A STUDY ON CREDIT MANAGEMENT AND ITS EFFECT ON PROFITABILITY OF NEPALESE COMMERCIAL BANKS

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Thesis Submitted to
Office of The Dean
Faculty of Management
Tribhuvan University

In Partial Fulfillment of the Requirements for the Degree of Master of Business Studies (M.B.S.)

Putalisadak, Kathmandu
March, 2010

RECOMMENDATION

This is to certify that the thesis

Submitted by

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Entitled

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has been prepared as approved by this Department in the prescribed format of Faculty of Management, Tribhuvan University. This thesis is forwarded for examination.

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ABBREVIATIONS

CA	-	Current Assets
CL	-	Current Liabilities
C.V.	-	Coefficient of Variation
EPS	-	Earning Per Share
EBL	-	Everest Bank Limited
JVB	-	Joint Venture Bank
MPS	-	Market Price Per Share
NABIL	-	Nabil Bank Limited
NPA	-	Non Performance Assets
NRB	-	Nepal Rastra Bank
P/E Ratio	-	Price Earning Ratio
ROA	-	Return on Assets
S.D.	-	Standard Deviation
SCBNL	-	Standard Chartered Bank Nepal Limited
SEBO	-	Security Board

TU	-	Tribhuvan University
WTO	-	World Trade Organization

CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

Lending is one of the most important functions of a commercial bank and the composition of loans and advances directly affects the performance and profitability of the bank. There is intense competition in banking business with limited market and less investment opportunities available.

Commercial banks are major financial institution, which occupy quite important place in the framework in every economy because they provide capital for the development of industry. Commercial banks formulate sound investment policies to make it more effective, which eventually contribute to the economic growth of country. The bound policies help commercial banks maximizing quality and quantity of investment and hereby achieve the own objective of profit maximization and social welfare. Formulation of sound investment policies and co-ordinate and planned efforts pushed forward the forces of economic growth.

Loan management is the essence of commercial banking; consequently the formulation and implementation of lending policies are among the most important responsibilities of directors and management. Well conceived lending policies and careful lending practices are essential if a bank is to perform its credit. Loan management effects on the company's profitability and liquidity so it is one of the crucial decisions for the commercial banks. The banks take almost care in analyzing the creditworthiness of the borrowing customer to ensure that the interest and the principal amount on loans are timely recovered without much trouble and legal process for the recovery. A sound lending policy is essential for the good performances of the bank are further to attain economic objectives directed towards acceleration of the development. Lending policy should be carefully analyzed and the banks should be careful while performing its credit creation effectively and to minimize the risk factor.

The wave of rising expectation and aspiration of people at present context of society, realized the need for rapid socio-economic development in the nation building process. The government has imparted a dynamic role and assigned the public sector with greater responsibility in fulfilling national goals and objectives. With this realization, the government initiated to build up multi-sector infrastructure in the fields of agriculture, industry, commerce, public works, transport, etc. In this context, banking was seen as a major supportive industry to uplift the economic condition of nation and its residents. Therefore, the government has adopted a liberal economic policy regarding operations of banks. About the financial liberalization process it is stated that the interest rate deregulation, curtailment or elimination of directed credits, lifting entry and exit barriers for financial intermediaries, restructuring of banking system and institution for regulatory and supervisory mechanism is some of the key components of such liberalization. This led to the influx of commercial banks in Nepal resulting today into 25 commercial banks. NABIL (previously Nepal Arab Bank Limited), the first joint venture bank in Nepal which was established on 2041 B.S. after adopting financial and economic liberalization policy by the government.

The first financial institution was introduced during the prime-ministership of Ranodip Singh (1933 B.S.) in the name of "Tejrath Adda" for granting loan to employees and public against security of gold silver and other treasures. Banking in true sense started with the inception of Nepal Bank Limited, a semi-governmental bank in 1994 B.S. NBL had a responsibility of attracting public out from the dominance of Sahu Mahajans and introducing banking services as well. After 20 years having an objective of developing banking practice, Nepal Rastra Bank started its operations from 14th Baisakh, 2013 BS. Nepal Bank Limited was only one commercial bank until 2022 BS. To develop a speedy and competitive banking service by reaching nooks and corners of the country, a fully government owned bank – Rastriya Banijya Bank was established in 2022 B.S.

Despite all these efforts, financial sector was found sluggish. The traditional financial system could not provide the public a quality service. Thus, the government initiates a liberal competition, which started to attract foreign investments. A foreign joint venture bank was established in 2041 B.S. with the name of Nepal Arab Bank Limited (now NABIL), which was the first joint venture commercial bank in Nepalese financial history. NABIL started knocking the doors of customers breaking the trend of knocking the doors of banks by customers (Bhattarai; 2061: 4-6).

It has been fully established that economic development of any country can be achieved only through a balanced growth in the field of industry, trade commerce and agriculture. And it has equally self-evident that commercial banks play vital role in the development of these fields. Therefore, productivity and competitiveness of commercial banks is very essential.

Lending is the primary business of any commercial bank and interest earned from them is the main source of income. Once the loan is given, it is supposed that the repayment of interest and principal shall have to be served without any hindrance. But it is not always true. Loans and interests are not always paid so easily by all the customers. Loans lended to the customers come under the Assets heading of balance sheet; and those loans which are not paid in time are considered as Non Performing Loan or Non Performing Assets (NPA). The criteria that determine a loan as NPA varies in different countries. In Nepalese scenario, Nepal Rastra Bank has classified the loans and advances as Non Performing Assets which are due for more than 90 days. Whatever the criteria is, the unhidden fact is that the NPA affects the banks operation and growth adversely. NPA has several impacts on financial institutions. Investments become worthless as expected return cannot be realized on the one hand and on the other hand, due to provisioning required for the risk mitigation, the profitability is directly affected. Similarly, monitoring expenses of such loans are costly too. Therefore, proper management, cost efficiency and speedy disposal of Non Performing Assets (NPA) are the most critical tasks of banks today to remain competitive. The problem of NPA in banks and financial institutions has been a matter of grave concern not only for the banks but also the real economy in general, as NPA can choke further expansion of credit which would impede the economic growth of the country. Any bottleneck in the smooth flow of credit is bound to create adverse repercussions in the economy. NPA is not therefore the concern of only lenders but also the public at large. Similarly, profit making is one of the major mottos of commercial banks and reducing the operating cost is one of the main deterministic factors to increase profitability. So, cost efficiency is also a major area of concern of commercial banks (Thapa, 2007:20-22).

A number of international researches show that there is a negative relationship between cost efficiency and NPA. Cost-inefficient banks may tend to have loan performance problems for a number of reasons. For example, banks with poor senior management may have problems in monitoring both their costs and their loan customers, with the losses of capital generated by both these phenomena potentially leading to failure.

Some other researches also show that there is a positive relationship between cost efficiency and NPA. They show that controlling extra cost such as underwriting and loan monitoring expenditures in order to achieve cost efficiency may reduce the operating cost in short run but it leads towards the increase in NPA in long run.

The proposed study will try to find out the trend of NPA, and its effects on profitability in Nepalese commercial banks. It will also try to find out whether NPA is preceding reduced cost efficiency or cost efficiency in present is contributing increase in future NPA.

Till the date there are 27 commercial banks in Nepal. Agriculture Development Bank (ADB) has also been listed in A class financial institutions two years ago. Therefore, there are 27 ‘A’ class financial institutions (commercial banks). Till the period of this study, a new commercial bank has also been found to be licensed to practice commercial banking operations in Nepal. The name and the year of establishment of the commercial banks operating in Nepal have been listed below:

Name of the bank	**Year of establishment (A.D.)**
1. Nepal Bank Limited	1937
2. Rastriya Banijya Bank	1965
3. NABIL Bank Limited	1984
4. Nepal Investment Bank Limited	1985
5. Standard Chartered Bank Limited	1986
6. Himalayan Bank Limited	1993
7. Nepal SBI Bank Limited	1993
8. Nepal Bangladesh Bank Limited	1994
9. Everest Bank Limited	1994
10. Bank of Kathmandu Limited	1995
11. Nepal Credit & Commerce Bank Limited	1996

12. Nepal Industrial and Commercial Bank Limited	1998
13. Lumbini Bank Limited	1998
14. Machhapuchchhree Bank Limited	1999
15. Kumari Bank Limited	2001
16. Laxmi Bank Limited	2002
17. Siddhartha Bank Limited	2003
18. Agriculture Development Bank Limited (ADB)	1965
19. Global Bank Limited	2007
20. Citizen Bank Limited	2007
21. Prime Bank Limited	2007
22. Bank of Asia Limited	2007
23. Sunrise Bank Limited	2007
24. NMB Bank Ltd.	2008
25. Development Credit Bank Ltd	2008
26. Kist Merchant Bank Limited	2009
27. Janta Bank Limited	2010

Besides, there are 35 Development Banks, 5 Grameen Vikas Banks, 72 Finance Companies, 19 Cooperatives Societies and 47 NGOs conducting financial transactions operating under the rules and regulations of Nepal Rastra Bank (NRB; Banking and Financial Statistics, 2065:3).

Bank is defined as a financial intermediary that channelizes funds between depositors and entrepreneurs. It is a financial institution that accepts deposits and channels the money into lending activities. In a general sense, bank acts as a financial intermediary. Intermediation is between depositors and entrepreneurs. A bank is an institution that deals with money by accepting deposits from the general public, corporate bodies and private organizations and deploys those deposits for profitable purposes in the form of loans and advances. Bank, by accepting deposits, takes up the role of custodian of public money. The transactions in the financial market heavily depend upon the banking system of the country. Without bank, it will be quite impossible for the industrialist and entrepreneurs to go directly to general public for getting their saving or investments. So, the simplest definition is that, bank takes the savings of the public by providing them with certain rate of interest and loans it to needy customers charging them higher rate of interest and thus, earns some profit by doing these transactions. This is the broadest form of banking, but at this age of time, their functions have increased manifold. Remitting of money, letter of credit, guarantee, issue of money, controlling monetary activities of country, etc. are also major functions of bank. For better understanding, an in-depth study of bank has been conducted. The term bank is mainly related to financial transitions to operate, run and facilitate various monetary activities.

