

Impact Assessment of Rising Non-Performing Assets on Nepal's Financial Stability

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Abstract

The banking sector in Nepal has played an important role to channel surplus credit into productive sectors, and fueling economic growth. However, the sudden rise of Non-Performing Loans (NPLs) has raised concerns about the stability of banking industry. While NPLs remained well below the global average in years following the NPL crisis of early 2000s, it once again surpassed the 5% threshold in April 2025. The regulatory body, Nepal Rastra Bank (NRB), has expanded its regulatory oversight in response to previous episodes of high NPL to prevent instability in the industry. This deterioration of assets coincided with declining credit growth further solidifying IMF's concern about evergreening loans. In addition to it, the COVID-19 slowdown, lax lending practices, herding behavior, prescribed sector lending mandates, and poorly adapted international frameworks also contributed to the rise of bad assets. Such persistently high NPLs lead to credit crunch, threaten bank profitability, undermine monetary policy, and dampen economic growth by limiting investment, employment, and consumption. A regression analysis also shows a negative relationship between NPLs and GDP growth in Nepal further raising the need for targeted regulatory responses to maintain financial stability.

Keywords: Non-Performing Loans, Nepal Rastra Bank, Credit Growth, Monetary Policy

Impact Assessment of Rising Non-Performing Assets on Nepal's Financial Stability

The banking sector is a crucial pillar of the modern economy which acts to funnel surplus credit from households to productive sectors. Nepal's modern banking system developed over the last few decades, and has integrated with the broader economy relatively well. While the financial sector, including banking institutions and non-banking financial institutions (NBFIs) have been able to drive economic growth and development, unchecked and underregulated periods have often led to devastating crises. The interconnectedness of the global economy entails a larger spillover effect even in countries with relatively managed banking systems, as seen during the 2008 financial crisis. To avert similar issues, there has been a continuing global consensus through establishment of institutions like the World Bank, the International Monetary Fund, and frameworks such as the BASEL framework, in addition to cooperation of the respective central banks of each country. They remain cautious about money supply, inflation, credit growth, bad assets and foreign reserves. BASEL framework has been developed over multiple stages, with BASEL-III being developed to improve the resilience of banking institutions to economic shocks (Basel Committee on Banking Supervision, 2011; 2017).

The Nepal Rastra Bank was established in 1956 with stabilizing exchange rates, issuing banking notes and guiding the country's monetary policy being the core mandate (Nepal Rastra Bank Act, 1955). Following the financial sector liberalization in the 1980s and 1990s, the number of banking and financial institutions increased, often without in-depth regulatory insight from the central bank. This created an early episode of high non-performing assets in the financial sector, as seen with Nepal Banijya Bank and Nepal Bank having 60% of their loan portfolio categorized at Non-performing during its peak. With this, Nepal Rastra Bank Act (2002) was introduced to increase the scope and mandate of the Central Bank to include ensuring

price stability, promoting public confidence in the financial system and maintaining external sector stability. Additionally, the Banking and Financial Institutions Act (2006) was introduced. With a stronger regulatory framework and increased oversight of the Central Bank, the NPLs decreased to below 5% by 2009 even as the global repercussions of the financial crisis were being seen. In the 2010s, with continued regulatory insight, and most importantly, the sustained high economic growth, NPLs remained well below the self-imposed threshold of 5%.

Current Problem

In April 2025, the average non-performing loans for commercial banks crossed the 5% threshold (Key Financial Indicators, 2025). Additionally, through a new directive, Nepal Rastra Bank now allows banks with less than 8% NPL ratio to participate in open market bidding for NRB's assets. While the 5% NPL ratio for Nepal is lower compared to Nepal's South Asian peers at 8% and the global average of 5.5%, the growth trajectory of NPL is more concerning (Anita et al, 2022; Goyal et al, 2023). The NPL ratio was at sub two percent level just two years prior (Key Financial Indicators, 2022). Additionally this increase in NPL coincided with the decrease in credit growth to single digits, down from mid-20s for the five years prior. This highlights a major concern echoed by the International Monetary Fund (IMF) through its reports, arguing that banks might be funneling new credit to bad borrowers to repay existing debt (IMF Article IV consultation, 2023). This has raised headaches for the central bank as it considers non-performing loans (NPLs) as a significant indicator in assessing the financial stability of the economy (Bhattarai, 2015 ; Ahmed, 2010).

