COMPARATIVE STUDY ON FINANCIAL PERFORMANCE OF EVEREST BANK LIMITED AND HIMALAYAN BANK LIMITED IN THE FRAMEWORK OF CAMELS

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RECOMMENDATION

This is to certify that the thesis

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DECLARATION

I hereby declare that the work reported in this thesis entitled **"Comparative Study on Financial Performance of Everest Bank Limited And Himalayan Bank Limited In The Framework of Camels''** submitted to Office of the Dean, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirement for the degree of Master of Business Studies (M.B.S) under the supervision of **Prof. Dr. Keshav Raj Joshi** of Shanker Dev Campus, T.U.

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Date: 23 August, 2014 **Rina Maharjan**

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ABBREVIATIONS

A.D	:	Anno. Domini
AIG	:	Accord Implementation Group
ALLL	:	Allowance for Loan and Lease Losses
APEC	:	Asia Pacific Economic Cooperation
B.S.	:	Bikram Sambat
BAFIO	:	Banks and Financial Institutions Ordinance
BCBS	:	Basel Committee of Banking Supervision
BHCs	:	Bank Holding Companies
BIS	:	Bank for international Settlement
CAMELS	:	Capital, Assets, Management, Earnings, Liquidity, Sensitivity to Market Risk.
CAR	:	Capital Adequacy Ratio
CGAP	:	Cumulative Gap
CRR	:	Cash Reserve Ratio
DI	:	Depository Institution
E.Pra.Ni.No	:	Licensed Financial Institution Directives Numbers
EBL	:	Everest Bank Limited
EPS	:	Earning Per Share
EVE	:	Economic Value of Equity
EWS	:	Early Warning System
FDIC	:	Federal Deposit Insurance Corporation, USA
FFIEC	:	Federal Finance Institution Examination Council, USA
FI	:	Financial Institution
FY	:	Fiscal Year
HBL	:	Himalayan Bank Limited
IRR	:	Internal Rate of Return
JVBs	:	Joint Venture Banks
NABIL	:	Nepal Indosuez Bank Limited
NEPSE	:	Nepal Stock Exchange
NGBL	:	Nepal Grindlays Bank Limited
NIDC	:	Nepal Industrial Development Corporation

NIM	:	Net Interest Margin
NPL	:	Non Performing Loan
NRB	:	Nepal Rastra Bank
OCC	:	Office of the Comptroller of the Country
P/E	:	Price Earning
PCA	:	Prompt Corrective Action
PL	:	Performing Loan
PLL	:	Provision for Loan and Losses
RBS	:	Rastriya Beema Sansthan
ROA	:	Return on Assets
ROE	:	Return on Equity
RWA	:	Risk Weight Assets
SBL	:	Siddhartha Bank Limited
SCOR	:	Statistical CAMELS Offsite Rating
UFIRS	:	Uniform Financial Institutions Rating System

CHAPTER-I
INTRODUCTION

1.1 Background of the Study

Bank are the financial institutions that offer the widest range of financial services especially credit, savings, payment services, and perform the widest range of financial functions of any business firm in the economy. This multiplicity of bank resource and functions has led to banks being labeled financial supermarkets and to familiar advertising slogans as 'Your Bank – a full service financial institution.' Banking institutions are largely responsible for collecting household saving in terms of different types of deposits and regulating them in the society by lending them in different sectors of the economy. This sector has now reached even to the most remote areas of the country and has contributed a good deal to the growth of the economy by lending their resources in small-scale industries under intensive banking program; the banks have contributed to the economic growth of the economy.

Banks are basically concerned with the transaction of money; however, today's banks are established for specific purposes. Different types of banks focus different types of services to their customers although the basic principle is the same. Banking concept existed even in the ancient periods when the gold smiths and the rich people used to issue receipt to the common people against the promise to safe keeping of their valuable items on the presentation of the receipt, the depositors would get back their gold and valuable after paying a small amount for the safe-keeping and savings.

Banking system occupies an important role in the economic development of a country. A banking institution is indispensable in a modern society. It plays a pivotal role in the economic development of a country and focus the core of the money market in an advance country. The basic function of the bank is to collect deposits as much as possible from customers and mobilize it into the most preferable and profitable sector like industry, commerce, agriculture, entertainment etc.

Like other countries, Goldsmiths, merchants and moneylenders were the ancient bankers of Nepal. Tejarath Adda established during the tenure of the Prime Minister Ranoddip Singh

was the first step towards the institutional development of banking in Nepal. Tejarath Adda did not collect deposits from the public but gave loans to employees and public against the bullion. But the concept of modern banking institution in Nepal was introduced when the first commercial bank, Nepal Bank Limited (NBL) was established in 1937 A.D. under Nepal Bank act 1936 A.D. Being a commercial bank, it was natural that NBL paid more attention to profit generating business and preferred opening branches at urban areas.

Nepal Rastra Bank (NRB) was set up in 1956 A.D. as a central bank under NRB act 1955 A.D. Since then it has been fluctuating as the government's bank and has contributed to the growth of financial sector. After this, government set up Rastriya Banijya Bank (RBB) in 1966 A.D. as a fully government owned commercial bank. As the name suggests, commercial banks are to carry out commercial transaction only. But commercial banks had to carry out the function of all type of financial institutions. Hence, Industrial Development Center (IDC) was set up in 1956 A.D. for industrial development. In 1959 A.D. IDC was converted to Nepal Industrial Development Corporation (NIDC). Similarly, Agricultural Development Bank (ADB) was established in 1968 A.D. to provide finance for agricultural produces so that agricultural productivity could be enhance by introducing modern agriculture techniques. Recently, there are 30 commercial banks. Nepal Investment Bank was established in 1986 A.D., Standard figured in 1987 A.D.,. In 1990s many other banks were established for providing the services to the general public. Such as Himalayan Bank Limited, Nepal SBI Bank, Nepal Bangladesh Bank, Everest Bank Ltd., Bank of Kathmandu Ltd., Nepal Credit and Commerce Bank, Lumbini Bank Ltd and Nepal Industrial and Commercial Bank Ltd. During the last decade, Machapuchhre Bank Ltd, Kumari Bank Ltd, Laxmi Bank Ltd, Siddhartha Bank Ltd, Global IME Bank Ltd, Citizens Bank Ltd, Prime Commercial Bank Ltd, NIC Asia Bank Ltd, Grand Bank Nepal Ltd, NMB Bank Ltd, Kist bank ltd, Mega Bank Ltd, Sunrise Bank Ltd, Janata Bank Ltd, Commerz and Trust Bank Ltd, Civil Axis Bank Ltd, Century Commercial Bank Ltd banks were established. The banking activities are getting very much dynamic as well as complex because of the higher return on investment, entrepreneurs were interested in setting of new bank including branches of foreign banks. However, current political and economic scenario of the country coupled with new prudential norms of Nepal Rastra Bank and stiff competition may make the entrepreneurs give a second thought to the idea of establishing banks.

The modern financial performance evaluation has greatly affected the role and importance of financial performance. Nowadays, finance is best characterized as ever changing with new ideas and techniques. Only efficient manager of the company can achieve the set up goals. If a bank does not maintain adequate equity capital, it makes the bank more risky. If a bank has inadequate equity capital, it must be used more debt that has high fixed cost. So any firm must have adequate equity capital in their capital structure.

The main objectives of the bank are to collect deposits as much as possible from the customers and to mobilize into the most profitable sector. If a bank fails to utilize its collected resources then it cannot generate revenue. Resource mobilization management of bank includes resource collection, investment portfolio, loans and advances, working capital, fixed assets management etc. It measures the extent to which bank is successful to utilize its resources. To measure the bank performance in many aspects, we should analyze its financial indicator with the help of financial statements.

Financial analysis is the process of identifying the financial strength and weakness of the concerned bank. It is the process of finding strength and weakness of the concerned bank. It is the process of finding details accounting information given in the financial statement. It is performed to determine the liquidity, solvency, efficiency and profitability position of an organization. The function or the performance of finance can be broken down into three major decisions i.e. the investment decision, the financing decision, and the dividend decisions. An optional combination of the three decisions will maximize the value of the firm.

1.1.1 Banking: An Introduction

The Lexis "Banking" is a derivative of terminology "Bank". Bank itself is an organization engaged in any or all the various functions of banking viz. receiving, collecting, transferring, paying, lending, investing, dealing exchanging and servicing (safe deposit, trusteeship, agency, custodianship) money and claims to money both domestically and internationally. This is a board concept under which different types of bank includes. There are several popular modalities of banking. It may differ country to country.

Bank is an institution which deals with money and credit. Bank accepts the deposit from the public and mobilizes the fund to the productive sectors. It also provides remittance facility to transfer money from one place to another. Generally bank accepts deposit from business institution and individuals, which is mobilized into productive sectors. Bank, is therefore known as accepting deposits and granting loan.

Banks are one of the most important sources of short term working capital for business. They have become active in recent years in making long term business loans. When business and consumers must make payment for purchase of goods and services, more often they use bank provides cheque, credits or debit card or electric account connected to a computer network. It is the banker to whom they turn most frequently for advice and counsel, when they need financial information and financial planning.

1.1.2 Development of Banking System in Nepal

Nepal's first commercial bank, Nepal Bank Limited, was established in November 15, 1937 A.D. The government owned 38.6% and general public owned 61.40% of the shares in the bank and controlled its operations to a large extent. Nepal Bank Limited is headquartered in Kathmandu and branches in other parts of the country.

Nepal Rastra Bank was established in 1956 A.D. as the central bank. Its function was to supervise commercial banks and to guide the basic monetary policy of the nation. Its major aims were to regulate the issue of paper money; secure countrywide circulation of Nepalese currency and achieve stability in its exchange rates; mobilize capital for economic development and for trade and industry growth; develop the banking system in the country, thereby ensuring the existence of banking facilities and maintain the economic interests of the general public. Nepal Rastra Bank also was to oversee foreign exchange rates and foreign exchange reserves.

There were two other specialized financial institutions. Nepal Industrial Development Corporation, a state-owned development finance organization headquartered in Kathmandu, was established in July 1959 A.D. with United States assistance to offer financial and

technical assistance to private industry. Although the government invested in the corporation, representatives from the private business sector also sat on the board of directors. The Co-operative Bank, which became the Agricultural Development Bank in 1967 A.D., was the main source of financing for small agribusinesses and cooperatives. The Agricultural Development Bank also served as the government's implementing agency for small farmers' group development projects assisted by the Asian Development Bank and financed by the United Nations Development Programme. Since the 1960s, both commercial and specialized banks have expanded. More businesses and households had better access to the credit market although the credit market had not expanded.

In the mid-1980s, three foreign commercial banks opened branches in Nepal. The Nepal Arab Bank was co-owned by the Emirates Bank International Limited (Dubai), the Nepalese government, and the Nepalese public. The Nepal Indosuez Bank was jointly owned by the French Banque Indosuez, Rastriya Banijya Bank, Rastriya Beema Sansthan (National Insurance Corporation), and the Nepalese public. Nepal Grindlays Bank was co-owned by a British firm called Grindlays Bank, local financial interests, and the Nepalese public.

There is a significant growth in the number of banks in Nepal in the last two decades. At the beginning of the 1980s when the financial sector was not liberalized, there were only two commercial banks. After the liberalization in the 1990s, financial sector has made a progress both in term of the number of banks and financial institutions and their branches. In recent, the number of commercial banks is 30 based on the applications for establishment of new banks as well as for the up-gradation of other financial institution, the number is likely to grow in the near future as well.

1.1.3 Concept of "CAMELS" Bank Rating System

Federal Reserve Bank of New York (1997 A.D.) has defined the component of CAMELS as rating system which produces a composite rating system which produces a composite rating of an institution's overall condition and performance by assessing five components: Capital adequacy, Asset quality, Management Administration, Earnings and Liquidity. The CAMELS was later updated with inclusion of sixth component, Sensitivity to Market Risk, now is referred to as the core component.

Bank Supervision Department (BSD) has been following the international supervisory practices along with tailor-made Nepalese relevant laws while supervising the commercial banks. BSD has been following compliance based supervision practice; but its efforts are directed at moving towards Risk Based Supervision.

The cornerstone of supervisory review is thorough, regularly, scheduled, on-site examinations. These examinations focus on six components of bank safety and soundness, known together as CAMELS (Capital Adequacy, Asset Quality, Management, Earning, Liquidity and Sensitivity to Market risk). The banks are assigned a grade of 1 (best) through 5 (worst) on each component. Supervisors use these six scores to award a composite CAMELS rating, also expressed as a 1 through 5 scales. The scores and ratings are kept confidential and used for supervisory response.

The component of bank's management cannot be assessed only in terms of the returns submitted by the bank. Thus, the off-site supervision does not analyze by using CAMELS rating. A separate rating has been devised for the off-site supervision, which uses the components of CAMELS except for the "M" representing management, and the rating is, thus, labeled CAELS. On the basis of these components, off-site supervision unit ranks the bank regularly. The result of the ranking remains confidential and used only for supervisor's information (www.nrb.org.np)

CAMELS Rating System

CAMELS were originally developed by the Federal Deposit Insurance Corporation (FDIC) for the purpose of determining when to schedule an on-site examination of a bank. The Federal Financial Institution Examination Council (FFIEC) is revised in January 1997 A.D, the UFIRS, which is commonly referred to as the CAMELS rating system. This system was designed by regulatory authorities to quantify the performance and the financial condition of the banks which it regulates. The CAMELS rating system is subjective. Benchmarks for each component are provided, but they are guidelines only, and present essential foundations upon which the composite rating is based. They do not eliminate consideration of other pertinent factors by the examiner. The uniform rating system provides the groundwork for necessary supervisory response and helps institutions supervised by all three US supervisors to be reasonably compared and evaluated. Ratings are assigned for each component in addition to

the overall rating of a bank's financial condition. The ratings are assigned on a scale from 1 to 5. The CAMELS ratings are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding banks' overall financial conditions, although they also reflect available public information.

The most important criteria for determining the appropriateness of Financial Institutions (FIs) to act as a financial intermediary are its solvency, profitability, and liquidity. In this respect, the Basel Committee on Banking Supervision (BCBS) of the Bank of International Settlements (BIS), since 1988 A.D, has recommended. The most common supervisory methods used by the regulatory agencies in promoting safety and soundness are on- site supervision and off-site supervision (Keefe, 2007). On-site examination ratings like CAMELS are useful in the analysis of the bank examinations. The CAMELS rating ranges from 1 to 5, lower rating represents better and well managed bank. CAMELS's framework is a common method for evaluating financial performance. This method is developed to assess not only of the financial performance of banks but also to manage risk. This CAMELS rating of banks is not disclosed to concerned banks and other external parties.

Bank supervisory authorities assign each bank a score on a scale of one (best) to five (worst) for each factor. If a bank has an average score less than two it is considered to be a high-quality institution, while banks with scores greater than three are considered to be less-than-satisfactory establishments. The system helps the supervisory authority identify banks that are in need of attention.

NRB central office prepared a working paper in 2006 A.D. about supervisory provision for foreign bank branches in Nepal. NRB supervises joint venture banks of financial information and compliance of applicable rules regulations and legal provisions including NRB directives. Performance of joint venture banks has been better than domestic banks reflected in profitability position, non- performing assets levels and capital adequacy position.

The commercial banks in Nepal can be broadly classified into two categories: public banks and private banks. The banks which are owned by the government are called as public banks while the banks owned by the private sector are categorized as private banks. The private banks can be further regrouped in to the domestic banks and joint venture banks. The country

is open to foreign investment and a numbers of joint venture banks came into existence. Out of 30 commercial banks six are joint venture as of mid- July 2013 licensed by NRB. Joint venture is a contractual business under taking between two or more parties and Joint venture bank is bank own by the joint investment of domestic investors and foreign banks. Joint venture banks have been increasing with an aim to provide modern banking services and facilities with more effectives.

1.1.4 Introduction of Selected Bank

a) Everest Bank Ltd.

Everest Bank Limited (EBL) started its operations in 1994 A.D with a view and objective of extending professionalized and efficient banking services to various segments of the society. The bank is providing customer-friendly services through its branch network. All the branches of the banks are connected through Anywhere Branch Banking System (ABBS), which enables customers for operational transactions from any branches. With an aim to help Nepalese citizens working abroad, the bank has entered into arrangements with banks and finance companies in different countries, which enable quick remittance of funds by Nepalese citizens in countries like UAE, Kuwait, Bahrain, Qatar, Saudi Arabia, Malaysia, etc.

Bank has set up its representative offices at New Delhi (India) to support Nepalese citizen remitting banking related money and advising services. Punjab National Bank (PNB), our joint venture partner (holding 20% equity in the bank) is the largest nationalized bank in India. With its presence virtually in all the important centers at India, Punjab National bank offers a wide variety of banking services which include corporate and personal banking, industrial fiancé, agricultural finance, financing of trade and international banking. Among the clients of the Bank are Indian conglomerates, medium and small industrial units, exporters, non-resident Indians and Multinational companies. The large presence and vast resource base have helped the Bank to build strong links with trade and industry (www.everestbankltd.com).

b) Himalayan Bank Ltd.

Himalayan Bank was established in l993 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 HBL 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.

All Branches of HBL are integrated into Globus (developed by Tremenos), the single Banking software where the Bank has made substantial investments. This has helped the Bank provide services like Any Branch Banking Facility (ABBS), 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 facilities are some of the products and services. HBL also has a dedicated offsite 'Disaster Recovery Management System'.

1.2 Focus of the Study

Nepal Rastra Bank (NRB) as a regulator and supervisor of the banking sector has been effortful to ensure as healthy and efficient financial sector by improving regulation on par with international standard. Bank supervision department of NRB bases its evaluation of financial performance of commercial banks on a CAMELS rating system. An effective performance measurement system presents both financial results and operating data on a responsibility basis. The study focuses on the financial performance of joint venture commercial banks in Nepal by using descriptive cum analytical research design. Many countries are applying CAMELS monitoring tools, which is designed by United Financial Institutions Ratings System (UFIRS) to supervisory controls in the commercial banks operation and helps to find the critical deficiencies faced by such banks. More specifically the study focuses on the trend of capital adequacy ratio and non-performing loan ratio relative to NRB standard and industrial average respectively. The study basically focuses on the past

financial performance (from Fiscal year 2008/09 A.D. through 2012/13 A.D) of Joint Venture Bank in the framework of CAMELS.

1.3 Statement of the Problem

Profitability position of all commercial banks is generally known through annual reposts. But information given in the annual reports is not enough to look into the performance of the commercial banks. Investors should analyze the performance on one hand and on the other hand regulatory body should carry out off-site and on-site supervision of commercial banks and keep their sound financial health. The major problem of the study is to check up to the financial health of all joint venture banks of Nepal in the framework of CAMELS. Therefore this study has attempted to solve the following specific research questions:

- How HBL and EBL banks are managing their Capital Adequacy?
- What is the trend of non-performing assets and loan loss provision in Joint Venture sampled banks?
- How HBL and EBL banks are managing their expenses with respect to revenues?
- What is the trend of earnings of HBL and EBL?
- What is the trend of liquidity position of the HBL and EBL?
- What is the sensitivity analysis?

1.4 Objective of the Study

The fundamental objective of this study is to analyze the financial performance analysis of two joint venture banks in the framework of CAMELS. The specific objectives of the study are given below:

- To describe the capital adequacy of JVBs.
- To analyze the trend of non-performing assets and loan loss provision in company.
- To examine operating efficiency of management of sampled joint venture banks.
- To describe the earning power of the given banks.
- To analyze liquidity position of JVBs.
- To examine the sensitivity of the sampled banks.

1.5 Significance of the Study

This study has mentioned the research which has focused on the comparative financial

performance between HBL and EBL in the framework of the CAMELS. It will help to know the existing problem of banks and give recommendation for their sound financial health. This research would help the managers to evaluate performance of their banks. CAMELS rating system will be crucial and convenient technique to assess the financial performance of any financial institutions and it will provide a framework for the supervisory authority. On the other hand, the study is important for the commercial banks, researchers, scholars, students and many other partners. At last it will add little worth to those who want to conduct a research work in the related topic.

1.6 Limitation of the Study

- The study fully depends upon the secondary data provided by the bank (i.e., Annual reports, NRB publication, working papers and dissertations.)
- The study has been done on the basis of the data provided by the organization so the output of the study is highly depended on data provided by the relevant bank.
- As the study focuses on the financial aspect of the bank, it does not cover overall the other aspect.
- The time-period of only 5 years have been taken for the study so the data has been mostly based on that particular time period. The bank's audited annual reports from the period 2008/09 to 2012/13 are the main source of information and treated as authentic.
- The evaluation made herein is taken of only 2 sample banks. It is focuses on the financial analysis of the study unit in the framework of the six components of CAMELS system.

1.7 Organization of the Study

The study has been classified into five basic chapters which are as follows:

Chapter –I: Introduction

The first chapter provides the introduction of banking, background of the study, an introduction to Everest Bank Ltd and Himalayan Bank Ltd, concept of CAMELS, Focus of study, Statement of problem, Objective of the study, Limitation of the study and Significance/Importance of the study.

Chapter- II: Review of Literature

The second chapter contains Conceptual review, Concept of Commercial Bank, Functions of Commercial Banks, Concept of Bank supervision, Supervisory and monitoring system of NRB, Fundamental concept and Background regarding Basel Accord, Need for Supervision and Monitoring, Method of Bank Supervision and Monitoring System, Bank Supervision types, Definition of CAMELS, CAMELS plus Corporate Governance Research Review, Research Gap.

Chapter- III: Research Methodology

This chapter contains the research methodology used in the study which includes Research Design, Population and Sample, Nature and Source of Data, Data Collection Procedure, Data Processing, Data Analysis Tools, Limitation of the research methodology.

Chapter-IV: Data Presentation and Analysis

The acquired data are analyzed and presented through the way of designed methodology in this chapter to accomplish the research objective. It includes Presentation and Analysis of Data, Capital Adequacy, Management Quality, Earning, Liquidity, Sensitivity to Market Risks, major Findings.

Chapter -V: Summary, Conclusion and Recommendations

The last and fifth chapter discusses summary, conclusion and recommendations of the overall study.

At the end an extensive bibliography and appendices are also included as a part of the research work.

CHAPTER-II
REVIEW OF LITERATURE

This chapter basically is concerned with review of literature relevant to the financial performance analysis of commercial banks, bank supervision, CAMELS rating system and review of research papers and dissertations. Conceptual review and research review is most important part of this chapter. Conceptual review deals with various component of financial performance of commercial bank. Research review presents the dissertation, articles and other related published and unpublished materials.

2.1 Conceptual Framework

This section presents the conceptual aspect of the study. It includes the concept of commercial banks, functions of commercial banks, historical development of commercial banks in Nepal, supervision system of NRB and methods of financial performance analysis.

2.1.1 Concept and Definition of Commercial Bank

A commercial bank is a type of financial intermediary and a type of bank. Commercial banking is also known as business banking. After the Great Depression, the U.S. Congress required that banks only engage in banking activities, whereas investment banks were limited to capital market activities. As the two no longer have to be under separate ownership under U.S. law, some use the term "commercial bank" to refer to a bank or a division of a bank primarily dealing with deposits and loans from corporations or large businesses.

In some other jurisdictions, the strict separation of investment and commercial banking never applied. Commercial banking may also be seen as distinct from retail banking, which involves the provision of financial services direct to consumers. Many banks offer both commercial and retail banking services.

An institution which accepts deposits, makes business loans, and offers related services. Commercial banks also allow for a variety of deposit accounts, such as checking, savings, and time deposit. These institutions are run to make a profit and owned by a group of individuals, yet some may be members of the Federal Reserve System. While commercial banks offer services to individuals, they are primarily concerned with receiving deposits and

lending to businesses.

The Nepalese organized financial sector is composed of banking sector and non-banking sector. Besides commercial banks, there are sizeable numbers of development banks, finance companies, micro-credit development banks, co-operative, NGOs and postal saving offices that undertake limited banking and near banking financial services. Non-bank financial sector comprises saving funds and trusts like Employee Provident Fund, Citizen Investment Trusts, and Mutual fund.

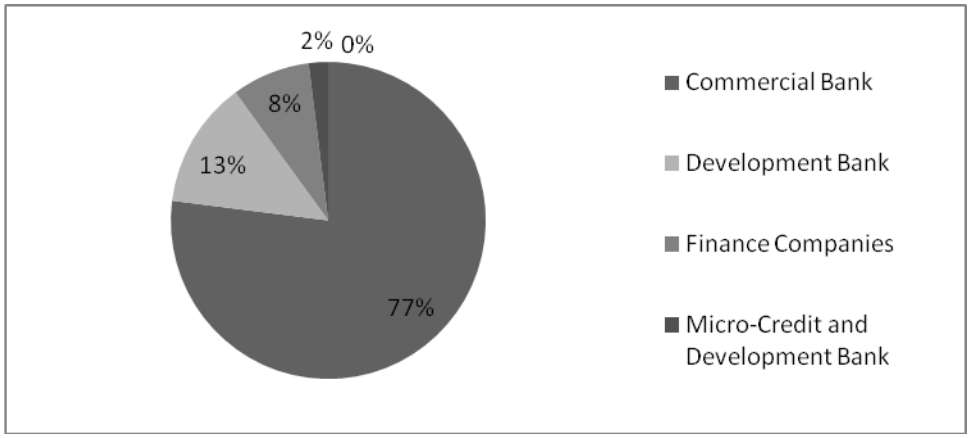
The growth of financial sector in Nepal is much better compared to other sectors in the country. The economic reforms initiated by the Government more than one and half decade ago have changed the landscape of several sectors of the Nepalese economy including the financial sector.

Despite the decade's conflict and political insurgency, this sector has continued to grow. Over the past 20 years, Nepal's financial significantly both in terms of business volume as well as size of assets and market has increased. Nepal has a reasonably diversified financial sector, as evidenced by the number and variety of institutions that play an active role in this sector, relative to Nepal's small and underdeveloped economic base.

Though Nepalese financial sector is reasonably diversified with institutional arrangement of varied nature of financial institutions, commercial banks are the major players in this system and they occupy substantial share in the structure of financial sector. The following table depicts the share of commercial banks out of total financial assets.

Figure 2.1

Share of Total Assets



(Source: - Bank and Financial Institutions Regulation Department, NRB)

The banking sector is an important part of the national economy. Banks take deposits, support the payment system and provide the largest source of funds in the market. Safe and sound banking system is of crucial importance for the financial stability and sustainable development. Nepal has a special characteristic of bank dominated financial sector. As the domestic capital and stock markets are in the initial stage of development, the banking sector largely dominates the entire financial sector.

The financial performance of the commercial banks can be categorized on the basis of assets, composition of assets, composition of liabilities, capital, deposit, loans and advances, non-banking assets, investment, earnings, and liquidity. The total assets of the bank and financial institutions licensed by NRB increased to Rs. 1381 billion in mid-July 2013 compared to Rs. 1166 billion in mid- July 2012 A.D. Figure 2.1 shows that commercial banks constituted a dominant share of 77 percent in total assets of the BFIs. It was 75.3 percent in the previous year. The share of finance companies has decreased to 8 percent in 2013 A.D. which was 10.9 percent in 2012 A.D. The share of development banks in total assets remained almost same to previous year i.e. 13 percent which was 12 percent in 2012 A.D.

Nepal Rastra Bank is committed to strengthen and ensure the stability and soundness of the banking system. In order to achieve the role of protecting the interests of depositors, the department has crafted a number of prudential requirements to be complied with by banking institutions. The prudential requirements advised on banking institutions are designed to limit

risk taking to levels that are manageable and that do not place the individual banking institution and the banking system at risk. In addition other prevailing laws, the main legislative framework for supervision function includes: -

- Nepal Rastra Bank Act 2002
- Bank and Financial Institutions Act, 2006 (Umbrella Act)
- Company Act 2007
- Supervision By-laws
- Directives to commercial banks and financial institutions

NRB has continued to review the relevant legislations and regulations in 2012/13 A.D. in order to put in place up-to-date regulatory framework that meets international standards and resolves the issues of the banking industry.

Banking system occupies an important role in the economic development of a country. A banking institution is indispensable in a modern society. It plays a pivotal role in the economic development of a country and focus the core of the money market in an advance country. The pivotal function of the bank is to collect deposits as much as possible from customers and mobilize it into the most preferable and profitable sector like industry, commerce, agriculture, entertainment etc.

2.1.2 The Role/Functions of Commercial Banks

Commercial banks engaged in the following activities:

- Accepting money on term deposit
- Lending money by the way of overdraft, installment loan or other
- Issuing bank drafts and bank cheques,
- Processing of payments by the way of telegraphic transfer, EFTPOS, internet banking or other means.
- Providing documentary and standby letter of credit, guarantees, performance bonds, securities underwriting commitments and other forms of off balance sheet exposures
- Currency exchange
- Safekeeping of documents and other items in safe deposit boxes

2.1.3 Concept of Bank Supervision

Tuning with the present scenario of globalization and increased economical activities in the country, commercial banks are now introducing complex and innovative banking products. This has amplified as well as diversified the functions to be performed by the Bank Supervision Department.

They are the special institutions in the financial market, which channelize the resources from surplus sector to the deficits sector of the economy. In this process, banks collect huge volume of resources from general public. In mobilizing resources from surplus to deficit sectors they operate with high leverage ratio. This inherent imbalance between 'own' funds and 'borrowed' funds in total capital structure is a peculiar feature of banking institution that ultimately arises concern by supervisory authority. Banks' shareholders have only a small amount of their own funds at stake. Therefore, there is an underlying incentive for banks to tend toward risk taking activities with the fund of depositors and outsiders. Therefore, supervision is necessary to protect the interest of depositors and other stakeholders.

In the absence of close supervision of banks, there may be a chance of arising shareholders' position "if head, I win, if tail, you lose". Banks are an important source of liquidity for an economy. They serve as financial intermediaries to allocate funds and risks among individuals and firms by extending loans or buying securities with funds that they receive as deposits.

A bank failure may have an adverse impact in the financial system, which can interfere the operation of the payments system as well as it could impact on overall economy. The contagion effects of a bank failure can have a huge systemic impact. Due to the special nature of activities, financial institutions are being supervised all over the world by the supervisory authority. Supervisory function is also a costly one.

Although the cost of supervision is high, the cost of no supervision or poor supervision is even higher. The cost of bank failure to the society as a whole is higher that the private cost (the loss to the shareholders). Depositors are generally not well informed to monitor the portfolio behavior of banks nor to enforce compliance as they have got negligible covenant regarding control of the bank.

Some of the major validations behind bank supervision are:

- To maintain stability and confidence i2n the financial system, thereby reducing the risk of loss to depositors and other stakeholders.
- To ensure that banks operate in a prudent way and they hold sufficient capital to support the risks that arise in the business.
- To foster an efficient and competitive banking system that is responsive to the public need for good quality and an easy access of financial services at a reasonable cost.

These risks are defined as follows:

- Credit Risk arises from a potential borrower failing to perform on an obligation.
- Market Risk is the risk to a FI's condition resulting from adverse movements in market interest rates or prices.
- Liquidity Risk is the potential that an institution will be unable to meet its obligations as they come due because of an inability to liquidate assets or obtain adequate funding.
- Operational Risk arises from the potential that inadequate information systems, operational problems, breaches in internal controls, fraud or unforeseen catastrophes will result in unexpected losses.
- Legal Risk arises from the potential that unenforceable contracts, lawsuits or adverse judgments can disrupt or otherwise negatively affect the operations or condition of a banking organization.
- Reputational Risk is the potential that negatively publicity regarding an institution's business practices, whether true or not, will cause a decline in the customer base, costly litigation or revenue reductions.

The framework can be interpreted as comprising three distinct yet complementary sets of arrangements.

- Legal and institutional arrangements for the formulation and implementation of public policy with respect to the financial sector, and the banking system in particular.
- Regulatory arrangements regarding the formulation of laws, policies, prescriptions, guidelines or directives applicable to banking institutions (e.g. entry requirements,

capital requirements, accounting and disclosure provisions, risk management guidelines)

- Supervisory arrangements with respect to the implementation of the banking regulations, monitoring and policing of their application.

2.1.4 Objective of Bank Supervision

With respect to the supervisory arrangements, the Core Principles describe what could be termed a "cradle to grave" approach covering the licensing of individual banks, the process of ongoing supervision and mechanisms for taking prompt corrective actions in case institutions do not meet regulatory or supervisory requirements (the latter would also include exit arrangements for institutions facing serious losses or default and the possible resulting activation of safety met arrangements). The overall objective of this comprehensive process of supervision is to guarantee that banks can be established, operated and restructured in a safe, transparent and efficient manner.

Bank supervisory agencies (like NRB in Nepal) are responsible for monitoring the financial conditions of commercial banks and enforcing related legislation and regulatory policy. Although much of the information needed to do so can be gathered from regulatory reports, on-site examinations are needed to verify report accurately and to gather further supervisory information. Much research has explored the value of this private information, both to the bank supervisors and to the public who monitor banks through the financial markets.