According to Concise Oxford Dictionary, the term bank has been defined as “A bank is an establishment of the custody of money which it pays out on customers’ order.” In the word of Kent, “A bank is an organization whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to other for expenditure.” A banker or bank is a person or company carrying on the business of receiving moneys, and colleting drafts, for customers subject to the obligation of honoring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts.

Therefore bank can easily be defined as the custodians of deposits. Bank is an institution which deals with money by accepting various types of deposits, disbursing loans and rendering other financial services “A bank is a business organization that receives and hold deposits of funds from other, grants loans or extends credits and transfers funds by written orders of depositors” (Dhungana, 1993: 2-4).

“The more developed financial system of the world characteristically falls into three parts: central bank, commercial banks and other financial institutions. The two banks selected for the study are joint venture commercial banks (Dhungana, 1993: 2-4).

Banks have today gained paramount trust of the public. Banking industry offers a wide range of services addressing the needs of public in different walks of life. At present, a large number of banks are operating in Nepal. Naturally, they are rendering a wide range of services. They are trying to keep up pace with the changes taking place in the world. But quantity does not count for quality. The financial institutions of all classes ‘A’ to ‘D’ are increasing every year. In a small economy like Nepal, it is a question of great concern as to how so many banks are surviving and reaping profit. The concern is not only about these days but also the sustainability of the operating banks in future days also. Therefore, the report will try to concentrate on three major private sector banks of Nepal, i.e., Himalayan Bank Limited (HBL), Nabil Bank Limited (NABIL) and Standard Chartered Bank Nepal Limited (SCBNL). It will focus on the comparative Profit Accountability of these three banks regarding profitability, liquidity, leverage positions, NPA status etc.

1.1.1 Introduction of the Sampled Commercial Banks

i) Nabil Bank Limited

Nabil Bank Limited, the first foreign joint venture bank of Nepal, started operations in July 1984. Nabil was incorporated with the objective of extending international standard modern banking services to various sectors of the society. Pursuing its objective, Nabil provides a full range of commercial banking services through its 21 points of representation across the country and over 170 reputed correspondent banks across the globe.

Nabil, as a pioneer in introducing many innovative products and marketing concepts in the domestic banking sector, represents a milestone in the banking history of Nepal as it started an era of modern banking with customer satisfaction measured as a focal objective while doing business.

Operations of the bank including day-to-day operations and risk management are managed by highly qualified and experienced management team. Bank is fully equipped with modern technology which includes ATMs, credit cards, state-of-art, world-renowned software from Infosys Technologies System, Banglore, India, Internet banking system and Tele banking system (www.nabilbankltd.com).

ii) Standard Chartered Bank Nepal Limited

Standard Chartered Bank Nepal Limited has been in operation in Nepal since 1987 when it was initially registered as a joint-venture operation. Today the Bank is an integral part of Standard Chartered Group who has 75% ownership in the company with 25% shares owned by the Nepalese public. The Bank enjoys the status the largest international bank currently operating in Nepal.

An integral part of the only international banking Group currently operating in Nepal, the Bank enjoys an impeccable reputation of a leading financial institution in the country. With 11 points of representation (7 Branches) and 9 ATMs across the Kingdom and with over 300 local staff, Standard Chartered Bank Nepal Ltd. is in a position to service its customers through a large domestic network. In addition to which the global network of Standard Chartered Group gives the Bank the unique opportunity to provide truly international banking in Nepal.

Standard Chartered Bank Nepal Limited offers a full range of banking products and services in Wholesale and Consumer banking, catering to a wide range of customers from individuals, to mid-market local corporate to multinationals and large public sector companies, as well as embassies, aid agencies, airlines, hotels and government corporations.

The Bank has been the pioneer in introducing 'customer focused' products and services in the country and aspires to continue to be a leader in introducing new products and highest level of service delivery. It is the first Bank in Nepal that has implemented the Anti-Money Laundering policy and applied the 'Know Your Customer' procedure on all the customer accounts.

iii) Himalayan Bank Limited

Himalayan Bank was established in 1993 in joint venture with Habib Bank Limited of Pakistan. Despite the cut-throat competition in the Nepalese Banking sector, Himalayan Bank has been able to maintain a lead in the primary banking activities- Loans and Deposits.

Legacy of Himalayan lives on in an institution that's known throughout Nepal for its innovative approaches to merchandising and customer service. Products such as Premium Savings Account, HBL Proprietary Card and Millionaire Deposit Scheme besides services such as ATMs and Tele-banking were first introduced by HBL. Other financial institutions in the country have been following our lead by introducing similar products and services. Therefore, we stand for the innovations that we bring about in this country to help our Customers besides modernizing the banking sector. With the highest deposit base and loan portfolio amongst private sector banks and extending guarantees to correspondent banks covering exposure of other local banks under our credit standing with foreign correspondent banks, we believe we obviously lead the banking sector of Nepal. The most recent rating of HBL by Bankers' Almanac as country's number 1 Bank easily confirms our claim.

All Branches of HBL are integrated into Globus (developed by Temenos), the single Banking software where the Bank has made substantial investments. This has helped the Bank provide services like 'Any Branch Banking Facility', Internet Banking and SMS Banking. Living up to the expectations and aspirations of the Customers and other stakeholders of being innovative, HBL very recently introduced several new products and services. Millionaire Deposit Scheme, Small Business Enterprises Loan, Pre-paid Visa Card, International Travel Quota Credit Card, Consumer Finance through Credit Card and online TOEFL, SAT, IELTS, etc. fee payment facility are some of the products and services. HBL also has a dedicated offsite 'Disaster Recovery Management System'. Looking at the number of Nepalese workers abroad and their need for formal money transfer channel; HBL has developed exclusive and proprietary online money transfer software- Himal Remit TM. By deputing our own staff with technical tie-ups with local exchange houses and banks, in the Middle East and Gulf region, HBL is the biggest inward remittance handling Bank in Nepal. All this only reflects that HBL has an outside-in rather than inside-out approach where Customers' needs and wants stand first.

1.2 Statement of the Problem

Banking business in Nepal though seemed developed and mushroomed only in urban areas of the country in recent days, has its own limitations and problems as regards to security, profitability and financial soundness. Currently there are 26 commercial banks under 'A' class financial institutions operating in the country. The inflow of money in the banks in the form of several kinds of deposits is huge but it could not be invested in more profitable, sustainable and riskless projects. In addition, many banks are found centered in the urban areas of the country. Therefore, there is a situation that needy people and small entrepreneurs residing in rural areas are still deprived from institutional credit. However, this study will not go to this vast sector and thus focus only on the level and quality of deposit mobilization of the three sampled banks as regards to profit earning capacity or status of profitability. Therefore, this study is centered on assessing the clear picture of the profitability of the three commercial banks in Nepal.

There is no confusion that credit management affects the profitability of commercial banks. But it without a systematic research or study, it cannot be said that how much the profit affected by credits. On the surface, cost efficiency and credit management might appear to be largely unrelated, because operations personnel typically do not participate in screening and monitoring loan customers, and because loan officers and review personnel typically do not participate in overseeing operations costs. Despite this separation between these two, we cannot reach to a conclusion that there is no any relationship between problem loans (NPA) and credit management of commercial banks. Therefore, to reveal the secret, it is necessary to conduct a systematic study. That is why this research will try to find out the relationship between these two. Likewise, this study will also highlight on the effect of credit management in banks profitability.

While giving the supportive framework to the research study, the questionnaires have been designed to be the main problem areas of the study and hence all tasks will be performed to provide the answers to these questions:

a) What are the major sources of funds for these banks?

b) How the funds obtained through various sources have been mobilized in order to boost profitability?

c) What is the situation of profitability of these banks?

d) What are the factors (mostly quantitative) that affect the profitability?

1.3 Objectives of the Study

The general objective of this study is to investigate the relationships between Non Performing Assets and its effect on profitability of Nepalese Commercial Banks. Therefore, the main objective is to find out exact financial performance of the three banks over the period of recent five years. The specific objectives of the study are:

i. To evaluate the profitability of sample banks for the past five years.
ii. To compare the key financial indicators of sample banks with respect to major sources of funds, their mobilization and their contribution on profit.
iii. To analyze the trend of NPA and to examine the relationship of NPA in bank's operating cost and loan loss provision.
iv. To provide appropriate suggestions and recommendations based on the findings of the study.

1.4 Significance of the Study

This study is not comprehensive to deal with and present detail information regarding the sampled banks. Anyway, this study will be of great significance to the following groups and individuals:

Further researchers and financial analysts: This study will leave over a lot of space to carry out further research studies in this topic and the related. This research report will be very helpful and will act as a potential guide to those interested research students or groups as well as financial analysts in the Nepalese market. University students of new generation: This study will be a valuable and a useful guideline to the upcoming students who want to gain some knowledge on this sector.

Government: Government sector is responsible for making several kinds of policy decisions. This report comprising of the study of commercial banks may provide a beautiful insight to form and thus bring policies conducive to banking sector.

All other interested individuals & parties: This study is also significant to all other interest individuals and parties those wishing to have some potential knowledge regarding profitability of the sampled commercial banks. This study may provide a valuable insight to the concerned parties who want to become investors in the shares of such companies.

Commercial Banks: Apart from the various groups and individuals mentioned above, this study will also be helpful to the respective commercial banks themselves to identify and have some glimpse of their own true picture.