This build in NPL in the banking sector can be attributed to a host of factors including bank-specific variables, central bank requirements and international frameworks in addition to the economic slowdown inflicted by the COVID pandemic. The economic slowdown post-covid

has had a devastating impact on businesses, both large-scale enterprises and MSMEs. Favorable macroeconomic conditions of high economic growth, moderate inflation leads to a lower non-performing loans ratio as the real amount firms owe to banks decreases while having a higher cash flow (Anita et al, 2022 ; Bhowmik and Sarker 2024; Goyal et al, 2023 ; Bhattarai, 2015; Pokharel et al 2025). Considering the consistent economic growth in the 2010s, and 2015 capital hike for banking institutions, businesses borrowed heavily that led to annual credit growth ranging in the mid to high 20s (NRB, 2015). The unexpected global pandemic, and subsequent halt in consumer activity led to decreased consumer, and business confidence hampering the economy. Even until 2022, with the credit growth continuing, the non-performing loans were able to remain under the radar, but continued tighter credit conditions led to NPLs rising on balance sheets.

Additionally, individual banks engaged in lax lending policy that led to a worse situation for those banks specifically (Pant, 2023; Bhattarai, 2014; Koju et al, 2018). Bank behaviors, such as herding, over liquidation and profit-incentive has led to banks being in this position. Bankers primarily engaged in herding to not risk managerial reputation, and in the process provide excess liquidity to initially profitable sectors (Jain and Gupta 1987 ; Devenow and Welch, 1996). Additionally, to further enhance managerial reputation, the executives engage in maximizing loan portfolio to increase profits to show in the books. This has led to some banks being more riskier and initially reaping profits, while others such as EBL and Standard Chartered were more cautious and now have a more stable loan portfolio. Empirical evidence also suggests a higher CD (credit deposit) ratio and bigger asset size in banking institutions have led to higher NPL (Pokharel et al 2025; Koju et al 2018).

Furthermore, the role of international institutions, frameworks and the central bank policies often seems to be under looked by politicians, policy makers and experts. International institutions and frameworks often use a one-size fits all mechanism which might not be as effective and efficient for an informal economy. The first step in this regard should've been to formalize the informal sectors, something that we lacked by haphazardly implementing international frameworks without adjusting to local needs. The central bank, in addition to international frameworks, also has various mandatory requirements that limit the ability of commercial banks to engage in lending policy freely. The sector-specific and industry-specific mandatory lending requirements set by the central bank to prioritize hydropower, construction, MSMEs often leads to credit oversaturation, and excess liquidity in these sectors, further forcing banks to lend to untrustworthy borrowers.

What it leads to?

This buildup of NPL, if persistent, can have devastating consequences for the banking industry, and the financial stability of the economy. While the direct effects of bad asset build-up is limited to banks' profitability, and their ability to increase their loan portfolio, such reduction in credit can have a ripple effect into the broader economy and potentially start a downward spiral.

Banking Sector Impact. While the initial effects of NPL build-up are limited to specific banks, and when contained within can prevent a spillover effect, the resilience of the banking sector might be tested. Banks see an impact on their profitability, and if bad asset build up is large enough, it can eat into their capital base. This reduction in profit is true both, intuitively and empirically, as papers are able to show the negative relationship with ROA. The Nepalese banking sector has worked with a small capital buffer above the regulatory minima, and any

erosion into the capital could cause issues for the banks (Gurung et al, 2024; Bhattarai, 2020; Shrestha and Khadka, 2024).

The banks are forced to set aside larger amounts for loan loss provision, and in extreme cases will require recapitalization, or bailouts as seen in the past. They will then act more cautiously in lending, often reducing the credit supply, and essentially barring smaller borrowers from the credit market. This reduction in credit supply not only affects borrowers, but also reduces the profitability of banks, making it harder for them to reverse the impact of bad assets.

The biggest headache, for both, the bank and the central bank is to not let the consumer confidence erode as in such instances as slight misinformation can lead to bank runs without giving banks the time to react (Brunnermeir et al, 2009 ; Goyal et al, 2023; Katuka et al, 2023).

Credit Impact. The broader trend of rising NPL across multiple banks can have a larger impact on the economy due to economy-wide reduction of credit supply. Banks struggling with bad assets tend to act more cautiously when lending to prevent worsening of the situation. We are already seeing this, as even with a credit deposit ratio of seventy eight, which is twelve percentage points lower than the regulatory maximum, the credit growth has fallen to low single digits in the last 2 years.

This tightened credit environment can have devastating effects on businesses, especially since they would miss investment opportunities, face cash flow uncertainty and in some instances, not be able to pay back existing obligations (Ding, Doman and Ferri, 1998). While bad borrowers are disproportionately affected due to lack of new credit, even good borrowers are penalized due to the systematic shift in lending practices.

The impact on collateral-less borrowing, especially practiced by MSMEs is even more concerning for an economy like Nepal. The tighter credit standards crowd out small businesses

from borrowing as they lack collateral or formal documentations, and often makes them resort to informal lending means. This is especially problematic for countries like Nepal as it further advances the informal economy which is hard to regulate and monitor, and the government would be of little help in instances of malpractice or fraud.

