

**CREDIT RISK MANAGEMENT AND PERFORMANCE OF
COMMERCIAL BANKS**

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1. Background of the study

Credit risk management is one of the most important function of a financial institution and composition of loans and advance directly affects the performance and profitability of the bank. Credit risk refers to the probability of loss due to borrower's failure to make payments on any type of the debt. When a borrower fails to pay any time of debt, your business loss revenue. Credit risk has gone from being a necessary business evil to a strategic survival imperative.

Credit risk management is the practice of mitigating losses by understanding the adequacy of the a bank's capital and loan loss at any given time a process that has long been a challenge for financial institution. Credit risk management is a crucial function of banking and financial institution as it basically does the business of lending borrowing of the money mainly belonging to shareholders and depositors (Treacy, & Carey,2000). Financial environment is dynamic. In this dynamic financial environment fluctuation in interest rate, exchange rate and commodity and real estate price are not something new. These fluctuations in economic and financial variables weaken the corporate strategies and performance of bank. Thus it's necessary that banks have a framework of risk management. Credit risk management allows a commercial bank to reduce risk and potential non-performing assets. Once commercial bank understand their risk and their cost, they will be determined their most profitable business and thus price product according to risk. Credit risk management affects on the company's profitability and liquidity so it's one of the crucial decisions for the financial institutions, consequently the formulation and implementation of lending policies are among the most important responsibilities of direction and management. The banks take almost care in analyzing the credit worthiness of the good performance of the bank and further to attain economic objectives directed towards acceleration of the development .Lending policy should be analyzing performing it's credit creation effectively and to minimize the risk factor.

The policy of commercial banks to make money results in the elastics credit system that is necessary for economy progress at relatively steady rate of growth. With increase pressure on banks to improve shareholders return bank have had to assume

higher risk and at the same time, manage these risk to avoid losses (Saunders & Marcia, 2011). According to Perez (2014), commercial banks face eight types of risk, which are market risk, operating risk, liquidity risk, credit risk, business risk, reputation risk, systemic risk and moral hazard. Out of these risk credit risk one of the major risks, while other two are market risk and operational risk. The Basel Committee on Banking Supervision define credit risk as the potential that bank borrower, or counter party, will fail to meet its payment obligation regarding the terms agreed with the bank, which focuses on the risks to banks and the financial system. BFIs play an important role in circulating money in the economy through loans funding the business enterprises. Risk arises while extending loans. Loans and repayments of the loans on time determine performance and profit that bank makes and also ascertains loss it has to face higher the debt higher will be the provision for the debt (Battarai 2016). It's essential for any financial institution to control and maintain credit limit, as BFIs major sources for injecting funds in the economy, the economy also inversely affected by losses faced by credit risk management.

This study can provide helpful information on policy and practices related to credit risk management being followed by commercial banks of Nepal, which ultimately helps understand scenarios related to credit risk by customer and commercial banks with cyclical and vicious impact (Nepal Rastra Bank, 2017).The main issues of this study is the credit risk assessment in the financial institution based on their internal efficiency, strength and weakness, assessment of assets and borrows. It also focuses on the policies for the credit risk mitigation as well as the problem being faced in credit risk management by Nepali commercial banks.

2. Problems statement

As financial institution are becoming main sources of mobilizing the financial resources, the large amount of commercial banks fund are concentrated on total loan portfolio. There for the success and failure of the finance company largely depend on the total credit risk management of commercial banks. The current situation has brought a cutthroat competition in banking business. There for the success and failure of the finance company largely depend on the total credit risk management and performance of banks. Credit risk refers to the probability of loss due to borrower's

failure to make payments on any type of the debt. Bank should be manage their liquidity problems for minimize risk. Bhattarai (2016) have conducted a research in effect of credit risk on the performance of Nepalese commercial banks and they found non- performing loan ratio has negative effect of bank performance where as CLA, bank size has positive effect of bank performance and CAR, CRR not considered as the influencing on bank performance. This study tries to analysis the present performance of bank which would give the answer of the following queries.