Researcher: This study has a lot of significance to me and further researchers also. On the course of preparation of this report study, researcher got acquainted with various newer terminologies and also was able to deal with different parties. As a result, my knowledge on banking sector of Nepal has also become broader both practically as well as theoretically which will also provide ample opportunities to new researchers.

1.5 Limitations of the Study

There are some inherent limitations in this research study which are presented below:

i. The study was confined only to the fiscal years 2003/04 to 2007/08. So the generalization was based on these periods only.

ii. Only three banks, namely HBL, NABIL and SCBNL were selected for the study. Comparison with only these three out of so many contemporary firms may not present the clear position of any firm.

iii. Reports were based mainly on the published data of the sampled banks, which have been manipulated with.

iv. Most of the data were secondary, which itself was a limiting factor. But for the clarification purpose some primary data were also collected.

1.6 Organization of the Study

The whole study is divided into the five different consecutive parts as mentioned below:

Chapter One: Introduction

This chapter comprises of general background entering the study, brief profile of the banks under study, significance of the study, objectives of the study, limitations of the study and organization of the study.

Chapter Two: Review of the literature

This part is divided into three two explicit headings. First part deals with the reviewing of the various literatures, definitions and concept of profit and profitability. The second one consists of the review of the existing studies, journals, articles and review of books concerned to profit and profitability.

Chapter Three: Research methodology

This part consists of the total population, sample of the study, data collection procedures and the analytical tools and techniques used in the study.

Chapter four: Presentation and analysis of data

This part constitutes the tabular and graphical representation of the collected data, their interpretation and analysis using various financial as well as statistical tools. Apart from it, summary of the major findings are also presented at the end of the chapter.

Chapter five: Summary, Conclusion and Recommendation

This chapter contains the summary of the whole study and relevant conclusions were drawn based on the study. A suitable set of recommendations were made at the end of the chapter.

CHAPTER TWO

REVIEW OF LITERATURE

2.1 Theoretical Review

Management is the system, which helps to complete jobs effectively. Credit management is also the system, which helps to manage credit effectively. In other words, credit management refers management of credit exposures arising form loans, corporate bonds and credit derivatives. Credit exposures are the main source of investment in commercial banks and return on such investment is supposed to be main source of income. Credit management strongly recommends analyzing and managing the credit risks. Credit risk is defined as the possibility that borrower will fail to meet its obligations in accordance with the agreed terms and conditions credit risk is not restricted to lending activities only but includes off balance sheet and inter-bank explores. The goal of the credit risk management is to maximize a bank's risk adjusted rate of return by maintaining the credit risk exposure within acceptable parameters. For most banks, loan are the largest and most obvious sources of credit, however, other sources of credit risk exist through out the activities of a bank, including in the banking book, and in the trading book, and both increasingly facing credit risk in various financial instruments other than land, including acceptances, inter bank transactions and guarantees and the settlement of transactions.

This study mainly focuses on the credit management practice and procedure of Nepalese commercial banks. Hence, it is rational to state these articles and reports those may make a clear concept to understand the said topic. “Banks and financial institutions are the vehicles through which public deposits are mobilized in various development activity i.e. Agricultural, Industry. Trade, Commercial Institution like commercial banks, development banks, financial companies and various micro-financing institution with different model”(Johnson, 1940: 130).

Credit administration involves the creation and management of risk assets. The process of lending takes into consideration about the people and system required for the evaluation and approval of loan request, negotiation of terms, documentation, disbursement, administration of outstanding loans and workouts, knowledge of the process and awareness of its strength and weaknesses are important in setting objectives and goals for lending activities and for allocating available funds to various lending functions such as commercial, installment and mortgage portfolios (Johnson, 1940: 132).

"The investor or whether banks, financial institutions, individuals, private or government sector, must not take the proposal by making decision without having adequate judgment because sometimes they perform out of norms, related studies, policies and techniques. A project appraisal will best viable only if it has accessed through conscious analysis as well as through thoroughly investment decisions to make its macro and micro level viability effective" (NRB, 2058: 125).

The term non-performing asset is, "loans or advances whose credit quality has deteriorated such that full collection of principal and /or interest in accordance with the contractual repayment terms of the loan or advances are in question". "An asset which ceases to generate income of the bank is called non-performing asset. The past due amount remaining uncovered for the two quarter consequently the amount would be classified as NPA for the whole year. It includes borrowers' defaults or delays in interest or principal repayment" (Dhanuskodi, 2006:7).

Lending is the primary business of any commercial bank and interest earned from them is the main source of income. Once the loan is given, it is supposed that the repayment of interest and principal shall have to be served without any hindrance. But it is not always true. Loans and interests are not always paid so easily by all the customers. Loans lended to the customers come under the Assets heading of balance sheet; and those loans which are not paid in time are considered as Non Performing Loan or Non Performing Assets (NPA). The criteria that determine a loan as NPA varies in different countries. In Nepalese scenario, Nepal Rastra Bank has classified the loans and advances as Non Performing Assets which are due for more than 90 days. Whatever the criteria is, the unhidden fact is that the NPA affects the banks operation and growth adversely. NPA has several impacts on financial institutions. Investments become worthless as expected return cannot be realized on the one hand and on the other hand, due to provisioning required for the risk mitigation, the profitability is directly affected. Similarly, monitoring expenses of such loans are costly too. Therefore, proper management, cost efficiency and speedy disposal of Non Performing Assets (NPA) are the most critical tasks of banks today to remain competitive. The problem of NPA in banks and financial institutions has been a matter of grave concern not only for the banks but also the real economy in general, as NPA can choke further expansion of credit which would impede the economic growth of the country. Any bottleneck in the smooth flow of credit is bound to create adverse repercussions in the economy. NPA is not therefore the concern of only lenders but also the public at large. Similarly, profit making is one of the major mottos of commercial banks and reducing the operating cost is one of the main deterministic factors to increase profitability. So, cost efficiency is also a major area of concern of commercial banks.

2.1.1 Credit Policy and Its Parameters

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 date on demand. Credit is the 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: 279). 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: 6)

In fact, it is a very sensitive subject that what sort of credit policy a bank should have. So, it should pay more attention to the loan, advances that it provides. The commercial banks are inspired with the motive of gaining profit. To fulfill these objectives, they should manage and improve its banking sector. They must give more attention to the flow of loan. Regarding loan policy, it should be clear and follow such policy which would match the economic policy of the nation.

Credit policy of EBL is the approved methodologies for conducting its lending operations with an objective to maximize profit of the bank and serve its best to the nation. The general assembly is the sole authority to approve such policy. Normally, the Board of Directors is authorized to approve such policy on the recommendation of the management. The general assembly in its annual general meeting or special meeting may initiate the approve changes or can guide the Board management to implement, suggest, renew or cancel the existing policies.

Credit management in EBL basically covers loan approval process, credit analysis, method and mechanism, lending documentation, disbursement and administration of loan including credit audit. As there is a saying "*Precaution is better than cure*" bank should be more analytical and farsighted while disbursing loan in order to prevent loan flow in unproductive sector and non-performing assets.

Types and Nature of Loan:

Based on time factor, EBL advances loan of the following types:

1. Short Term Loan:

This loan is given up to the period of 1 year to those who have lower requirements than other types. EBL grants this loan to agricultural sector, small industrial sector, small projects etc.

2. Mid term loan:

These types of loans are sanctioned for the period of 5 to 10 years.

3. Long term loan:

Long term loans are granted for the period of more than 10 years. Generally these types of loan are sanctioned to the big industries whose requirements are large. These types of loans are provided for financing fixed assets.

Nature of Loan:

EBL with increment in services provides different natures of loans to its customers as per their requirement.

1. The loans and advances under Fund based:

a. Term Loan:

Term loans are given for the purpose of financing fixed assets. The interest rates for prime sectors are 8 to 10% and for others are 10 to 11%.

b. Working Capital short term Loan:

EBL provides this loan to meet the day-to-day transactions of the companies, industries. The interest rates for primary sectors are 7 to 9% and for other sectors are 9 to 10%. It is essential for running any companies, businesses, industries etc.

c. Overdraft Loan:

This loan facility is provided to those clients who are regular customers of the bank for a long period of time. They have built up strong and trustworthiness relationships with the bank for which they can overdraw money from their account as per their requirement and approval from the bank. The rate is at 8 to 10.15% for prime sector whereas 10.5 to 11% for other sectors.

d. Trust Receipt Loan (import loan):

This type of loan is mainly provided for importers against letter of credit. The bank provides 80% of loan to their valued client for the credit period of 90/120/150/180 days. Importers then repay their loan amount to bank after sell of particular goods. The rate is at 6.75 to 8% for prime sector whereas 8 to 10% for other sectors.

e. Hire Purchase Loan:

This loan is provided for the purchase of automobiles, vehicles etc. to professionals, companies, business executives etc. The interest rate charged is 8.5 to 10.5%.

f. Housing Loan:

The bank also provides this type of loan to its customers where the interest rate is 9% for the maturity up to 5years and for above 5 years it is 9.75%.

2. **Under Non-funded loan, EBL has classified the followings**:

a. Exports credit:

i. Pre-shipment:

This type of loan is mainly provided for exporters. Exporters have to send goods to the importer as requested. Then, for the production of the certain quantity of goods, exporter without money asks the bank for loan. Importer after receiving goods, clears the amount of the exporter, exporter then clears his loan amount along with the interest of the bank.

ii. Post-shipment:

This type of loan is mainly provided for exporters. When goods are produced as asked by the importer, exporter needs to send it. But exporter without any amount to meet operating expenses occurred on shop and loading goods on shop asks for loan with the bank.

The interest rate fixed on these loans is 7 to 8%.

b. Bank Guarantee:

EBL takes guarantee on behalf of its customer to the third party to make payment up to a specified amount. The third party feels assured that in case of default, bank will clear the due amount. The bank provides various types of bank guarantee to its customers such as bid bond, performance bond, advance payment guarantee, custom guarantee, and credit guarantee.