Over the last few years supervisors have adopted new approaches and developed new systems for ongoing banking supervision in order to be better equipped to face the many challenges presented by financial innovation and globalization. These new systems seek to assess and track changes in a bank's financial condition and risk profile and to generate timely warning for the supervisor to help initiate warranted action. G10 countries have developed recently supervisory risk assessment and early warning systems and are currently in use or being developed. Some other systems that were developed but subsequently not put to use, or used but subsequently discontinued for one reason or another. While some of the systems are able to provide ex post indication of existing problems, other systems try to generate ex ante warnings of potential problems that may emerge or develop in the future on

account of the current risk profile of the banking institution. Overall, supervisory risk assessment and early warning systems assist in:

- Systematical assessment of banking institution within a formalized framework both at a time of on-site examination and in between examinations through off-site monitoring;
- Identification of institution and areas within institutions where problems exist or are likely to emerge;
- Prioritization of bank examinations for optimal allocation of supervisory resources and pre-examination planning; and
- Initiation of warranted and timely action by the supervisory.

2.1.5 Process of Bank Supervision

Ongoing banking supervision consists of a differentiated mix of Off-site monitoring procedures and On-site monitoring procedures. Off-site monitoring is the minimum tools for ongoing supervision. Supervisory authorities which so not have the mandate of resources to carry out periodic onsite examinations, rely extensively on this method to monitor the financial condition and performance of banks and to identify those institutions that may need closure scrutiny. The process involves analyzing and reviewing periodic financial and other information received by the supervisor relating to banks' activities. Supervisors typically subject regulated banks to reporting requirements covering, for instance balance sheet and profit and loss statements, business profile, loans, investments, liabilities, capital and liquidity levels, loan loss provisions, etc.

During on-site examinations, supervisors make an overall assessment of a banking institution on the premises of the organization. Examinations be specialized and trained bank examiners allow a more hands-on assessment of qualitative factors such as management capabilities and internal control procedures that may not be reflected adequately in regulatory reports. Supervisory authorities may also commission outside organization such as external auditors to undertake a full on-site examination or to review specific areas of operations within a banking institution.

Of course, external auditors also conduct independently, annual statutory audits of the accounts of a banking firm as well as the firm's compliance with accounting procedures and best practices. In principle, this should provide the supervisor with an additional assurance

that the accounts of a bank provide a true and fair view of the bank's financial position. In many cases, bank examiners will pay particular attention to these audit reports and to the ways in which banks deal with recommendations formulated by their external auditors.

2.1.6 Supervisory and Monitoring System of Nepal Rastra Bank

Central bank is the regulator of banks and financial institutions. Its' liability and obligation is to promote and maintain the safety, soundness and integrity of the financial system. An important function of a central bank is supervision and monitoring of banks and financial company to find out the solvency position and take corrective action in time when needed. Monitoring system is a check and follow-up system. It conform that suggestion and direction given while supervision are properly conducted or not. Central bank monitors commercial banks and financial institutions after supervision and inspection. There is a separate monitoring department in Nepal Rastra Bank. Based on the findings of supervision, the supervisory and inspection department gives advice and instructions to the banks and financial institutions to regulate their performances. In order to see whether these advices and instructors have been properly followed or not, bank monitors them. This is conducted through monitoring departments.

Before the establishment of the Nepal Rastra Bank, the function of the inspection and supervision used to be carried out by the officials by His Majesty government of auditor general office. With liberalization of financial sector in mind 1980s, a number of banks and financial institutions have been increased. These institutions provide services of varied nature by using advance technologies, in this context, supervisory function of the Nepal Rastra Bank has become more challenging. As a result, supervision of financial institutions was established in 1984 A.D. as a separate department. At the present there are separate departments for supervision of commercial banks and financial institutions namely banks supervisions department and financial institutions supervision departments.

Bank supervision department is responsible for executing the supervisory policies to ensure effective supervision of commercial banks of the country. Trained examiners and analysts in the bank supervision department supervise and monitor the activities of commercial banks. In addition to monitoring the financial condition of the banks, examiners also review compliance with applicable laws and regulations and seek corrective measures where

necessary. The obvious key objective of supervision thus becomes to ensure the long run safety of the banking industry through promotion and consolidation of the public confidence in the country's banking system. Effective supervision of these institutions is an essential component of a strong economic environment. The task of supervision is to ensure that banks operate in a safe and sound manner and they hold capital and reserves sufficient to support the risk that arise in their business. Strong and effective banking supervision contributes in enhancing effective macroeconomic policy along with financial stability in any country. A weak regulatory framework and poor supervision provide grants for inefficient and unsafe banking practices which increase the risk of bank failure.

However, the nature of the supervision and its detailed application varies greatly from country to country depending upon principally, the characters of its industry its size and complexity and the objectives and priorities. General, every central bank has a separate supervision department. Recently, supervision department adopts a modern method of supervision and inspection, newly developed by Bank for International Settlement (BIS). This method is found more effective in comparison to the tradition systems. It is known as "CAMELS" rating method.

Nepal Rastra Bank (NRB) has adopted two approaches to monitor and supervise the financial health of the financial institution through off-site and on-site supervision. CAMELS ratings of the commercial bank should be done after completion of on-site inspection and same should be used for internal purpose for further monitoring and necessary action in the areas of problems. In the case of Nepal, NRB has also introduced the system for rating all the banks every year on the basis of CAMELS rating system.

To achieve such objective Nepal Rastra Bank has issued a number of regulations and prudential norms that have to be complied with by banking institutions. Such regulations are designed for bank and financial institutions to limit excessive risk taking to manageable levels.

The NRB while issuing the regulations for banking sector from time to time takes strong references of the following documents or sources:

- To maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other stakeholders.
- To ensure that banks operate in a prudent way and they hold sufficient capital to support the risks that arise in the business.
- To foster an efficient and competitive banking system that is responsive to the public need for good quality and as easy access of financial services at a reasonable cost.

These reasons call for an independent and autonomous supervisory authority to conduct direct assessment of the overall banking system.

2.1.7 Fundamental Concept and Background Regarding Basel Accord

1. Definition of Basel Capital Accord

Basel Capital accord is a capital adequacy framework developed by the Basel Committee. In 1988, the Basel Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital requirement of 8% on banks Risk Weighted Assets (RWA). The 1988 framework is also known as "Basel-I". Since 1988, this framework has been progressively introduced not only in member countries but also virtually in all other countries.

2. Definition of Basel Committee

The Basel committee on Banking Supervision (BCBS) is popularly referred as Basel Committee. It was established by the central bank Governors of the Group of Ten Countries (G-10) at the end of 1974 and meets regularly four times a year. It has about twenty-five technical working groups and task forces, which also meet regularly. Now the Committee's members come from Argentina, Australia, Belgium, Brazil, Canada, China, France, Germany, Hong Kong SAR, India, Indonesia, Italy, Japan, Korea, Luxembourg, Mexico, Netherland, Russia, Saudi Arabia, Singapore, South Africa, Spain, Sweden, Switzerland, Turkey, United Kingdom and the United States. Countries are represented by their central bank and also by the authority with formal responsibility for the supervision of banking business where this is not the central bank. The Basel Committee provides a forum for regular cooperation on banking supervisory matters.

Later renamed as the Basel Committee on Banking Supervision, the Committee was designed as a forum for regular cooperation between its member countries on banking supervisory matters. Its aim was and is to enhance financial stability by improving supervisory knowhow and the quality of banking supervision worldwide.

The Committee seeks to achieve its aims by setting minimum supervisory standards; by improving the effectiveness of techniques for supervising international banking business; and by exchanging information on national supervisory arrangements. And, to engage with the challenges presented by diversified financial conglomerates, the Committee also works with other standard-setting bodies, including those of the securities and insurance industries.

Since the first meeting in February 1975, meetings have been held regularly three or four times a year. After starting life as a G10 body, the Committee expanded its membership in 2009 and now includes 27 jurisdictions. The Committee now reports to an oversight body, the Group of Central Bank Governors and Heads of Supervision (GHOS), which comprises central bank governors and (non-central bank) heads of supervision from member countries.

Countries are represented on the Committee by their central bank and also by the authority with formal responsibility for the prudential supervision of banking business where this is not the central bank. The present Chairman of the Committee is Stefan Ingves, Governor of the Riksbank, Sweden's central bank.

The Committee's decisions have no legal force. Rather, the Committee formulates supervisory standards and guidelines and recommends statements of best practice in the expectation that individual national authorities will implement them. In this way, the Committee encourages convergence towards common standards and monitors their implementation, but without attempting detailed harmonization of member countries' supervisory approaches.

At the outset, one important aim of the Committee's work was to close gaps in international supervisory coverage so that (i) no foreign banking establishment would escape supervision; and (ii) that supervision would be adequate and consistent across member jurisdictions. A first step in this direction was the paper issued in 1975 that came to be known as the

"Concordat", which set out principles by which supervisory responsibility should be shared for banks' foreign branches, subsidiaries and joint ventures between host and parent (or home) supervisory authorities. In May 1983, the Concordat was revised and re-issued as *Principles for the supervision of banks' foreign establishments*.

In April 1990, a supplement to the 1983 Concordat was issued with the aim of improving the cross-border flow of prudential information between banking supervisors. In June 1992, certain principles of the Concordat were reformulated as minimum standards. These standards were communicated to other banking supervisory authorities, who were invited to endorse them, and published in July 1992.2 A brief history of the Basel Committee, drawn up by a joint working group that included supervisors from non-G10 jurisdictions and offshore centers. The document presented proposals for overcoming the impediments to effective consolidated supervision of the cross-border operations of international banks. Subsequently endorsed by supervisors from 140 countries, the report helped to forge relationships between supervisors in home and host countries.

3. Definition of Basel-II

The "International convergence on capital measurement and capital standard-2004" is popularly known as Basel-II. It is a capital adequacy related standard framed by Basel Committee. After the successful implementation of 1988 accord in more than 100 countries, the Basel Committee on Banking Supervision reached in agreement on a number of important issues for promoting best and uniform banking practices as well as setting standards and guidelines for supervisory function. Following extensive interaction with banks, industry groups and supervisory authorities that are not members of the Committee, the revised framework was issued on 26 June 2004, which is being regularly revised. The Basel-II aims to replace Basel I and to make the capital framework more risk sensitive.

Basel II has recommended major revision on the international standard on bank's capital adequacy, which requires banks to implement risk management policies that closely align banks capital with its economic capital. The Basel II has been introduced basically for the protection of depositor's interest by preserving the integrity of capital in Banks.

4. Mandatory of Basel- II

Basel-II has been designed to provide options for banks and banking systems worldwide, the Basel Committee acknowledges that moving towards its adoption in the near further may not but the first priority for all central banks in all non-G10 countries interims of what is needed to strengthen their supervision.

Basel-II aims to build on a solid foundation of prudent capital regulation, supervision and market discipline, and to enhance further risk management and financial stability.

As such, the Committee encourages each national supervisor to consider carefully the benefits of the new Framework in the context of its own domestic banking system and in developing a timetable and approach to implementation. Given resource and other constraints, these plans may extend beyond the Committee's implementation dates. That said, supervisors should consider implementing key elements of the supervisory review and market discipline components o the new Framework if the Basel II minimum capital requirements are not fully implemented by the implementation date. It is said that the national supervisors should also ensure that banks that do not implement Basel II are subject to prudent capital regulation and sound accounting and provisioning policies.

5. Approaches of Basel II

A major innovation of the Basel II is the introduction of distinct options for the calculation of key types of banking risk. For credit, operational and market risk, there are different approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks' operations and of the financial market infrastructure. The following table identifies primary approaches available by risk type:

SN Credit Risk Operational Risk Market Risk

- Standardized Approach Basic Indicator Approach Standardized Approach
- Foundation IRB Approach Standardized Approach Internal Model Approach
- Advance IRB Approach Advanced Measurement Approaches (AMA)

6. Basic Characteristics of Basel-II

Basel-II captures the risk through its three pillar minimum capital requirement, supervisory review process and market discipline. It addresses not only the credit and market risk but also the operational risk. The risk is computed based on the actual risk profile of the counterpart. It is not ad hock or general. Hence the capital is truly risk based.

7. Adaption of Advanced Approaches

We understand that the new framework developed by the Basel Committee is a product of long exercise in the globe. It is mainly the outcome of sophistication in to developed economy and complex product introduced in to the global market. The approach to Basel II in Nepal is to confirm to best international standards with local context. We plan to adopt advance approaches gradually as the market attains maturity and emerge as more sophisticated. Those banks planning for the advance approaches are requested to collect loss data and also adhere to the sound practice for risk management. Banks will be encouraged to move along the advance approaches as they achieve increasing sophistication in their risk management systems and processes.

However, banks must obtain prior approval of the Nepal Rasta Bank if they intend to use any one of the advanced approaches namely Standardized Approach, IRB Approach, Advanced Measurement Approach.

8. Towards Basel III

Even before Lehman Brothers collapsed in September 2008, the need for a fundamental strengthening of the Basel II framework had become apparent. The banking sector had entered the crisis with too much leverage and inadequate liquidity buffers. These defects were accompanied by poor governance and risk management, as well as inappropriate incentive structures. The combination of these factors was manifest in the mispricing of credit and liquidity risk, and excess credit growth.

Responding to these risk factors, the Basel Committee issued *Principles for Sound Liquidity Risk Management and Supervision* in the same month that Lehman Brothers failed. In July 2009, the Committee issued a further package of documents to strengthen the Basel II capital framework, notably with regard to the treatment of certain complex securitization positions, off-balance sheet vehicles and trading book exposures. These enhancements were part of a

broader effort to strengthen the regulation and supervision of internationally active banks, in the light of weaknesses revealed by the financial market crisis.

In September 2010, the Group of Governors and Heads of Supervision announced higher global minimum capital standards for commercial banks. This followed an agreement reached in July regarding the overall design of the capital and liquidity reform package, now referred to as "Basel III". In November 2010, the new capital and liquidity standards were endorsed at the G20 Leaders Summit in Seoul.

The new proposed standards were set out in *Basel III: International Framework for Liquidity Risk Measurement, Standards and Monitoring*, issued by the Committee in mid-December 2010. A new capital framework revises and strengthens the three pillars established by Basel II. The accord is also extended with several innovations, namely:

- An additional layer of common equity – the capital conservation buffer – that, when breached, restricts payouts of earnings to help protect the minimum common equity requirement;
- A countercyclical capital buffer, which places restrictions on participation by banks in system-wide credit booms with the aim of reducing their losses in credit busts;
- Proposals to require additional capital and liquidity to be held by banks whose failure would threaten the entire banking system;
- A leverage ratio – a minimum amount of loss-absorbing capital relative to all of a bank's assets and off-balance-sheet exposures regardless of risk weighting;
- Liquidity requirements – a minimum liquidity ratio, intended to provide enough cash to cover funding needs over a 30-day period of stress; and a longer-term ratio intended to address maturity mismatches over the entire balance sheet; and
- Additional proposals for systemically important banks, including requirements for augmented contingent capital and strengthened arrangements for cross-border supervision and resolution.

In January 2012, the Group of Central Bank Governors and Heads of Supervision (GHOS) endorsed the comprehensive process proposed by the Committee to monitor members' implementation of Basel III. The process consists of the following three levels of review:
Level 1: ensuring the timely adoption of Basel III;

Level 2: ensuring regulatory consistency with Basel III; and
Level 3: ensuring consistency of outcomes (initially focusing on risk-weighted assets).

The Basel Committee has worked in close collaboration with the Financial Stability Board (FSB) given the FSB's role in coordinating the monitoring of implementation of regulatory reforms. The Committee designed its programmed to be consistent with the FSB's *Coordination Framework for Monitoring the Implementation of Financial Reforms* (CFIM) as agreed by the G20.A brief history of the Basel Committee 5.

These tightened definitions of capital, significantly higher minimum ratios and the introduction of a macro prudential overlay represent a fundamental overhaul for banking regulation. At the same time, the Basel Committee, its governing body and the G20 Leaders have emphasized that the reforms will be introduced in a way that does not impede the recovery of the real economy.

In addition, time is needed to translate the new internationally agreed standards into national legislation. To reflect these concerns, a set of transitional arrangements for the new standards was announced as early as September 2010, although national authorities are free to impose higher standards and shorten transition periods where appropriate.

The new, strengthened definition of capital will be phased in over five years: the requirements were introduced in 2013 and will be fully implemented by the end of 2017. Capital instruments that no longer qualify as non-common equity Tier 1 capital or Tier 2 capital will be phased out over 10 years beginning 1 January 2013.

Turning to the minimum capital requirements, the higher minimums for common equity and Tier 1 capital are being phased in from 2013, and will become effective at the beginning of 2015. The schedule will be as follows:

- The minimum common equity and Tier 1 requirements increased from 2% and 4% levels to 3.5% and 4.5%, respectively, at the beginning of 2013.
- The minimum common equity and Tier 1 requirements will be 4% and 5.5%, respectively, starting in 2014.

- The final requirements for common equity and Tier 1 capital will be 4.5% and 6%, respectively, beginning in 2015.

The 2.5% capital conservation buffer, which will comprise common equity and is in addition to the 4.5% minimum requirement, will be phased in progressively starting on 1 January 2016, and will become fully effective by 1 January 2019.
The leverage ratio will also be phased in gradually. The test (the so-called "parallel run period") began in 2013 and will run until 2017, with a view to migrating to a Pillar 1 treatment on 1 January 2018 based on review and appropriate calibration.

The liquidity coverage ratio (LCR) will be phased in from 1 January 2015 and will require banks to hold a buffer of high-quality liquid assets sufficient to deal with the cash outflows encountered in an acute short-term stress scenario as specified by supervisors. To ensure that banks can implement the LCR without disruption to their financing activities, the minimum LCR requirement will begin at 60% in 2015, rising in equal annual steps of 10 percentage points to reach 100% on 1 January 2019.

The other minimum liquidity standard introduced by Basel III is the net stable funding ratio. This requirement, which will be introduced as a minimum standard by 1 January 2018, will address funding mismatches and provide incentives for banks to use stable sources to fund their activities.

9. Is "New Capital Adequacy Framework (NCAF)" of Nepal different from Basel Capital Accord?

Nepal Rasta Bank has developed and enforced capital adequacy requirement based on international practices with appropriate level of customization based on domestic state of market developments. The existing regulatory capital is based on the Basel committee's 1988 recommendations. The NCAF outlines the Nepal Rastra Bank's guidelines for domestic commercial banks, which is based on the simplest approaches of Basel II framework.

10. Regarding Applicability NCAF to all Financial Institutions

Only "A" Class Financial Institutions, licensed by Nepal Rastra Bank under the Bank and Financial Institution Act, 2063 are subject to this new capital adequacy framework.

11. Definition of Tier 1 Capital and Tier II Capital

Capital that is fully paid up and having no fixed servicing or dividend costs attached to it and really available to absorb losses qualify as Tier-1 capital. Tier 1 capital is also termed as core capital. Core capital also needs to have a very high degree of permanence if it is to be treated as Tier 1.

Tier 2 Capital consist of general loan loss provision, revaluation reserve, and exchange equalization reserve, investments adjustment reserves, and other reserves, redeemable preference share and subordinated term debt. Tier-II capitals shall be subject to the certain limitations and restrictions. Amount of Tier-2 capital shall not exceed tier 1 capital, sum of Tier I and Tier II capital is Total Capital.

12. Description of Risk Weighted Exposure

Risk weighted exposure is the maximum amount of risk attached to a portfolio or a transaction or underlying assets. It is the sum of risk weight for credit risk, market risk, operational risk and any supervisory adjustments on such risk weigh.

13. Regarding Basel-II Practicable to Our Contest

The true Basel-II is almost impracticable for the numbers of years in our context. However the journey should be started and should keep in touch to the international developments and be prepared to capture the principle in full when the need arises. It is encouraged by the different simplest options available in the framework. The simplest approaches are practicable and it has been enforced to the commercial banking industry. The destination to advance approaches is really a long one in our context.

14. Regarding Commitment from the NRB for Adoption

There is no any commitment for the adoption of Basel-II. The initiation towards the Basel-II is voluntary one and to follow the international best practice in time. NRB has decided to go for the Basel-II in a simplified way to be practicable in our circumstances. Based on that policy, NRB's intention and adoption plan is communicated to the FSI/BIS for their reference.

15. Challenges for the NCAF Implementation

The Basel-II is challengeable to supervisor as well as banking industry. The supervisory capacity building, market discipline, issue of poor governance in to the industry, poor governance in to the market, poor data base, lack of credit rating agencies, re-capitalization of negative net worth bank and lack of adequate, accurate and reliable financial data are some of the challenges ahead for effective implementation of New capital adequacy framework.(www.nrb.org.np)

2.1.8 Need for Supervision and Monitoring

The world of finance has undergone profound changes as evidenced by the rapid technological development for processing and transmitting data, the growing internationalization of financial system, the increasing phenomenon of financial innovations coupled with competition and deregulation. The new financial environment has necessitated the development of new and the adaptations of existing supervisory policies, practices and procedures. The difficult economic environment has reduced earnings capacity of many sectors in the economy, there by affecting the overall performance of commercial banks. These challenges are deals with through effective banking supervision.

The banks and financial institutions are established with the permission of the central bank. When the central banks permit to carry out transaction, it fixes various terms and conditions. In addition to it issues necessary directions from time to time about loan, deposits, liquidity, re-finance, capital fund, rate of interest and spread etc. It is very necessary to inspect their activities after investigating whether or not the banks and financial institutionary have followed the current law and the direction and instruction of the central bank to move them in to the directed track. The common people, the central bank and the government do have deep interest in the well running of them because the banks and the financial institutions collect the amount from the public as deposits. Therefore, to secure the interest of the depositors and the investors to manage the strong and competent financial system regulation, inspection and supervision of the banks and financial intuitions is considered compulsory. Although, cost of supervision is high, there are a number of reasons why supervision is important of commercial bank. So, the need for supervision and monitoring can be described as follows;

- To investigate regulatory whether the banks and financial institutions have performed the functions within the limitation of the present laws and the direction or not.

- To evaluate whether the present laws and regulation are sufficient or not.
- To maintain stability and confidence in the financial system resulting into reduced risk of loss to depositors and other stakeholders.
- To find out the effectiveness of the internal control system and rules.
- To aware of whether the management information system is certain of not.
- To ensure that banks have resources appropriate to undertake risks, including adequate capital, sound management capabilities and effective control systems and accounting records.
- To ensure that banks operate in a safe and sound manner and they hold capital and reserve sufficient to support the risk that arise in their business.
- To decide whether the strategy of risk management has been followed or not, to lessen the possible risk in the banking and financial business.
- To give necessary information to the banks.

There are also the key objectives behind the supervision of banks in Nepal. The basic objectives of supervision of NRB is to conduct a direct assessment of the overall condition of the banking institutions based on off-site and on-site evaluation of the institutions capital, assets, management, earnings, liquidity and a review of their records, systems and internal control and to determine whether the institutions has complied with relevant mandatory and regulatory requirements.

2.1.9 Method of Bank Supervision and Monitoring System

The most common supervisory tools used by the regulatory agencies in promoting safety and soundness are on site examination and off site examinations approach. Each serves a unique purpose. The ideal approach could vary for supervisors operating in different environment. However, the optimal approach lies somewhere between the two extremes since neither approach is a substitute for another. A mix of the two approaches would appear to yield the best result. Bank supervision department has been using a combination of these various approaches to supplement its supervision process. Generally, the supervision can be made in the following ways;

2.1.9.1 On-Site Examinations

On-site examination to evaluate effectively the safety and soundness of the commercial banks and the banks are operating in line with prudential banking practice and complying with applicable laws and regulations. It is effective which cannot be covered in off-site supervision. Especially, the documents about loan accounts expenses, letter of credit, bank guarantee, remittance should be checked properly while on-site supervision which made by visit of the place of the bank by the team of inspections of the central bank.

There are four fundamental reasons for on-site examinations. The first is to determine the commercial bank, financial position and the quality of its portfolio and operations so as to ensure that it is not operation against the interest of the depositors. Second, periodic on-site examinations provide the best means of determining banks adherence to laws and regulations. Third, the examinations, process can help prevent problem situations from remaining uncorrected and unhealthy to the point. Finally, examinations supply supervisors with an understanding of the nature relative seriousness and ultimate cause of banks problems and thus provide a sound factual foundation on which to base corrective measures recommendations and instructions.

Although, on-site examination is the most effective tool for sporting safety and soundness problem, it is costly and burdens some. On-site examination is costly to supervisors because of the examiner resources required and burdensome to bankers because of the intrusion into daily operations. In fact, physical inspection of banks books is often the only way to detect irregularities in the operation of the bank that may indicate illegal or ill-advised actions by bank employees.

In sum, on site examinations are the best way to supervisors to track the condition of banks, however, since examinations cannot be continuously on-site, regulators also use off-site supervision to help span the gap between regulatory scheduled on site examinations.

2.1.9.2 Off-site Supervision

Bank supervisors support on-site examinations with off-site supervision. Off-site supervision is performed by studying the documents provided by commercial banks. An inspection carried out without visiting the places of the banks. The function includes the analysis of financial statement other necessary documents, annual report, and information received from the commercial banks. Generally, documents and reports are received on a weekly, monthly, quarterly, annually basis. The off-site supervision is continuous process. From it we can get true picture of the problems of the bank. It makes it easy to devise the way for protection from the possible future crisis. The objective of off-site supervision is to quickly identify negative trends and emerging problems and to resolve the issues before they become so serious that they could negatively effect of commercial banks. Moreover, as the cost and complexity of examine banks have risen it has become increasingly more difficult for the banks regulators to attract and retain quality bank examiners.

On the other hand, advances in computer technology give bank regulators the ability to monitor the condition of banks without conducting an on-site examination. Therefore, off-site monitoring of banks has become an important part of the regulatory examination umbrella. Use of off-site supervision, however, is not a substitute for periodic on site examination. Instead, it is a valuable complement to the examination process. Off-site supervision has several advantages. For instance, it is far less intrusive and uses fewer personnel than on-site examinations and since off-site supervision can identify banks that show sign of financial distress, it also helps regulators allocate on-site examination resources efficiency.

Off-site supervision can often identify potential problems, particularly in the interval between on-site supervision, thereby providing early detection and prompting corrective action. This supervision also identify potential problems of the commercial banks and monitoring compliance of various prudential regulations issued by NRB to ensure long term stability of commercial banks.

In the course of supervision when inspectors find minor mistakes they provide suggestion and guidelines for correction. The inspectors should prepare a report containing all the findings after conducting supervision, if a bank is found violated of neglected the rules and

regulations, the central bank, on the recommendation of supervision departments may be a simple warning to tuff penalty like inaction license, penalty charges etc.

2.1.10 Financial Performance Analysis in the Framework of CAMELS Bank Rating System

The CAMELS rating system is an internal supervisory tool for evaluating the safety and soundness of financial institutions using by capital adequacy, assets quality, management quality earnings and liquidity. Infect the rating system initially emerges as CAMELS covering the first five parameters only. The six component sensitivity to market risk(s) has only been used since January 1, 1997. The most notable change to the system is the proposed addition on an "S" to make "CAMELS".

Federal and state regulations regularly assess the financial condition of each bank and specific risks faced on site examination and periodic report. Based on these methodologies the bank's operations are assessed in respect of the components of CAMELS and the individual ratings of the component and a consolidated. The Uniform Financial Institutions Rating System (UFIRS) was adopted by the Federal Financial Institutions Examination Council (FFIEC) on November 13, 1979 A.D. UFIRS is revised in 1997 A.D. This rating is the UFIRS designed to evaluate banks condition on a uniform basis.

CAMELS rating system is used three federal banking supervisors (Federal Reserve, the FDIC, the office of the comptroller of the currency) and other financial supervisory agencies to supervision and examination time to time of bank. The CAMELS rating range from 1 to 5 CAMELS framework is common method for analyzing the health of financial institutions. All exam materials are highly confidential including the CAMELS. These ratings are not release to the public but only to the top management and the appropriate supervisory staff.

This rating system is common method for analyzing the health of financial institution. This system was originally developed by the FDIC. CAMELS are an ideal rating system practiced worldwide by central banks and rating agencies to evaluate and analysis safety and soundness of a bank. Reserve Bank of India has been used CAMELS ratings in its supervisory regulations of the banking system. In Nepal CAMELS rating system is still in its initial phase NRB has introduced the system for rating all the banks every year.

Composite Ratings

An international bank rating system with which bank supervisory authorities rate institutions according to six factors. The six factors are represented by the acronym 'CAMELS'. The six key components used to assess an institution's financial condition and operations are:

- Capital adequacy
- Asset quality
- Management capability
- Earnings
- Liquidity and
- Sensitivity to market risk.

This rating is based on financial statements of the bank and on-site examination by three federal banking supervisors (the Federal Reserve, the FDIC, and the OCC) and other financial supervisory agencies to provide a convenient summary of bank conditions at the times of exam. The banks for this rating is the uniform financial institutions rating system (UFIRS) designed to evaluated banks condition on a uniform basis and to identify banks requiring special attention or concern. Bank supervisory authorities assign each bank a score on a scale from one to five with 1 being strongest and 5 being weakest. If a bank have an average score less than two it is considered to be a high quality institutions while banks with scores greater than 3 are considered to be less than satisfactory establishments. The system helps the supervisory authority identify banks that are in need of attention. Bank with ratings of 1 or 2 are considered to present few if any supervisory concerns while banks with raring of 3,4,5 present moderate to extreme degrees of supervisory concern.

The composite ratings from 1 to 5 are as follows:
Composite 1: The composite rating one is thought to indicate strong FIs that could weather adverse economic condition. These FIs are highest rating performance and risk management practices and thee least degree of supervisory concern. These FIs are in substantial compliance with laws and regulations.

Composite 2: The composite rating of two means that the FIs could be severely weakened by adverse economic conditions. FIs in the group are fundamentally sound but many reflect

modest weakness correctable in the normal courses of business. Overall risk management practices are satisfactory relative to the institutions size, complexity, and risk profit.

Composite 3: The three rated FIs are through to be at risk in unfavorable economic environment. There FIs in this category exhibit financial operational or compliance weaknesses rating from moderately severe to unsatisfactory.

Composite 4: Four rated FIs are considered to be banks that are danger of failing unless corrective actions are taken. These FIs generally exhibit unsafe and unsound practices or condition. These are serious financial or managerial deficiencies that result in unsatisfactory performance. There may be significant non compliances with laws and regulations.

Composite 5: FIs in this category indicates that the bank is likely to fail in the near future. These FIs are lowest rating performance, inadequate risk management precipices and therefore the highest degree of supervisory concern.

2.2 Definition of Components of CAMELS

2.2.1 Capital Adequacy(C)

The first component of the CAMELS rating is capital adequacy. A key principle in bank supervision which is regards capital as the cornerstone of a banks' strength. Bank capital is a source of financial support to protect an institution losses arising out of the unexpected risks. Strong capital base is the prerequisite for the safety and soundness of any bank. Commercial bank should have adequate capital to support the stability and sustainability of its operation. A financial institution, which has adequate capital can flow more loan and has the capital to bear the possible risk in future. Adequate capital helps to gain faith of the depositors, investors and the loan donors to increase the loan investment capacity to make defective property bearable and to make defective property bearable and to raise the credit of the bank. Bank capital serves three basic roles. The first, and most obvious, is that it is a source of funds. A new bank requires funds to internal investment. Established banks require capital to finance their growth, as well as to maintain and modernize operations. The second function of capital is to serve as a cushion to absorb unexpected operating losses. The third function of bank capital bears on the question of adequate capital bank regulators establishes minimum requirements to promote safety and soundness in banking system. The capital component is

based on evaluation of and provide for future growth. An evaluation of capital relies on many factors such as regulatory capital requirements trends portfolio and institutional risk growth, adequacy of risk funds, management capability and other factors as appropriate.
Nepal Rastra Bank has ultimate power of right to decided how much capital is needed for a bank or non bank financed institutions. Adequacy and inadequacy of bank capital directly affects the banking transactions. The adequacy of bank capital is the most important aspect of a bank. If there is inadequacy of capital, the bank should take step for the adequacy of capital as per legal requirement. The bank should remove the inadequacy of bank capital through the medium of collecting of ownership and borrowed capital. If the bank cannot maintain the adequate capital, it may give many defects. The defects caused by the bank capital do not lead the bank forwards. So, special attention should be given to capital adequacy system of the bank capital. The adequacy of the bank capital is necessary for the following functions:

- **For the Payments of all Types of Deposits:**

Adequacy of bank capital is necessary for a bank, to give the payment of the amount of all types of deposits to its customers. Hence, the adequacy of bank capital is needed to gain trust from its customers.

- **To Meet the Demand of All Types of Cash Reserve Funds:**

A bank should deposit the amount in different types of funds, in the Nepal Rastra Bank and in its own bank. The commercial bank should deposit cash in such funds. This is a legal obligation, which is created in two ways. One obligation occurs by the provision of law and another obligation takes place due to circulars, policy and directives issued by the Nepal Rastra Bank. A bank cannot reject both of these obligations. Therefore, there is a need of an adequate bank capital for the deposit of cash in all funds created.

- **Investment for Banking Transaction and Business**

With the lack of an adequate bank capital, the bank cannot meet daily administrative expenditure and the investment in different sectors to earn profit. So, to perform the above given functions the bank needs an adequate bank capital. Directly, the above mentioned functions affect to be adequacy of bank capital.