- i. What is the relationship between credit risk management and performance of commercial bank?
- ii. What is the impact of CAR, NPLR, CLA, CRR and Bank size on ROA of Nepalese commercial bank?
- iii. What is the impact of CAR, NPLR, CRR, and Bank size on ROE of Nepalese commercial bank?

3. Objectives of the study

The main purpose of the study is to examine the factors impact credit risk management and bank performance of commercial bank in Nepal. To achieve the main purpose, the following purposes are set:

- i. To examine the relationship between credit risk management and performance of Nepalese commercial banks.
- ii. To examine the impact of CAR, NPLR, CLA, Cash reserve ratio and Bank size on ROA of Nepalese commercial banks.
- iii. To examine the impact of CAR, NPLR, CLA, CRR and Bank size on ROE of Nepalese commercial banks.

4. Rational of the study

This study will provide importance information to those who are planning to invest in the study will give a clear framework.

Loan is the main product of commercial bank. It plays the significance impact on the financial institution's liquidity and profitability. But the most worry factor in banking industry is the total management of loan. Due to the excessive amount of non-

performing assets in finance companies, there is the wide spread suspicion on the performance on the commercial bank.

Nepal Government has just enacted the debt recovery act and approved the long waited regulation on debt recovery to speed up the financial reforms in the financial sector. As the proposed study is focused on the total aspect of credit risk management of commercial bank, it would give information to speed up the process.

The proposed study would be of enormous assistance to the executives of commercial bank on how they should manage the different composition of loans. The study would be important as it provides theoretical framework of different aspects of credit risk management.

5. Limitation of the study

- i. The study has based on secondary data provided by Nepal Rastra Bank.
- ii. The study based on data and information provided by Siddhartha Bank Ltd, Laxmi Bank Ltd, Himalayan Bank Ltd and Everest Bank Ltd.
- iii. The study has been limited to time period of 2010/11 to 2019/20.

6. Review of literature

Review of literature means reviewing research studies or other relevant proposition in the related credit management of commercial bank. A summary of the writings of recognized authorities and previous research provide that the researcher is familiar with what is already known and what is still unknown and untested (Best and Khan - 2008). This study shows that all past and previous studies and conclusions.. For review study, the researcher uses different books and journal, thesis, reviews and abstracts, indexes, reports, and dissertation or research studies published by various institutions.

6.1 Theoretical review

Credit is the sum amount of money lent by the creditor (Bank) to the borrower (Customers) either on the basis of security or without security. Sum of the money lent by a bank, is known as credit (Oxford Advanced Learners Dictionary 1992). Credit and advances is an important item on the asset side of the balance sheet of a commercial bank. Bank earns interest on credits and advances, which is one of the

major sources of income for banks. Bank prepares credit portfolio, otherwise it will not only add bad debts but also affect profitability adversely (Varshney and Swaroop 1994).

Credit is financial assets resulting from the delivery of cash or other assets by a lender to a borrower in return for an obligation of repay on specified on demand. Banks generally grants credit on four ways (Chhabra and Taneja 1991).

CAMELS' model as a tool is very effective, efficient and accurate to be used as a performance evaluate in banking industries and to anticipate the future and relative risk. CAMEL ratios are calculated in order to focus on financial performance also evaluate relative risk. The CAMEL rating frame work is a system of rating for onsite examinations of banking institutions (Barr et al., 2002). The Basel accord refers to a set of banking supervision regulation set by the Basel Committee on Banking Supervision (BCBS). The Basel accords formed the goal of creating an international regulatory framework for managing credit risk and market risk. (BCBS) consisting of G10 country (Belgium, Canada, France, German, Italy, Japan, Netherland, Sweden, Switzerland, United Kingdom and United Stated) adopted the credit risk based capital requirement guidelines in July 1988. Their key function is to ensure that bank hold enough cash reserve to meet their financial obligation and survive in financial and economic distress, aims to strength corporate governance, risk management and transparency.