Principles Included In Credit Policy

- Principles of Safety of funds:
- Principle of Liquidity:
- Principal of purpose of Loan:
- Principles of profitability:
- Principal of Security:
- Principal of National Interest:

2.1.2 Objectives of Sound Credit Policy

Considering the importance of lending to the individual bank and society it serves, it is imperative that the bank meticulously plans its credit operations.

- To provide guidance to lending officers

- To make quality credit decisions
- To establish a standard for control
- To provide authority to different level of management
- To comply with the regulations.
- To avoid unnecessary risks.
- To have performing assets.

2.1.3 Prudence in Lending

The primary business of the bank is creating and delivering quality financial services to its customers throughout Nepal. Its customer base consists of individual, corporations, other financial institution, public sector companies, and co-operatives. The financial services presently provided by the bank include commercial banking, retail banking and treasury services.

General policy guidelines shall govern the implementation of the business strategy of the bank with respect to credit extensions.

- The bank shall adhere to all Regulatory Guidelines and all amendments including those provided by NRB.
- The bank shall not make any credit facility available to anyone whose moral integrity is questionable. Fundamental rule is "*Know Your Customer*".
- Credit officers must thoroughly understand the lending rationale for any credit request.
- Credit officers must acquire information about borrower's purpose, source of repayment and repayment plan.
- Borrowers whether or not related to bank must provide complete, accurate and up-to-date financial information.
- Credit extensions to borrowers shall be in accordance to NRB directives.
- The bank will not lend to investment companies that are not listed in the Stock Exchange.

2.1.4 Credit Analysis

There is practice of analyzing 7C's of credit about borrower by the bank before approving proposal:

- **Character:**

Character refers to personal traits such as ethics, honesty, integrity, reliability of borrower's, which is significant for lending decision. The actual purpose, trustworthiness in answering the queries, responsibility and seriousness in making efforts to repay loan is observed by the bank.

- **Capacity:**

The bank views two aspects. Firstly, the bank sees whether the applicant possess legal capacity to borrow loan. Secondly, whether the applicant has capacity to generate sufficient income to repay the loan amount or not. If the borrower has high capacity, quality management and good market value then the capacity of the client is said to be high and bank grants loan on that basis. Hence, suitable ratios (liquidity, leverage, profitability, efficiency) are analyzed based on historical and projected financials.

- **Capital:**

Capital refers to net worth of the borrower. Leverage ratio will be high if the borrower has low capital. A bank gives loan only when it finds leverage ratio acceptable to it or if the borrower has enough capital.

- **Collateral:**

To safeguard its risky assets in case of default, bank asks for securities or collateral from the borrower, no matter how prosper the financial position of the borrower is. Collateral can be fixed in nature- land, building, machinery or working capital like inventories and account receivables.

❖ **Condition:**

Condition refers to the general economic condition beyond the control of borrower such as security, political and other social condition affects the business. Loan is given to the borrower if lending official feels general condition is favorable for that type of business.

❖ **Cash Flow:**

The credit officials usually check the cash flow of the business to ascertain repayment of the loan amount taken with interest. If the figure shows positive response then they advance loan to such clients.

❖ **Credit Information:**

The bank should confirm the type of loan the borrower requires and should provide all the credit information beforehand.

Lending is one of the most important functions of a commercial bank and the composition of loans and advances directly affects the performance and profitability of the bank. There is intense competition in banking business with limited market and less investment opportunities available.

Commercial banks are major financial institution, which occupy quite important place in the framework in every economy because they provide capital for the development of industry. Commercial banks formulate sound investment policies to make it more effective, which eventually contribute to the economic growth of country. The bound policies help commercial banks maximizing quality and quantity of investment and hereby achieve the own objective of profit maximization and social welfare. Formulation of sound investment policies and co-ordinate and planned efforts pushed forward the forces of economic growth.

Loan management is the essence of commercial banking; consequently the formulation and implementation of lending policies are among the most important responsibilities of directors and management. Well conceived lending policies and careful lending practices are essential if a bank is to perform its credit. Loan management effects on the company's profitability and liquidity so it is one of the crucial decisions for the commercial banks. The banks take almost care in analyzing the creditworthiness of the borrowing customer to ensure that the interest and the principal amount on loans are timely recovered without much trouble and legal process for the recovery. A sound lending policy is essential for the good performances of the bank are further to attain economic objectives directed towards acceleration of the development. Lending policy should be carefully analyzed and the banks should be careful while performing its credit creation effectively and to minimize the risk factor.

The wave of rising expectation and aspiration of people at present context of society, realized the need for rapid socio-economic development in the nation building process. The government has imparted a dynamic role and assigned the public sector with greater responsibility in fulfilling national goals and objectives. With this realization, the government initiated to build up multi-sector infrastructure in the fields of agriculture, industry, commerce, public works, transport, etc. In this context, banking was seen as a major supportive industry to uplift the economic condition of nation and its residents. Therefore, the government has adopted a liberal economic policy regarding operations of banks. About the financial liberalization process it is stated that the interest rate deregulation, curtailment or elimination of directed credits, lifting entry and exit barriers for financial intermediaries, restructuring of banking system and institution for regulatory and supervisory mechanism is some of the key components of such liberalization. This led to the influx of commercial banks in Nepal resulting today into 25 commercial banks. NABIL (previously Nepal Arab Bank Limited), the first joint venture bank in Nepal which was established on 2041 B.S. after adopting financial and economic liberalization policy by the government.

The first financial institution was introduced during the prime-ministership of Ranodip Singh (1933 B.S.) in the name of “Tejrath Adda” for granting loan to employees and public against security of gold silver and other treasures. Banking in true sense started with the inception of Nepal Bank Limited, a semi-governmental bank in 1994 B.S. NBL had a responsibility of attracting public out from the dominance of Sahu Mahajans and introducing banking services as well. After 20 years having an objective of developing banking practice, Nepal Rastra Bank started its operations from 14th Baisakh, 2013 BS. Nepal Bank Limited was only one commercial bank until 2022 BS. To develop a speedy and competitive banking service by reaching nooks and corners of the country, a fully government owned bank – Rastriya Banijya Bank was established in 2022 B.S.

Despite all these efforts, financial sector was found sluggish. The traditional financial system could not provide the public a quality service. Thus, the government initiates a liberal competition, which started to attract foreign investments. A foreign joint venture bank was established in 2041 B.S. with the name of Nepal Arab Bank Limited (now NABIL), which was the first joint venture commercial bank in Nepalese financial history. NABIL started knocking the doors of customers breaking the trend of knocking the doors of banks by customers (Bhattarai; 2061: 4-6).

It has been fully established that economic development of any country can be achieved only through a balanced growth in the field of industry, trade commerce and agriculture. And it has equally self-evident that commercial banks play vital role in the development of these fields. Therefore, productivity and competitiveness of commercial banks is very essential.

Lending is the primary business of any commercial bank and interest earned from them is the main source of income. Once the loan is given, it is supposed that the repayment of interest and principal shall have to be served without any hindrance. But it is not always true. Loans and interests are not always paid so easily by all the customers. Loans lended to the customers come under the Assets heading of balance sheet; and those loans which are not paid in time are considered as Non Performing Loan or Non Performing Assets (NPA). The criteria that determine a loan as NPA varies in different countries. In Nepalese scenario, Nepal Rastra Bank has classified the loans and advances as Non Performing Assets which are due for more than 90 days. Whatever the criteria is, the unhidden fact is that the NPA affects the banks operation and growth adversely. NPA has several impacts on financial institutions. Investments become worthless as expected return cannot be realized on the one hand and on the other hand, due to provisioning required for the risk mitigation, the profitability is directly affected. Similarly, monitoring expenses of such loans are costly too. Therefore, proper management, cost efficiency and speedy disposal of Non Performing Assets (NPA) are the most critical tasks of banks today to remain competitive. The problem of NPA in banks and financial institutions has been a matter of grave concern not only for the banks but also the real economy in general, as NPA can choke further expansion of credit which would impede the economic growth of the country. Any bottleneck in the smooth flow of credit is bound to create adverse repercussions in the economy. NPA is not therefore the concern of only lenders but also the public at large. Similarly, profit making is one of the major mottos of commercial banks and reducing the operating cost is one of the main deterministic factors to increase profitability. So, cost efficiency is also a major area of concern of commercial banks (Thapa, 2007:20-22).

A number of international researches show that there is a negative relationship between cost efficiency and NPA. Cost-inefficient banks may tend to have loan performance problems for a number of reasons. For example, banks with poor senior management may have problems in monitoring both their costs and their loan customers, with the losses of capital generated by both these phenomena potentially leading to failure.

Some other researches also show that there is a positive relationship between cost efficiency and NPA. They show that controlling extra cost such as underwriting and loan monitoring expenditures in order to achieve cost efficiency may reduce the operating cost in short run but it leads towards the increase in NPA in long run.

The proposed study will try to find out the trend of NPA, and its effects on profitability in Nepalese commercial banks. It will also try to find out whether NPA is preceding reduced cost efficiency or cost efficiency in present is contributing increase in future NPA.

According to Concise Oxford Dictionary, the term bank has been defined as "A bank is an establishment of the custody of money which it pays out on customers' order." In the word of Kent, "A bank is an organization whose principal operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to other for expenditure." A banker or bank is a person or company carrying on the business of receiving moneys, and colleting drafts, for customers subject to the obligation of honoring cheques drawn upon them from time to time by the customers to the extent of the amounts available on their current accounts.

Therefore bank can easily be defined as the custodians of deposits. Bank is an institution which deals with money by accepting various types of deposits, disbursing loans and rendering other financial services "A bank is a business organization that receives and hold deposits of funds from other, grants loans or extends credits and transfers funds by written orders of depositors" (Dhungana, 1993: 2-4).