Real Economy Impact. The credit contraction in the banking sector has a direct impact on investment in the real economy. The firms are not able to borrow, and are hard hit in capital intensive sectors like manufacturing, construction and hydropower. Additionally, even MSMEs face funding restrictions which in turn reduces the investment and subsequently the output produced by these firms.

Additionally, this reduction in investment and output also negatively affects employment generation. As firms continue to struggle due to slower economic activity and increased financial constraints, they engage in hiring freeze further contributing to the unemployment. This increase in unemployment constrains the finances of individuals and households, and as a cautionary measure they reduce spending. This often leads to a vicious cycle where due to slowed economic activity, unemployment rises as firms can't spend on hiring people which leads to reduced consumer consumption which again leads to slowed economic activity (Balgova et al 2016, Katuka et al, 2023). This has ripple effects into prices of real assets (Klein, 2013; Ari, Chen and Ratnovski, 2021).

Policy Impact. High NPL ratio can significantly undermine monetary policy, especially in times of crisis where the central bank relies on monetary policy to stimulate economic activity. Even while the central bank tries to inject liquidity, or lower policy rates, banks are unwilling to lend considering their bad loan portfolio. We have already seen early signs of this in Nepal, as

even with NRB lowering interest rates, the banking institutions are twelve percentage points below the credit-deposit ratio limit.

This breakdown of monetary policy transmission reduces the effectiveness of monetary policy, and the central bank would essentially be helpless and would need to rely on fiscal policy to stabilize the macroeconomic environment.

In addition to the need for stronger and targeted fiscal policy, the government might also need to, as seen with NBL and RBB in 2003, actively restructure and recapitalize institutions with piling bad debt. These bailouts and recapitalization often put a significant burden on the government, diverting resources away from essential sectors.

Such situations of active government intervention and increased regulatory oversight is often seen as a bad sign by credit rating agencies, and subsequently international investors. This situation could lead to decrease in capital inflow, foreign direct investment and further slowdown the economic activity.

Through a regression analysis on the impact of NPL on the GDP growth in Nepal, we use a panel dataset with 50 observations, and we see a significant negative relationship between NPL and GDP growth. This shows that a sustained high NPL level can have concerning effects on economic growth.

+ Regression results							
GDP_growth	Coef.	St.Err	t-value	p-value	[95% Conf	Interval]	Sig
NPL_ratio	-70495.299	38021.776	-1.85	.097	-156506.53	15515.935	*
Loan_Loss_Provision	49103.349	47081.956	1.04	.324	-57403.435	155610.13	
Lending_Interest	-20061.114	5110.782	-3.93	.003	-31622.506	-8499.722	***
Credit_Deposit_Ratio	13927.86	2089.489	6.67	0	9201.108	18654.612	***
Capital_Adequacy_Ratio	23431.165	29221.947	0.80	.443	-42673.473	89535.803	
Leverage_Ratio	36005.202	19911.658	1.81	.104	-9038.097	81048.501	
Constant	-940525.09	688908.23	-1.37	.205	-2498943.8	617893.61	
Mean dependent var		443703.513	SD dependent var			98409.081	
R-squared		0.762	Number of obs			50	
F-test		149.038	Prob > F			0.000	
Akaike crit. (AIC)		1230.761	Bayesian crit. (BIC)			1242.233	

*** $p < .01$, ** $p < .05$, * $p < .1$

Table 1.1 ; Panel Regression with GDP Growth as Dependent Variable

Policy Recommendations

Loan Resolution Mechanism The bad loan resolution mechanism needs to be simplified with the introduction of an Asset Management Company (AMC), along with enabling banks to sell distressed assets in secondary markets and enabling equity conversion. Enabling banks to easily sell distressed assets, either to AMC or individual investors, helps banks free up cash separated for loan loss provision while also providing better conditions for the defaulter.

Macro-Prudential Policies Macroprudential policies such as liquidity and capital buffers need to be introduced, and further strengthened to prevent unchecked periods of credit boom. NRB has introduced capital buffers following BASEL III, and it needs to expand such policies to promote stability.

Early Warning Systems Nepal Rastra Bank should take a more aggressive approach to assessing the financial health of banking institutions by increasing the frequency and depth of Asset Quality Review. Additionally, they should also engage in a more detailed credit risk stress tests on banks to measure the impact of shocks on CAR and NPL levels. Additionally, as seen in

India with SBI, banks need to improve risk assessment models with help of AI-based detection tools to properly identify and manage potential default risks. These AI-based systems would analyze expense patterns, transaction flows and other documents more efficiently to assess credit risk.

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