Pradhan and Shah (2019) focused on credit risk assessment practices in commercial banks on the basis of their internal efficiency, assessment of assets and borrower. The model of the study is based on the analysis of relationship between credit risk management practices, credit risk mitigation measures and obstacles and loan repayment. Based on a descriptive research approach the study has used survey-based primary data and performed a correlation analysis on them. It discovered that credit risk management practices and credit risk mitigation measures have a positive relationship with loan repayment, while obstacles faced by borrowers have no significant relationship with loan repayment. The study findings can provide good insights to commercial bank managers in analyzing their model of credit risk management system, policies and practices, and in establishing a profitable and sustainable model for credit risk assessment, by setting a risk tolerance level and managing credit risks vis-a-vis the prevailing market completion.

Paudel (2012) explored various parameters pertinent to credit risk management as it affect banks' financial performance. Such parameters covered in the study were; default rate, cost per loan assets and capital adequacy ratio. Financial report of 31 banks were used to analyze for eleven years (2001-2011) comparing the profitability ratio to default rate, cost of per loan assets and capital adequacy ratio which was presented in descriptive, correlation and regression was used to analyze the data. The study revealed that all these parameters have an inverse impact on banks' financial performance; however, the default rate is the most predictor of bank financial performance. The recommendation is to advice banks to design and formulate strategies that will not only minimize the exposure of the banks to credit risk but will enhance profitability.

Abiola and Olausi (2014) examined credit risk management in banks has become more important not only because of the financial crisis that the industry is experiencing currently, but also a crucial concept which determine banks' survival, growth and profitability. The aim of this study is to investigate the impact of credit risk management on the performance of commercial banks in Nigeria. Financial reports of seven commercial banking firms were used to analyze for seven years (2005 – 2011). The panel regression model was employed for the estimation of the model. In the model, Return on Equity (ROE) and Return on Asset (ROA) were used as the performance indicators while Non-Performing Loans (NPL) and Capital Adequacy Ratio (CAR) as credit risk management indicators. The findings revealed that credit risk management has a significant impact on the profitability of commercial banks' in Nigeria.

Bhattarai (2016) examined the effect of credit risk on performance of Nepalese commercial banks. The descriptive and causal comparative research designs have been adopted for the study. The pooled data of 14 commercial banks for the period 2010 to 2015 have been analyzed using regression model. The regression results revealed that 'non-performing loan ratio' had negative effect on bank performance whereas 'cost per loan assets' had positive effect on bank performance. In addition to credit risk indicators, bank size had positive effect on bank performance. Capital adequacy ratio and cash reserve are not considered as the influencing variables on bank performance. This study concluded that there is significant relationship between bank performance and credit risk indicators.

Bhattarai, (2015) examined the non-performing loans (NPL) of financial institutions are considered as a significant issue in the context of Nepal for last few decades. The paper aims to identify the impact of macroeconomic variables (GDP, Inflation, and Real Effective Exchange Rate) and bank specific variables (size, change in loan, real lending rate of interest, and share of loan to total assets) on the non-performing loan of the commercial banks in Nepal. The study was conducted mainly with secondary sources. The data were collected for 26 commercial banks covering the period of 2002-2015 with 227 observations. The study found that macroeconomic variables such as the real effective exchange rate have significantly negative impact on non-performing loan. The impact of GDP growth rate was found to be insignificant in this study. One year lagged inflation rate has significant positive impact on non-performing loan. The banks which charge relatively higher real interest rate have higher non-performing loan, which is consistent with the findings of previous studies.

7. Research methodology

Research is a systematic and organized effort to investigate facts and methodology is the method of doing research in well manner and also the research for gaining the knowledge about method of goal achievement, which we desire is known as research methodology. So, research methodology means the analysis of specific topic by using proper method. In other words, research methodology is a process of arriving to the solution of problem through planned and systematic dealing with collection, analysis and interpretation of the facts.