“The more developed financial system of the world characteristically falls into three parts: central bank, commercial banks and other financial institutions. The two banks selected for the study are joint venture commercial banks (Dhungana, 1993: 2-4).

Banks have today gained paramount trust of the public. Banking industry offers a wide range of services addressing the needs of public in different walks of life. At present, a large number of banks are operating in Nepal. Naturally, they are rendering a wide range of services. They are trying to keep up pace with the changes taking place in the world. But quantity does not count for quality. The financial institutions of all classes ‘A’ to ‘D’ are increasing every year. In a small economy like Nepal, it is a question of great concern as to how so many banks are surviving and reaping profit. The concern is not only about these days but also the sustainability of the operating banks in future days also. Therefore, the report will try to concentrate on three major private sector banks of Nepal, i.e., Himalayan Bank Limited (HBL), Nabil Bank Limited (NABIL) and Standard Chartered Bank Nepal Limited (SCBNL). It will focus on the comparative Profit Accountability of these three banks regarding profitability, liquidity, leverage positions, NPA status etc.

1.1.1 Introduction of the Sampled Commercial Banks

i) Nabil Bank Limited

Nabil Bank Limited, the first foreign joint venture bank of Nepal, started operations in July 1984. Nabil was incorporated with the objective of extending international standard modern banking services to various sectors of the society. Pursuing its objective, Nabil provides a full range of commercial banking services through its 21 points of representation across the country and over 170 reputed correspondent banks across the globe.

Nabil, as a pioneer in introducing many innovative products and marketing concepts in the domestic banking sector, represents a milestone in the banking history of Nepal as it started an era of modern banking with customer satisfaction measured as a focal objective while doing business.

Operations of the bank including day-to-day operations and risk management are managed by highly qualified and experienced management team. Bank is fully equipped with modern technology which includes ATMs, credit cards, state-of-art, world-renowned software from

Infosys Technologies System, Banglore, India, Internet banking system and Tele banking system (www.nabilbankltd.com).

ii) Standard Chartered Bank Nepal Limited

Standard Chartered Bank Nepal Limited has been in operation in Nepal since 1987 when it was initially registered as a joint-venture operation. Today the Bank is an integral part of Standard Chartered Group who has 75% ownership in the company with 25% shares owned by the Nepalese public. The Bank enjoys the status the largest international bank currently operating in Nepal.

An integral part of the only international banking Group currently operating in Nepal, the Bank enjoys an impeccable reputation of a leading financial institution in the country. With 11 points of representation (7 Branches) and 9 ATMs across the Kingdom and with over 300 local staff, Standard Chartered Bank Nepal Ltd. is in a position to service its customers through a large domestic network. In addition to which the global network of Standard Chartered Group gives the Bank the unique opportunity to provide truly international banking in Nepal.

Standard Chartered Bank Nepal Limited offers a full range of banking products and services in Wholesale and Consumer banking, catering to a wide range of customers from individuals, to mid-market local corporate to multinationals and large public sector companies, as well as embassies, aid agencies, airlines, hotels and government corporations.

The Bank has been the pioneer in introducing 'customer focused' products and services in the country and aspires to continue to be a leader in introducing new products and highest level of service delivery. It is the first Bank in Nepal that has implemented the Anti-Money Laundering policy and applied the 'Know Your Customer' procedure on all the customer accounts.

iii) Himalayan Bank Limited

Himalayan Bank was established in 1993 in joint venture with Habib Bank Limited of Pakistan. Despite the cut-throat competition in the Nepalese Banking sector, Himalayan Bank has been able to maintain a lead in the primary banking activities- Loans and Deposits.

Legacy of Himalayan lives on in an institution that's known throughout Nepal for its innovative approaches to merchandising and customer service. Products such as Premium Savings Account, HBL Proprietary Card and Millionaire Deposit Scheme besides services such as ATMs and Tele-banking were first introduced by HBL. Other financial institutions in the country have been following our lead by introducing similar products and services. Therefore, we stand for the innovations that we bring about in this country to help our Customers besides modernizing the banking sector. With the highest deposit base and loan portfolio amongst private sector banks and extending guarantees to correspondent banks covering exposure of other local banks under our credit standing with foreign correspondent banks, we believe we obviously lead the banking sector of Nepal. The most recent rating of HBL by Bankers' Almanac as country's number 1 Bank easily confirms our claim.

All Branches of HBL are integrated into Globus (developed by Temenos), the single Banking software where the Bank has made substantial investments. This has helped the Bank provide services like 'Any Branch Banking Facility', Internet Banking and SMS Banking. Living up to the expectations and aspirations of the Customers and other stakeholders of being innovative, HBL very recently introduced several new products and services. Millionaire Deposit Scheme, Small Business Enterprises Loan, Pre-paid Visa Card, International Travel Quota Credit Card, Consumer Finance through Credit Card and online TOEFL, SAT, IELTS, etc. fee payment facility are some of the products and services. HBL also has a dedicated offsite 'Disaster Recovery Management System'. Looking at the number of Nepalese workers abroad and their need for formal money transfer channel; HBL has developed exclusive and proprietary online money transfer software- Himal Remit TM. By deputing our own staff with technical tie-ups with local exchange houses and banks, in the Middle East and Gulf region, HBL is the biggest inward remittance handling Bank in Nepal. All this only reflects that HBL has an outside-in rather than inside-out approach where Customers' needs and wants stand first.

Banking business in Nepal though seemed developed and mushroomed only in urban areas of the country in recent days, has its own limitations and problems as regards to security, profitability and financial soundness. Currently there are 26 commercial banks under 'A' class financial institutions operating in the country. The inflow of money in the banks in the form of several kinds of deposits is huge but it could not be invested in more profitable, sustainable and riskless projects. In addition, many banks are found centered in the urban areas of the country. Therefore, there is a situation that needy people and small entrepreneurs residing in rural areas are still deprived from institutional credit. However, this study will not go to this vast sector and thus focus only on the level and quality of deposit mobilization of the three sampled banks as regards to profit earning capacity or status of profitability. Therefore, this study is centered on assessing the clear picture of the profitability of the three commercial banks in Nepal.

There is no confusion that credit management affects the profitability of commercial banks. But it without a systematic research or study, it cannot be said that how much the profit affected by credits. On the surface, cost efficiency and credit management might appear to be largely unrelated, because operations personnel typically do not participate in screening and monitoring loan customers, and because loan officers and review personnel typically do not participate in overseeing operations costs. Despite this separation between these two, we cannot reach to a conclusion that there is no any relationship between problem loans (NPA) and credit management of commercial banks. Therefore, to reveal the secret, it is necessary to conduct a systematic study. That is why this research will try to find out the relationship between these two. Likewise, this study will also highlight on the effect of credit management in banks profitability.

While giving the supportive framework to the research study, the questionnaires have been designed to be the main problem areas of the study and hence all tasks will be performed to provide the answers to these questions:

e) What are the major sources of funds for these banks?

f) How the funds obtained through various sources have been mobilized in order to boost profitability?

g) What is the situation of profitability of these banks?

h) What are the factors (mostly quantitative) that affect the profitability?

1.3 Objectives of the Study

The general objective of this study is to investigate the relationships between Non Performing Assets and its effect on profitability of Nepalese Commercial Banks. Therefore, the main objective is to find out exact financial performance of the three banks over the period of recent five years. The specific objectives of the study are:

v. To evaluate the profitability of sample banks for the past five years.

vi. To compare the key financial indicators of sample banks with respect to major sources of funds, their mobilization and their contribution on profit.

vii. To analyze the trend of NPA and to examine the relationship of NPA in bank's operating cost and loan loss provision.

viii. To provide appropriate suggestions and recommendations based on the findings of the study.

1.4 Significance of the Study

This study is not comprehensive to deal with and present detail information regarding the sampled banks. Anyway, this study will be of great significance to the following groups and individuals:

Further researchers and financial analysts: This study will leave over a lot of space to carry out further research studies in this topic and the related. This research report will be very helpful and will act as a potential guide to those interested research students or groups as well as financial analysts in the Nepalese market. University students of new generation: This study will be a valuable and a useful guideline to the upcoming students who want to gain some knowledge on this sector.

Government: Government sector is responsible for making several kinds of policy decisions. This report comprising of the study of commercial banks may provide a beautiful insight to form and thus bring policies conducive to banking sector.

All other interested individuals & parties: This study is also significant to all other interest individuals and parties those wishing to have some potential knowledge regarding profitability of the sampled commercial banks. This study may provide a valuable insight to the concerned parties who want to become investors in the shares of such companies.

Commercial Banks: Apart from the various groups and individuals mentioned above, this study will also be helpful to the respective commercial banks themselves to identify and have some glimpse of their own true picture.

Researcher: This study has a lot of significance to me and further researchers also. On the course of preparation of this report study, researcher got acquainted with various newer terminologies and also was able to deal with different parties. As a result, my knowledge on banking sector of Nepal has also become broader both practically as well as theoretically which will also provide ample opportunities to new researchers.

1.5 Limitations of the Study

There are some inherent limitations in this research study which are presented below:

v. The study was confined only to the fiscal years 2003/04 to 2007/08. So the generalization was based on these periods only.

vi. Only three banks, namely HBL, NABIL and SCBNL were selected for the study. Comparison with only these three out of so many contemporary firms may not present the clear position of any firm.

vii. Reports were based mainly on the published data of the sampled banks, which have been manipulated with.

viii. Most of the data were secondary, which itself was a limiting factor. But for the clarification purpose some primary data were also collected.

1.6 Organization of the Study

The whole study is divided into the five different consecutive parts as mentioned below:

Chapter One: Introduction

This chapter comprises of general background entering the study, brief profile of the banks under study, significance of the study, objectives of the study, limitations of the study and organization of the study.