- **Absorbs Losses**

Capital allows institutions to continue its operations when operating losses or other adverse financial results are experienced.

- **Promotes Public Confidence**

Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.

- **Restricts Excessive Asset Growth**

Capital, along with minimum capital ration standards, restrains unjustified asset expansion by requiring that asset growth be funded by a commensurate amount of additional capital.

- **Provides Protection to Depositors**

Placing owners at significant risk of loss, should the institution fail; help to minimize the potential "moral hazard" and promotes safe and sound banking practices.

Capital is necessary for the bank to operate. While many areas of a bank are important and subject to scrutiny, capital adequacy is the area that triggers the most regulatory action. This action is largely based on the three major ratios used in the assessment of capital adequacy, which are:

- The Tier 1 Risk-Based Capital Ratio
- The Total Risk-Based Capital Ratio
- The Tier 1 Leverage Ratio

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- Size of the bank
- Volume of inferior quality assets
- Bank's growth experience, plans and prospects
- Quality of capital Retained earnings
- Access to capital markets

- Non-ledger assets and sound values not shown on books (real property at nominal values, charge-offs with firm recovery values, tax adjustments).

The FDIC Improvement Act of 1991, which created a link between enforcement actions and the level of capital held by a bank. This supervisory link is commonly known as Prompt Corrective Action (PCA) and aims to resolve banking problems early and at the least cost to the bank insurance fund. PCA has classified the banks as:

Well-Capitalized

To be considered well-capitalized, a bank will meet the following conditions:

- Total risk-based capital ratio is 10 percent or more,
- Tier 1 risk-based capital ratio is 6 percent or more, and
- Tier 1 leverage ratio is 5 percent or more

In addition to these ratio guidelines, to be well capitalized a bank cannot be subject to an order, a written agreement, a capital directive or a PCA directive.

Adequately Capitalized

To be considered well capitalized, a bank will meet the following conditions:

- Total risk-based ratio is at least NRB minimum capital adequacy ratio requirement.
- Tier 1 risk-based capital ratio is at least NRB minimum Tier I capital ratio requirement.
- Tier 1 leverage ratio is at least 4 percent.

Undercapitalized

To be considered undercapitalized, a bank will meet the following conditions:

- Total risk-based capital ratio is less than 8 percent,
- Tier 1 risk-based capital ratio is less than 4 percent, or Tier 1 leverage ratio is less than 4 percent.

Significantly Undercapitalized

To be considered significantly undercapitalized, a bank will meet the following conditions:

- Total risk-based capital ratio is less than 6 percent,
- Tier 1 risk-based capital ratio is less than 3 percent, or
- Tier 1 leverage ratio is less than 3 percent.

Ratings Capital Component

- A rating of 1 indicates a strong capital level relative to the institution's risk profile.
- A rating of 2 indicates a satisfactory capital level relative to the FIs risk profile.
- A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institutions' capital level exceeds minimum regulatory and statutory requirements.
- A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened. Assistance from shareholders or other external sources of financial support may be required.
- A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support it required.

A FI is expected to maintain capital commensurate with the nature and extend of risks to the institution and the ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

2.2.2 Assets Quality (A)

This is one of the most critical factors in determining overall condition of any bank. Primary factors that can be considered are the quality of loan portfolio, mix of risk assets and credit administration system. The assets quality means the capacity of assets to generate income as well as the recover ability of the principal amount.

This component is based on an assessment of both the quality of the current portfolio and the quality of the associated management process that substantially impact the quality of assets. An assessment of assets relies on many factors such as loan portfolio management, investment portfolio trends, risk identification process, and other factors that affect the quality performance, income producing capacity and stability of assets. Examiner judgment is to the quality of each borrowers and his ability to repay the loan. It is necessary to study the quality of assets to maintain the sound economic condition of the financial institutions. For this purpose, it should be checked up whatever the risk found, which is fixed by the NRB is maintained or not by the commercial banks and FIs. For this provision it helps the FIs to save for losing the various types of financial risk with the provision of keeping the risk fund according to the quality of the assets as per the rules regulation and policy of the central bank. Loans are usually the largest of the assets items and can also carry the greatest amount of potential risk to the bank's capital account.

Non-Performing Assets / Loan (NPA)

Non-performing loan means an outstanding loan not repaid, i.e. neither payment on interest or principle are made. In case of the banks the loans and advances are the assets as the banks flow loans for the funds generated through shareholders equity ,money deposited by the people and fund having through the borrows . Hence the term NPA means the loans and advances that are not performing well. Thus all the irregular loans can be terms as NPA. Generally, non-performing loans/assets include all loans in the portfolio more than 90 days overdue on interest or principle payments. The definition of NPA differs with countries of the Asia pacific economic cooperation (APEC) forum: loan is classified as non-performing only after it has been in arrear for at least six months. In India, after three months from the date of deemed commercial production to release interest income, any default or reschedule was considered as an NPA on the book of accounts.

Implication of NPAs

Financial crisis emerged from Thailand in South East Asian countries largely is considered to be due to higher level of NPAs existed with the FIs, The situation was grave when the assets stopped to repay loans to credit agencies which was borrowed from overseas capital market.

Evaluation of Asset Quality

The evaluation of asset quality should consider the adequacy of the Allowance for Loan and lease Losses (ALLL) and weight the exposure to counter-party, issuer or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including, but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered.

Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any local and regional conditions that might impact bank performance. In addition, any systemic weaknesses, as opposed to isolated problems, should be given appropriate consideration. The following is not a complete list of all possible factors that may influence an examiner's assessment; however, all assessments should consider the following;

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices,
- The level, distribution, severity, and trend of problem, classified, on accrual, restructured, delinquent, and non-performing assets for both on-balance and off-balance sheet transactions,
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves,
- The credit risk arising from or reduced by off-balance sheet transactions, such as un-funded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit,
- The diversification and quality of the loan and investment portfolios,
- The extent of securities underwriting activities and exposure to counter-parties in trading activities,
- The existence of asset concentrations,
- The adequacy of loan and investment policies, procedures, and practices,
- The ability of management to properly administer its asset, including the timely identification and collection of problem assets,
- The adequacy of internal controls and management information systems,
- The volume and nature of credit documentation exceptions.

As with the evaluation of other component ratings, the above factors, among others, should be evaluated not only according to the current level but also considering any ongoing trends. The same level might be looked on more or less favorably depending on any improving or deteriorating trends in one or more factors.

Rating the Asset Quality Factor

The Asset Quality Rating definitions are applied following a thorough evaluation of existing and potential risks and the mitigation of those risks. The definitions of each rating are as follows:

- A rating 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality is such institution is of minimal supervisory concern.
- A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classification and other weakness warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.
- A rating of 3 is assigned when quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality. The level and severity of classified assets, other weakness, and risks require an elevated level of supervisory concern.
- A rating 4 is assigned to FIs with deficient assent quality or credit administration practices. The levels of risk and problem assets are significant; inadequacy controlled, and subjects the FI to potential losses that, if left unchecked, may threaten its viability.
- A rating of 5 represents critically deficient asset quality of credit administration practices that present and imminent threat to the institution's viability.

NRB unified directive for Banks & Non-Bank through directive number E.Pra. Ni. No. 02/068/69, requires the banks to classify outstanding loans and advances on the basis of Principal amount. As per the directive the loans and Advances should be classified into the following four categories:

Pass

Loans and Advances whose principal amount are not past due over for 3 months include in this category. These are classified and defined as performing loans.

Substandard

All loan and advances that are past due for a period of 3 months to 6 months included in this category.

Doubtful

All loans and advances, which are past due for a period of 6 months to 1 year, included in this category.

Loss

All loans and advances which are past due for more than 1 year and have least or thin possibility if recovery of considered unrecoverable shall include in this category. Besides this, any whether past due or not, in situations of inadequate security, borrower declared insolvent, no whereabouts of the borrower or misuse of borrowed fund, are to be classified as Loss category.

The directive further requires banks to provision for loan loss, on the basis of the outstanding loans and advances and bills purchased classified as above. Loan loss provision set aside for performing loans is defined as General Loan Loss Provision and that set aside for non-performing loan as Specific Loan Loss Provision.

Loan Class	Loan Loss Provision
Pass	1%
Substandard	25%
Doubtful	50%
Loss	100%

With the objectives of lowering risk of bank loans to a few big borrowers and to increase the access of small and middle size borrowers to the bank loans, NRB through directive number E.Pra.Ni.Na 03/068/69 Limits commercial banks to extend credit to a single borrower or group of related borrowers up to 25% of its core capital for fund based credit facilities and

not more than 50% of its core capital for Non fund based credit facilities like letters of credit, guarantees, acceptances, commitments.

The facilities extended against bank's own fixed time deposit, HMG securities, NRB Bonds, counter guarantees of World Bank/Agricultural Development Bank/International A+ rated banks (as per list of top 1000 world international banks published by the loan on based magazine, "The Banker"), are excluded from the restriction. Likewise advances and facilities to be used for the purpose of importing specified merchandise by the following public corporation are also excluded:

Name of the corporation	**Merchandise**
Nepal Oil Corporation	Petrol,Diesel,Kerosene,L.P.G.
Nepal Food Corporation	Cereals

2.2.3 Management Quality

The capabilities of the board of directors and management, in their respective roles, to identify, measure, monitor and control the risks of an institution's activities and to ensure a FI's safe, sound and efficient operation in compliance with applicable laws and regulations is reflected in this rating. Depending on the nature and scope of an institution's activities, management practice may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal liquidity and other risks. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies, processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audits program and internal control environment; and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved. The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors

- The level and quantity of oversight and support of all institution activities by the board of directors and management.

- The ability of the board of directors and management, in their respective roles, to plan for, and respond to, risks that may arise from changing business conditions or the initiation of new activities or products.
- The adequacy of, and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timeliness, and effectiveness of management information and risk monitoring system appropriate for the institution's size, complexity, and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations and internal policies.
- Compliance with laws, regulations.
- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Rating the Management Factor

- A rating of 1 indicates strong performance by management and the board of directors and strong risk management practices relative to the institution's size, complexity, and risk profile. All significant risks are consistently and effectively identified, measured, monitored and controlled and the board has demonstrated the ability to promptly and successfully address existing and potential problems and risks.
- A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity, and risk profile. Minor weakness may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured, monitored, and controlled.
- A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be

insufficient for the type, size or condition of the institution. Problems and significant risks may be inadequacy identified, measured, monitored, or, controlled.

- A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measure, monitored or controlled and require immediate action by the board of director and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.
- A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored, or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

2.2.4 Earnings Quality (E)

This parameter lays importance on how a bank earns its profit. This also explains the sustainability and growth in earnings in the future. Earnings are rated on both recent performance and the historical stability of the earnings stream. The earnings of the banks should able to absent normal and expected losses in given period. It also provides a source of financial support by contributing to the intuition's internal generation of capital.

Earning quality is the ability of a bank to continue to realize strong earnings performance. It is based on an evaluation of the quantity, quality and sustainability of the banks earning performance. An evaluation of earning considers factors, composition and quality of net income, stability of earnings performance, relationship to portfolio risk and quality of earning management etc.

Earning quality is quite possible for a bank to register impressive profitability ratio and assuming unacceptable degree of risk. Return on assets return on equity, interest spread ratio, gross margin operating profit margin and net profit margin are commonly used profitability indicators.

Under the UFIRS, in evaluating the adequacy of FI's earnings performance, consideration should be given to:

- The level of earnings, including trends and stability,
- The ability to provide for adequate capital through retained earnings,
- The quality and sources of earnings,
- The level of expenses in relation to operations,
- The adequacy of the budgeting systems, forecasting processes, and management information systems in general,
- The adequacy of provisions to maintain the ALLL and other valuation allowance accounts,
- The earnings exposure to market risk such as interest rate, foreign exchange, Price risks.

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings are the initial safeguard against the risks of engaging in the banking business, and represent the first lien of defense against capital depletion resulting from shrinkage in asset value. Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

Evaluation of Earnings Performance

An analysis of earnings comprises of examiner reviewing each component of the Earnings Analysis Trail and Ratio Analysis. Generally, the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, non-interest income, non-interest expense, provision for loan and lease losses, and income taxes. Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a board level view of the component's performance. The level of progression along the analysis tail will depend on a variety of factors including the level and trend of the ratio(s), changes since the previous examination, and the institution's risk profile.

Earnings Ratio Analysis: Several key ratios used in the earnings analysis are used as shown below

- Net Income to Average Assets Ratio [Return on Assets (ROA) ratio]
- Net Interest Income to Average Assets Ratio
- Net Interest Income to Average Earning Assets Ratio
- Non-interest Income to Average Assets Ratio
- Non-interest Expense to Average Assets Ratio
- Provision for Loan and Lease Losses (PLLL) to Average Assets Ratio
- Realized Gains/Losses on Securities to Average Assets Ratio(s)

Earnings quality is the ability of a bank to continue to realize strong earnings performance. It is quite possible for a bank to register impressive profitability ratios and high volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either asset with higher credit risk will boost short-term earnings. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and non-performing assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a non-accrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

An institution's assets quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Rating the Earnings Factor

- Earnings rated 1 are strong. Earnings more than sufficient to support operations and maintain adequate capital and allowance levels after are given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings.

- Earnings rated 2 would be satisfactory and sufficient to support operations and maintain adequate capital and allowance levels after consideration is given to asset quality, growth, and other factors affecting the quality, quantity and trend of earnings. Earnings that are relatively static, or even experiencing a slight decline, may receive a 2 rating provided the institution's level of earnings is adequate in view of the assessment factors listed above.
- Earnings rate 3 may need to improve. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth, and other factors affecting the quality, quantity, and trend of earning.
- A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowance levels. Erratic fluctuations in net income margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous year may characterize institutions so rated.
- A rating of 5 indicates earnings that are critically deficient. A FI with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

2.2.5 Liquidity (L)

Liquidity management is a critical factor influencing the financial health of the banks. It is the extent to which the bank has funds available to meet cash demands for loans and deposit withdraws. This is an important area of risk facing banks because a liquidity crisis many result in the failure of a solvent bank. Examiners look at the banks funding sources as well as the liquidity of assets in determining the rating.

Banks must be able to manage demand and supply of funds. Cash balance bank, bank balance and investment in government bonds are the most liquid form assets. Optimum liquidity is achieved by balancing risks and returns. In banks liquidity needs to be high enough to meet even unexpected changes in liquidity needs and sources. On other hands, liquidity should not be too high because there is on opportunity cost in the sense of excessive near cash assets that could be earning higher rates of return if funds were invested in other assets. Thus, the bank must trade off the cost of maintaining excessive liquidity and the cost of insufficient liquidity.

Banks are also concerned about the danger of not having sufficient cash and borrowing capacity to meet deposit withdraws loan demand and other cash need. Liquidity risk is danger of having insufficient cash to meet a bank's obligation when due. It affect the health of commercial bank adversely affects the profitability of financial institutions. NRB directive (2013 A.D) number E.Pra.Ni. 05/068/069 requires the banks to classify the assets and liquidity on the basis of maturity period classification different time interval for liquidity risk minimize.

NRB Directives Related to Liquidity

According to NRB, every commercial bank has maintained minimum balance of cash reserve ratio 5% of their total deposit liabilities compulsory. Under sub-section (1) they should be bears the following penalty for not sufficient of minimum requirement balance.

- First time insufficient balance is exiting interest rate.
- For second times of under balance is double interest rate.
- For third times of under balance is triple interest rate.

In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect ability to quickly is not maintained at a high cost, or through undue reliance in funding sources that may not be available in times of financial stress or adverse changes in market conditions. Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors.

- The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
- The availability of assets readily convertible to cash without undue loss.
- Access to money markets and other sources of funding.
- The level of diversification of funding sources, both on-and-off-balance sheet.

- The degree of reliance on short-term, volatile sources of funds, including borrowing and brokered deposits, to fund longer-term assets.
- The trend and stability of deposits.
- The ability to securitize and sell certain pool of assets.
- The capability of management of management to property identify, measure, monitor, and control the institution's liquidity position, management information systems, and contingency funding plans.

Rating the Liquidity Factor

- A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
- A rating of 2 indicated satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weakness may be evident in funds management practices.
- A rating 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may significant weakness in funds management practices.
- A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet liquidity needs.
- A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Liquidity Management Concepts

There are several principles which the economists have propounded to resolve the conflicts between objectives of liquidity, Safety and profitability. These concepts are discussed as under:

- **The Real Bills Doctrine**

The Real Bills doctrine states that a commercial bank should extend only short-term self-liquidating productive loans to business firms. Self liquidating loans are those meant to finance the production, storage, transportation, and distribution. When such goods are ultimately sold, the loans are considered to liquidate themselves automatically. Secondly, there is no risk of running into bad debts since they mature in the short run and are for productive purpose. Lastly, such loans earn income for the banks as they are productive.

- **The Shift-ability Theory**

H.G. Moulton propounded the shift-ability theory of bank liquidity. According to this view, an asset to be perfectly shift-ability must be immediately transferable without capital loss when the need for liquidity arises. But in a general crisis requires that all banks should posses such assets which can be shifted on to the central bank which is the lender of the last resort. This theory has certain elements of truth.

- **The Anticipated Income Theory**

The Anticipated Income Theory was developed by H.V. Proch in 1944 based on term loan practices by USA commercial banks. According to this theory, the bank plans for liquidation of long term loans from the anticipated income of the borrower regardless of the nature and character of a borrower's business. The bank puts restrictions on the financial activities of the borrower while granting this loan. Consequently, the bank takes into consideration not only the security but with major Consideration, the anticipated earnings of the borrower. This theory is superior to the bills doctrine and the shift-ability theory because it fulfills the three objectives of liquidity, safety, and profitability.

- **The Liabilities Management Theory**

This theory was developed in the 1960s.According to this theory, there is no need for banks to grant self-liquidating loans and keep liquid assets because they can borrow reserve money in the money market in case of need. A bank can acquire reserves by creating additional liabilities against it from different sources. These sources includes the issuing of time certificates of deposit, borrowing from the other commercial banks, borrowing from the central bank, raising of capital funds by issuing shares, and by plowing back of profits.

Liquidity Management Techniques

Techniques for liquidity assessment have evolved over the years with the significant changes in the monetary policy operating procedures. Despite the uncertainly in predicting liquidity conditions, econometric models could be used to provide first indicative forecasts, given the estimated structure of inter-relationships based on past information. The treasury or fund manager of any banks and FIs should adopt following techniques for effective liquidity management.

Liquidity Planning

The liquidity planning entails the accurate estimation of liquidity needs and the structuring of the portfolio to meet the expected liquidity needs. To ensure that funds are available to meet the liquidity needs at the lower cost, the treasury manager of the banks and FIs must manage its money position to comply with the reserve requirements as well as managing its liquid sources.

Managing Cash Position

A cash position refers to the amount in the process of collection and currency and demand balances due from other banks and the central bank. Numerous transactions that cause an inflow or outflow of cash during a day continually change the cash position of the banks and FIs., because cash yields no income. Cash holdings must be limited to a minimum. The treasury/fund manager may invest any excess cash or may acquire additional cash sources from interbank loans or from discount window at the central bank.

Managing Liquidity Position

Once the liquidity needs of the banks and FIs have been estimated, the treasury manger must decide how these needs are to be funded. The banks and FIs must choose between two general liquidity management strategies, namely asset management and liquidity management. In the asset management, assets are sold to meet liquidity needs. A combination of these strategies is normally employed. The following guidelines must be kept in mind by the treasury manager when managing the liquidity position of the banks and FIs:

- The treasury manager must coordinate and keeps track of the activities and strategies of the funds-raising and funds-using departments within the banks and FIs.
- The treasury managers should know the timing of large withdrawals from big credit clients or depositors in order to plan.
- The priorities and objective of liquidity management should be clear and properly communicated.
- The needs and decision must be evaluated on a continuous basis to invest access liquidity and avoid liquidity shortages.

Controlling Liquidity Risk

To assess how well the banks and FIs are managing its liquidity position, the management should be cautious on the following signals from the marketplace that indicate a pending liquidity problem.

- Public confidence in terms of withdrawal of deposits from the banks and FIs.
- Share price behavior, falling share prices indicate perceived liquidity problems.
- Risk premiums on money market borrowings.
- Losses because of the hasty sale of assets for liquidity purpose.
- Inability to meet the demands of new credits customers.
- More frequent and larger borrowings from the central bank.

Considering the aforementioned technique, the treasury manager must also consider the purposes of the liquidity need, the length of time for which funds are needed, the access to liability markets, the cost and characteristics of various liquidity sources and interest rate forecast. It is revealed that the large banks have better access to liability liquidity sources due to the better assets and a broader capital base. The small banks have to rely more on assets for liquidity. Thus, an effective liquidity management is essential to reduce costs.

A liquidity ratio measures an entity's ability to pay its short-term obligations out of liquid assets. Liquidity (L) was generally represented in previous studies with a ratio of cash (with some adjustment for short-term liquid securities) to total assets (Tam and Kiang, 1992 A.D; Espahbodi, 1991A.D; Lane et al., 1977A.D; Sinkey, 1975A.D).

NRB Directives related to Liquidity

NRB had given the instruction to the commercials banks since 1966 A.D. to deposit the amount the amount ratio of 8 percent from their deposit liability. In the beginning of 1990 A.D. the increase in the quantity of internal credit was very high and began to show negative effect on economy. The deflation grew up to 21 percent. So, high liquidity appeared in economy, hence, control of the negative effect that may fall on economy to improve the growth of price rate and improvement of the position of loss of running account and control the capacity of flowing the loan of the commercial banks, was necessary and the NRB second time prescribed liquidity ratio. It made compulsory to invest 24 percent the amount of the total deposit of the commercial bank in Nepal Government Bond, treasury bills, or NRB

Bonds. With some signs of improvement of economy, the investment ratio was revised accordingly, since December1990 A.DSince the beginning of 1993 A.D, the economy showed improvement and the rate of deflation fell down to 8.8% with this, the provision of investing in the government securities was removed.

With effective from, April 1998 A.D, commercial banks were required to maintain liquidity of 8% of the total Current & Saving deposits and 6% of the fixed deposits, in addition to 3% of total deposit in cash at vault. Since then the NRB reserve requirement has been changed. To ensure adequate liquidity, following arrangements have been put into force by NRB effective from 22 July 2013.

NRB directives on Reserve Requirement at NRB Account of Banks

a)	Cash Reserve Ratio	5 % (Before 1st Kartik 2069)
b)	Cash Reserve Ratio	5.5 % (effective from 1st Kartik, 2069)

The compliance of liquidity maintenance, the NRB applies following procedures:

- The CRR maintained by the banks will be examined on the basis of average weekly balance of deposit liability immediately preceding 2nd week. A week shall comprise form each Sunday through Saturday.
- CRR will not be calculated for the week which is fully off.
- Weekly statement of deposit balances to be submitted to NRB inspection and Supervision department within 15 days from the date of end of the week.
- Weekly average of Monday to Friday of Total Deposit, Cash in Vault and NRB balance is calculated by dividing by 5.

In the case of shortfall in maintenance of NRB balance, Penalty will be levied for failing to maintain the adequate liquidity and the applicable rate of penalty is as follows:

- First time short fall = Equivalent to bank rate/highest refinance rate
- Second time short fall = Equivalent to 2 times of bank rate
- Third time shortfall and all subsequent shortfalls = Equivalent to 3 times of bank rate

2.2.6 Sensitivity to Market Risk

Market risk is the current and potential risk to earnings and stockholders' equity resulting from adverse movements in market rates or prices. The three areas of market risk are interest rate risk, foreign exchange risk and commodity or equity price risk. For most FIs, market risk primarily reflects exposing to changes in interest rates. The sensitivity to market risk components focuses on an institution's ability to identify, monitor, manage and control its market risk and provides FIs management with a clear and focused indication of supervisory concerns in this area.

Equity prices risk examines how changes in market prices, interest rates and foreign exchange rates affect the market values of any equities, fixed income securities, foreign exchange currency holdings, and associated derivative and other off-balance sheet contracts. Foreign exchange risk arises from changes in foreign exchange rates that affect the values of assets liabilities and off-balance sheet activities denominated in currencies different from the banks domestic currency.

Interest rate risk analysis compares the sensitivity of interest income to change in assets yields with the sensitivity of interest expense to changes in the interest lost of liabilities.

Dollar gap, duration gap and simulation are three techniques of measuring interest rate risk. The dollar gap is the oldest technique. The most commonly used measure of the interest sensitivity position of a financial institution is duration gap analysis. Duration is defined as the elasticity measure that indicates the relative price sensitivity of different securities. The duration gap is the difference between the duration of a bank's assets and liabilities. It helps to explain how changed in interest rates affect the market value of a bank assets and liabilities. Thus, the focus of gap analysis is on net interest income or net worth the number of years of the duration of assets and liabilities.
Net worth = Assets-liabilities.

If duration gap is positive lie, the duration of assets exceeds the duration of liabilities then increases in interest rates will reduce the value of net worth and decreases in interest rates will increase the value of net worth. Conversely the duration gap is negative with the duration

of asset less than the duration of liabilities, raising interest rate will increase the value of net worth, whereas falling interest rates will lead to a reduction in it.

An aggressive interest rate risk management strategy would alter the duration gap in anticipation of changes in interest rates. If interest rates were expected to increase management would want to shift from positive to a negative gap position. It could do this by reducing the duration of asses or increasing the duration of liabilities.

Simulation analysis determines the effect of interest rate changes on short-term net interest income net income. It also measure risk presented by non-parallel yield curve shift. Simulation models are often not "user friendly" and may require more data and expertise than other interest rate risk measurement system.

According to NRB directive every commercial bank should classified of risk and provision for minimizes the risk. There are liquidity, interest rate, foreign exchange, loan and investment risk to monitoring on related of banking and financial institutional risk.

2.3 CAMELS plus Corporate Governance

After following economic liberalization policy since mid 1980s, the establishment of joint stock Company in Nepal has been speed up. Competition in the banking sector is being more intense. Banks are required to compare in the domestic market as also in the international market in the context of liberalization and globalization. Adoption of corporate governance practices assumes greater importance in this context. A corporate governance system is expected to provide protection to shareholders and creditors and to assure them of getting return on their investment.

Corporate governance is defined as a set of rules and the relationships between a company's management and its board of director's shareholders and other stakeholders.

These rules help setup mechanisms of attaining good governance. Globalization and liberalization policies also play a decisive role increasing the demand for good governance. Effective corporate governance may be described as reconciliation between the power and

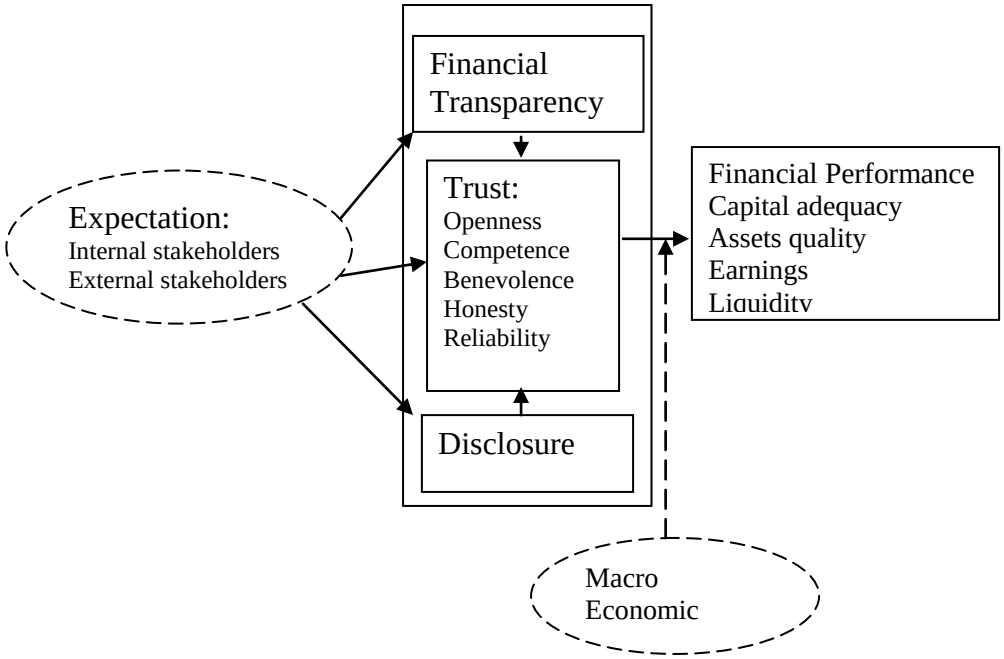
obligations of the board of directors to ensure good performance awareness of the rights and duties of stakeholders and the expectation of the society. Good corporate governance feature such as transparency, accountability, information disclosures, and stringent ethics. It helps ensure the business corporations undertake their operations to maximize shareholders value, which will eventually bring benefits to other stakeholders from a long term perspective. The poor governance practices including inadequate disclosures, lack of independent over right directors and weak minority shareholders tend to discourage investment and weaken incentives for efficient management. Good corporate governance will enhance the company's image .It helps to introduced good practice in corporate behavior with a view to rebuilding and maintaining public trust in company.

In Nepalese banking industry, lack of proper corporate governance, we had also faced lots of problem and loss of public faith on banking system in past days. But we can see a ray of hope with the stringent supervision system adoption by NRB on banking supervision with the implementation of Basel II framework recommended by Basel Committee of Banking Supervision (BCBS). Basel II framework has recommended various suggestions policies to address corporate governance in banking institution would be the great help for the commercial banks operation in Nepal. Effective corporate governance practices are essential to achieving and maintaining public truth and confidence in the banking system. Poor corporate governance can lead market to lose confidence in the ability of a bank to properly manage its assets and liability, including deposits with could in turn liquidity crises.

To understand corporate governance and financial Performance variables in relation to commercial banks, the major corporate governance pillars i.e. financial transparency, discloser and trust are dissected. Financial performance especially relating to commercial banks is also reviewed based in the performance dimensions comprising capital adequacy, assets quality, earnings and liquidity. The significance of stakeholders in commercial banks is also highlighter.

Figure 2.2

Corporate Governance and Financial Performance Conceptual Framework



Numerous stakeholders (internal and external) exist in any business enterprises some of these include; customers, stakeholders, government among others. Internal stakeholders such as the employees and external stakeholders like stakeholders, customers, tax authorities and bank supervisors. Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Macro economic variables through factors such as inflation and changes in interest rates may either enhance or distress commercial banks financial performance. Awareness of the importance of corporate governance is growing. The NRB has introduced higher corporate governance standards for banks and other financial companies as part of a wider program of financial sector reform. Effective control system and strong corporate governance are the basic foundation of a sound and stable bank. Realizing the importance of this facet NRB has issued a directive on corporate of director and employees.

Basic Principle of Corporate Governance in Banking Organization

There are major 8 principles formulated and evolved by BCBS for enhancing corporate governance of banking institutions. These principles if practiced honestly, banking institution could be run very efficiently and effectively with controlled management resulting good financial health of the organization practicing of these principles is very much essential for the banking industry of the developing countries like Nepal. These principles have briefly discussed below in the Nepalese perspectives.

Principle1

Board members should be qualified of their positions, have a clear understanding of their positions. In most of the banking and financial institutions of Nepal it has been observed that the board of directors have been nominated according to their share investment in the banks where their qualification and understanding capabilities about the core functions of the bank have been almost neglected. The minimum qualification for being member of the board of directors has been raise as one of the important principles requirement for a bank and financial institution.

Principle 2

The board of directors should approve and oversee the banks strategic objectives and corporate values that are communicated throughout the banking organization. Generally, board of directors without mark accepts the policies and strategic objectives of the bank recommended by the employees or the consultant. But formulation of the strategic objectives and the corporate values of a bank is the main task of the board of directors. Where ensuring full implementation of such formulated policies is another must important to oversee by the board of directors.

Principle 3:

The board of directors should set and enforce clear lines of responsibility and accountability through the organization.It is third principle the board of directors must set and enforce the lines of responsibility and accountability of the each part of the banking organization including individual element of the functioning team and departments. Performance of the task according to the set responsibility has to be measured and accountably rewarded and

punished for the good and bad doings respectively. So, that a clear understanding of the responsibility and their accountability is communicated throughout the banking organization.

Principle 4:
The board should ensure that there is appropriate oversight by senior management consistent with board police. It is another principle of corporate governance that the board of directors must have proper and effective review process and controlling mechanism that the senior management is working according to the policy set by the board all the time.

Principle 5:
The board and senior management should effectively utilize the work conducted by the internal audit function, external auditors and internal control functions.

The board of directors and the senior management of bank should study deeply the report submitted by the internal auditors, external auditor's regulators instructions and utilize their recommendations and should be committed to follow.

Principle 6:
The bank should be governed in a transparent manner. Transparency is the most important principle of the corporate governance that all the discloser of a bank is published transparently and operation of the bank is conducted in transparent manner. It is different for shareholders, other stakeholders and the market participates to effectively monitor and properly hold accountable the board of directors and the senior management when there is lack of transparency.

Principle 7:
The board should ensure that compensation policies and practices are consistent with the bank's corporate culture, Long term objectives and strategy and control environment.