Research methodology deals with research design, nature and sources of data collection adopt by a researcher in studying a problem with certain objectives in view or it is a various sequential steps to how research in accomplished, it depends on the researcher. Research methodology is the way of doing and completing research work.

7.1 Research design

Research design refers to the planning or making a decision before starting with the research study. To fulfill the objectives of the study it emphasizes on descriptive research design. Descriptive research design helps to gain an accurate profile events persons or situation. This research design meets the objective of the study.

7.2 Population and sample

The total population of the study is the 27 commercial bank in Nepal. According to the convenience sampling method Siddhartha Bank Ltd, Laxmi Bank Ltd, Himalayan Bank Ltd and Everest Bank Ltd are the sampled bank of this study.

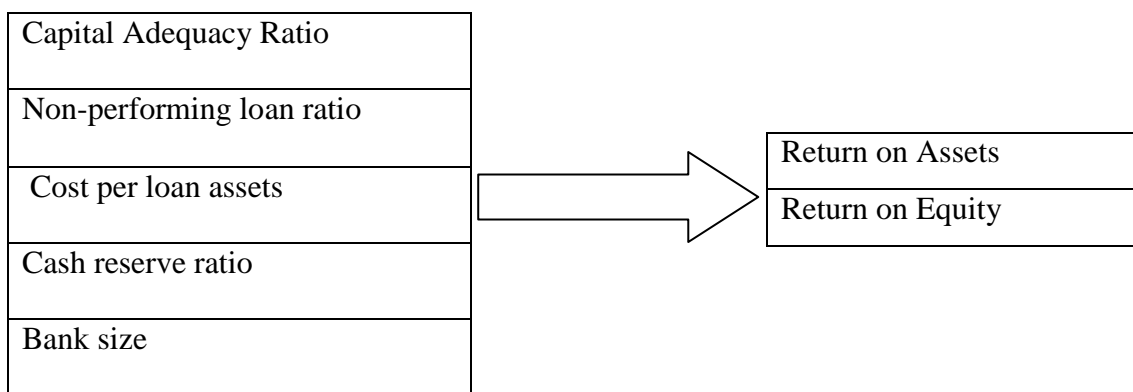
7.3 Nature and source of data

This study will base on secondary data provided. Data and information have been extracted from the annual reports of the bank collected from the concerned bank and downloaded from official websites. The supplementary data and information have been acquired from various sources like newspaper, magazines, brochures, booklets, periodicals and bulletins, published and unpublished reports, related documents and journals available in library of Tribhuvan University, and Nepal Rastra Bank.

7.4 Research framework and definition of variables

Independent variables

Dependent variables



Sources: (Bhattarai, 2016)

7.4 Data analysis method

Different tools will be select according to the nature of data as well as subject matter. "The analysis of data consists of organizing, tabulating, and performing statistical analysis" (Wolf and Pant: 127). Trend analysis, mean, standard deviation and

correlated. Microsoft Excel and SPSS software application is used for calculating data.

8. Chapter plan

The present study is organized in such way that the stated objectives can easily be fulfilled. The structure of the study will try to analyze the study in a systematic way. The study report has presented the systematic presentation and finding of the study. The study report is designed in five chapters which are as follows

Chapter -I: This chapter describes the basic concept and background of the study. It has served orientation for readers to know about the basic information of the research area, various problems of the study, objectives of the study and need or significance of the **Chapter –II:** The second chapter of the study assures readers that they are familiar with important research that has been carried out in similar areas. It also establishes that the study as a link in a chain of research that is developing and emerging knowledge about concerned field.

Chapter-III: Research methodology refers to the various sequential steps to be adopted by a researcher in studying a problem with certain objectives in view. It describes about the various source of data related with study and various tools and techniques employed for presenting the data.

Chapter-IV: This chapter analysis the data related with study and presents the finding of the study and also comments briefly on them.

Chapter-V: On the basis of the results from data analysis, the researcher concluded about the performance of the concerned organization for better improvement.

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