Chapter Two: Review of the literature

This part is divided into three two explicit headings. First part deals with the reviewing of the various literatures, definitions and concept of profit and profitability. The second one consists of the review of the existing studies, journals, articles and review of books concerned to profit and profitability.

Chapter Three: Research methodology

This part consists of the total population, sample of the study, data collection procedures and the analytical tools and techniques used in the study.

Chapter four: Presentation and analysis of data

This part constitutes the tabular and graphical representation of the collected data, their interpretation and analysis using various financial as well as statistical tools. Apart from it, summary of the major findings are also presented at the end of the chapter.

Chapter five: Summary, Conclusion and Recommendation

This chapter contains the summary of the whole study and relevant conclusions were drawn based on the study. A suitable set of recommendations were made at the end of the chapter.

Management is the system, which helps to complete jobs effectively. Credit management is also the system, which helps to manage credit effectively. In other words, credit management refers management of credit exposures arising form loans, corporate bonds and credit derivatives. Credit exposures are the main source of investment in commercial banks and return on such investment is supposed to be main source of income. Credit management strongly recommends analyzing and managing the credit risks. Credit risk is defined as the possibility that borrower will fail to meet its obligations in accordance with the agreed terms and conditions credit risk is not restricted to lending activities only but includes off balance sheet and inter-bank explores. The goal of the credit risk management is to maximize a bank's risk adjusted rate of return by maintaining the credit risk exposure within acceptable parameters. For most banks, loan are the largest and most obvious sources of credit, however, other sources of credit risk exist through out the activities of a bank, including in the banking book, and in the trading book, and both increasingly facing credit risk in various financial instruments other than land, including acceptances, inter bank transactions and guarantees and the settlement of transactions.

This study mainly focuses on the credit management practice and procedure of Nepalese commercial banks. Hence, it is rational to state these articles and reports those may make a clear concept to understand the said topic. “Banks and financial institutions are the vehicles through which public deposits are mobilized in various development activity i.e. Agricultural, Industry. Trade, Commercial Institution like commercial banks, development banks, financial companies and various micro-financing institution with different model”(Johnson, 1940: 130).

Credit administration involves the creation and management of risk assets. The process of lending takes into consideration about the people and system required for the evaluation and approval of loan request, negotiation of terms, documentation, disbursement, administration of outstanding loans and workouts, knowledge of the process and awareness of its strength and weaknesses are important in setting objectives and goals for lending activities and for allocating available funds to various lending functions such as commercial, installment and mortgage portfolios (Johnson, 1940: 132).

“The investor or whether banks, financial institutions, individuals, private or government sector, must not take the proposal by making decision without having adequate judgment because sometimes they perform out of norms, related studies, policies and techniques. A project appraisal will best viable only if it has accessed through conscious analysis as well as through thoroughly investment decisions to make its macro and micro level viability effective” (NRB, 2058: 125).

The term non-performing asset is, “loans or advances whose credit quality has deteriorated such that full collection of principal and /or interest in accordance with the contractual repayment terms of the loan or advances are in question”. “An asset which ceases to generate income of the bank is called non-performing asset. The past due amount remaining uncovered for the two quarter consequently the amount would be classified as NPA for the whole year. It includes borrowers’ defaults or delays in interest or principal repayment” (Dhanuskodi, 2006:7).

Lending is the primary business of any commercial bank and interest earned from them is the main source of income. Once the loan is given, it is supposed that the repayment of interest and principal shall have to be served without any hindrance. But it is not always true. Loans and interests are not always paid so easily by all the customers. Loans lended to the customers come under the Assets heading of balance sheet; and those loans which are not paid in time are considered as Non Performing Loan or Non Performing Assets (NPA). The criteria that determine a loan as NPA varies in different countries. In Nepalese scenario, Nepal Rastra Bank has classified the loans and advances as Non Performing Assets which are due for more than 90 days. Whatever the criteria is, the unhidden fact is that the NPA affects the banks operation and growth adversely. NPA has several impacts on financial institutions. Investments become worthless as expected return cannot be realized on the one hand and on the other hand, due to provisioning required for the risk mitigation, the profitability is directly affected. Similarly, monitoring expenses of such loans are costly too. Therefore, proper management, cost efficiency and speedy disposal of Non Performing Assets (NPA) are the most critical tasks of banks today to remain competitive. The problem of NPA in banks and financial institutions has been a matter of grave concern not only for the banks but also the real economy in general, as NPA can choke further expansion of credit which would impede the economic growth of the country. Any bottleneck in the smooth flow of credit is bound to create adverse repercussions in the economy. NPA is not therefore the concern of only lenders but also the public at large. Similarly, profit making is one of the major mottos of commercial banks and reducing the operating cost is one of the main deterministic factors to increase profitability. So, cost efficiency is also a major area of concern of commercial banks.

2.1.1 Credit Policy and Its Parameters

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 date on demand. Credit is the 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: 279). 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: 6)

In fact, it is a very sensitive subject that what sort of credit policy a bank should have. So, it should pay more attention to the loan, advances that it provides. The commercial banks are inspired with the motive of gaining profit. To fulfill these objectives, they should manage and improve its banking sector. They must give more attention to the flow of loan. Regarding loan policy, it should be clear and follow such policy which would match the economic policy of the nation.

Credit policy of EBL is the approved methodologies for conducting its lending operations with an objective to maximize profit of the bank and serve its best to the nation. The general assembly is the sole authority to approve such policy. Normally, the Board of Directors is authorized to approve such policy on the recommendation of the management. The general assembly in its annual general meeting or special meeting may initiate the approve changes or can guide the Board management to implement, suggest, renew or cancel the existing policies.

Credit management in EBL basically covers loan approval process, credit analysis, method and mechanism, lending documentation, disbursement and administration of loan including credit audit. As there is a saying "*Precaution is better than cure*" bank should be more analytical and farsighted while disbursing loan in order to prevent loan flow in unproductive sector and non-performing assets.

Types and Nature of Loan:

Based on time factor, EBL advances loan of the following types:

1. Short Term Loan:

This loan is given up to the period of 1 year to those who have lower requirements than other types. EBL grants this loan to agricultural sector, small industrial sector, small projects etc.

4. Mid term loan:

These types of loans are sanctioned for the period of 5 to 10 years.

5. Long term loan:

Long term loans are granted for the period of more than 10 years. Generally these types of loan are sanctioned to the big industries whose requirements are large. These types of loans are provided for financing fixed assets.

Nature of Loan:

EBL with increment in services provides different natures of loans to its customers as per their requirement.

1. The loans and advances under Fund based:

a. Term Loan:

Term loans are given for the purpose of financing fixed assets. The interest rates for prime sectors are 8 to 10% and for others are 10 to 11%.

b. Working Capital short term Loan:

EBL provides this loan to meet the day-to-day transactions of the companies, industries. The interest rates for primary sectors are 7 to 9% and for other sectors are 9 to 10%. It is essential for running any companies, businesses, industries etc.

c. Overdraft Loan:

This loan facility is provided to those clients who are regular customers of the bank for a long period of time. They have built up strong and trustworthiness relationships with the bank for which they can overdraw money from their account as per their requirement and approval from the bank. The rate is at 8 to 10.15% for prime sector whereas 10.5 to 11% for other sectors.

d. Trust Receipt Loan (import loan):

This type of loan is mainly provided for importers against letter of credit. The bank provides 80% of loan to their valued client for the credit period of 90/120/150/180 days. Importers then repay their loan amount to bank after sell of particular goods. The rate is at 6.75 to 8% for prime sector whereas 8 to 10% for other sectors.

e. Hire Purchase Loan:

This loan is provided for the purchase of automobiles, vehicles etc. to professionals, companies, business executives etc. The interest rate charged is 8.5 to 10.5%.

f. Housing Loan:

The bank also provides this type of loan to its customers where the interest rate is 9% for the maturity up to 5years and for above 5 years it is 9.75%.

2. **Under Non-funded loan, EBL has classified the followings**:

a. Exports credit:

i. Pre-shipment:

This type of loan is mainly provided for exporters. Exporters have to send goods to the importer as requested. Then, for the production of the certain quantity of goods, exporter without money asks the bank for loan. Importer after receiving goods, clears the amount of the exporter, exporter then clears his loan amount along with the interest of the bank.

ii. Post-shipment:

This type of loan is mainly provided for exporters. When goods are produced as asked by the importer, exporter needs to send it. But exporter without any amount to meet operating expenses occurred on shop and loading goods on shop asks for loan with the bank.

The interest rate fixed on these loans is 7 to 8%.

b. Bank Guarantee:

EBL takes guarantee on behalf of its customer to the third party to make payment up to a specified amount. The third party feels assured that in case of default, bank will clear the due amount. The bank provides various types of bank guarantee to its customers such as bid bond, performance bond, advance payment guarantee, custom guarantee, and credit guarantee.

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Considering the importance of lending to the individual bank and society it serves, it is imperative that the bank meticulously plans its credit operations.

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- The bank shall not make any credit facility available to anyone whose moral integrity is questionable. Fundamental rule is "*Know Your Customer*".
- Credit officers must thoroughly understand the lending rationale for any credit request.
- Credit officers must acquire information about borrower's purpose, source of repayment and repayment plan.
- Borrowers whether or not related to bank must provide complete, accurate and up-to-date financial information.
- Credit extensions to borrowers shall be in accordance to NRB directives.
- The bank will not lend to investment companies that are not listed in the Stock Exchange.

2.1.4 Credit Analysis

There is practice of analyzing 7C's of credit about borrower by the bank before approving proposal:

- **Character:**

Character refers to personal traits such as ethics, honesty, integrity, reliability of borrower's, which is significant for lending decision. The actual purpose, trustworthiness in answering the queries, responsibility and seriousness in making efforts to repay loan is observed by the bank.