Compensation and remuneration to the board of directors and the senior management of the bank should be controlled and regulated by the appropriate policy and accordingly practiced throughout the banking organization. Executive or non executive board of directors should not take any compensation of remuneration deviating to the norms of the policy set out and they should very much conscious for such compensation to be taken by other senior

managers. This commitment and compliance is most important for the enhancement of the better corporate governance of a banking organization.

Principle 8:
The board and senior management should understand the bank's operational structure including where the bank operates in jurisdictions.

Banks may choose to operate in a particulars jurisdiction or may establish complex structures often for legitimate and appropriate business purpose. However, operating in such jurisdiction may pose financial, legal and reputation risks to the banking organization. Clear understanding of such possible risk by the board of directors and the senior management is very much important for the effective corporate governance in a banking institution.

Hence, for enhancement of the corporate governance in banking organization above 8 basic principles formulated and recommended by the Basel committee for banking supervision could be a great help especially in the context of Nepalese culture of managing banking organization.

2.4 Research Review

This section contains the review of different research works are carried out by different scholars within the different countries including dissertations by Nepalese scholars, which is related with financial performance analysis of commercial bank.

2.4.1 Review of Articles

This section deals with the review of relevant studies and research articles. To review the previous studies and articles are available in internet. It has become to the most easily accessible medium to gain information in subject matter. The review of relevant articles publishes in different journals which are available in concerned web sites.

Several academic studies have examined whether and to what extent private supervisory information is useful in the supervisory monitoring of banks. Earlier studies such as Sinkey,

Altman, Martin, Avery and Hanweek and Barthetal respectively 1975, 1977, 1997, 1984, and 1985 analyzed the financial characteristics of banks and of savings and loans associations.

Accordingly, these studies adopt more or less the same variables, based on the five categories of capital adequacy, asset quality, management, earnings quality (CAMELS) that are used by the regulators for the evaluation process.

Hirtle and Lopez, have conducted a research on supervisory information and the frequency of bank examinations at Federal Reserve Bank of New York in 1991. They examined the usefulness of past CAMELS ratings in assessing banks current conditions. They find that conditional on current public information, the private supervisory information contained in past CAMELS ratings provide further insight into bank current conditions as summarized by current CAMELS ratings. They also find that over the period from 1989 to 1995, the private supervisory information gathered during the last on-site exam remains useful with respect to the current condition of a bank for up to 6 to 12 quarters (or 1.5 to 3 years). The overall conclusion drawn from academic studies is that private supervisory information as summarized by CAMELS ratings is clearly useful in the supervisory monitoring of bank conditions.

Kolari, Glennon, Shin and Caputo have presented their work paper to the predicting large U.S. Commercial bank failure in January 2000 A.D. They apply empirical method to the problem of predicting bank. Because of the sampling limitations scant research has examined the feasibility of using computer based early warning system (EWSs) to make such predictions. In the late 1980s and early 1990s numerous large banks failed in the United States, enabling us to collect a sample of 50 failed banks with more than $250 million in assets as well as a matched sampled of 50 non-failed large banks. These samples were split into original and holdout samples of different sizes. Both the parametric method of logic analysis and the non parametric approach of trait recognition are employed to i) develop classification EWS models based on the original samples and ii) test the predictive ability of these models using the holdout samples. Both legit and trait recognition out performed legit in a variety of test. However, over the holdout samples, trait recognition performed legit in a variety of test, including overall accuracy, large bank failure accuracy, weighted efficiency scores and stability using data from one year before as well as two years before failures.

Other results from the trait recognition models reveal that complex two and three variable inter actions between financial and accounting variables contain additional information about bank risk not found in the individual variables themselves. They conclude that non parametric EWSs can provide information about the future viability of large banks.

Sahajuala and Vanden Berch based their work paper on Basel committee on banking supervision in 2000 A.D. They study a number of new banks monitoring systems currently in use or under development in various G10 countries such systems are collectively termed "Supervisory Risk Assessment and Warning Systems". The objective of the paper was to provide an overview of the different approaches taken by bank supervision and to make a preliminary general assessment of the methods that are being used or developed. The study reveals that supervisory authorities are now clearly moving towards putting in place more formed structured and risk focused procedures. For on-going banking supervision individual approaches and systems have been developed and adopted typically in the 1990s, with a greater focus on risk profiles and risk management capabilities of individual banking institutions and on the generation of timely warning of potential changes to a banks' financial position. These new and modified systems have contributed positively to the supervisory process, and supervisors are working towards refining the systems further in order to improve the system accuracy and predictive power.

Gilbert Neyer and Vaughan prepared working paper to the role of a CAMELS downgrade model in bank surveillance at Federal Reserve Bank of St. Lowis in 2000 A.D. This article examiner the potential contribution to bank supervision of a model designed to predict which banks will have their supervisory ratings down-graded in future periods. Bank supervision rely on various tools of off-site surveillance to track the condition of banks under their jurisdiction between on-site examination including econometric models one of the models that the federal reserve system uses for surveillance was estimated to predict bank failures. Because bank failures have been so rare during the last decade, the coefficients on this model have been "frozen" since 1991. Each quarter the surveillance staff at the board of governors provides the supervision staff in the Reserve Banks the probabilities of failure by the banks subject to fed supervision, based on the coefficient of this bank failure model and the latest call report data for each bank. The number of banks downgraded to problem status in recent years has been substantially larger than the number of bank failures. During a period of few

bank failures, the relevance of this bank failure model for surveillance depends to some extent on the accuracy of the model in predicting which banks will have their supervisory ratings downgraded to problem status in future periods. This paper compares the ability of two models to predict downgraded of supervisory ratings problem status the board staff model, which was estimated to predict bank failures, and a model estimated to predict downgrades of supervisory ratings. They find that both models do about as well in predicting downgrades of supervisory ratings for the early 1990s. They empirically compare the predictive ability of the Federal Reserve board's system to estimate examination rating (SEER). Failure prediction model with a model they develop to predict downgrades in bank condition from CAMELS ratings 1 or 2 to ratings 3, 4, or 5. They conclude that the downgrade model may prove to be a useful supplement to the board model for estimating failures during periods when most banks are healthy but that the downgrade model should not be considered a replacement for the current surveillance framework.

Dziobek, Hobbs and Marston develop a framework for assessing the adequacy of managements for market liquidity in 2000 A.D.The components of a balanced liquidity infrastructure are largely institutional in nature including the existence of legal contract rights and information disclosure. Prevailing monitory arrangements, design aspects of central bank instruments ad arrangements, for payments and money market operations also bear directly on banks' ability to manage short term liquidity. For instance, high transactions costs resulting from rigid instrument design and trading rules can discourage trades and contribute to price volatility. Foreign exchange regulations such as capital controls and prudential controls on open foreign currency positions can effects access to foreign currency, liquidity. For example, overly tight limits on net positions in foreign exchange can constrain banks ability to manage liquidity through currency conversion. Restriction on the use of currency derivatives also limits the incentive for developing hedging mechanisms that can improve management of liquidity and other types of risks.

A. Cole and W. Gunther have prepared paper on predicting bank failure through comparison of one and off-site monitoring system in 2004 A.D. They find on site examination re regulators primary tools for monitoring the financial condition of federally insured depository institutions. In this paper they assess the speed with which the information content of the supervisory rating assigned during bank exams the CAMELS Rating-decays. This is an

important issue because cost and regulatory burden considerations often cause CAMELS rating to be assigned relatively infrequently. As a benchmark for information content they use econometric forecasts of bank failures generated by applying a probit model to publicly available accounting data. When compared with all CAMELS ratings available at a given point in time, the econometric forecast provide a more accurate indication of failure. Further analysis reveals that this overall finding reflects the tendency for a CAMELS ratings information content of deteriorate noticeable begging in the second and third quarter after the rating initially was assigned.

Gordon-Hart has conducted a research work on Basel II, the risk to the global consensus in 2004 A.D. Basel II has been the subject of intense debate amongst bankers around the world, it will replace the original Basel accord of 1988, but unlike the latter it looks as if the new accord will undermine the global consensus. It is a costly exercise and the heightened risk of regulatory arbitrage may yet distort the competitive landscape. In particular, the completely different ways in which Basel II will be implementing in the USA and EU post a change for institutions that operate on a global scale. This article is a brief examination of the key difference and challenges posed by the draft accord the prospects for a final drat being truly final seems remote and Basel III may well have to be on the agenda before the ink in dry on Basel II.

Derviz and Podpiera prepared paper on predicting Bank CAMELS and S&P Ratings at Czech Republic in 2005 A.D.They investigate the determinants of the movements in the long term standards and poor and CAMELS bank ratings in the Czech Republic during the period when the three biggest banks representing approximately 60% of the Czech banking sectors total asserts. Were privatized (i.e. the time span 1998-2001 A.D.). The same list of explanatory variables corresponding to the CAMELS rating inputs employed by the Czech National banks, banking sector regulators was examined for both ratings in order to select significant predictors among them. They employed an order responds logic model to analyze the monthly long run S&P ratings and panel data framework for the analysis of the quarterly CAMELS rating. The predictors for which they found significant explanatory power are capital adequacy, credit spread, the ratio of total loans to total assets and the total value at risk. Models based on these predictors exhibited a predictive accuracy of 70%. Additionally, we found that the verified variables satisfactory predict the S&P rating on month ahead.

Baral has conducted a research on health check-up of commercial banks in the framework of CAMELS at joint venture banks in Nepal in December 2005. He used the annual reports data set of joint venture banks and NRB supervision reports published his paper abstract in the journal of Nepalese business studies. The paper examined the financial health of joint venture banks in the CAMELS framework for a period ranging from 2008 to fiscal year 2013. The basis of publicly available financing health of joint venture banks is better than that the other commercial banks.

Rijal has conducted a paper to examine the application of management control system in Nepalese commercial banks. The Nepalese commercial banking sector is very competitive. The commercial banks are competing mainly in service and many of them adapting differentiation of commercial bank are customer retention. Commercial banks are encouraging employees to upgrade their knowledge and skill. The working environment is also congenial in Nepalese commercial banks and the informal organization and communication system also gradually exist in some of the commercial banks of Nepal. However, the future research needs to examine the relationship between management control system and effectiveness of the commercial banks of Nepal.

2.4.2 Review of Dissertation

Previous several dissertation works have been conducted by various researchers regarding different aspects of commercial banks such as financial performance, capital structure, investment policy, non-interest.
Some of them has presented as follows:

Chand(2006), in his thesis, "*Financial Performance Analysis of Himalayan Bank Limited in the Framework of CAMELS*", has the main objective of analyzing the financial condition of HBL.

The Main Objectives of the Study

- To measure the liquidity ratios of the selected bank.

- To examine the capital strength and assets quality of the bank.
- To evaluate the profitability position and management of the bank.

The Major Findings of the Study

- The capital adequacy of the bank was generally above the NRB standards in all the years.
- The non-performing loan to loan ratios were all below the industrial average and the international standard. The loan loss provision of the bank is decreasing constantly in each year.
- The management proxy ratios, total expense to total income ratio and earning per employees were favorable to the bank.
- The earning quality ratios were generally above the benchmark prescribed by the World Bank. The overall liquidity position of the bank was in good condition.
- The cumulative gap of risk sensitive assets and risk sensitive liabilities, re-pried over the over maturity bucket was in continuous decreasing trend. The interest rate sensitivity ratio to the total earning assets over the short term horizon was in decreasing trend.

Shrestha(2007), in his thesis, " *A Comparative Analysis of Financial Status and Performance Evaluation of HBL and NABIL Bank in the Framework of CAMELS Rating System.*" He has used different financial tools to meet the following relevant objectives.

The Main Objectives of the Study

- To analyze capital adequacy & liquidity position of HBL & NABIL and compare with regulatory minimum capital requirement.
- To analyze quality of asset and evaluation risk weighted assets of HBL & NABIL.
- To evaluate the level, trend and stability of HBL & NABIL earning.

His main findings were as follows:

The capital adequacy ratio of both banks is generally above the NRB standard which shows that both banks are running with adequate capital and sufficient to meet the banking operation as per NRB standard. The decreasing trend of non-performing loans and advances ratio of both banks helps to conclude that the bank is aware of non-performing loans and adopting the appropriate policies to manage this problem and to increase the quality of asset. The

management proxy ratios are favorable of the bank. Decreasing trend on the ratio of total expenses to total revenue and increasing trend of EPS shows that NABIL has effective management soundness but in the case of HBL, both total expenses to revenue ratio and earning per employee are is in deceasing trend, which implies overstaffing in the bank. Overall, both banks are managed and operating efficiently.

Malla (2008), has conducted a study on, "*Financial Performance Analysis of Annapurna Finance Company Limited in the Framework of CAMELS*." The main objective of the study was to analyze the financial performance of Annapurna Finance Company Limited (AFCL) in the framework of CAMELS. The study was based on secondary data covering the period of five years. She used various financial and statistical tools to get the meaningful result and to meet the research objective.

The major findings of the study were;

- The capital fund of AFCL is sound and sufficient to meet the financial operation as per the NRB standard.
- The non-performing loan ratios are below the international standard and in fluctuating trend. The loan loss ratios are also fluctuating but in increasing trend during the study period.
- The management proxy ratio total expense to total income ratios are also in fluctuating trend due to changes in taxation rate and increase in provision for possible losses. Another management proxy ratio earning per employee is in increasing trend.
- The earning quality ratios are generally in fluctuating and decreasing trend except the net interest margin which is in increasing trend.
- The overall liquidity position of AFCL is in good condition.

Wagley (2009), conducted the *"Study on Financial Performance Evaluation of Listed Commercial Banks in the Framework of CAMELS.*" He has taken EBL bank as the example of the study to analyze the publicity available data and compared with the benchmark as prescribed by the NRB with the following objectives:

- To find out the financial health to find out the liquidity position of EBL.
- To find out the liquidity position of EBL.

The major findings of the study are as follows:

- EBL bank was found to be financially of sound health in the framework of all CAMELS components.
- In overall the liquidity position of the bank was found to be affected by the current liquidity crunch on going on the financial market.

Shrestha (2012), has conducted a study on, "*Capital Adequacy & its Significance to Commercial Banks (With Special Reference to Selected Commercial Banks)*."
Objectives of the study:

- To analyze the implementation status of the directives given by NRB.
- To evaluate capital adequacy of the commercial banks(NABIL, EBL, BOK)
- To examine the efficiency and weakness of capital adequacy ratio.

The Major Findings of the Study

- Comparative study of capital adequacy of banks shows that the entire bank taken as sample exceeds the mandatory requirement of core capital of 6% as per the present NRB directives.
- The deposit components of a bank are positively correlated with the Bank's Capital Fund. So that the increase in capital causes the increase on deposit.
- During the analysis it has been found that the capital adequacy ratio is positively correlated o Return on Equity. So, the bank enjoying more return on equity may enjoy the higher capital adequacy ratio.
- Risk weighted assets of the bank are positively correlated with the bank's capital fund. We can say that the increase in capital adequacy ratio causes the increase in risk weighted assets.
- Non- performing loan is directly correlated to the capital adequacy ratio. This phenomenon should be kept in regard while fixing the capital adequacy ratio the banks should maintain.
- In every fiscal year the Total Capital Fund of every sample banks have been increasing.

Subedi (2013), has conducted a study on, "*NRB Unified Directives on Capital Adequacy Norms and Its Impact- A case study of Everest Bank Ltd*." The main objective of the study was;

- To analyze the significance and impact of NRB capital adequacy Norms on Everest Bank Ltd.
- To examine the capital adequacy of EBL.
- To examine the relation of Capital Fund to the other stakes of the bank.

The Major Findings of the Study

- Capital Fund of EBL has grown consistently over the study period of five years.
- It is found that the bank is quite successful in maintaining capital adequacy as prescribed by NRB.
- The capital to deposit ratio of EBL is found to be satisfactory.

2.5 Research Gap

Efficient banking system is not only the output of the rules and regulations imposed by the regulators. Banks and financial institutions can do a lot by imposing self governance rather than corporate governance. In this regard this research has tried pretty more to reflect the self governance practices adopted by Everest Bank Ltd and Himalayan Bank Ltd by means of CAMELS rating, which is quite new and challenging in it but is an opportunity to learn and identify the strength and weaknesses of the above mentioned commercial banks. This research work is different than of other researches carried out in this regard because of the new directives of NRB regarding the paid up capital of commercial banks.

NRB has directed all the banks and financial institutions to upgrade their paid up capital as 2000 million by the year 2013 A.D. Research work is probably the first one to reflect the capital adequacy, trend of asset composition, and trend of earnings, risk weighted assets and liquidity position of the sample commercial banks.

CHAPTER-III
RESEARCH METHODOLOGY

This chapter is concerned with the procedures and techniques used to achieve the objectives of the study. It includes research design, population and sample, nature and sources of data, methods of data collection, data analysis, tools and limitations of methodology.

3.1 Research Design

This study is based on descriptive cum analytical research approach to achieve the desired objectives. This study examines and evaluates performance of joint venture banks in the framework of CAMELS. Financial ratios are applied to examine facts and descriptive techniques are adopted to evaluate financial performance of joint venture banks.

3.2 Population and Sample

There are 30 commercial banks in operation till the end of this study. Out of this 3 are public and 27 are private banks. Among these private bank, 6 are joint venture banks. For the purpose of this study, those joint venture banks are taken as the population which has completed their five years operation by the end of fiscal year 2012/13. From the population 2 commercial banks were sampled randomly. This represents 33.33% of the population. Simple random sampling method was used to select sample banks. The sampling frame is closely related to population. It is given in Appendix 1.

3.3 Nature and Sources of Data

This study is fully based on the secondary data. Therefore, the main sources of data are historical data disclosed by published reports of commercial bank especially annual report of sample banks. The regulatory data were collected form NRB directives and reports. The basic conceptual information was collected through BASEL, FDIC and NRB publications and working papers which are available in website. The major sources of data used in this study are:

- NRB Reports and Bulletins, and its' website.
- Various articles published in journals and financial magazine;
- Basel committee publications through its official website;

- Nepal Stock Exchange Reports;
- Research paper and dissertations of website of the sample bank in addition supportive qualitative information was collected by formal and informal discussions with the senior staff of the banks.

3.4 Data Collection Procedure

The required data of this study is entirely based on the historical data disclosed in annual reports. NRB publications were downloaded the website of NRB. Relevant information and annual report of respective commercial banks have been obtained from the sampled bank's branch and website of the bank. Conceptual review and research review has been through related text books. Reviews of working paper written by various international scholars were downloaded from the related websites respectively. Related text books are available in Central Library T.U., Public Library Kathmandu and NRB publication, different Journals, Magazines and other published and unpublished reports help to research more convenient.

3.5 Data Processing

At first relevant date were extracted from above mentioned sources and recorded in the master sheet. The data were then entered into the spread sheet to workout. The financial ratios were worked out with the help of applicable software such as Microsoft word, Microsoft excel. In addition tables were generated with the help of Microsoft excel.

Data Analysis Tools

Financial ratios in the framework of CAMELS have been used to analyze the financial performance of joint venture banks. The relevant ratios used in this study are given in ensuring part of this section.

3.5.1 Capital Adequacy

Total Capital Ratio (TCR)

Total capital is the sum of Tier I core capital and Tier II supplementary capital. Capital ratio used to measure of capital in the banks. It is determine by the following model.

$$\text{Total Capital Ratio} = \frac{\text{Total Capital Fund}}{\text{Total Risk Weighted Assets}} \times 100\%$$

Where,

Total Capital Fund = Core Capital+ Supplementary Capital

Total Risk weighted Assets = On-Balance Sheet Risk Assets + Off-Balance Sheet Risk Adjusted Assets

Core Capital Adequacy Ratio

Core ratio shows the relationship between the total core capital or internal sources and total risk adjusted assets. It is calculated by using the following model;

$$\text{Core Adequacy Capital Ratio} = \frac{\text{Core Capital}}{\text{Total Risk Adjustment Assets}} \times 100$$

Supplementary Capital Adequacy Ratio

Tier I capital ratio is the expression of numerical relationship between Tier I capital and total risk adjusted assets. It shows the absolute contribution of supplementary capital in capital adequacy. It is calculated by using the following model;

$$\text{Supplementary Capital Adequacy Ratio} = \frac{\text{Supplementary Capital}}{\text{Total Risk Adequacy Ratio}} \times 100$$

3.5.2 Assets Quality

Non-Performing Loan to Total Loan (NPL)

It measures the proportion of Non Performing loan in total loan and advance. The ratio is used to analyze the assets quality of the bank and determine by using the given model.

$$\text{Non Performing Loan to Total Loan Ratio} = \frac{\text{Non Performing Loan}}{\text{Total Loans and Advance}} \times 100\%$$

Where,

Non-Performing Loan

These loans which is not recovered within the given the time frame either in the form of interest or principle repayment.

Loan Loss Ratio (LLR)

A loan loss ratio indicates the valuable allowance offset against total loans which represents the amount considered by management to be adequate to absorb unexpected losses inherent in the loan portfolio. For the purpose of this study following model is used to determine the loan loss ratio.

$$\text{Loan Loss Ratio} = \frac{\text{Loan Loss Provision}}{\text{Total Loan and Advances}} \times 100\%$$

3.5.3 Management Efficiency

Operating Expenses Ratio (OER): Operating Expenses Ratio is the expression of numerical relationship between total operating expenses and total operating revenue of the bank. The objective of bank is reducing operating of expenses and increased in the total operating revenue. Higher operating expenses ratio indicates that financial institutions may not be operating efficiency, following model can be used calculation of operating expenses ratio.

$$\text{Operating Expenses Ratio} = \frac{\text{Total Operation Expenses}}{\text{Total operating Revenue}} \times 100$$

Where,

Total Operating Expenses = Interest expenses+ employees expenses+ office operating expenses+ exchange fluctuation loss+ provision for possible loss.

Total Operating Revenues= Interest Income +Commission and Discount + other operating income +Exchange Income.

Earning Per Employees (EPE)

EPE is numerical relationship between net operating incomes and total numbers of employees. Low or decrease earning per employees can reflect in efficiencies as a result of overstaffing, with similar repercussions in terms of profitability. It is calculated by uses of the following models;

Earning per Employees = $\frac{\text{Net Operating Income}}{\text{Number of Employees}} \times 100$

3.5.4 Earning Performance

Return on Equity (ROE)

Return on Equity is a measure of the return on money provided by the firm's owners on equity, higher the investment which the shareholders will undertake. It also measures a firm's efficiency at generating profits from every dollar of net assets. And shows who well a company uses investment dollars to generate earnings growth. For the purpose of the study following models is used to determine the return on equity ratio.

Return on Equity = $\frac{\text{Net Income After Tax}}{\text{Total Equity Capital}} \times 100\%$

Total Equity Capital= Paid up Capital + Reserve Funds and Surplus

Return on Assets (ROA)

Return on Assets is a measure of the return on money provided by both owners and creditors and is a measure of how efficiently all resources are managed. It indicates how capably the management of the bank has been converting the institutions assets into net earnings. It is calculated by using the following modes.

Return on Assets = $\frac{\text{Net Income After Tax}}{\text{Total Assets}} \times 100$

Net Interest Margin (NIM)

It refers to the income generated by banks via their operations. It is the difference between the average interests generate by the bank on loans advances, and toe average interest paid by the bank deposits.

Net interest margins of banks may vary depending upon market conditions. For the purpose of the study following model issued to determine net interest margin

Net interest Margin = $\frac{\text{Net Interest Income}}{\text{Earning Assets}} \times 100\%$

Where,

Net Interest Income= Interest Income-Interest Expenses

Earning Assets = Loan and Advances+ Investment on securities

Earnings per Share (EPS)

EPS are the earnings returned on the initial investment amount. It provides a direct measure of the returns flowing to the bank's owners-it's stockholder-measured relative to the numbers of share to the public. It gives the strength of the share in the market; following is the expression of earning per share.

$$\text{Earnings per Share} = \frac{\text{Net Income After Tax}}{\text{No.of Share of Common Stock}} \times 100$$

No of Share of Common Stock= Paid up Capital/Rs. 100

3.5.5 Liquidity Position

Liquid Assets to Total Deposits Ratio

It measures the proportion of total liquid assets in total deposits. For more it shows the overall short term liquidity position. The higher liquidity position and lower ratio shows the en efficient liquidity position of the bank. It is calculated by the using following model;

$$\text{Total Liquid Assets to Total Deposits Ratio} = \frac{\text{Total Liquid Assets}}{\text{Total Deposits}} \times 100\%$$

Where,

Total liquid Assets = Cash in hand + NRB Balance+ Domestic Bank Balance + Foreign Bank Balance + Placement+ Investment in Government Securities

NRB Balance to Total Deposits Ratio

It measures the proportion of NRB balance in total deposits. For the purpose of this study following model is used to determine the NRB balance to total deposits ratio.

$$\text{NRB Balance to total Deposits Ratio} = \frac{\text{NRB Balance}}{\text{Total Deposits}} \times 100$$

NRB Balance = Balance with Nepal Rastra Bank

Cash in Vault to Total Deposit Ratio

It shows the percentage of total deposit maintained as vault. It is worked out by using the following model;

$$\text{Cash in Vault to Deposits Ratio} = \frac{\text{Cash in Vault}}{\text{Total Deposit}}$$

Where,

Cash in Vault = Cash in hand+ Foreign currency in hand

3.5.6 Interest Rate Sensitivity

The interest rate sensitivity position of a financial institution is estimated by gap analysis. A gap exists between these interest sensitive assets and interest sensitive liabilities. The interest sensitive assets in a each planning period i.e. day, week, month etc which is exceed the volume of interest sensitive liabilities subject to re pricing the bank is said to have a positive gap and to be assets sensitive. If ΔRi is the average interest rate change affecting assets and liabilities that can be re priced within i^{th} maturity bucket, the effect on the Bank's Net Interest Income (NII) in the i^{th} maturity bucket is calculated by ;

$$\left[\Delta NIIi = \left(\sum_{i=1Day}^{i=1th\ Maturity\ Bucket} RSAi - \sum_{i=1Day}^{i=1th\ Maturity\ Bucket} RSLi \right) X\Delta\Delta R\right]$$

$$= GAPi\ X\Delta Ri$$

Where,

ΔNIIi = Change in interest income in the 1^{th} maturity bucket

Gapi = Rupee size of gap between book value of Rate Sensitive Assets (RSA) and Rate Sensitive Liabilities (RLA) in Maturity bucket i

N = Number of pairs of observation.

3.6 Limitation of the Methodology

The major portion of analysis has been done on the basis of the available secondary data and information. Simple random sampling method has been drawing the sample which method itself is not free from bias. This study is focused on the financial analysis of joint venture banks in the framework of CAMELS system and is based on the audited financial annual reports of sampled joint venture banks during the study period from the 2008/09 through

2012/13. NRB had adopted CAMELS rating system to evaluate bank performance in recent year. The effective of CAMELS ratings assessment requires quarterly financial reports. This study is based on annual report. So the conclusion drawn on the basis of analysis of data published annually may not be accurate as the conclusion draw on the basis of the analysis of quarterly published data.

CHAPTER- IV
DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter deals with the presentation and analysis of data collected from different sources with the focus on the CAMELS component. As stated in the theoretical prescription, the financial performance analysis of Everest Bank Limited and Himalayan Bank Limited are concentrated in the five component of CAMELS; i.e. Capital Adequacy, Assets Quality, Management Quality, Earning Quality and Liquidity. The data collected from annual reports of respective banks have been analyzed with the application of CAMELS.

4.2 Data Presentation and Analysis

The data collected from different sources has been refined and documented in Excel tables, which are further processed to analyze and arrived at the findings on the financial conditions of above mentioned banks in terms of CAMELS Analysis. The major findings of the study on financial performance of Everest Bank Limited (EBL) and Himalayan Bank Limited (HBL) are also described on each section and part of CAMELS Analysis.

4.2.1 Capital Adequacy

Capital Adequacy is a measure of an FI's financial strength, in particular its ability to cushion operational and abnormal losses. In other words, it is a ratio of solvency. Capital Adequacy is a measure of a commercial bank's capital as a percentage of its risk weighted assets, such as the loans it has provided and the securities it holds. The capital requirement is a bank regulation, which sets a framework on how commercial banks must handle their capital. The categorization of assets and capital is highly standardized so that it can be risk weighted. Total risk weighted assets comprise the sum of on-balance sheet assets and off-balance sheet items. Capital adequacy component analysis of sampled joint venture banks is used to find out whether banks are maintaining capital adequacy ratio as directed by NRB. Capital adequacy ratio, core capital ratio and supplementary ratio are used to analyze the of capital adequacy of banks.

It has become recognized that capital adequacy more appropriately relates to asset structure than to the volume of liabilities. Risk Weight Assets, Core Capital and Supplementary Capital are major figures used to calculate Capital Adequacy Ratio.

Minimum capital adequacy ratios have been designed to ensure banks can absorb a reasonable level of losses before becoming insolvent. The higher the capital adequacy ratios a bank has, the greater the level of unexpected losses it can absorb before becoming insolvent. An FI should have adequate capital to support its risk assets in accordance with the risk-weighted capital ratio framework.

Risk-weighted assets are the total of all assets held by the bank which are weighted for credit risk according to a formula determined by the Regulator (usually the country's Central Bank). Assets-at-risk are defined as the total of the impaired values of assets at the date of making the advance to the sub borrower. Assets are typically classified as: (i) risk-free; (ii) minimum risk; (iii) general risk; (iv) substandard; (v) "workout" (or minimal chance of recovery); and (vi) fixed assets, furniture and office equipment, computers, etc. To each of these classifications is awarded a percentage of their values for which an FI's capital is needed to cover risk of losses. Most central banks follow the Bank of International Settlements (BIS) guidelines in setting formulae for asset risk weights. Nepal Rastra Bank has categorized the assets of the bank, on the balance sheet items and off the balance sheet items, on their nature and risk associated with them. So The Total Risk Weighted Asset is computed by the multiplying the Total net value of asset by its risk weight. In the context of Nepal, NRB has assigned following weight for following Assets of Banks

0% Risk Weight Asset

Cash Balance, Gold (Tradable), Balance with Nepal Rastra Bank, Investment in Government Security, Investment in Nepal Rastra Bank’s Bond, Fully Secured Loans against own Fixed Deposit Receipt, Fully Secured Loan against Government Security, Bills Collection.

10% Risk Weight Asset

Forward Foreign Exchange Contract

20% Risk Weight Asset

Balances with domestic licensed banks and financial institutions, fully secured FDR Loan against Fixed deposit receipt of other banks, Receipt of other licensed banks & financial institutions, Balances with foreign banks, money at call, loan against guarantees of Internationally Rated banks, other investment in Internationally Rated banks, Letter of Credit with maturity less than 6 month (full value), Guarantees issued against counter guarantee of Internationally rated Foreign banks.

50% Risk Weight Asset

Letter of Credit with maturity more than 6 months (Full Value), Bid Bond, Performance Bond.

100% Risk Weight Asset

Investment in shares, debentures and bonds, other investment, loan & advances and bills purchased/ discounted, fixed assets, all other assets, other accrued interest receivable (accrued interest receivable- interest on government security-interest suspense), advanced payment guarantee, financial guarantee, other guarantee, irrevocable loan commitment, contingent liabilities in respect of income tax, all other contingent liabilities

The 1993 Basel Accord enforced the capital ratio to risk adjusted assets of commercial banks. According to this accord, core capital must equal to or exceed 4 percent of the risk weighted assets of the commercial banks. Similarly, the amount of the supplementary capital should not exceed the amount of the core capital and the total capital must equal or exceed 8 percent of risk weighted assets. NRB initially fixed the core capital at the level of 4.5 percent of the risk weighted assets and total capital at the level of 9 percent of risk weighted assets of the commercial banks (NRB 2058). The mandatory level of total capital, as set by Nepal Rastra Bank, for the FY 2008/09 is 10% and for FY 2008/09 to 2012/13 is 11% of risk weighted assets of commercial banks. But NRB has strictly directed all commercial banks that the amount of the supplementary capital should not be in excess to the amount of the core capital (NRB 2013). Capital Adequacy Ratio is calculated as:

$$\text{Capital Adequacy Ratio} = \frac{\text{Total Capital Fund}}{\text{Total Risk Weight Asset}}$$

$$= \frac{\text{Tire I Capital} + \text{Tire II Capital}}{\text{Total Risk Weight Assets}}$$

$$= \frac{\text{Core Capital} + \text{Supplementaty Capital}}{\text{Total Risk Weight Assets}}$$

Table 4.1 is the observed Capital Adequacy Ratio during the study period in numerical terms which is presented below:

Table 4.1

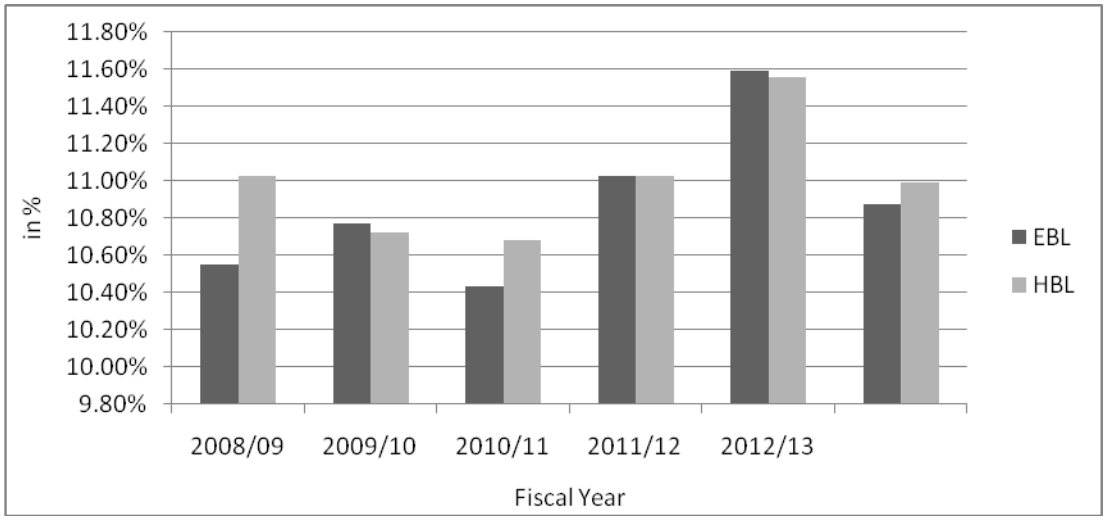
Capital Adequacy Ratio

Fiscal Year	Banks	Total Capital Fund "in Million"	Total Risk Adjusted Asset "in Million"	Capital Adequacy Ratio
2008/09	EBL	2703.8	25619.7	10.55%
	HBL	3845.2	34905.9	11.02%
2009/10	EBL	3257.1	30240.4	10.77%
	HBL	4218.4	39357.1	10.72%
2010/11	EBL	3605.8	34583.5	10.43%
	HBL	4711.2	44124.5	10.68%
2011/12	EBL	4574.7	41525.3	11.02%
	HBL	5283.9	47934.9	11.02%
2012/13	EBL	5777.6	49834.1	11.59%
	HBL	6414.4	55520.6	11.55%
Average	EBL	3983.8	36360.6	10.87%
	HBL	4894.62	44368.6	10.99%

Figure 4.1 is a bar diagram which represents the above tabulated numerical data which helps to compare the Capital Adequacy Ratio among these two banks.

