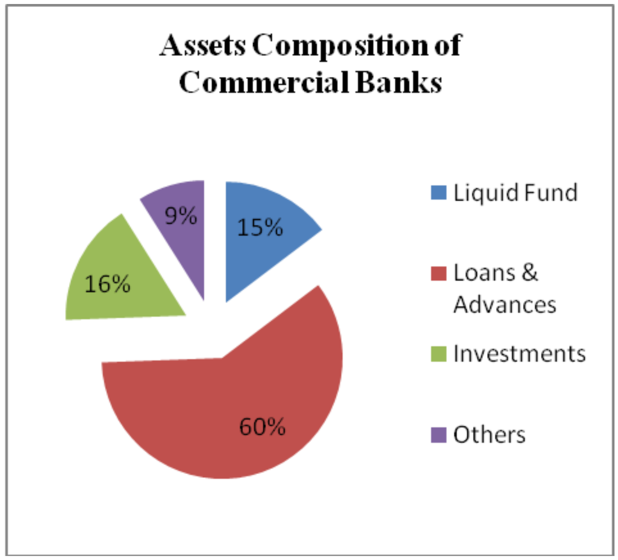


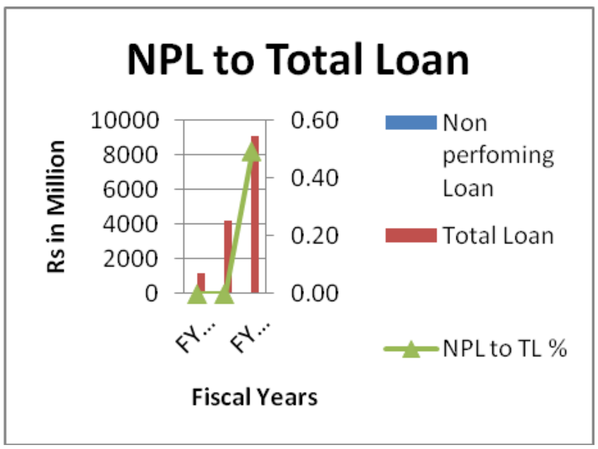


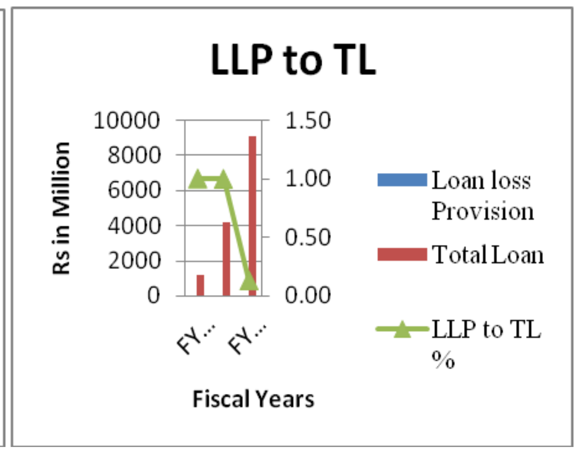
The above figures show the asset and liabilities structure of commercial banks in Nepal. It shows out of 81 percent of deposit liabilities are used for 60 percent of risk assets (loans and advances). The overall performance of the banking industry during the F.Y. 2011/12 has remained satisfactory. A total asset of the bank has increased by 23.04 percent, in comparison to the growth of 10.17 percent in the last year. The capital adequacy position of the commercial banks as a whole improved significantly. All the banks, except two public sector banks namely Nepal Bank Limited (NBL) and Rastriya Banijya Bank Limited (RBBL) have met minimum regulatory capital. Similarly, the assets quality of the banking industry also remained well.

The better performance of any commercial bank is based on how well the bank manages its credit risk which ultimately depends on the quality of credit extended by the bank. Hence, with the objective to analyze the practices adopted by the new banks to manage its credit risk in order to achieve sustainable banking, the study on Century Commercial Bank has been done.