- **Capacity:**

The bank views two aspects. Firstly, the bank sees whether the applicant possess legal capacity to borrow loan. Secondly, whether the applicant has capacity to generate sufficient income to repay the loan amount or not. If the borrower has high capacity, quality management and good market value then the capacity of the client is said to be high and bank grants loan on that basis. Hence, suitable ratios (liquidity, leverage, profitability, efficiency) are analyzed based on historical and projected financials.

- **Capital:**

Capital refers to net worth of the borrower. Leverage ratio will be high if the borrower has low capital. A bank gives loan only when it finds leverage ratio acceptable to it or if the borrower has enough capital.

- **Collateral:**

To safeguard its risky assets in case of default, bank asks for securities or collateral from the borrower, no matter how prosper the financial position of the borrower is. Collateral can be fixed in nature- land, building, machinery or working capital like inventories and account receivables.

❖ **Condition:**

Condition refers to the general economic condition beyond the control of borrower such as security, political and other social condition affects the business. Loan is given to the borrower if lending official feels general condition is favorable for that type of business.

❖ **Cash Flow:**

The credit officials usually check the cash flow of the business to ascertain repayment of the loan amount taken with interest. If the figure shows positive response then they advance loan to such clients.

❖ **Credit Information:**

The bank should confirm the type of loan the borrower requires and should provide all the credit information beforehand.

CHAPTER THREE

RESEARCH METHODOLOGY

Research methodology refers to the systematic and meticulous study and investigation on the particular subject matter. This chapter describes the approach, materials, and procedures of the present study in order to analyze the primary and secondary data.

3.1 Research Design

The main objective of this study is to provide an overview on credit management and analysis of Nabil Bank Limited, Himalayan Bank Limited and Standard Chartered Bank Limited. This study describes and explores the credit policy and its implementation by Nabil Bank Limited, Himalayan Bank Limited and Standard Chartered Bank Limited toward diversification of investments. So, descriptive, exploratory and analytical methods are combined, as the study demands, for the best result. The research design is thus an integrated frame of descriptive study and exploratory study.

3.2 Population and Sample

There are 27 commercial banks operating in the country which were the population of this research study. Out of this population, only three commercial banks namely HBL, NABIL and SCBNL were taken as the sample of the study based on some commonalities.

3.3 Sources of Data

The main sources of data for this study are secondary data. According to the requirement, published balance sheets, profit and loss A/C and other related statements of account as well as annual report of the bank have also been collected for the last five years. For the purpose of study, various related books, booklets magazines, journals, newspapers and thesis made in this field have been referred. Personal interview, discussion and consultations are also done as primary data.

3.4 Data Collection Procedure

Both the primary and secondary data were used for the preparation of this report. Necessary and required data were collected from the corporate department of NABIL, HBL and SCBNL. Concerned personnel of the respected department were in contact. For primary data interview, field visit, and personal observation have been considered for gathering the information. And for secondary data, annual report of NABIL, HBL and SCBNL, related academic books and literature, bank's internal reports, files and others have been considered for making this report authentic and more realistic. The concerned personnel provided all the consolidated data records as per the requirement of the report. The data compiled were classified and tabulated to the need of the study. On the basis of study, conclusions were drawn and suitable recommendations were also made. This study covered a period of immediate past five years from fiscal year 2004/05 to 2008/09.

3.5 Tools Used in the Study

Relevant statistical tools and financial tools are used to find out the best appropriate outcomes as per designed objectives of the present study. The present research has used mix of following tools in the analysis.

- Financial Tools

- Statistical Tools

3.5.1 Financial Tools

The financial tools used for analyzing the data were profitability and asset management ratios under ratio analysis. The formulas of key indictors used in this study were as follows:

CHAPTER FOUR

PRESENTATION AND ANALYSIS OF DATA

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4.1. Financial Analysis

4.1.1 Return on Assets

This is one of the best measures of profitability of the commercial banks, which indicates the extent of the utilization of the overall assets of the commercial banks in generating income. Higher ratio is desirable for all banks. This ratio was computed by using the following formula.

$$\text{Return on assets (ROA)} = \frac{\text{Net profit after taxes}}{\text{Total assets}} \times 100\%$$

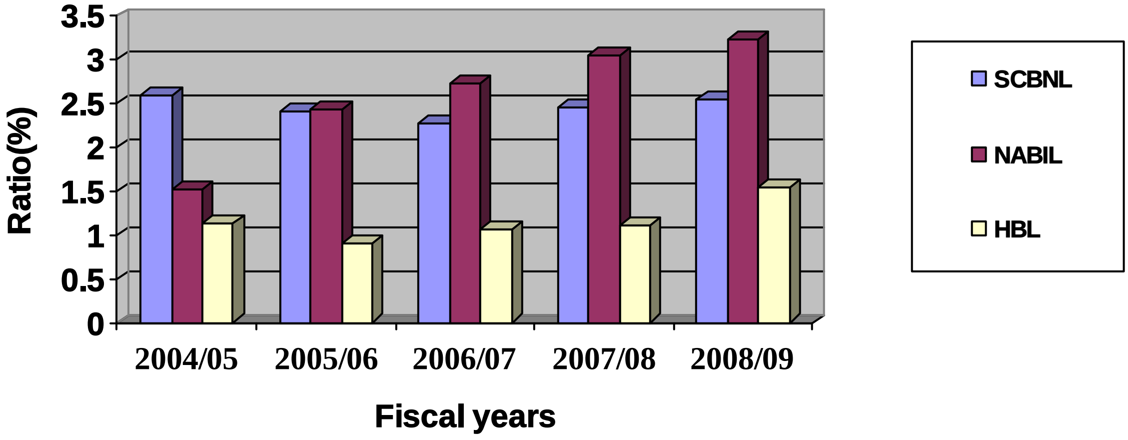
Table: 4.1

Return on Total Assets of Commercial Banks (%)

	Year					**Average (%)**	**S.D**	**C.V.**
	2004/05	**2005/06**	**2006/07**	**2007/08**	**2008/09**			
SCBNL	2.6	2.42	2.27	2.46	2.55	2.46	0.13	5.20
NABIL	1.53	2.43	2.73	3.06	3.23	2.60	0.67	25.83
HBL	1.14	0.91	1.06	1.11	1.55	1.15	0.24	20.66

Source: Annual Reports of Banks

Figure 4.1: Return on total assets of Commercial Banks (%)



The table depicts the scenarios of return on total assets of commercial banks. The return on total assets gives the major indicator of profitability of the banks. The return on assets ratios of SCBNL were 2.6%, 2.42%, 2.27%, 2.46% and 2.55% for the fiscal years 2004/05, 2005/06, 2006/07, 2007/08 and 2008/09 respectively. The average ROA for the bank over the immediate past five year period was found to be 2.46% with a coefficient of variation of 5.20%.

The ROAs of NABIL were 1.53%, 2.43%, 2.73%, 3.06% and 3.23% for the fiscal years 2004/05, 2005/06, 2006/07, 2007/08 and 2008/09 respectively with an average of 2.60% over the period. The variability of ratio per unit of average remained 25.83%.

The ROAs of HBL were s 1.14%, 0.91%, 1.06%, 1.11% and 1.55% in the fiscal years 2004/05, 2005/06, 2006/07, 2007/08 and 2008/09 respectively. The average ROA of the bank was found to be 1.15% with a coefficient of variation of 20.66%.

The above table shows that NABIL had the highest average ROA for the period and HBL had the lowest average return on assets ratio among the three banks. The average ROA of SCBNL lied between the ROAs of the two banks. Likewise, the coefficient of variation of the ratios of NABIL was the highest and the coefficient of variation of the return on assets of SCBNL was the lowest of the three. This indicated that SCBNL's returns on assets ratios were more consistent as compared to the ROAs of the other two banks.

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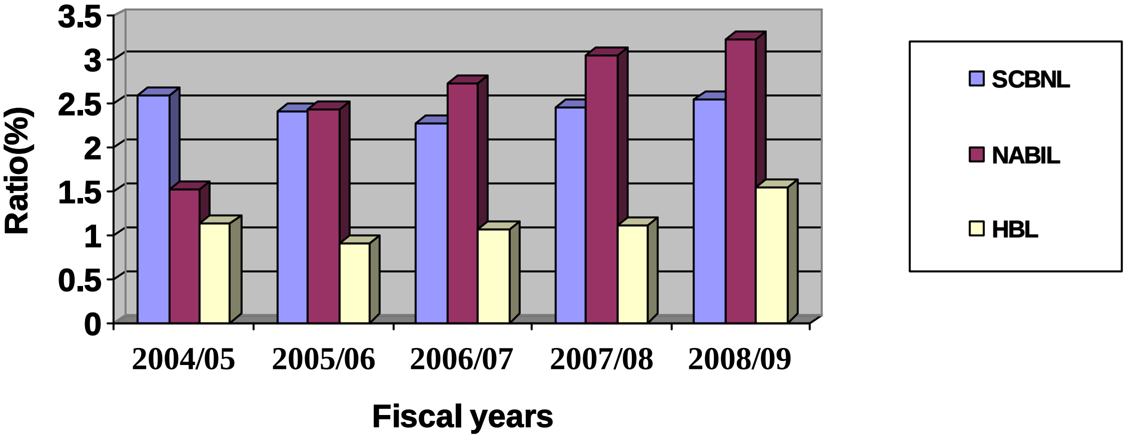