Figure 4.1

Capital Adequacy Ratio



The above table 4.1 and Figure 4.1 explains about the Capital Adequacy Ratio of HBL of 11.02% is the highest and EBL 10.55% is the lowest in FY 2008/09; EBL of 10.77% is the highest and HBL of 10.72% is the lowest in FY 2009/10; HBL of 10.68% is the highest and EBL of 10.43% is the lowest in FY 2010/11; EBL and HBL of 11.02% are same in FY 2011/12 and EBL of 11.59 % is the highest and HBL of 11.55% is the lowest in the FY 2012/13 among the selected banks. Furthermore Figure 4.2 helps to find out the trend of these banks regarding Capital Adequacy Ratio over the last five year's period. The average Capital adequacy of HBL of 10.99% is higher than EBL of 10.87%.

Figure 4.2

Trend Analysis of Capital Adequacy Ratio

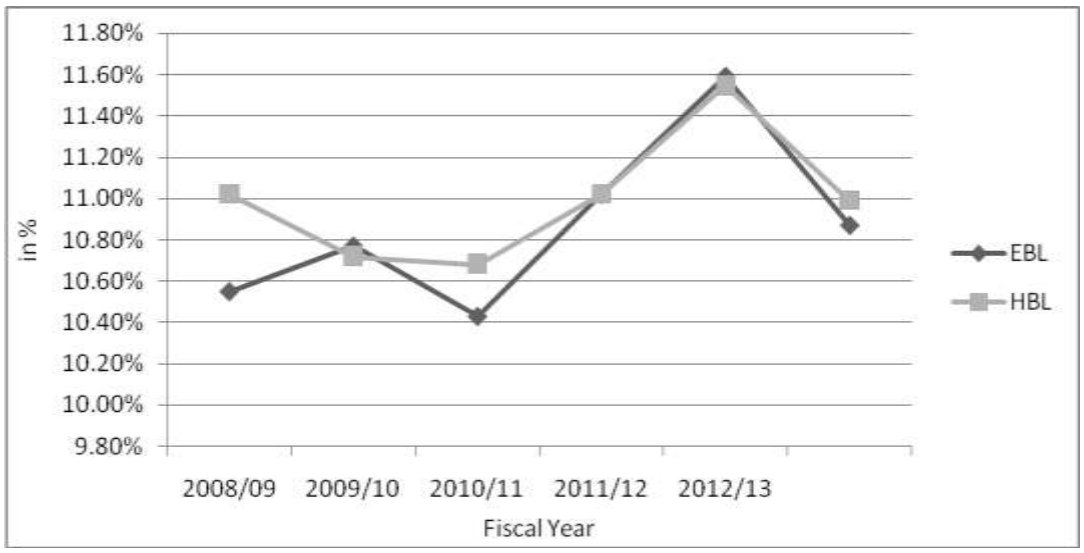


Figure 4.2 is the trend analysis of these banks over the five year's study period. As shown in the figure Capital Adequacy Ratio of EBL started by 10.55% in FY 2008/09, increasing in FY 2009/10 and again decreasing in FY 2010/11 from 10.77% to 10.43%, then it is constantly increasing till FY 2012/13. Overall Capital Adequacy Ratio of EBL is in increasing trend.

Similarly, HBL has starting of 11.02% in FY 2008/09, then after decreases in FY 2009/10 & 2010/11, increasing in FY 2011/12 and reaching to 11.55% at the end of study period 2012/13. Overall Capital Adequacy Ratio of HBL also is in increasing trend.

Capital Adequacy ratio has two parts, which are

4.2.1.1 Tier I (Core) Capital Adequacy Ratio

Tier I Capital is the core measure of a bank's financial strength from a regulator's point of view. It is also known as Core Capital. In the context of Nepal, Tier I (core/primary) Capital includes Paid-up Capital, Share Premium, Non redeemable Preference Share, General Reserve Fund, Cumulative Profit / Loss, Capital Redemption Reserve, Capital Adjustment Fund/ Proposed Bonus Share and Other Free Reserve. Amount of the Goodwill, Fictitious Assets, Investment in excess of prescribe limit specified by NRB, and investment in security of companies with financial interest is deducted from the sum of all elements of the primary capital to arrive at the core capital.

Tier I ratio shows the relationship between the total core capital or internal sources and total risk adjusted assets. The theoretical reason for holding capital is that it should provide protection against unexpected losses. It is also called Core Capital Ratio (CCR). The mandatory level of Core Capital, as set by Nepal Rastra Bank, for the FY 2008/09 is 5% and for FY 2008/09 to 2012/13 is 5.5% of risk weighted assets of commercial banks. It is calculated by using the following model.

$$\text{Tier I Capital Adequacy Ratio} = \frac{\text{Tire 1Capital}}{\text{Total Risk Weight Asset}}$$

OR

$$\text{Core Capital Adequacy Ratio} = \frac{\text{Core Capital}}{\text{Total Risk Weight Asset}}$$

Table 4.2 is the observed Tire I (Core) Capital Adequacy Ratio during the study period in numerical terms which is presented below:

Table 4.2

Tier I (Core) Capital Adequacy Ratio

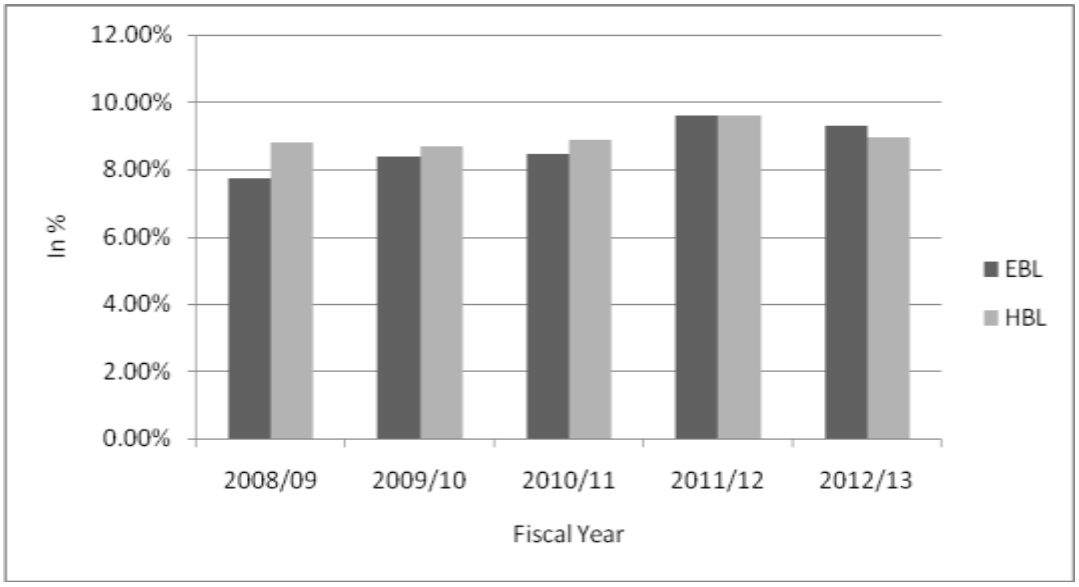
Fiscal Year	Banks	Core Capital "in Million"	Total Risk Adjusted Asset "in Million"	Core Capital Ratio
2008/09	EBL	1981.6	25619.7	7.73%
	HBL	3074.4	34905.9	8.81%
2009/10	EBL	2537.09	30240.4	8.39%
	HBL	3414.6	39357.1	8.68%
2010/11	EBL	2927.2	34583.5	8.46%
	HBL	3916.9	44124.5	8.88%
2011/12	EBL	3990.9	41525.3	9.61%
	HBL	4600.2	47934.9	9.60%
2012/13	EBL	4639.8	49834.1	9.31%
	HBL	4972.2	55520.6	8.96%
Average	EBL	3215.32	36360.6	8.70%
	HBL	3995.66	44368.6	8.99%

Source: Annual Report of HBL and EBL

Figure 4.3 is a bar diagram which represents the above tabulated numerical data which helps to compare the Core Capital Adequacy Ratio among these two banks.

Figure 4.3

Tier I (Core) Capital Adequacy Ratio



As shown in the above table 4.2 and Figure 4.3 the Core Capital Adequacy Ratio of HBL of 8.81% is the highest and EBL of 7.73% is the lowest in FY 2008/2009; HBL of 8.68% is the highest and EBL of 8.39% is the lowest in FY 2009/10; HBL of 8.46% is the highest and EBL of 8.88% is the lowest in FY 2010/11; EBL of 9.61% is the highest and 9.60% of HBL is the lowest in FY 2011/12 and EBL of 9.31% is the highest and HBL of 8.96% is the lowest in the FY 2012/13 between these banks. Furthermore Figure 4.4 helps to find out the trend of these two banks regarding Tier I (Core) Capital Adequacy Ratio over the last five year's period. The core capital ratio of HBL of 8.99% is greater than EBL of 8.70% in average.

Figure 4.4

Trend Analysis of Tier I (Core) Capital Adequacy Ratio

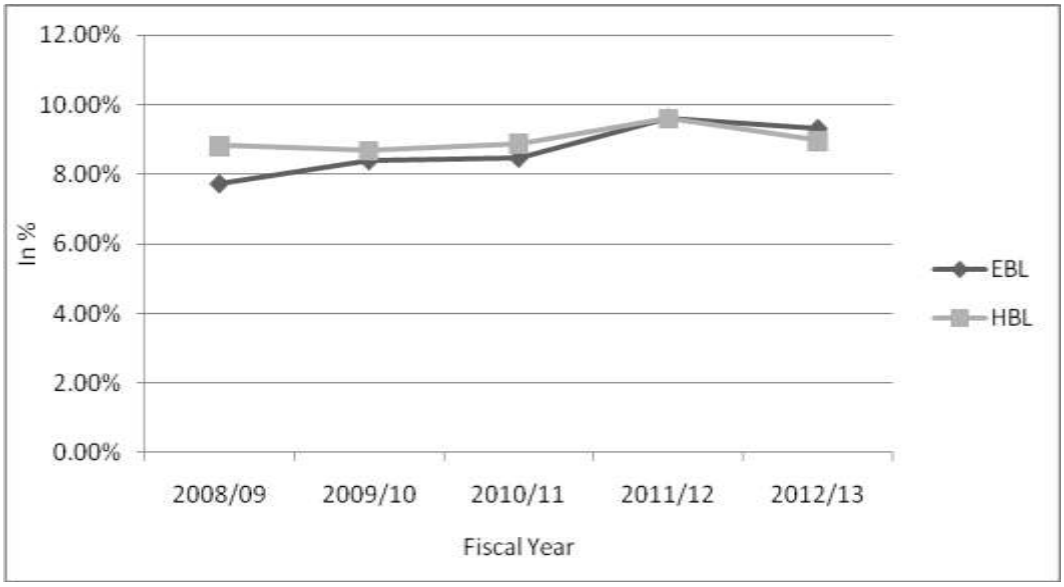


Figure 4.4 is the trend analysis of these banks over the five year's study period. As shown in the figure Core Capital Adequacy Ratio of EBL started by 7.73% in FY 2008/09, increasing there after till FY 2011/12 and reaching to 9.61% and decreasing thereafter. Overall Core Capital Adequacy Ratio of EBL is in increasing trend.

Similarly, Core Capital Adequacy Ratio of HBL is almost highest comparing between these two banks starting with 8.81% in FY 2008/09, then it is decreasing in FY 2009/10 & slightly increasing in FY 2010/11 and FY 2011/12, it is again decreasing in 2012/13 reaching to 8.96% at the end of study period 2012/13. Overall Core Capital Adequacy Ratio of HBL is fluctuating.

4.2.1.2 Tier II (Supplementary) Capital Adequacy Ratio

Tier II Capital is a measure of a bank's financial strength with regard to the second most reliable form of financial capital, from a regulator's point of view. This ratio shows the absolute contribution of supplementary capital in capital adequacy. In Nepalese context, Tier II (supplementary) capital comprises of Loan Loss Provision on Pass Loan, Assets Revaluation Fund, Hybrid Capital Instruments, Unsecured Subordinated Term Debt, Exchange Equalization Fund, Excess Loan Loss Provision, and Provision for Loss on

Investment. It is used to analyze the supplementary capital adequacy of the banks and determined by using the following model.

$$\text{Tire II Capital Adequacy Ratio} = \frac{\text{Tire II Capital}}{\text{Total Risk Weight Asset}}$$

OR

$$\text{Supplementary Capital Adequacy Ratio} = \frac{\text{Supplementary Capital}}{\text{Total Risk Weight Asset}}$$

Table 4.3 is the observed Tire II (Supplementary) Capital Adequacy Ratio during the study period in numerical terms which is presented below:

Table 4.3

Tier II (Supplementary) Capital Adequacy Ratio

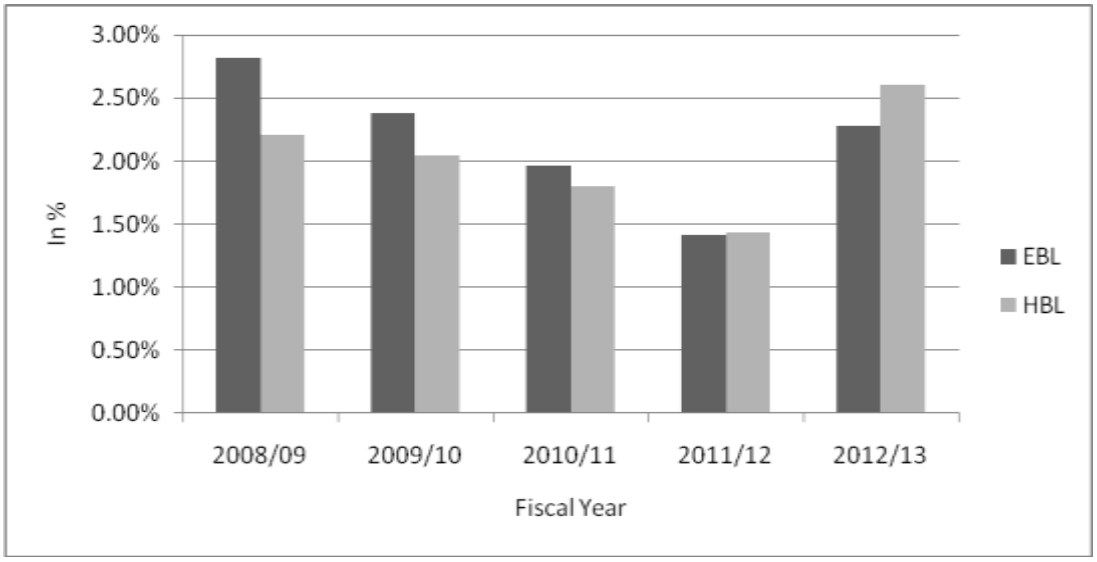
Fiscal Year	Banks	Supplementary Capital "in Million"	Total Risk Adjusted Asset "in Million"	Supplementary Capital Ratio
2008/2009	EBL	722.3	25619.7	2.82%
	HBL	770.8	34905.9	2.21%
2009/2010	EBL	720.05	30240.4	2.38%
	HBL	803.7	39357.1	2.04%
2010/2011	EBL	678.7	34583.5	1.96%
	HBL	794.3	44124.5	1.80%
2011/2012	EBL	583.8	41525.3	1.41%
	HBL	683.8	47934.9	1.43%
2012/2013	EBL	1137.9	49834.1	2.28%
	HBL	1442.3	55520.6	2.60%
Average	EBL	768.55	36360.6	2.17%
	HBL	898.98	44368.6	2.02%

Source: Annual Report of HBL and EBL

Figure 4.5 is a bar diagram which represents the above tabulated numerical data which helps to compare the Supplementary Capital Adequacy Ratio among these two banks.

Figure 4.5

Tier II (Supplementary) Capital Adequacy Ratio



The given table 4.3 and Figure 4.5 describes the Supplementary Capital Adequacy Ratio of EBL of 2.82% is the highest and HBL of 2.21% is the lowest in FY 2008/09; HBL of 2.38% is the highest and EBL of 2.04% is the lowest in FY 2009/10; EBL of 1.96% is the highest and HBL of 1.80% is the lowest in FY 2010/11; HBL of 1.43% is the highest and 1.41% of EBL is the lowest in FY 2011/12 and HBL of 2.60% is the highest and EBL of 2.28% is the lowest in the FY 2012/13 among these banks. Furthermore Figure 4.6 helps to find out the trend of two banks regarding Tier II (Supplementary) Capital Adequacy Ratio over the last five year's period.

Figure 4.6

Trend Analysis of Tier II (Supplementary) Capital Adequacy Ratio

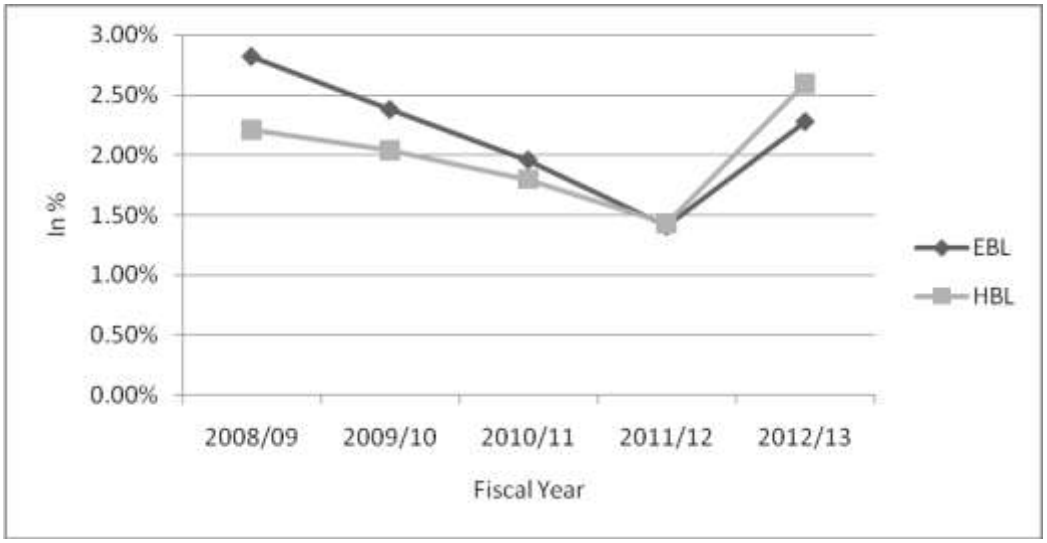


Figure 4.6 is the trend analysis of these banks over the five year's study period. As shown in the figure Tier II (Supplementary) Capital Adequacy Ratio of EBL is highest among two banks till 2010/11 starting from 2.82%, it is decreasing in FY 2011/12 and slightly increasing in FY 2012/13 and reached to 2.28%. Overall Supplementary Capital Adequacy Ratio of EBL is in increasing trend.

Similarly, Supplementary Capital Adequacy Ratio of HBL started with2.21% in FY 2008/09, decreasing in FY 2009/10, it is constantly decreasing from FY 2009/10 to FY 2011/12 and again increasing in 2012/13 reaching to 2.60% at the end of study period. Overall Supplementary Capital Adequacy Ratio of HBL also is in decreasing trend.

4.2.2 Assets Quality

Asset quality has direct impact on the financial performance of an FI. The quality of assets particularly, loan assets and investments, would depend largely on the risk management system of the institution. Credit risk is one of the factors that affect the health of an individual FI. The extent of the credit risk depends on the quality of assets held by an individual FI. The quality of assets held by an FI depends on exposure to specific risks, trends in non-performing loans, and the health and profitability of bank borrowers: especially the corporate sector. We can use a number of measures to indicate the quality of assets held by FIs. ADB suggests these measures: loan concentration by industry, region, borrower and portfolio quality; related party policies and exposure on outstanding loan, approval process of loan,

check and balance of loans; loan loss provision ratio; portfolio in arrear; loan loss ratio; and reserve ratio—of checking the quality of assets of an FI (ADB 2002).

NRB uses composition of assets, nonperforming loan to total loan ratio, net nonperforming loan to total loan ratio as the indicators of the quality of assets of commercial banks (NRB 2005). NRB has directed the commercial banks in regards to the concentration of the loan. Any licensed FI can grant the fund base loan to a single borrower or borrowers related to the same business group up to the 25 percent of its primary capital. In the same vein, it can provide the non-fund base loan up to 50 percent of its core capital (NRB 2005). Similarly, it has directed FIs to classify the loans into performing loan and nonperforming loans. The loans that are not due and 3 months past due fall in the class of performing loans/performing assets (which are overdue up to 3 months) and others do in the non-performing loans. Further, non-performing loans are classified into three groups: substandard (Which are overdue from 3 month up to 6 months), doubtful (which are overdue from 6 months up to 12 months), and bad debt/ loss (which are over due after 1 year). Here are the some regulations that NRB has made e regarding to the provision of performing and non performing loan which are given below:

- For any normal loan, Commercial banks have to make 1 percent provision for pass loan/performing loan, 25 percent for substandard loan, 50 percent for doubtful loan and 100 percent for bad loan (NRB 2005).
- If any bank has given loan on the basis of Personal Guarantee (i.e. without taking any movable or immovable property as security), bank has to make 20 percent more provision in general, i.e. 21 percent provision for pass loan/performing loan, 45 percent for substandard loan, 70 percent for doubtful loan and 100 percent for bad loan.
- Shareholder holding 1 percent or more shares of any bank cannot take a lone from that bank. If loan is already taken before this NRB regulation, that bank has to make 2 provision for pass loan/performing loan, 50 percent for substandard loan, 100percent for doubtful loan.
- In the case of reschedule of restructured loans (i.e. Old Principle + Due interest = New principle), any bank has to report to the NRB about the restructured and has to make a provision of 12.50, considering as pass loan/performing loan, on the first day of reschedule / reschedule, 50 percent for substandard loan, 100 percent for doubtful loan.

Under the Asset Quality following ratios are used to measure the performance of banks.

4.2.2.1 Performing Loan Ratio

Performing loan refers to those good loans of bank which are paying its Principle + Interest on time or overdue up to 3 months. So, The Performing Loan Ratio is the proportion of Performing Loan to Total Loan and Advances. This ratio shows the proportion of good loans. Hence, higher Performing Loan Ratio reflects the competency or success of loan department of bank and vice versa or the better financial health of bank. The ratio is used to analyze the asset quality of the bank and determined by using the given model.

$$\text{Performing Loan Ratio} = \frac{\text{Total Performing Loan}}{\text{Total Loan And Advances}}$$

Where,

Total Performing Loan = Those loans which have been paying or overdue up to 3 months either in the form of interest servicing or principal repayment,

or

= Pass Loan + Restructured Loan

Total Loan & Advances = Total Performing Loan + Total Non Performing Loan

Table 4.4 is the observed Performing Loan Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.4

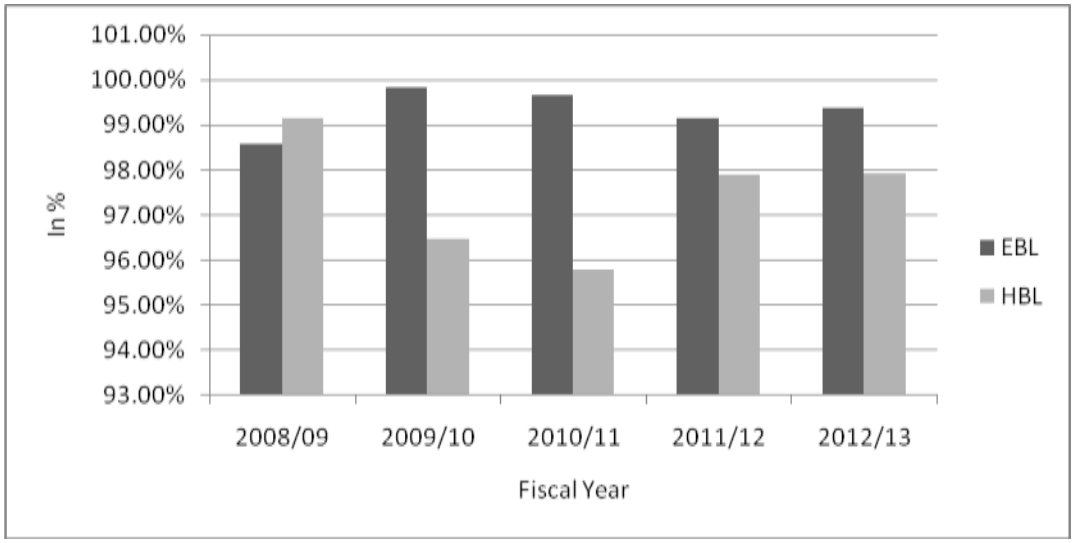
Performing Loan Ratio

Fiscal Year	Banks	Total Performing Loan "in Million"	Total Loan & Advances "in Million"	Performing Loan Ratio
2008/09	EBL	24351.5	24469.6	98.58%
	HBL	24968.2	25179.6	99.16%
2009/10	EBL	28112.6	28156.4	99.84%
	HBL	28098.9	29123.5	96.48%
2010/11	EBL	31553.3	31661.8	99.66%
	HBL	31576.5	32968.3	95.78%
2011/12	EBL	36309.5	36618.8	99.16%
	HBL	35217.3	35968.5	97.91%
2012/13	EBL	43921.6	44197.7	99.38%
	HBL	39871.2	41057.4	97.93%
Average	EBL	32849.7	33020.86	99.32%
	HBL	31946.42	32859.46	97.45%

Figure 4.7 is a bar diagram which represents the above tabulated numerical data which helps to compare the Performing Loan Ratio among these banks.

Figure 4.7

Performing Loan Ratio



The table 4.4 and Figure 4.7 shows the Performing Loan Ratio of HBL of 99.16% is the highest and EBL of 98.58% is the lowest in FY 2008/09; EBL of 99.84% is the highest and HBL of 96.48% is the lowest in FY 2009/10; EBL of 99.66% is the highest and HBL of 95.78% is the lowest in FY 2010/11; EBL of 99.16% is the highest and 97.91% of HBL is the lowest in FY 2011/12 and EBL of 99.38% is the highest and HBL of 97.93% is the lowest in the FY 2012/13 among these two banks. Furthermore Figure 4.8 helps to find out the trend of these banks regarding Performing Loan Ratio over the last five year's period. In average, the performing loan ratio of EBL of 99.32% is better than that of HBL of 97.45%.

Figure 4.8

Trend Analysis of Performing Loan Ratio

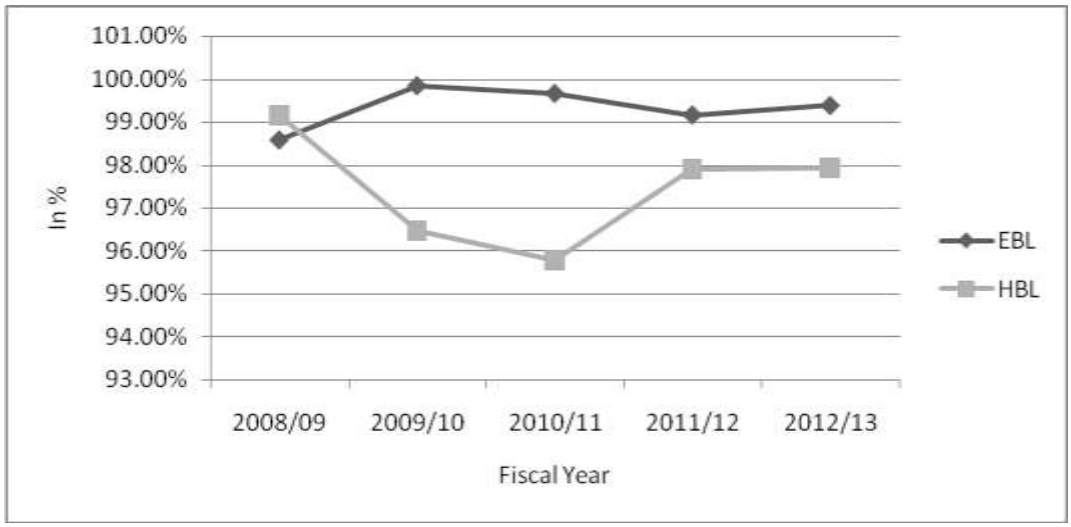


Figure 4.8 is the trend analysis of these banks over the five year's study period. As shown in the figure Performing Loan Ratio of EBL started from 98.58% in FY 2008/09, increasing in FY 2009/10 and decreasing in FY 2010/11 till FY 2011/12. The ratio is again increasing in FY 2012/13. So, the trend analysis is showing EBL is doing good regarding its performing loan ratio.

Similarly, Performing Loan Ratio of HBL started with 99.16% in FY 2008/09, decreasing in FY 2009/10 and 2010/11 and again increasing in FY 2011/12 and 2012/13 reaching 97.93% at the end of study period. In General, Performing Loan Ratio of HBL is not too bad.

4.2.2.2 Non-Performing Loan Ratio

Non-performing loan refers to those loans which are not paying its Principle + Interest in time or overdue more than three months. So, it consists of Sub-standard loan, Doubtful loan and Bad Loan. The non-performing loan ratio indicates the relationship between Non-performing Loan and Total Loan. It measures the proportion of Non-performing Loan in Total Loan and Advances. Higher non performing loan ratio indicates that the bank's assets are not doing well or the loan department is not so conscious while passing loan. So, lower ratio will be preferred regarding Non-performing Loan Ratio. The ratio is determined by using the given model.

$$\text{Non Performing Loan Ratio} = \frac{\text{Total Non Performing Loan}}{\text{Total loan and Advances}}$$

Where,

Total Non-performing Loan = those loans which have been past due either in the form of interest servicing or principal repayment and graded as possible default

OR

= Sub Standard Loan + Doubtful Loan + Bad Loan

Total Loan & Advances = Total Performing Loan + Total Non Performing Loan

Performing Loan = Pass Loan + Restructured Loan

Table 4.5 is the observed Non Performing Loan Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.5

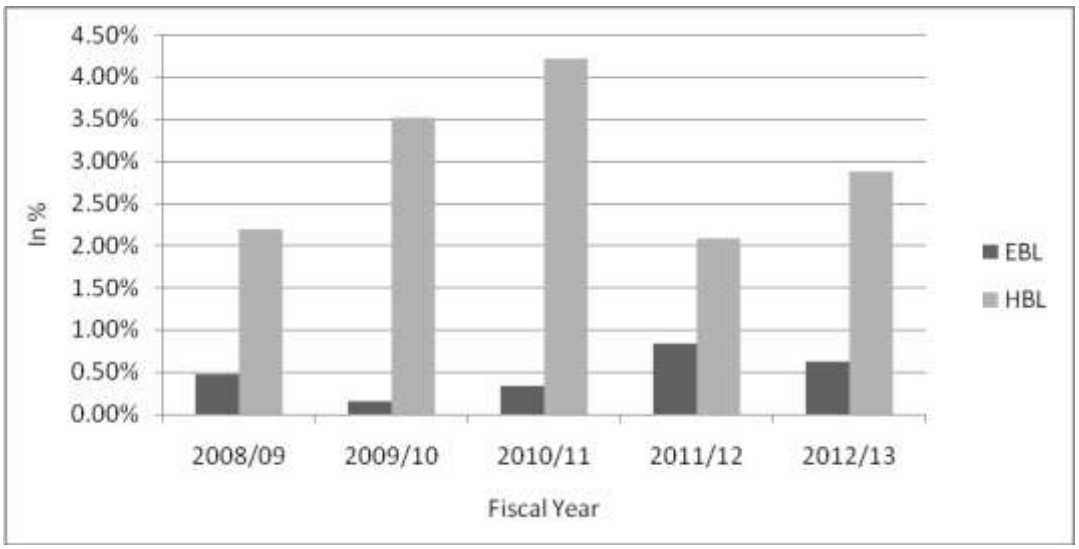
Non Performing Loan Ratio

Fiscal Year	Banks	Total Non Performing Loan "in Million"	Total Loan & Advances "in Million"	Non Performing Loan Ratio
2008/09	EBL	117.9	24469.6	0.48%
	HBL	551.3	25179.6	2.19%
2009/10	EBL	43.7	28156.4	0.16%
	HBL	1024.8	29123.5	3.52%
2010/11	EBL	108.5	31661.8	0.34%
	HBL	1391.8	32968.3	4.22%
2011/12	EBL	307.5	36618.8	0.84%
	HBL	751.2	35968.5	2.09%
2012/13	EBL	276.2	44197.7	0.62%
	HBL	1186.2	41057.4	2.89%
Average	EBL	170.76	33020.86	0.49%
	HBL	981.06	32859.46	2.98%

Figure 4.9 is a bar diagram which represents the above tabulated numerical data which helps to compare the Non Performing Loan Ratio among these banks.