Status of Credit Quality

CCBL has negligible non performing assets which resulted into zero Non Performing (NPL) to Total Loan (TL) ratio and Loan Loss Provision (LLP) to TL ratio. The bank has adopted its in house credit policy and also comply the regulations set by Nepal Rastra Bank which help the bank to regulate its credit operation in efficient and effective manner.





CCBL has used its internal risk rating model to categorize the quality of loan to the customers. The loan which has high degree of risk or chances of default is flagged by high grade and low grade is given to loan portfolio with less risk, besides the bank's enhancing the quality of credit from the starting phase of credit extension process. Most of the banks seek the solution of the problem when it occurs but it is important to prevent the problem to occur. Hence CCBL has developed well constructed and framed credit appraisal policies which help in the deep assessment of the risks associated with credit extension and helps into taking rational decisions. The bank has developed credit department at every branch level which help in the assessment of the loan from root level itself. The credit division critically analyzes the proposal from different perspectives in line with statutory, regulatory and internal guidelines. Thereafter, if the business proposal is found to be credit worthy, it is placed in the credit committee. The Credit Committee

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is comprised of seasoned bankers who evaluate credit proposals. The committee analyzes in depth financial as well as non financial information regarding the borrower such as business history, market situation, future prospects of the market, managerial capabilities, cash flow and then declines or recommends approval of the designated credit authorities. To ensure proper and adequate risk analysis and timely customer service, our credit policy and procedures guide (CPPG) provides various layers in the credit approval process. The CPPG has conferred specific discretion ranging from the General Managers to the Executive Credit Committee, the penultimate credit authority of the Bank. Both the adoption of international standards via in-house Credit Policy, procedures Guide and formation of Credit Quality Control (CQC) unit for monitoring the quality of credit, are at the account level and portfolio level.

Steps adopted by CCBL to enhance the quality of credit and establish sound Credit Risk Management Practices:

- Regular review of the credit portfolio by the senior Management with periodic reporting to the Board of Directors.
- Separate independent audit and inspection of borrowers by internal auditors in addition to audit and inspection by statutory auditors.
- Strict adherence to the prudential guidelines of the Central Bank on Loan Classification, Interest Recognition, Asset Classification, Single Obligor Limit, Sectoral Exposure etc.
- Establishing suitable exposure limits for borrowers and sectors and monitoring the limits on a regular basis.
- Risk mitigation steps with a special emphasis on collateral.
- Setting counterparty limits based on their financial strength.

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- Training of lending and legal officers on documentation and professional valuations. Developing skills and expertise of lending officers to scientifically assess project viability and customer integrity.
- Educating the staff on provisions in the Banks and Financial Institution Act and other relevant statues and the regulatory guidelines of the Central Bank. Seeking external legal opinion and advice.
- Identifying Early Warning Signals (EWS) and taking prompt action thereon.
- Constant posts sanction monitoring with special independent team for verification of current assets

Future Challenges in Banking: Where to stand?

The banking industry in Nepal is likely to pass through few important policy changes (or challenges) in the near future. These changes, mostly being introduced by the regulator, are likely to be in the best long term interest of the Industry and are expected to have a far-reaching impact on the industry in Nepal. Some of the changes in its order of implementation are Base Rate, Internal Risk Rating (IRR), Interest Rate Corridor and BASEL III. Hence, the new commercial banks should be ready to prepare them to cope with the domestic as well as international challenges. Many commercial banks in Nepal are going through mergers and acquisition process under the supervision of NRB but Merger and acquisition is not the alternative it is the compulsion. Hence, it is found that the new commercial bank should develop its own internal policy strong enough that will able to match with the trend of economic growth. With the objective of making profit it short term, it should not make haphazard lending but has to make clear assessment of the loan from various aspects and grade the customer for credit extension. Hence the Bank should follow the effective credit risk management practice in order to achieve sustainable banking for future.

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