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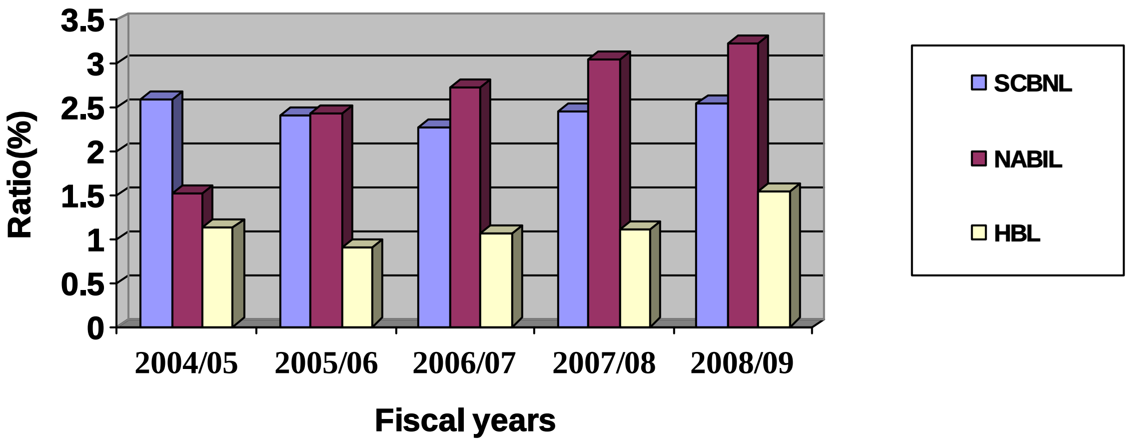

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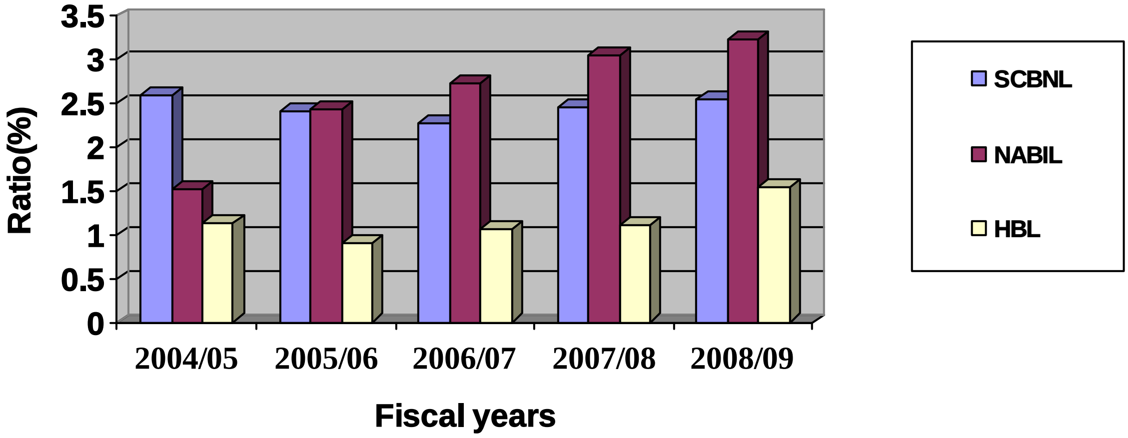

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CHAPTER FIVE

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Lending is the primary business of any commercial bank and interest earned from them is the main source of income. Once the loan is given, it is supposed that the repayment of interest and principal shall have to be served without any hindrance. But it is not always true. Loans and interests are not always paid so easily by all the customers. Loans lended to the customers come under the Assets heading of balance sheet; and those loans which are not paid in time are considered as Non Performing Loan or Non Performing Assets (NPA). This study was carried out with the objective of comparing the non-performing assets and profitability of the three sampled commercial banks: SCBNL, NABIL and HBL. At present, there are 26 commercial banks operating in Nepal. However, for this study, only three leading commercial banks were taken as the sample. The study was conducted within a period of five years.

An asset which ceases to generate income of the bank is called non-performing asset. The past due amount remaining uncovered for the two quarter consequently the amount would be classified as NPA for the whole year. It includes borrowers' defaults or delays in interest or principal repayment. The term Non-performing is, "loans or advances whose credit quality has deteriorated such that full collection of principal and /or interest in accordance with the contractual repayment terms of the loan or advances is in question. SCBNL had the highest EPS, net profit, profit margin ratio, return on assets ratios and lowest non-performing to total credit ratios over the period. Similarly, NABIL had the immediate highest position of the above indicators. And HBL had the lowest EPS and net profit. It also had the lowest net profit margin ratio, return on assets, return on fixed assets and highest non-performing credit to total credit ratio over the study period as compared to the other two banks. Similarly, SCBNL had the highest market price over the period. The market price per share of NABIL occupied the second position in the market. And the market price per share of HBL was the lowest of the three.

5.2 Conclusion

The study found that SCBNL had the highest average non-performing assets to loan loss provisioning ratios, given by non-performing assets to loan loss provision ratio of 21.63%, while NABIL had the lowest average non-performing assets to loan loss provision ratio of 1.35% over the study period. The average non-performing assets to loan loss provision ratio of HBL lied in between these two. It indicates that SCBNL had been recovering its non-performing assets for possible cause of loan loss as compared to NPA in an efficient way in as compared to the other two banks. However, NABIL seemed little backward in recovering its non-performing assets for possible cause of loan loss. HBL had the lowest coefficient of variation of the ratios while NABIL had the highest coefficient of variation of the ratios in comparison of the CVs of the three banks mutually. However, there is slight difference in calculated CVs of the banks. Therefore, it indicates that HBL's non-performing assets to loan loss provisioning ratios were the most consistent of the three while NABIL's ratios were the most variable or fluctuating.

The criteria that determine a loan as NPA varies in different countries. In Nepalese scenario, Nepal Rastra Bank has classified the loans and advances as Non Performing Assets which are due for more than 90 days. Whatever the criteria is, the unhidden fact is that the NPA affects the banks operation and growth adversely. NPA has several impacts on financial institutions. Investments become worthless as expected return cannot be realized on the one hand and on the other hand, due to provisioning required for the risk mitigation, the profitability is directly affected. Similarly, monitoring expenses of such loans are costly too. Therefore, proper management, cost efficiency and speedy disposal of Non Performing Assets (NPA) are the most critical tasks of banks today to remain competitive. The problem of NPA in banks and financial institutions has been a matter of grave concern not only for the banks but also the real economy in general, as NPA can choke further expansion of credit which would impede the economic growth of the country. Any bottleneck in the smooth flow of credit is bound to create adverse repercussions in the economy. NPA is not therefore the concern of only lenders but also the public at large. Similarly, profit making is one of the major mottos of commercial banks and reducing the operating cost is one of the main deterministic factors to increase profitability. So, cost efficiency is also a major area of concern of commercial banks. The average non-performing credits to total credit ratios of SCBNL bank for the immediate past five-year period was 3.57% with a coefficient of variation of 28.21%. The average non-performing credits to total credit ratios of NABIL bank for the immediate past five-year period was 4.75% with a coefficient of variation of 33.91%. Similarly average non-performing credits to total credit ratios of HBL bank for the immediate past five-year period was 7.70% with a coefficient of variation of 60.14%.

The comparison of non performing credits ratio to total credit and advance showed that HBL had the highest average non-performing loans to total credit ratio among the three banks. HBL had also the highest coefficient of variation of the ratios. SCBNL had the lowest average non-performing credit to total credit ratio over the period among the three sampled commercial banks.

The average ratio of non-performing assets to loan loss provisioning given by non-performing assets to loan loss provision of SCBNL bank for the immediate past five-year period was 21.63% with a coefficient of variation of just 39.0%. Similarly average ratio of the NABIL bank for the immediate past five-year period was 1.35% with a coefficient of variation of just 67.0%. The average ratio non-performing assets to loan loss provisioning of HBL bank for the immediate past five-year period was 17.92% with a study coefficient of variation of 18.0%.

SCBNL had the highest net profit and EPS. And HBL had the lowest net profit and EPS among the three sampled banks. The profitability ratios of SCBNL were the best among all. SCBNL and NABIL had utilized its assets more efficiently in generating income. And HBL’s assets were not utilized efficiently as compared to the other two banks in generating total income of the bank. NABIL was found the most efficient of the three in mobilizing its total deposit. Then came the HBL and the lowest portion of total deposit was found to be mobilized by NABIL in extending credit. However, the quality of extended credit was the best for SCBNL, moderate for NABIL and the worst for HBL among the three banks.

Based on overall performance, assets mobilization, profitability ratios, quality of the lending, and market prices, SCBNL occupied the leading and the highest position, NABIL occupied the second position, and HBL occupied the third position among the three banks. Therefore, it was concluded that SCBNL was the most efficient, NABIL moderately efficient and HBL the least efficient (satisfactory) bank among the three as regards to study of overall performance and profitability.

5.3 Recommendations

The studies on credit management of Nabil, HBL and SCBNL have revealed various credit performance and functional aspects of banks. The following recommendations can be used to improve and promote positive image of the bank:

- The profitability in terms of return on assets and profit margin of all the banks seemed too low in comparison to the huge amount of investment made by them. Therefore, all the three banks are recommended to increase their net income, reduce their operating expenses and try to increase profitability ratios.
- Despite having higher credit to total deposit ratio, HBL had the highest non-performing credit to total loans, which is one of the major factors that reduces profitability. Therefore, HBL should try to decrease its non-performing credit to total loans ratio. Other two banks should also strive to eliminate their non-performing loans ratio.
- Banks should try to correct their market prices according to the net worth, earnings per share and other profitability indicators. The banks are recommended to decrease their price-earnings ratios to a reasonable level.
- HBL should focus more on using non-fund business as compared to the other banks.
- This study carries a lot of limitations. So a more comprehensive study needs to be carried from the concerned authorities and further researchers to reach a more authentic conclusion depicting the picture of the banks' NPA.
- Projects with old technology should not be considered for finance. Large exposure on big corporate or single project should be avoided.
- As for as possible, repayment of term loans should be fixed on monthly basis rather than on quarterly or semi annual basis so that overlap of interest due can be minimized. The Credit section should carefully watch the warning signals viz. non-payment of quarterly interest, dishonor of check etc. Effective inspection system should be implemented

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