Figure 4.9

Loan Loss Coverage Ratio



The above table 4.5 and Figure 4.9 shows the Non Performing Loan Ratio of HBL of 2.19% is the highest and EBL of 0.48% is the lowest in FY 2008/09; HBL of 3.52% is the highest and EBL of 0.16% is the lowest in FY 2009/10; HBL of 4.22% is the highest and EBL of

0.34% is the lowest in FY 2010/11; HBL of 2.09% is the highest and 0.84% of EBL is the lowest in FY 2011/12 and HBL of 2.89% is the highest and EBL of 0.62% is the lowest in the FY 2012/13 among these banks. Furthermore Figure 4.10 helps to find out the trend of these banks regarding Non Performing Loan Ratio over the last five year's period. The EBL of 0.49% is shows that the bank's position is better than HBL's of 2.98% in average.

Figure 4.10

Trend Analysis of Non Performing Loan Ratio

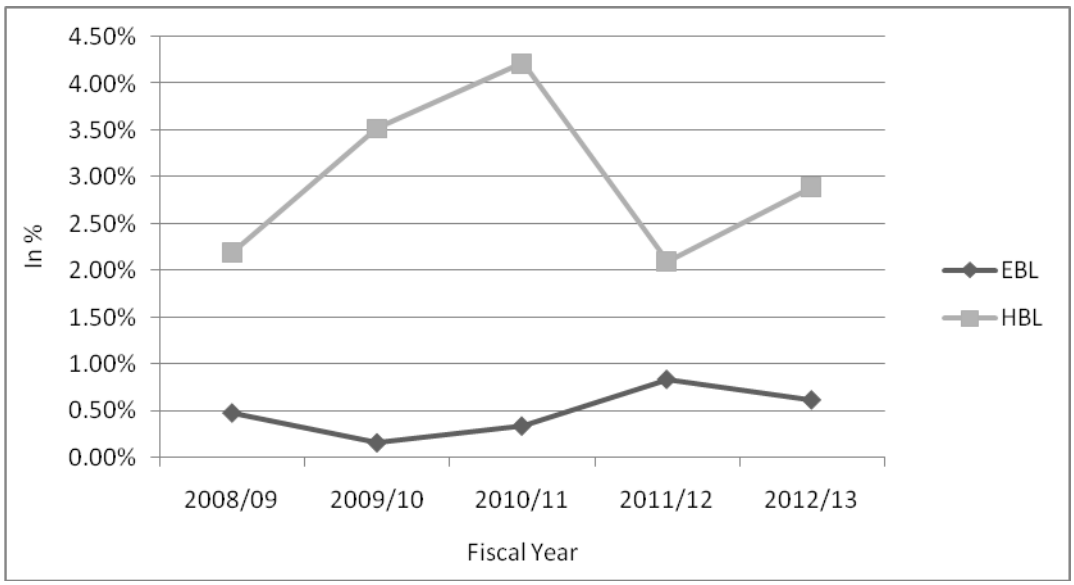


Figure 4.10 is the trend analysis of these banks over the five year's study period. As shown in the figure Non Performing Loan Ratio of EBL started from 0.48 % in FY 2008/09 and is fluctuating onwards. The ratio is decreasing in 2009/10 and increasing thereafter from 2010/11 to 2011/12, and again it is in decreasing in FY 2012/13 reaching 0.62%. So, trend analysis shows that EBL is able to decrease its non performing loan which is good sign of bank.

Likewise, Non Performing Loan Ratio of HBL started with 2.19% in FY 2008/09, increasing in 2009/10 and 2010/11, decreasing in FY 2011/12 and 2012/13 and reached to 2.82%. In general Non Performing Loan Ratio of HBL is in decreasing trend.

4.2.2.3 Loan Loss Coverage Ratio

Loan Loss Coverage Ratio is the relationship between Total Loan Loss Provision and Total Non Performing Loan. It measures the proportion of Total Loan Loss Provision in relation to Total Non Performing loan. Out of the Total Non-Performing if some loans become bad or default then that loss to the bank is covered from the Loan Loss Provision fund. So, from that point of view, higher the loan loss coverage ratio is better for the banks. . The ratio is determined by using the given model:

$$\text{Loan Loss Coverage Ratio} = \frac{\text{Total Loan Loss Provision}}{\text{Total Non Performing Loan}}$$

Where,

Total Loan Loss Provision = Provision on (Pass Loan+ Restructured Loan + Sub Standard Loan + Doubtful Loan + Bad Loan

Total Non Performing Loan = Sub Standard Loan + Doubtful Loan + Bad Loan

Table 4.6 is the observed Loan Loss Coverage Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.6

Loan Loss Coverage Ratio

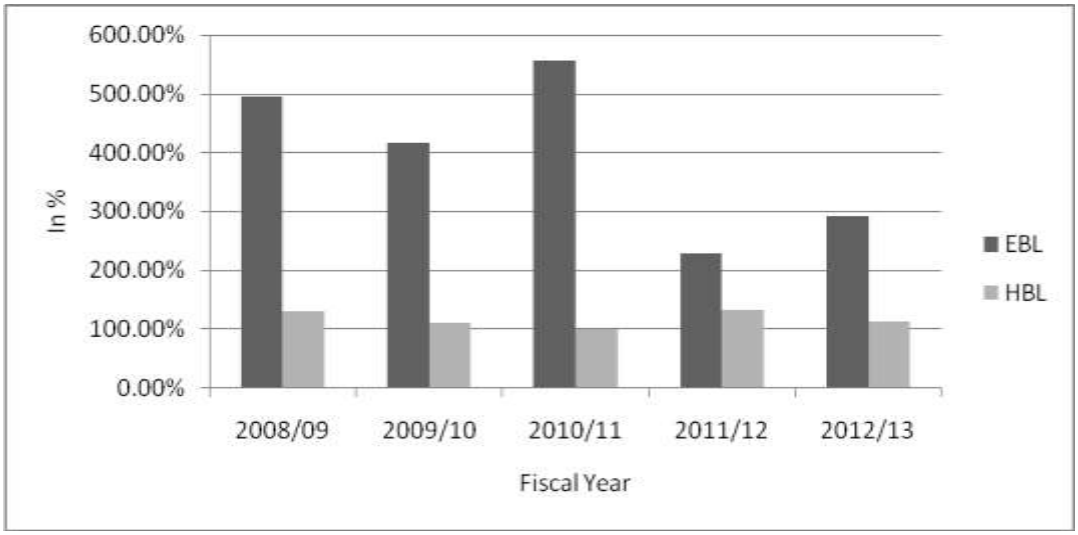
Fiscal Year	Banks	Total Loan Loss Provision "in Million"	Total Non Performing Loan "in Million"	Loan Loss Coverage Ratio
2008/09	EBL	584.88	117.9	496.08%
	HBL	726.4	551.3	131.76%
2009/10	EBL	599.78	143.7	417.38%
	HBL	1143.1	1024.8	111.54%
2010/11	EBL	604.2	108.5	556.87%
	HBL	1401.3	1391.8	100.68%
2011/12	EBL	705.9	307.5	229.56%
	HBL	1003.04	751.2	133.53%
2012/13	EBL	804.6	276.2	291.31%
	HBL	1333.6	1186.2	112.43%
Average	EBL	659.87	190.76	398.24%
	HBL	1121.49	981.06	117.99%

Source: Annual Report of EBL and HBL

Figure 4.11 is a bar diagram which represents the above tabulated numerical data which helps to compare the Loan Loss Coverage Ratio among these banks.

Figure 4.11

Loan Loss Coverage Ratio



The above table 4.6 and Figure 4.11 illustrates the Loan Loss Coverage Ratio of EBL of 496.08% is the highest and HBL of 131.76% is the lowest in FY 2008/09; EBL of 417.38% is the highest and HBL of 111.54% is the lowest in FY 2009/10; EBL of 556.87% is the highest and HBL of 100.68% is the lowest in FY 2010/11; EBL of 229.56% is the highest and 133.53% of HBL is the lowest in FY 2011/12 and EBL of 291.31% is the highest and HBL of 112.43% is the lowest in the FY 2012/13 among these two banks. Furthermore Figure 4.12 helps to find out the trend of these banks regarding Loan Loss Coverage Ratio over the last five year's period. The loan loss coverage ratio of EBL is better than HBL, i.e., 398.24%>117.99%. Higher the loan loss coverage ratio better will be the bank's position.

Figure 4.12

Trend Analysis of Loan Loss Coverage Ratio

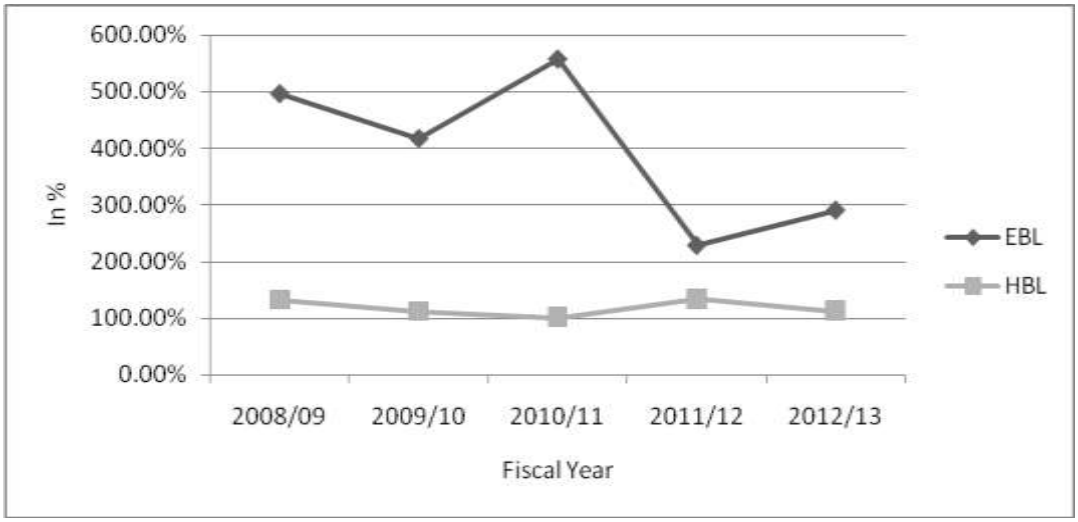


Figure 4.12 is the trend analysis of these two banks over the five year's study period. As shown in the figure Loan Loss Coverage Ratio of EBL started from 496.08 % in FY 2008/09 and thereafter is continuously increasing till FY 2010/11 and reaches to 556.87%. It is decreasing thereafter from FY 2011/12 to 2012/13. So, trend analysis shows that EBL is able to increase its Loan Loss Coverage Ratio continuously which will be benefit to the bank if any loan goes to band or default but it is decreasing from 2011/12 and 2012/13.

Likewise, Loan Loss Coverage Ratio of HBL started with 131.76% in FY 2008/09, decreasing in FY 2009/10 and 2010/11, increasing in FY 2011/12 and again decreasing in 2012/13 and reaches to 112.43%. In general Loan Loss Coverage Ratio of HBL is fluctuating.

4.2.2.4 Loan Loss Provision Ratio

Out of the main functions of the bank one of them is to provide loans to customers. It is important to take note that non-performing loan signals risk of non recovery of the loan which is invested from the pool fund of deposits taken from general public. So, when bank provides loan to customer then there will be chance to convert those loans to Pass Loan, Sub Standard Loan, Doubtful Loan and Bad Loan. In all cases the banks have to keep the provision to protect the public interest as well as taking the preventive measure for the sound health of financial. It reflects adequacy to absorb estimated credit losses associated with the

loan and lease portfolio of the bank or it shows the percentage of the provision made to make good the default loans. The provision for loan losses is a charge to current earnings to build the Allowance for Loan and Lease Losses (ALLL). This ratio indicates the proportion of the loan loss provision on Total Loan and Advances. A high ratio is always better safety net to the general public but supposed to mean a bad quality of assets. Central bank has to protect rights of public and thus will be happy with the higher ratio of loan loss provision. However despite of safety net benefits, higher loan loss provision also indicates the banks profit is crunching down by this higher provision as well as poor credit management.

In fact provision made on loans depends on whether information on 'bad loans' is correctly revealed. For the purpose of this study following model is used to determine the Loan Loss Provision Ratio:

$$\text{Loan Loss Provision Ratio} = \frac{\text{Total Loan Loss Provision}}{\text{Total Loan and Advances}}$$

Where,

Total Loan Loss Provision = Provision on (Pass Loan+ Restructured Loan + Sub Standard Loan + Doubtful Loan + Bad Loan

Total Loan & Advances = Total Performing Loan + Total Non Performing Loan

Performing Loan = Pass Loan + Restructured Loan

Total Non Performing Loan = Sub Standard Loan + Doubtful Loan + Bad Loan

Table 4.7 is the observed Loan Loss Provision Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.7

Loan Loss Provision Ratio

Fiscal Year	Banks	Total Loan Loss Provision "in Million"	Total Loan & Advances "in Million"	Loan Loss Provision Ratio
2008/09	EBL	584.88	24469.6	2.39%
	HBL	726.4	25179.6	2.88%
2009/10	EBL	599.78	28156.4	2.13%
	HBL	1143.1	29123.5	3.93%
2010/11	EBL	604.2	31661.8	1.91%
	HBL	1401.3	32968.3	4.25%

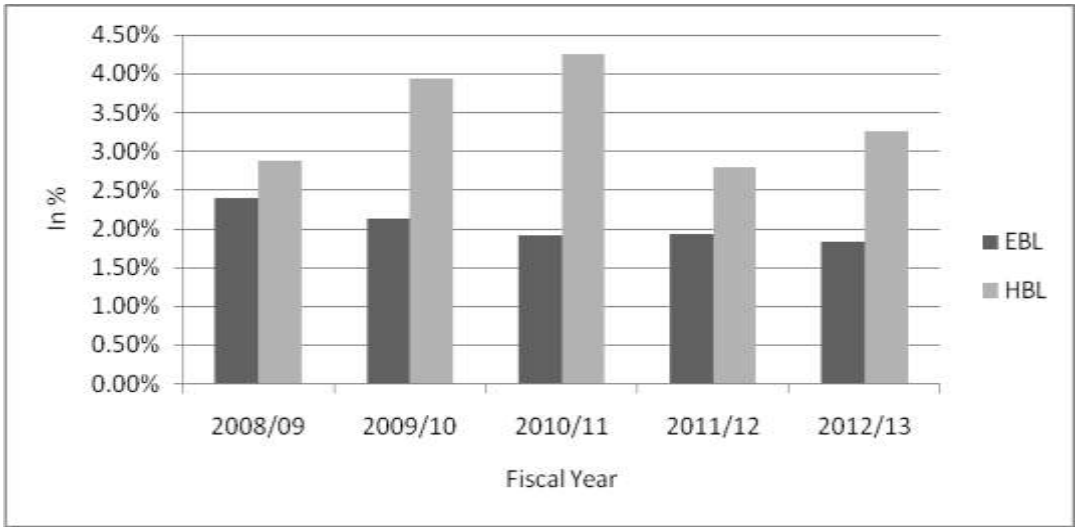
2011/12	EBL	705.9	36618.8	1.93%
	HBL	1003.04	35968.5	2.79%
2012/13	EBL	804.6	44197.7	1.82%
	HBL	1333.6	41057.4	3.25%
Average	EBL	659.87	33020.86	2.04%
	HBL	1121.49	32859.46	3.42%

Source: Annual Report EBL and HBL

Figure 4.13 is a bar diagram which represents the above tabulated numerical data which helps to compare the Loan Loss Provision Ratio among these banks.

Figure 4.13

Loan Loss Provision Ratio



From the above table 4.7 and Figure 4.13 the Loan Loss Provision Ratio of HBL of 2.88% is the highest and HBL of 2.39% is the lowest in FY 2008/09, HBL of 3.93% is the highest and EBL of 2.13% is the lowest in FY 2009/10; HBL of 4.25% is the highest and EBL of 1.91% is the lowest in FY 2010/11; HBL of 2.79% is the highest and 1.93% of EBL is the lowest in FY 2011/12 and HBL of 3.25% is the highest and EBL of 1.82% is the lowest in the FY 2012/13 among these banks. In average, the loan loss provision ratio of EBL is better than HBL. Furthermore Figure 4.14 helps to find out the trend of these two banks regarding Loan Loss Provision Ratio over the last five year's period.

Figure 4.14

Trend Analysis of Loan Loss Provision Ratio

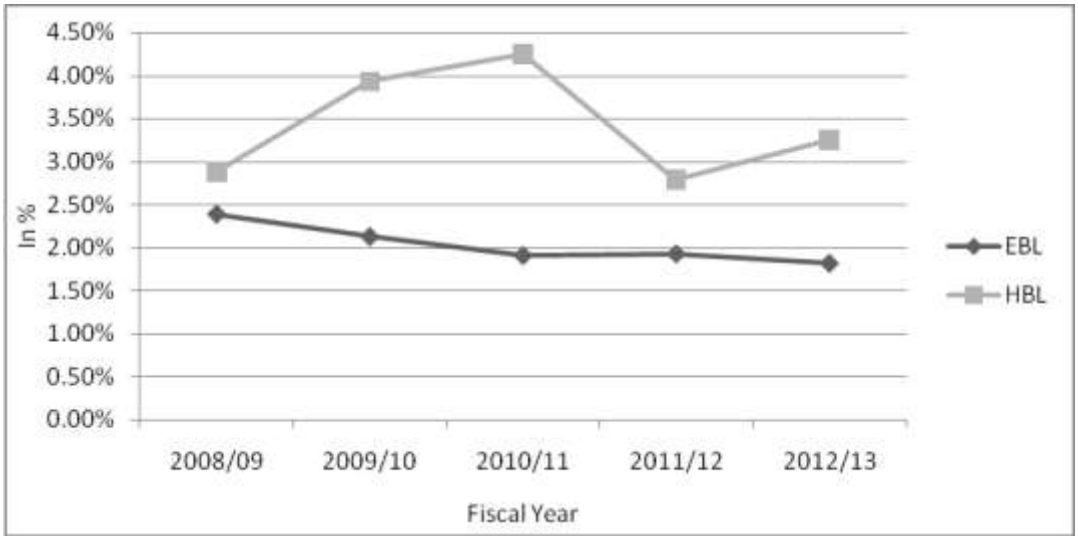


Figure 4.14 is the trend analysis of these banks over the five year's study period. As shown in the figure Loan Loss Provision Ratio of EBL started from 2.39% in FY 2008/09 and thereafter it is decreasing in FY 2009/10 and 2010/11, thereafter it is increasing in 2011/12 and again increasing in FY 2012/13 reaching to 1.82%.

Similarly, Loan Loss Provision Ratio of HBL started with 2.88% in FY 2008/09, thereafter is continuously increasing in FY 2009/10 and 2010/11, thereafter it decreasing in FY 2011/12 and again increasing in 2012/13 and reached 3.25%.

4.2.3 Management Efficiency

Management is a key functioning force of an institution that leads it towards its success. Policy determination, formulation of procurers, preparation of business plan, and implementation of the planned projects are some of the core functions of management. In financial institutions like banks, policies related to deposits, loans and other services are rendered by management that is essential to achieve organizational objectives. Sound management is a key to bank performance but is difficult to measure. The performance of the other four CAMELS components will depend on the vision, capability, agility, professionalism, integrity, and competence of the FI's management and can be quantified fairly easily from current financial statements. Management quality is a somewhat elusive and subjective measurement. As sound management is crucial for the success of any institution, management quality is generally accorded greater weighting in the assessment of

the overall CAMELS composite rating. It is primarily a qualitative factor applicable to individual institutions. Management performance can be measured up by two ways. One, observing the physical facilities in place and another is measuring the organizational systems and efficiency factors. Though not compressive, following points generally points out the quality of management skills.

- Structure and authority distribution among employees
- Abilities to meet sufficient expenses
- Robust internal control / check, reporting systems include.
- Diversified human resources (combination of managers and experts)
- Formal work flow and effective communication system
- Service excellence, good customer relations
- Good working environment
- Well-functioning, set of functional sub systems.

Several indicators, however, can jointly serve as an indicator of management soundness. Operating Expenses Ratio, Earning per Employee, Cost per Loan, Average Loan size and Cost per unit of Money Lent can be used as a proxy of the management quality. ADB recommends cost per unit of money lent as a proxy of management quality and can be computed by:

$$\text{Cost per Unit of Money Lent} = \frac{\text{Operating Cost}}{\text{Total Amount Disbursed}}$$

But this cannot be used as an indicator of management quality in Nepal. Since the data on amount of the total loan mobilized during a particular FY is not available in published financial statements and annual reports. As stated earlier, NRB has skipped up this component of CAMELS in the performance evaluation of commercial banks. So here are some basic formulas that are used to measure Management Quality:

4.2.3.1 Total Expense to Total Income Ratio

The ratio of total expenses to total revenue is used as a proxy measure of the management quality and the expression of numerical relationship between total expenses to total incomes of the bank. A high or increasing ratio of expenses to total revenues can indicate that FIs may

not be operating efficiently. This can be due to management deficiencies. In any case, it is likely to negatively affect profitability. (IMF 2000)

Commercial banks earnings originate from interest earned loans and advances, investments, commissions and discounts; foreign exchange rate gains and other miscellaneous income. Conversely, it expends on depositors interest, staff salary, provident fund allowances and other operating expenses like rent, water and electricity, fuel expenses, audit fee expenses, management expenses, depreciation, miscellaneous expenses and all other expenses direct related to the operation of the bank. Expenses such as loss on sale of assets, write off exp, losses shortage, written off, provision for income tax are non-operating expenses.

$$\text{Total Expenses to income Ratio} = \frac{\text{Total Expenses}}{\text{Total Income}}$$

Where,

Total Expenses = Interest Expenses + Employee Expenses +Other Operating Expenses + Exchange Loss + Non Operating Loss

Total Income = Interest Income + Commission & Discount Income + Other Operating Income + Exchange Gain +Non Operating Income

Table 4.8 is the observed Total Expenses to Total Income Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.8

Total Expenses to Total Income Ratio

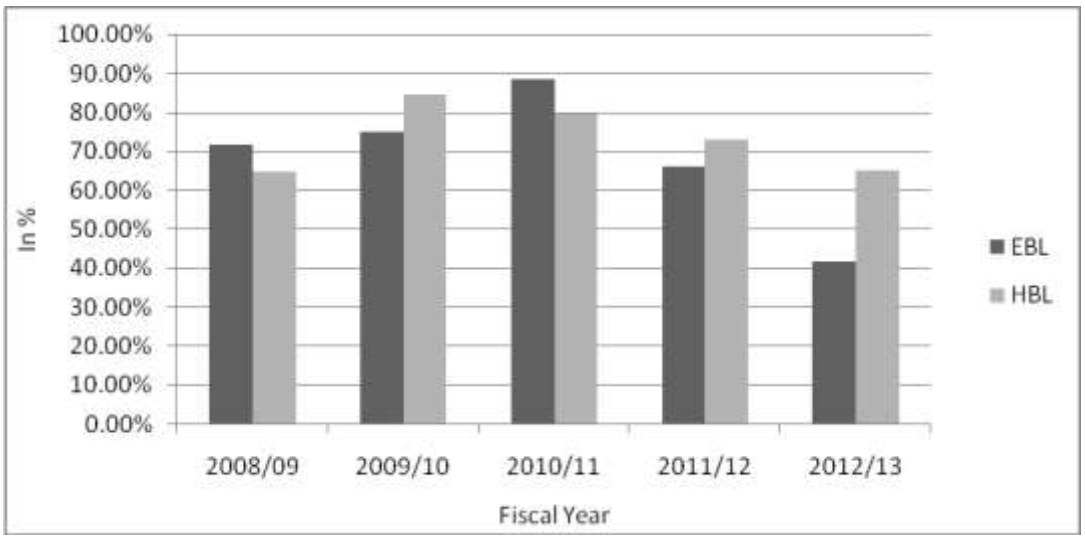
Fiscal Year	Banks	Total Expenses "in Million"	Total Income "in Million"	Total Expenses to Total Income Ratio
2008/09	EBL	1833.5	2557.8	71.68%
	HBL	1893.29	2922.83	64.78%
2009/10	EBL	2626.7	3500.7	75.03%
	HBL	3132.26	3711.49	84.39%
2010/11	EBL	3744.9	4228.8	88.56%
	HBL	3986.34	5001.55	79.70%
2011/12	EBL	3627.9	5483.07	66.17%
	HBL	4173.11	5727.65	72.86%
2012/13	EBL	3249.3	7796.5	41.68%
	HBL	3670.15	5643.03	65.04%

Average	EBL	3016.16	4713.37	68.62%
	HBL	3371.03	4601.31	73.35%

Figure 4.15 is a bar diagram which represents the above tabulated numerical data which helps to compare the Total Expenses to Total Income Ratio among these banks.

Figure 4.15

Total Expenses to Total Income Ratio



The above table 4.8 and Figure 4.15 describes Total Expenses to Total Income Ratio of EBL of 71.68% is the highest and HBL of 64.78% is the lowest in FY 2008/09; HBL of 84.39% is the highest and EBL of 75.03% is the lowest in FY 2009/10; EBL of 88.56% is the highest and HBL of 79.70% is the lowest in FY 2010/11; HBL of 72.86% is the highest and 66.17% of EBL is the lowest in FY 2011/12 and HBL of 65.04% is the highest and EBL of 41.68% is the lowest in the FY 2012/13 among these two banks. The operating efficiency of EBL of 68.62% is better than HBL of 73.35% i.e. EBL is profitable than HBL. Furthermore Figure 4.16 helps to find out the trend of these banks regarding Total Expenses to Total Income Ratio over the last five year's period.

Figure 4.16

Trend Analysis of Total Expenses to Total Income Ratio

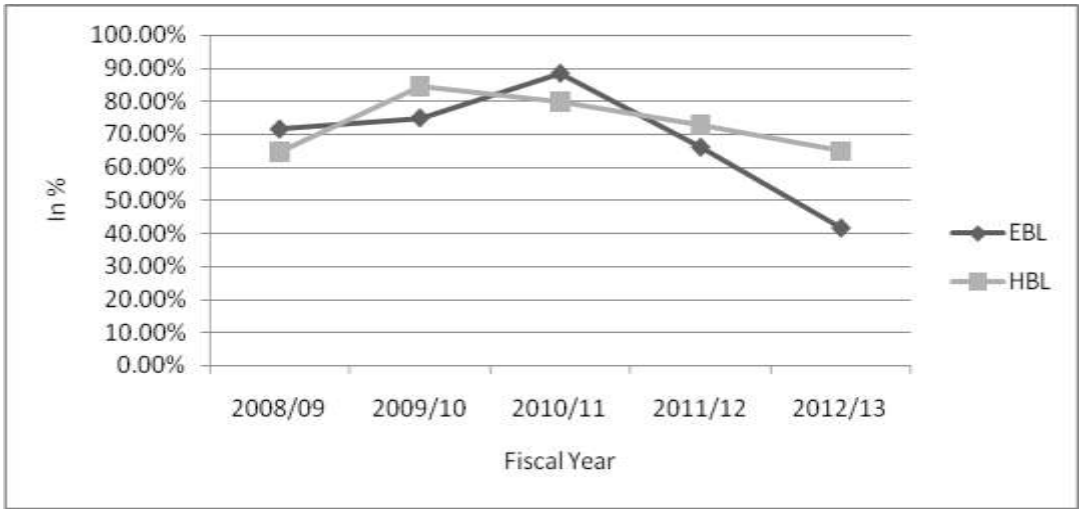


Figure 4.16 is the trend analysis of these banks over the five year's study period. As shown in the figure, Total Expenses to Total Income Ratio of EBL started from 71.68 % in FY 2008/09, it is continuously increasing in FY 2009/10 and 2010/11, thereafter it is decreasing in FY 2011/12 and 2012/13 and reached to 41.68%.

Similarly, Total Expenses to Total Income Ratio of HBL started with 64.78%, in FY 2008/09, it is increasing in FY 2009/10, and thereafter it is decreasing continuously after FY 2010/11 to 2012/13 reached to 65.04%.

4.2.3.2 Earning Per Employee

Earning per employee is the numerical relationship between Net Profit after Taxes to Total Numbers of Employee. Low or decreasing earnings per employee can reflect inefficiencies as a result of overstaffing, with similar repercussions in terms of profitability (IMF, 2000). It is calculated by using the following model:

$$\text{Earning Per Employee} = \frac{\text{Net Profit After Tax}}{\text{Total No.of Employees}}$$

Table 4.9 is the observed Earning per Employee of these banks during the study period in numerical terms which is presented below:

Table 4.9

Earning per Employee

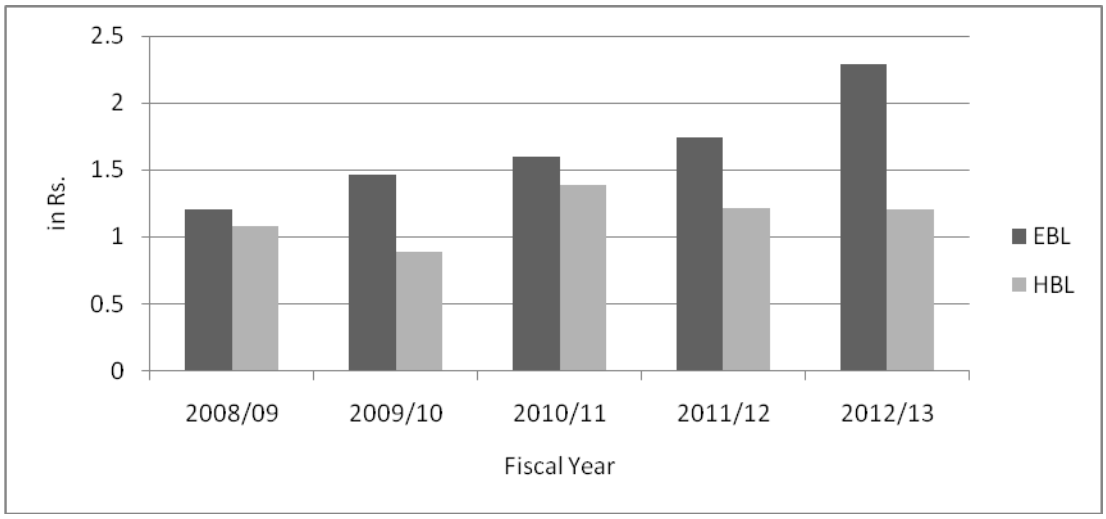
Fiscal Year	Banks	Net Profit after Tax "in Million"	No of Employees	Earning Per Employee "in Million"
2008/09	EBL	638.7	534	1.20
	HBL	635.9	591	1.08
2009/10	EBL	831.8	568	1.46
	HBL	508.8	577	0.88
2010/11	EBL	931.3	583	1.60
	HBL	893.1	647	1.38
2011/12	EBL	1090.6	625	1.74
	HBL	958.6	793	1.21
2012/13	EBL	1471.1	643	2.29
	HBL	943.7	830	1.20
Average	EBL	992.7	590.6	1.66
	HBL	788.02	687.6	1.15

Annual Report of EBL and HBL

Figure 4.17 is a bar diagram which represents the above tabulated numerical data which helps to compare the Earning per Employee among these banks.

Figure 4.17

Earning per Employee



As shown in the above table 4.9 and Figure 4.17 Earning per Employee of EBL of Rs. 1.2 million is the highest and HBL of Rs. 1.8 million is the lowest in FY 2008/09; EBL of Rs. 1.46 million is the highest and HBL of Rs. 0.88 million is the lowest in FY 2009/10; EBL of Rs. 1.60 million is the highest and HBL of Rs. 1.38 million is the lowest in FY 2010/11; EBL of Rs. 1.74 million is the highest and Rs. 1.21 million of HBL is the lowest in FY 2011/12

and EBL of Rs. 2.29 million is the highest and HBL of Rs. 1.20 million is the lowest in the FY 2012/13 among these two banks. The earning per employee of EBL of 1.66 million is higher than HBL of 1.15 million. This shows EBL has more staff than HBL. Furthermore Figure 4.18 helps to find out the trend of these banks regarding Earning per Employee over the last five year's period.

Figure 4.18

Trend Analysis of Earning Per Employee

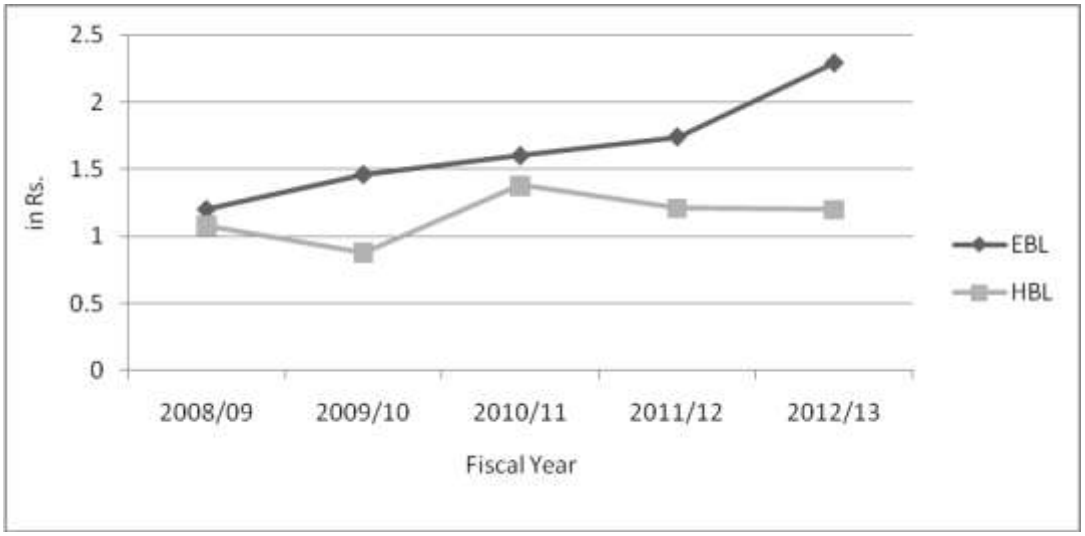


Figure 4.18 is the trend analysis of these banks over the five year's study period. As shown in the figure, Earning per Employee of EBL started from Rs. 1.20 million in FY 2008/09, and thereafter it is continuously increasing from FY 2009/10 till 2012/13 and reached to Rs. 2.29 million.

Likewise, Earning per Employee of HBL started with Rs. 1.08 million in FY 2008/09, decreasing in FY 2009/10 and increasing in 2010/11, it is again decreasing in FY 2011/12 and 2012/13 reaching to Rs. 1.20 million.

4.2.4 Earning

Earnings determine the ability of a bank to retain capital, absorb loan losses, support the future growth of assets, and provide a return to investors. The largest source of income for a bank is net interest revenue (interest income from lending activity less interest paid on deposits and debt). The second most important source is from investing activity. A substantial source of income also comes from foreign exchange and precious metal trading, and commissions/transaction fees and trust operations.

Earning capacity largely counts on the efficiency of management. The quality and trend of earnings of an institution depend largely on how well the management manages the assets and liabilities of the institution. An FI must earn reasonable profit to support asset growth, build up adequate reserves and enhance shareholders' value. Good earnings performance would inspire the confidence of depositors, investors, creditors, and the public at large. Chronically, loss making commercial banks reduces their capital base, risk the solvency and eventually bring down the wealth of their shareholders. Conversely, constantly profit making banks add equity to the total capital fund, reduce the risk of insolvency, and finally increase the wealth of their shareholders. Since, chronically unprofitable FI risks insolvency on one hand and on the others, unusually high profitability can reflect excessive risk taking of an FI, management and decision making body has to be conscious about it.

Earning capacity or profitability keeps up the sound health of an FI. So, earning capacity is one of the indicators of the sound health of a commercial bank. Though different indicators can be used to measure the profitability of banks, NRB uses return on total assets as an indicator of profitability of a commercial bank. In addition, it uses the absolute measures such as interest income, net interest income, noninterest income, net non-interest income, non-operating income, net non-operating income and net profit, to evaluate the profitability of a commercial bank (NRB 2005). Here we use the following tools to measures the earning

4.2.4.1 Return on Equity (ROE)

The return on equity indicates the relationship between net profits after taxes to total equity capital. Return on equity reveals how much profit a company earned in comparison to the total amount of shareholder equity found on the balance sheet. In other words, It measures a firm's efficiency at generating profits from every dollar of net assets (assets minus liabilities), and shows how well a company uses investment dollars to generate earnings growth. So, it measures the ability to augment capital internally (increase net worth), pay a dividend to the shareholders and also measures the return on the stockholder's investment. A business that has a high return on equity is more likely to be one that is capable of generating cash internally. ROE encompasses the three pillars of corporate management--profitability, asset management, and financial leverage. By seeing how well the executive team balances these components, investors can not only get an excellent sense of whether they will receive a

decent return on equity but can also assesses management's ability to get the job done. For the most part, the higher a company's return on equity compared to its industry, the better. For the purpose of the study following model is used to determine the return on equity ratio:

Return on Equity (ROE) = $\frac{\text{Net Income After Tax}}{\text{Share Holder}'\text{sFund}}$

Table 4.10 is the observed Return on Equity of these banks during the study period in numerical terms which is presented below:

Table 4.10

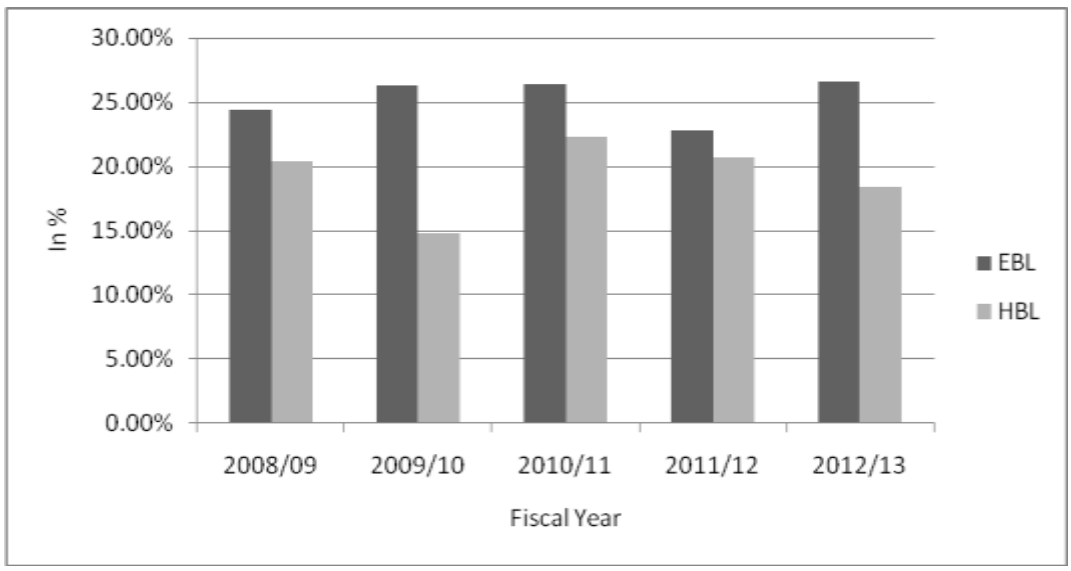
Return on Equity (ROE)

Fiscal Year	Banks	Net Profit after Tax "in Million"	Share Holder's Fund "in Million"	Return on Equity (ROE)
2008/09	EBL	638.7	2620	24.38%
	HBL	635.9	3119.8	20.38%
2009/10	EBL	831.8	3169.1	26.25%
	HBL	508.8	3439.2	14.79%
2010/11	EBL	931.3	3531.3	26.37%
	HBL	893.1	3995.5	22.35%
2011/12	EBL	1090.6	4774.6	22.84%
	HBL	958.6	4632.01	20.70%
2012/13	EBL	1471.1	5524.2	26.63%
	HBL	943.7	5123.2	18.42%
Average	EBL	992.7	3923.84	25.29%
	HBL	788.02	4061.94	19.33%

Figure 4.19 is a bar diagram which represents the above tabulated numerical data which helps to compare the Return on Equity among these two banks.

Figure 4.19

Return on Equity (ROE)



From the above table 4.10 and Figure 4.19, the Return on Equity of EBL of 24.38% is the highest and HBL of 20.38% is the lowest in FY 2008/09; EBL of 26.25% is the highest and HBL of 14.79% is the lowest in FY 2009/10; EBL of 26.37% is the highest and HBL of

22.35% is the lowest in FY 2010/11; EBL of 22.84% is the highest and 20.70% of HBL is the lowest in FY 2011/12 and EBL of 26.63% is the highest and HBL of 18.42% is the lowest in the FY 2012/13 among these two banks. The ROE is higher in EBL of 25.29% than HBL of 19.33% which indicates the good performance of shareholders in the company. Furthermore Figure 4.20 helps to find out the trend of these banks regarding Return on Equity over the last five year's period.

Figure 4.20

Trend Analysis of Return on Equity

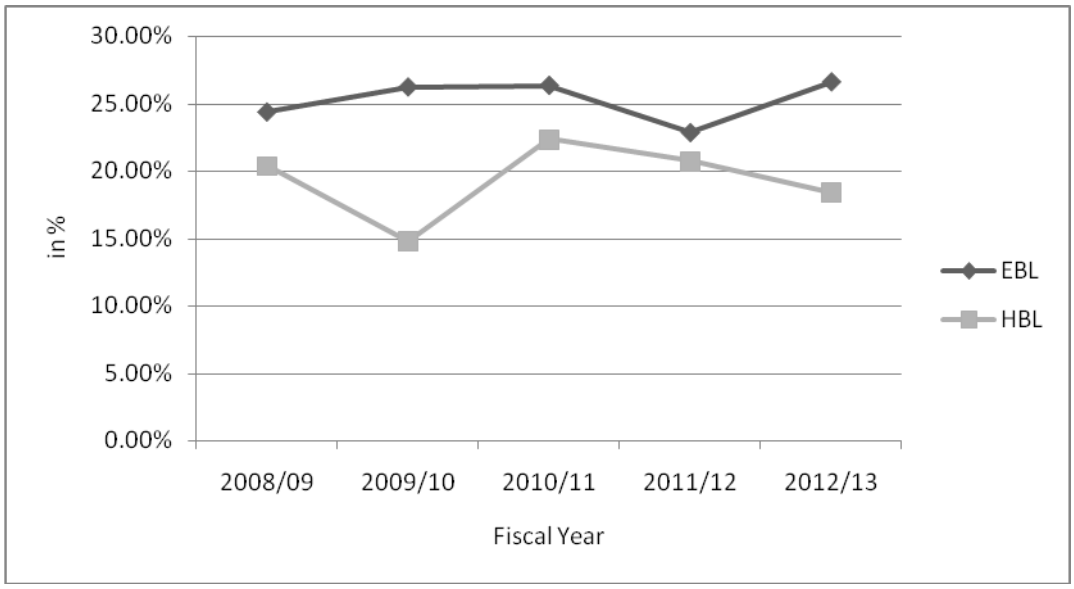


Figure 4.20 is the trend analysis of these banks over the five year's study period. As shown in the figure Return on Equity of EBL started from 24.38% in FY 2008/09, increasing in FY 2009/10 and 2010/11, it is decreasing in FY 2011/12 and thereafter is continuously increasing till 2012/13 and reached to 26.63%.

Similarly, Return on Equity of HBL started with 20.38% in FY 2008/09 and then it is decreasing in FY 2009/10 and again increasing in 2010/11, decreasing in FY 2011/12 and increasing again in FY 2012/13 and reached to 18.42%.

Overall trend line shows that return on equity of both banks are in increasing trend which is good for shareholders.

4.2.4.2 Return on Assets (ROA)

Return on assets is the numerical relationship between Net Income after taxes to total assets of a bank. It measures how the assets are utilized by indicating the profitability of the assets base or asset mix. ROA gives an idea as to how efficient management is at using its assets to generate earnings. The assets of the company are comprised of both debt and equity. Both of these types of financing are used to fund the operations of the company.

The ROA figure gives investors and potential investors an idea of how effectively the company is converting the money it has to invest into net income. A comparison of net income and average total assets, the ROA ratio reveals how much income has been able to squeeze from each dollar's worth of a company's assets. Higher the ROA, the better is the quality of assets and efficient asset utilization; because the company is earning more money on less investment. It is calculated by using the following model.

$$\text{Return on Assets (ROA)} = \frac{\text{Net Income After Tax}}{\text{Total Assets}}$$

Table 4.11 is the observed Return on Assets of these banks during the study period in numerical terms which is presented below:

Table 4.11

Return on Assets (ROA)

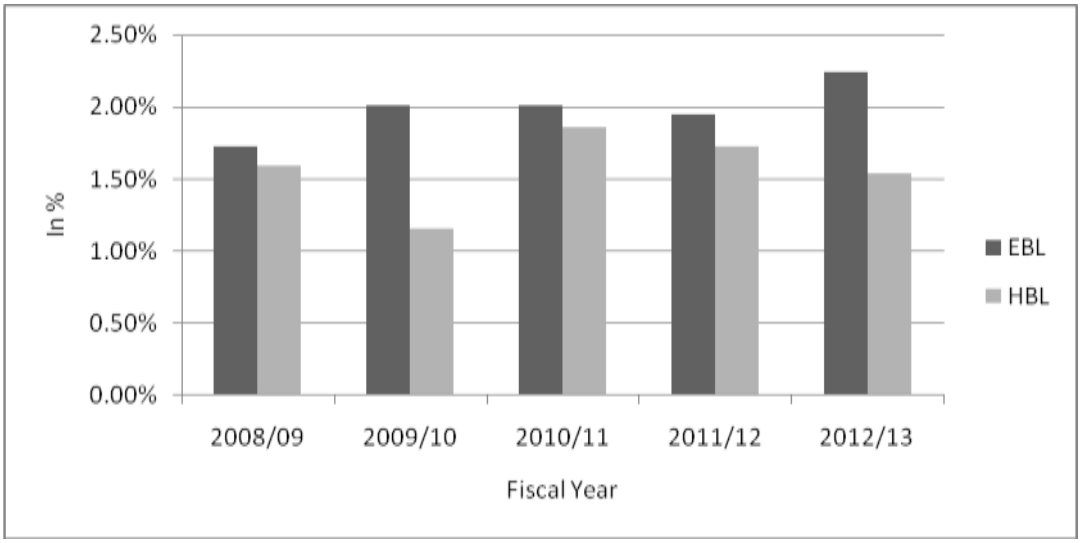
Fiscal Year	Banks	Net Profit after Tax "in Million"	Total Asset "in Million"	Return on Asset (ROA)
2008/09	EBL	638.7	36917	1.73%
	HBL	635.9	40046.7	1.59%
2009/10	EBL	831.8	41383	2.01%
	HBL	508.8	43860.2	1.16%
2010/11	EBL	931.3	46236	2.01%
	HBL	893.1	48137.3	1.86%
2011/12	EBL	1090.6	55813	1.95%
	HBL	958.6	55367.4	1.73%
2012/13	EBL	1471.1	65741	2.24%
	HBL	943.7	61152.9	1.54%
Average	EBL	992.7	49218	1.99%
	HBL	788.02	49712.9	1.58%

Source: Annual Report of EBL and HBL

Figure 4.21 is a bar diagram which represents the above tabulated numerical data which helps to compare the Return on Assets among these banks.

Figure: 4.21

Return on Assets (ROA)



The above table 4.11 and Figure 4.21 shows the Return on Assets of EBL of 1.73% is the highest and HBL of 1.59% is the lowest in FY 2008/09; EBL of 2.01% is the highest and HBL of 1.16% is the lowest in FY 2009/10; EBL of 2.01% is the highest and HBL of 1.86% is the lowest in FY 2010/11; EBL of 1.95% is the highest and 1.73% of HBL is the lowest in FY 2011/12 and EBL of 2.24% is the highest and HBL of 1.54% is the lowest in the FY 2012/13 among these two banks. In average, the ROA of EBL is 1.99% and HBL is 1.58%. This indicates the quality of assets and utilization of assets is better in EBL than that of HBL. Furthermore Figure 4.22 helps to find out the trend of these banks regarding Return on Assets over the last five year's period.

Figure: 4.22

Trend Analysis of Return on Assets

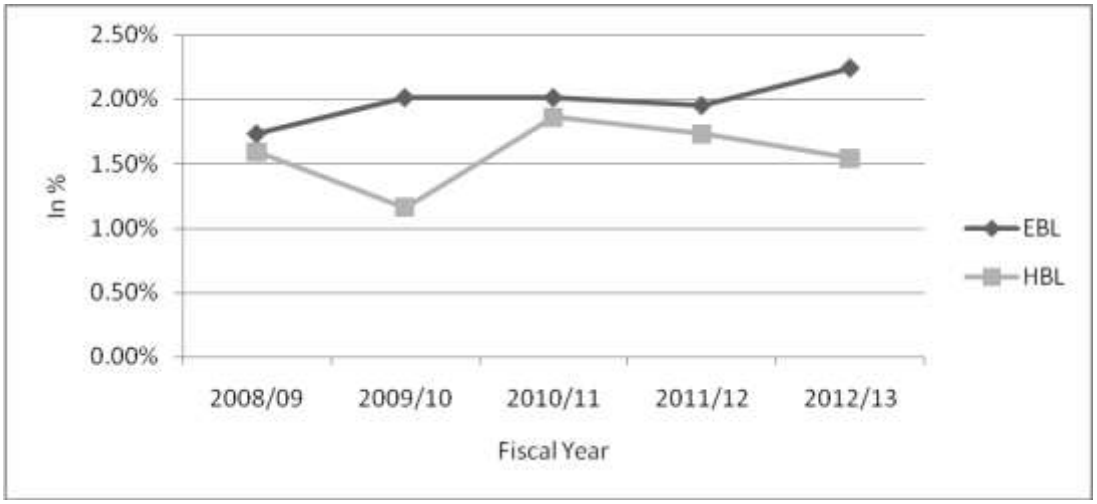


Figure 4.22 is the trend analysis of these two banks over the five year's study period. As shown in the figure Return on Assets of EBL started from 1.73 % in FY 2008/09, constantly increasing in FY 2009/10 and 2010/11, decreasing in FY 2011/12 and again increasing in FY 2012/13 and reached to 2.24%.

Similarly, Return on Assets of HBL started with 1.59% as it was the beginning period of operation of the bank in FY 2008/09, decreasing in FY 2009/10, again increasing in FY 2010/11 and thereafter decreasing in FY 2011/12 and 2012/13 and reached to 1.54%.

Overall comparing the initial period of study period at the end Return on Assets of both banks has increased.

4.2.4.3 Earning Per Share (EPS)

Earnings per share are generally considered to be the single most important variable in determining a share's price. It is the portion of a company's profit allocated to each outstanding share of common stock. An important aspect of EPS that's often ignored is the capital that is required to generate the earnings (net income) in the calculation. Two companies could generate the same EPS number, but one could do so with less equity (investment) - that company would be more efficient at using its capital to generate income and, all other things being equal would be a "better" company. Following is the expression of earning per share:

Earnings per Share (EPS) = $\frac{\text{Net Income after Tax}}{\text{No.of Share outstanding}}$

Table 4.12 is the observed Earning per Share of these banks during the study period in numerical terms which is presented below:

Table 4.12

Earnings per Share (EPS)

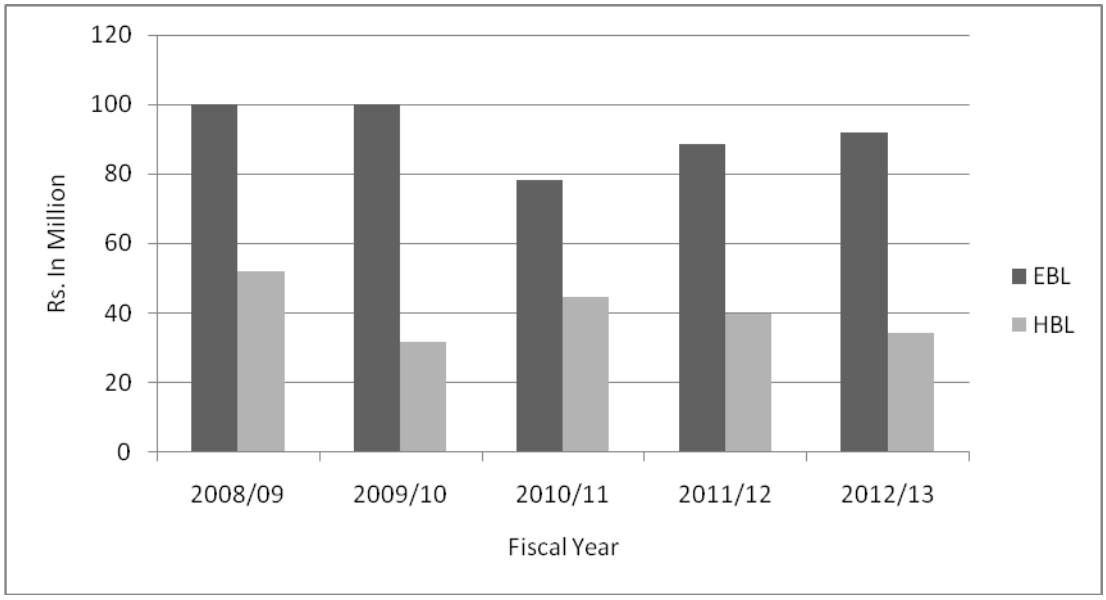
Fiscal Year	Banks	Net Profit after Tax "in Million"	No of shares outstanding	Earnings Per Share "in Million"
2008/09	EBL	638.7	6.39	99.99
	HBL	635.9	12.2	52.12
2009/10	EBL	831.8	8.3	100.22
	HBL	508.8	16	31.80
2010/11	EBL	931.3	11.9	78.26
	HBL	893.1	20	44.66
2011/12	EBL	1090.6	12.3	88.67
	HBL	958.6	24	39.94
2012/13	EBL	1471.1	16.01	91.89
	HBL	943.7	27.6	34.19
Average	EBL	992.7	10.98	91.81
	HBL	788.02	19.96	40.54

Source: Annual Report of EBL and HBL

Figure 4.23 is a bar diagram which represents the above tabulated numerical data which helps to compare the Earning per Share among these banks.

Figure: 4.23

Earnings per Share (EPS)



The above table 4.12 and Figure 4.23 illustrates the Earning per Share of EBL of Rs.99.99 million is the highest and HBL of Rs.52.12 million is the lowest in FY 2008/09; EBL of Rs.100.22 million is the highest and HBL of Rs. 31.80 million is the lowest in FY 2009/10; EBL of Rs.78.26 million is the highest and HBL of Rs. 44.66 million is the lowest in FY 2010/11; EBL of Rs. 88.67 million is the highest and Rs. 39.94 million of HBL is the lowest FY 2011/12 and EBL of Rs. 91.89 is the highest and SBL of Rs. 34.19 million is the lowest in the FY 2012/13 among these two banks. The EBL has higher earnings per share than that of HBL in average i.e. 91.81million of EBL and 40.50 million of HBL. Furthermore Figure 4.24 helps to find out the trend of these banks regarding Earning per Share over the last five year's period.

Figure: 4.24

Trend Analysis of Earning Per Share

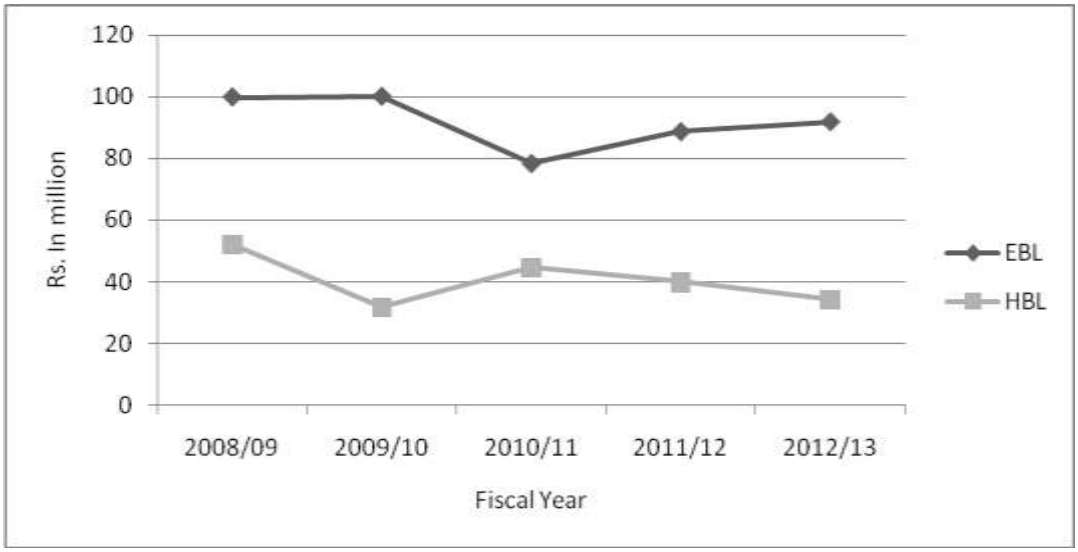


Figure 4.24 is the trend analysis of these banks over the five year's study period. As shown in the figure Earnings per Share of EBL started from Rs. 99.99 million in FY 2008/09, increasing in FY 2009/10 then after it is increasing continuously from FY 2010/11 till 2012/13 and reached to Rs.91.89 million at the end of FY 2012/13.

Similarly, Earning per Share of HBL started with Rs. 52.15 million in FY 2008/09, decreasing in FY 2009/10, increasing in FY 2010/11 and continuously decreasing in FY 2011/12 and 2012/13 and reached to Rs. 34.19 million.

4.2.4.4 Price Earning (P/E) Ratio

The P/E gives an idea of what the market is willing to pay for the company's earnings or an indication of how many times you are paying for a company's stock verse a company's earnings. The higher the P/E the more the market is willing to pay for the company's earnings. Some investors read a high P/E as an overpriced stock and that may be the case, however it can also indicate the market has high hopes for this stock's future and has bid up the price. It is simply a company's stock price divided by a company's earnings per share. P/E ratios can be used to compare against other companies, or against a company's own historical P/E ratio. It is believed by some that a company with a high (large) P/E ratio is expensive verse a company with a low P/E ratio, since with a high P/E ratio you are paying a larger multiple verses a company's earnings.

$$\text{Price Earning (P/E)} = \frac{\text{Market Price Per Share}}{\text{Earning Price Per Share}}$$

Table 4.13 is the observed Price Earnings Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.13

Price Earning (P/E) Ratio

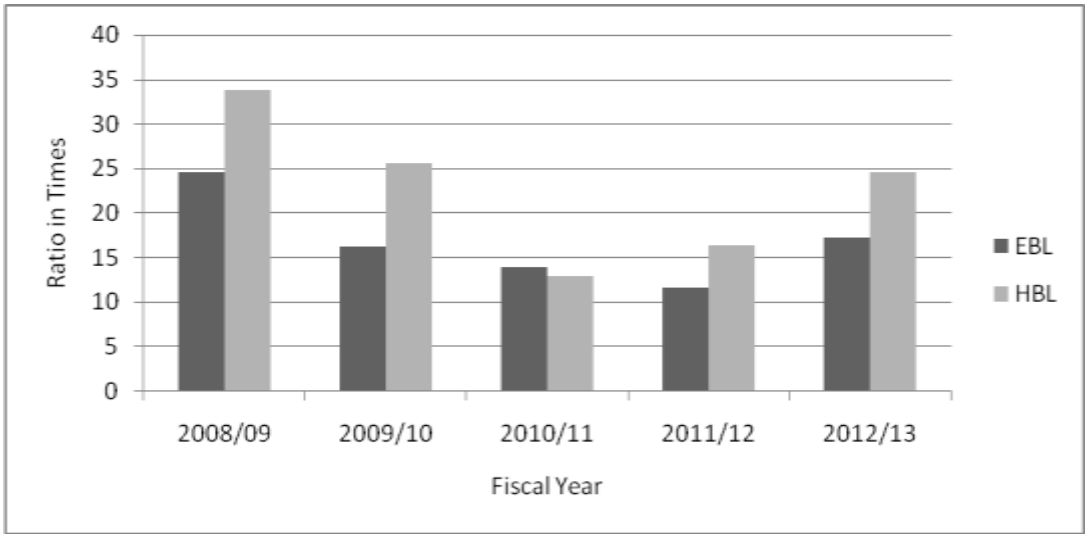
Fiscal Year	Banks	Market Price Per Share "in Million"	Earning Price Per Share "in Million"	P/E Ratio
2008/09	EBL	2455	99.99	24.55
	HBL	1760	52.12	33.77
2009/10	EBL	1630	100.22	16.26
	HBL	816	31.80	25.66
2010/11	EBL	1094	78.26	13.98
	HBL	575	44.66	12.88
2011/12	EBL	1033	88.67	11.65
	HBL	653	39.94	16.35
2012/13	EBL	1591	91.89	17.31
	HBL	700	34.19	24.55
Average	EBL	1560.6	91.81	16.75
	HBL	900.8	40.54	22.64

Source: Annual Report of EBL and HBL

Figure 4.25 is a bar diagram which represents the above tabulated numerical data which helps to compare the Price Earnings Ratio among these two banks.

Figure 4.25

Price Earnings Ratio



As shown in the above table 4.13 and Figure 4.25, Price Earnings Ratio of HBL of 33.77 times is the highest than that of EBL is 24.55 times in FY 2008/09. In the FY 2009/10 Price Earnings Ratio of HBL of 25.66 times is the highest than that of EBL is 16.26 times. In the FY 2010/11 EBL has highest Price Earnings Ratio of 13.98 times and lowest of HBL of 12.88 times. Similarly in the FY 2011/12, HBL has highest Price Earnings Ratio of 16.35 times and EBL has lowest of 11.65 times. Finally, in the FY 2012/13, HBL has highest price Earnings Ratio of 24.55 times and EBL has lowest of 17.31 times. The Price Earnings ratio of HBL of 22.64 times is higher than EBL of 16.75 times in average. Furthermore Figure 4.26 helps to find out the trend of these two banks regarding Price Earnings Ratio over the last five year's period.

Figure: 4.26

Trend Analysis of Price Earnings Ratio

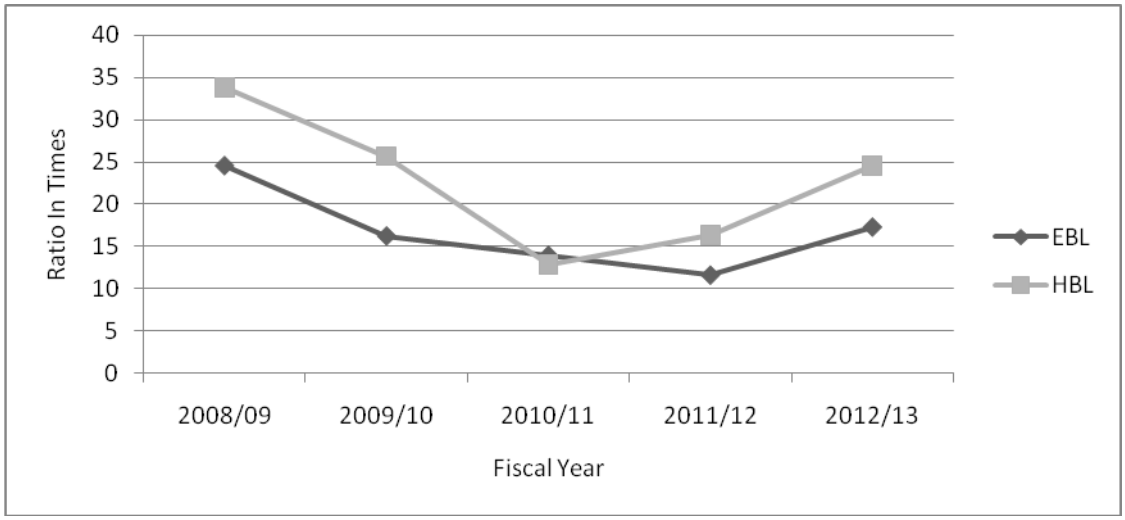


Figure 4.26 is the trend analysis of these two banks over the five year's study period. As shown in the figure Price Earnings Ratio of EBL started from 24.55 times in FY 2008/09, continuously decreasing in FY 2009/10 till 2011/12 and increasing in FY 2012/13 and reached to 17.31 times.

Likewise, Price Earnings Ratio of HBL started with 33.77 times in FY 2008/09, decreasing in FY 2009/10 and 2010/11 and continuously increasing till FY 2012/13 and reached to 24.55 times.

Overall the Price Earnings Ratio of both banks is decreasing during the study period but in average the ratio is higher in HBL than EBL.

4.2.4.5 Net Interest Margin

Net interest margin is net interest income expressed as a percentage of average earning assets. So it is the expression of numerical relationship between net interest income and total earning assets of a bank. It measures how large a spread between interest revenues and interest costs management has been able to achieve by close control over the bank's earning assets and the pursuit of the cheapest sources of funding (Rose, 1999). The lower the net interest margin, approximately 3.0% or lower, generally it is reflective of a bank with a large volume of non-earning or low-yielding assets. For the purpose of the study following model is used to determine net interest margin:

$$\text{Net Interest Margin} = \frac{\text{Net Interest Income}}{\text{Total Earning Assets}}$$

Where,

Net interest income = Interest Income – Interest Expenses

Total Earning assets = Total Interest bearing Assets

= Money at Call and Short Notice + Investment + Loans, Advances and Bills Purchase

Table 4.14 is the observed Net Interest Margin of these banks during the study period in numerical terms which is presented below:

Table 4.14

Net interest Margin

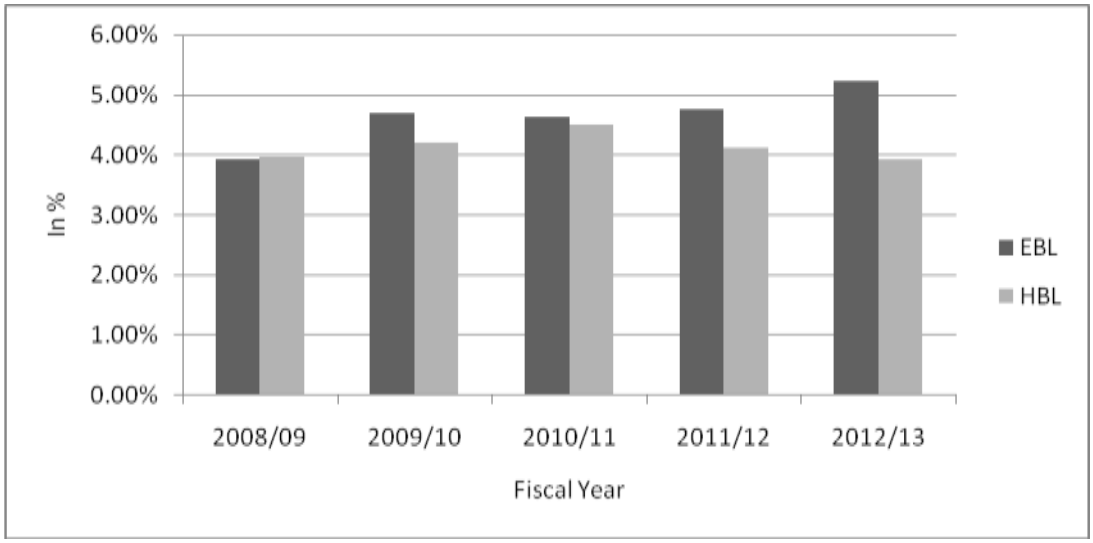
Fiscal Year	Banks	Net Interest Income "in Million"	Total Earning Assets "in Million"	Net Interest Margin
2008/09	EBL	1173.9	29833.2	3.93%
	HBL	1407.4	35401	3.98%
2009/10	EBL	1529.7	32564.7	4.70%
	HBL	1595.1	37877.5	4.21%
2010/11	EBL	1795.2	38801.6	4.63%
	HBL	1911.3	42472.2	4.50%
2011/12	EBL	2086.7	43774.6	4.77%
	HBL	1908.4	46264.7	4.12%
2012/13	EBL	2757.7	52657.1	5.24%
	HBL	2508.3	54777.7	3.93%
Average	EBL	1868.65	39526.24	4.65%
	HBL	1866.1	43358.62	4.15%

Source: Annual Report of EBL and HBL

Figure 4.27 is a bar diagram which represents the above tabulated numerical data which helps to compare the Net Interest Margin among these two banks.

Figure: 4.27

Net Interest Margin



From the above table 4.14 and Figure 4.27, Net Interest Margin of HBL of 3.98% is the highest and EBL of 3.93% is the lowest in FY 2008/09; EBL of 4.70% is the highest and HBL of 4.21% is the lowest in FY 2009/10; EBL of 4.63% is the highest and HBL of 4.50% is the lowest in FY 2010/11; EBL of 4.77% is the highest and 4.12% of HBL is the lowest in FY 2011/12 and EBL of 5.24% is the highest and HBL of 3.93% is the lowest in the FY 2012/13 among these two banks. In average, Net Interest margin of EBL of 4.65% and HBL of 4.15% are slightly similar. Furthermore Figure 4.28 helps to find out the trend of these banks regarding Net Interest Margin over the last five year's period.

Figure 4.28

Trend Analysis of Net Interest Margin

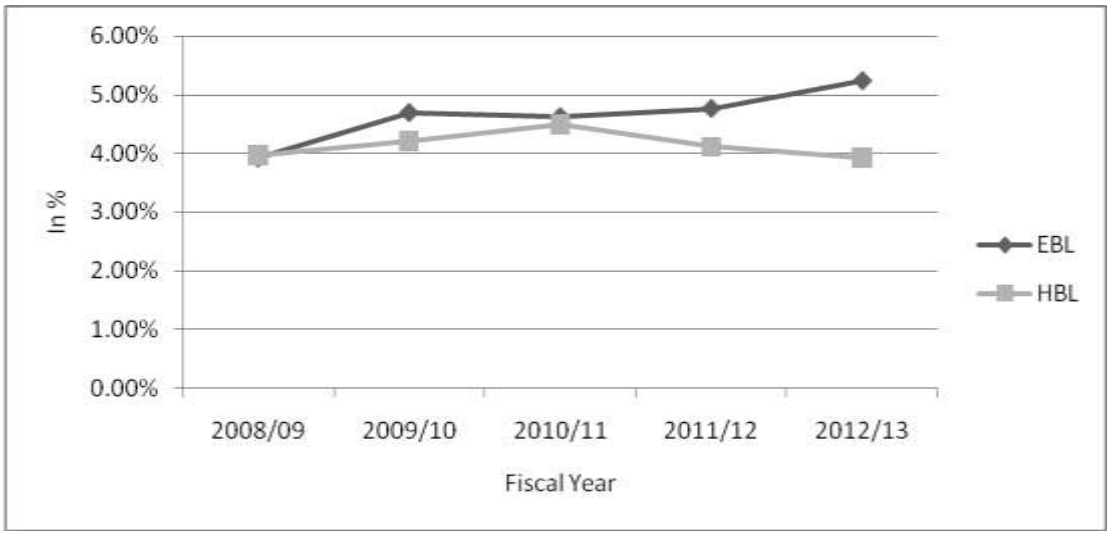


Figure 4.28 is the trend analysis of these banks over the five year's study period. As shown in the figure Net Interest Margin of EBL started from 3.93% in FY 2008/09, increasing in FY 2009/10 and decreasing in 2010/11, thereafter it is increasing in FY 2011/12 and 2012/13 and reached to 5.24% in FY 2012/13.

Likewise, Net Interest Margin of HBL started with 3.98% in FY 2008/09, increasing in FY 2009/10 and 2010/11, and then after it is decreasing continuously in FY 2011/12 and 2012/13 and it reached to 3.93%.

4.2.5 Liquidity

Liquidity refers to reserves of cash, securities, a bank's ability to convert an asset into cash, and unused bank lines of credit. Liquidity shows ability of institution to meet projected near term obligations. Liquidity must be sufficient to meet all maturing unsecured debt obligations due within a one-year time horizon without incremental access to the unsecured markets. An FI must always be liquid to meet depositors' and creditors' demand to maintain public confidence. There needs to be an effective asset and liability management system to minimize maturity mismatches between assets and liabilities and to optimize returns.

Liquidity risk threats the solvency of FIs. Much more liquidity surplus hurts the profitability of the commercial bank by reducing the return on assets. Similarly, liquid deficit also costs much to the commercial banks in term of the higher purchasing price of liquidity and hurt in the reputation of the banks. In the case of commercial banks, first type of liquidity risk arises when depositors of commercial banks seek to withdraw their money and the second type does when commitment holders want to exercise the commitments recorded off the balance sheet. Commercial banks have to borrow the additional funds or sell the assets at fire sale price to pay off the deposit liabilities. They become insolvent if sale price of the assets are not enough to meet the liability withdrawals.

The second type of liquidity risk arises when demand for unexpected loans cannot be met due to the lack of the funds. Commercial banks can raise the funds by running down their cash assets, borrowing additional funds in the money markets and selling off other assets at distressed price. Both liability side liquidity risk (first type risk) and asset side liquidity risk

(second type risk) affect the health of commercial banks adversely. But maintaining the high liquidity position to minimize such risks also adversely affects the profitability of FIs. Return on highly liquid assets is almost zero. Therefore, FIs should strike the tradeoff between liquidity position and profitability so that they could maintain their health sound. Commercial bank's liquidity exposure can be measured by analyzing the sources and uses of liquidity.

NRB uses total loan to total deposit ratio (LDR), cash and equivalents to total assets ratio (CETAR), cash and equivalents to total deposit ratio (CETDR), and cash balance with NRB to total deposit ratio (CBNRBR) to measure the liquidity position of commercial banks.

4.2.5.1 Cash Reserve Ratio (CRR)

It is the minimum amount of reserves a bank must hold in the form account balance with NRB. This ratio ensures minimum level of the bank's first line of defense in meeting depositor's obligations. It is the mandatory reserve that the commercial bank has to keep in the form of cash in their account in NRB for depositors' assurance and safety of bank which also reflects the bank's goodwill. As per the regulation made by NRB, Cash Reserve Ratio is to be maintained 5% on average of total deposits of bank on weekly basis. It is calculated as

$$\text{NRB Balance to Total Deposit Ratio} = \frac{\text{Local Currency Balance in NRB}}{\text{Total Local Currency Deposit} - \text{Margin Deposit}}$$

Since, we cannot find the daily deposit amount in annual report and also cannot access it, we cannot find cash reserve ratio and compare it as mandatory set by NRB of 5% on average of total deposit of bank on weekly basis. So, it will give false information or mislead to others if we calculate it on the figure that is given on year ending Balance Sheet.

4.2.5.2 Cash in Vault to Total Deposit Ratio

Cash in vault to total deposits ratio indicates the relationship between cash in vault to total deposits. It shows the percentage of total deposit maintained as vault. Cash at vault facilitates the commercial banks to meet their daily operational activities and solve the immediate liquidity crisis or we can say that this ratio measures the immediate obligation mainly cash withdraw by the depositors. Lower ratio indicates that the company might face a liquidity crunch while paying its obligation; where as a very high ratio indicates that the company has

been keeping its idle fund and not deploying them properly. It is worked out by using the following model:

$$\text{Cash in Vault to Total Deposit Ratio} = \frac{\text{Cash in Vault}}{\text{Total Deposits}}$$

Where,

Cash in vault = Local Currency in Hand + Foreign Currency in Hand

Total Deposit = Total Deposit of Non Interest Bearing Accounts + Total Deposits of interest Bearing Accounts (Local Currency +Foreign Currency)

Table 4.15 is the observed Cash in Vault to Total Deposit Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.15

Cash in Vault to Total Deposit Ratio

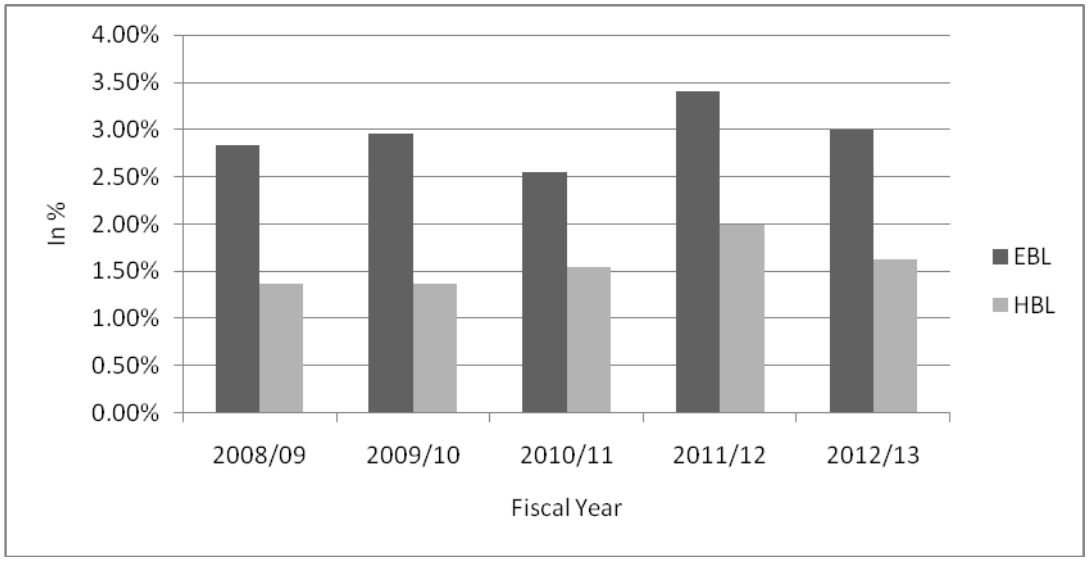
Fiscal Year	Banks	Cash in Vault "in Million"	Total Deposit "in Million"	Cash in Vault to Total Deposit Ratio
2008/09	EBL	944.7	33322.9	2.83%
	HBL	473.8	34682.3	1.37%
2009/10	EBL	1091.5	36932.3	2.96%
	HBL	514.2	37611.2	1.37%
2010/11	EBL	1048.99	41127.9	2.55%
	HBL	632.1	40920.6	1.54%
2011/12	EBL	1700.99	50006.1	3.40%
	HBL	951.3	47730.9	1.99%
2012/13	EBL	1723.2	57720.5	2.99%
	HBL	865.1	53072.3	1.63%
Average	EBL	1301.88	43821.94	2.95%
	HBL	687.3	42803.46	1.58%

Source: Annual Report of EBL and HBL

Figure 4.29 is a bar diagram which represents the above tabulated numerical data which helps to compare the Cash in Vault to Total Deposit Ratio among these banks.

Figure 4.29

Cash in Vault to Total Deposit Ratio



The above table 4.15 and Figure 4.29 shows Cash in Vault to Total Deposit Ratio of EBL of 2.83% is the highest and HBL of 1.37% is the lowest in FY 2008/09; EBL of 2.96% is the highest and HBL of 1.37% is the lowest in FY 2009/10; EBL of 2.55% is the highest and HBL of 1.54% is the lowest in FY 2010/11; EBL of 3.40% is the highest and 1.99% of HBL is the lowest in FY 2011/12 and EBL of 2.99% is the highest and HBL of 1.63% is the lowest in the FY 2012/13 among these two banks. The average of EBL of 2.95% is highest than HBL of 1.58%. This indicates that EBL has been keeping its idle fund and not deploying them properly. Furthermore Figure 4.30 helps to find out the trend of these banks regarding Cash in Vault to Total Deposit Ratio over the last five year's period.

Figure 4.30

Trend Analysis of Cash in Vault to Total Deposit Ratio

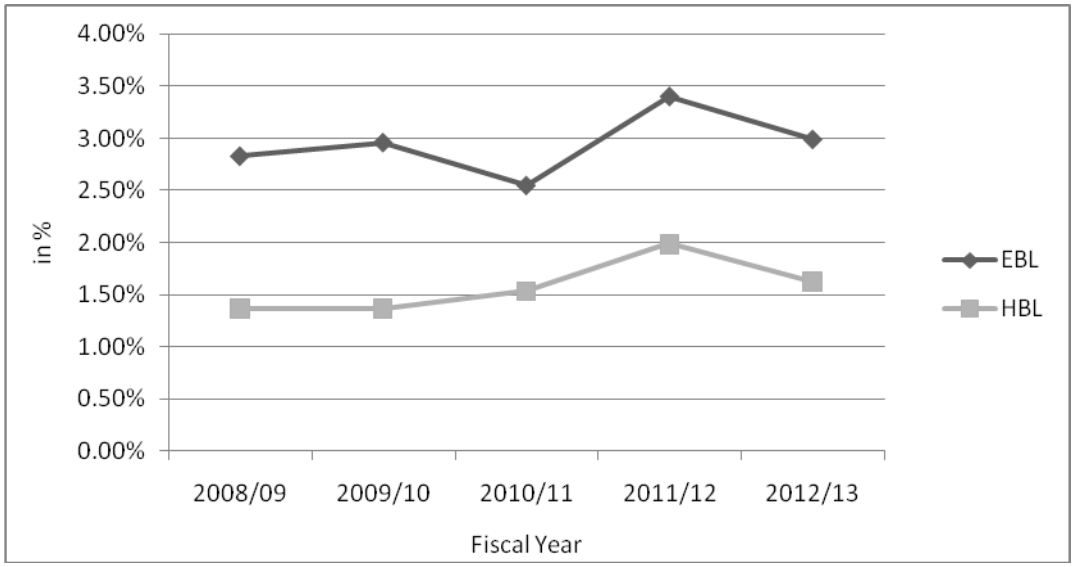


Figure 4.30 is the trend analysis of these banks over the five year's study period. As shown in the figure, Cash in Vault to Total Deposit Ratio of EBL started from 2.83% in FY 2008/09, increasing in FY 2009/10, decreasing in FY 2009/10 and thereafter decreasing in FY 2010/11 till 2012/13 and reached to 2.99% in FY 2006/07.

Similarly, Cash in Vault to Total Deposit Ratio of HBL started with 1.37%, constant in FY 2009/10 and increasing thereafter from 2010/11 to 2011/12 and again decreasing in FY 2012/13 and reached to 1.63% in FY 2012/13.

4.2.5.3 Cash & Bank Balance to Total Deposit Ratio

This ratio tests cash balance kept in the bank required to meet depositors day to day withdraw. Banks earning is result of floating or investing depositors money but also necessary to maintain adequate cash balance to meet daily operation as well. This need to strike out a balance and not tying up of fund more than need that will adversely affect bank's profitability. It is calculated as:

$$\text{Cash and Bank Balance Ratio} = \frac{\text{Total Cash and Bank Balance}}{\text{Total Deposits}}$$

Where,

Total Cash & Bank Balance = Cash Balance + Balance with NRB + Balance with Bank/Financial Institution (Local Currency +Foreign Currency)

Total Deposit = Total Deposit of Non Interest Bearing Accounts + Total Deposits of interest Bearing Accounts (Local Currency +Foreign Currency)

Table 4.16 is the observed Cash and Bank Balance to Total Deposit Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.16

Cash and Bank Balance to Total Deposit Ratio

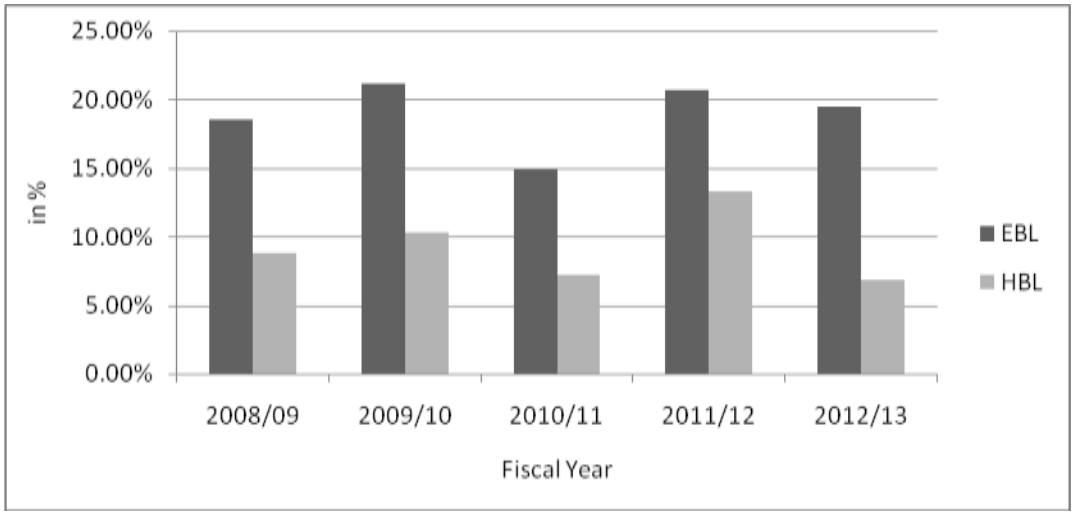
Fiscal Year	Banks	Cash & Bank Balance "in Million"	Total Deposit "in Million"	Cash & Bank Balance to Total Deposit Ratio
2008/09	EBL	6164.4	33322.9	18.50%
	HBL	3048.5	34682.3	8.79%
2009/10	EBL	7818.8	36932.3	21.17%
	HBL	3866.5	37611.2	10.28%
2010/11	EBL	6122.8	41127.9	14.89%
	HBL	2964.7	40920.6	7.25%
2011/12	EBL	10363.3	50006.1	20.72%
	HBL	6362.3	47730.9	13.33%
2012/13	EBL	11215.7	57720.5	19.43%
	HBL	3648.2	53072.3	6.87%
Average	EBL	8337	43821.94	18.94%
	HBL	3978.04	42803.46	9.30%

Source: Annual Report of EBL and HBL

Figure 4.31 is a bar diagram which represents the above tabulated numerical data which helps to compare the Cash and Bank Balance to Total Deposit Ratio among these banks.

Figure 4.31

Cash and Bank Balance to Total Deposit Ratio



As shown in the above table 4.16 and Figure 4.31 Cash and Bank Balance to Total Deposit Ratio of EBL of 18.50% is the highest and HBL of 8.79% is the lowest in FY 2008/09, EBL of 21.17% is the highest and HBL of 10.28% is the lowest in FY 2009/10; EBL of 14.89% is the highest and HBL of 7.25% is the lowest in FY 2010/11; EBL of 20.72% is the highest and HBL of 13.33% is the lowest in FY 2011/12 and EBL of 19.43% is the highest and 6.87% of HBL is the lowest in FY 2012/13 among these banks. In average the cash and bank balance to deposit ratio is higher in EBL of 18.94% than HBL of 9.30%. Furthermore Figure 4.32 helps to find out the trend of these banks regarding Cash and Bank Balance to Total Deposit Ratio over the last five year's period.

Figure 4.32

Trend Analysis of Cash and Bank Balance Ratio

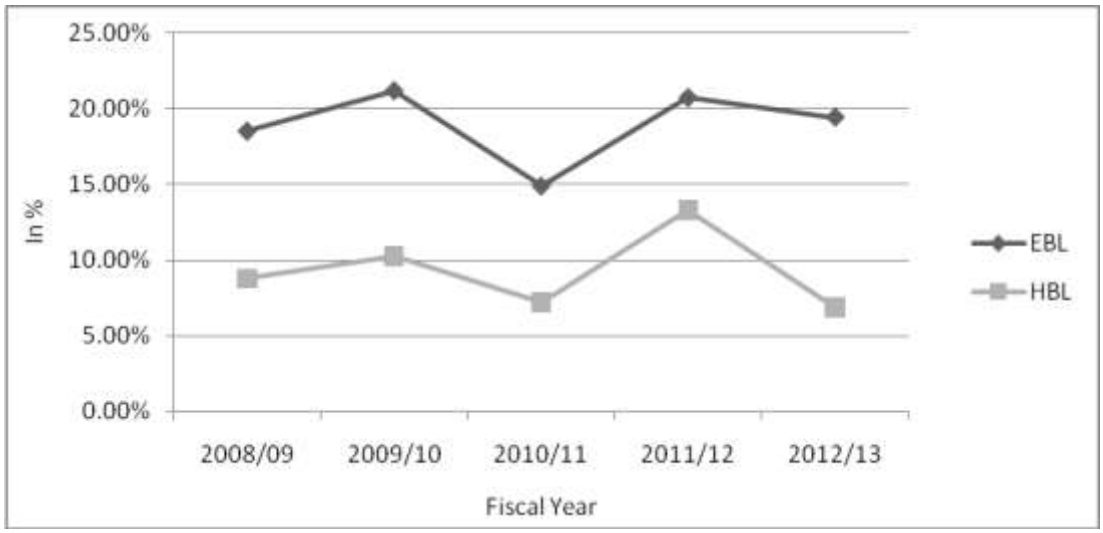


Figure 4.32 is the trend analysis of these banks over the five year's study period. As shown in the figure, Cash and Bank Balance to Total Deposit Ratio of EBL started from 18.50% in FY 2008/09, increasing in FY 2009/10, and again decreasing in FY 2010/1, it is again increasing in FY 2011/12 and thereafter decreasing in FY 2012/13 and reached to 19.43% by the end of FY 2012/13.

Similarly, Cash and Bank Balance to Total Deposit Ratio of HBL started with 8.79% in FY 2008/09, increasing in FY 2009/10, decreasing in FY 2010/11 and again increasing in FY 2011/12, thereafter it is decreasing and reached to 6.87% in FY 2012/13.

4.2.5.4 Investment in Government Security to Total Deposit Ratio

Government security refers to the securities issued by the government or through NRB. It can be in the form of treasury bills, government bond, NRB Bond etc. Government securities are least risky, highly liquid and moderately paying instruments and usually short term in nature. Although they generate a low return but in the need of liquidity they play a vital role to save the bank from solvency as they can be traded in the market easily at any time when the bank need fund immediately. It not only protect the banks from the solvency but also useful to absorb the excess liquidity of banks for the short periods. This ratio indicates how much portion of the fund is utilized in the least risky investment and calculated as:

$$\text{Investment in Gov. Security to Total Deposit} = \frac{\text{Investment in Goverment Security}}{\text{Total Deposits}}$$

Where,

Total Deposit = Total Deposit of Non Interest Bearing Accounts + Total Deposits of interest Bearing Accounts (Local Currency +Foreign Currency)

Table 4.17 is the observed Investment in Government Security to Total Deposit Ratio of these two banks during the study period in numerical terms which is presented below:

Table 4.17

Investment in Government Security to Total Deposit Ratio

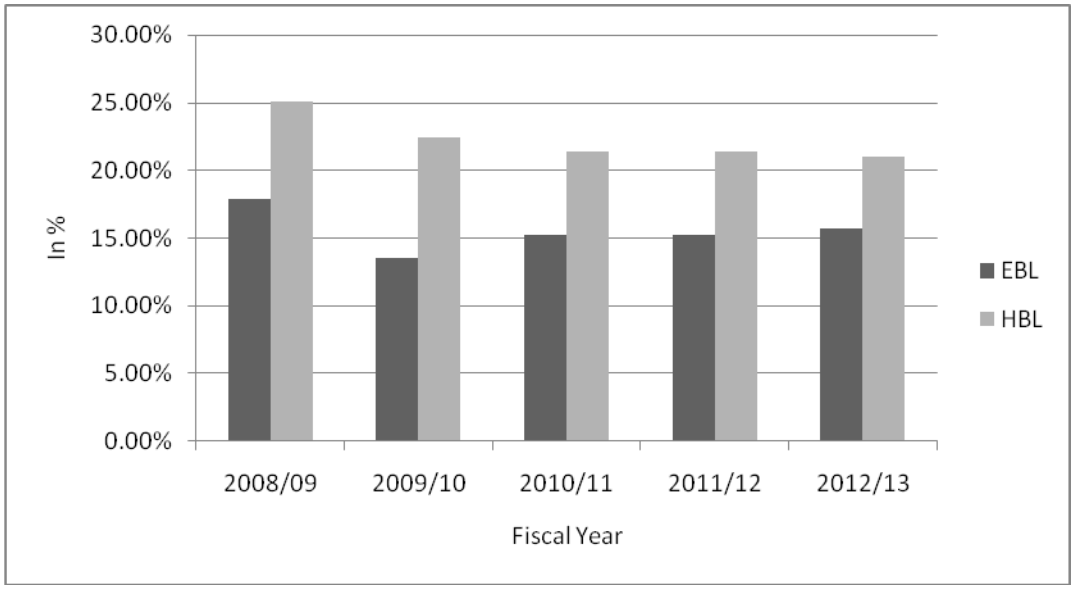
Fiscal Year	Banks	Investment in Govt. Security "in Million"	Total Deposit "in Million"	Investment in Govt. Security to Total Deposit Ratio
2008/09	EBL	5950.08	33322.9	17.86%
	HBL	8710.7	34682.3	25.12%
2009/10	EBL	5009.9	36932.3	13.57%
	HBL	8444.9	37611.2	22.45%
2010/11	EBL	6245.4	41127.9	15.19%
	HBL	8769.9	40920.6	21.43%
2011/12	EBL	7865.23	50006.1	15.19%
	HBL	10031.6	47730.9	21.43%
2012/13	EBL	9265.5	57720.5	15.73%
	HBL	12993.3	53072.3	21.02%
Average	EBL	6867.22	43821.94	15.51%
	HBL	9790.08	42803.46	22.29%

Source: Annual Report of EBL and HBL

Figure 4.33 is a bar diagram which represents the above tabulated numerical data which helps to compare the Investment in Government Security to Total Deposit Ratio among these banks.

Figure 4.33

Investment in Government Security to Total Deposit Ratio



As shown in the above table 4.17 and Figure 4.33 Investment in Government Security to Total Deposit Ratio of HBL of 25.12% is the highest and EBL of 17.86% is the lowest in FY 2008/09; HBL of 22.45% is the highest and EBL of 13.57% is the lowest in FY 2009/10; HBL of 21.43% is the highest and EBL of 15.19% is the lowest in FY 2010/11; HBL of 21.43% is the highest and 15.19% of EBL is the lowest in FY 2011/12 and HBL of 21.02% is the highest and EBL of 15.73% is the lowest in the FY 2012/13 among these two banks. HBL of 22.29% will not face liquidity than EBL of 15.51% due to high investment in government securities. Furthermore Figure 4.34 helps to find out the trend of these banks regarding Investment in Government Security to Total Deposit Ratio over the last five year's period.

Figure 4.34

Trend Analysis of Investment in Gov. Security to Total Deposit Ratio

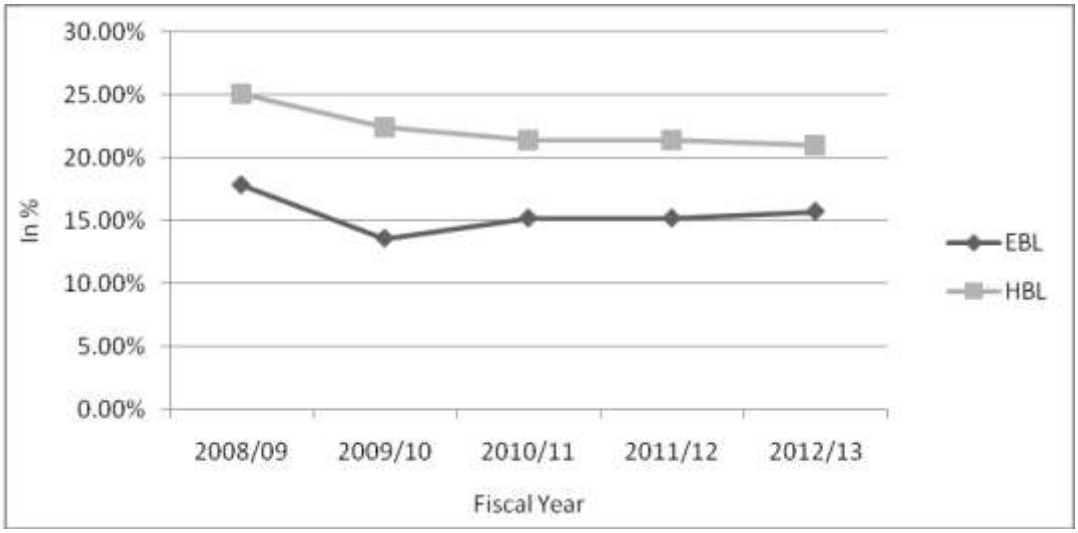


Figure 4.34 is the trend analysis of these banks over the five year's study period. As shown in the figure, Investment in Government Security to Total Deposit Ratio of EBL started from 17.86% in FY 2008/09, decreasing in FY 2009/10 and thereafter continuously increasing in FY 2011/12 till FY 2012/13 and it reached to 15.73% by the end of FY 2012/13.

Similarly, Investment in Government Security to Total Deposit Ratio of HBL started with 25.12% in FY 2008/09, decreasing in FY 2009/10, increasing thereafter in FY 2010/11 and 2011/12 and again decreasing in FY 2012/13 and it reached to 21.02% in FY 2012/13.

4.2.5.5 Liquid Assets to Total Deposit Ratio

Total liquid assets to total deposits ratio is a numerical relationship between total liquid assets and total deposits of a bank. The higher ratio implies better liquidity position. But when the bank keep much liquid asset to safe from liquidity risk, it impact in profitability because the return is low on liquid assets. Therefore bank has to maintain the balance between liquidity and profitability. It is calculated by using the following model:

$$\text{Total Liquid Asset to Total Deposit Ratio} = \frac{\text{Total Liquid Asset}}{\text{Total Deposit}}$$

Where,

Total Liquid assets = Cash in hand + NRB Balance + Domestic bank balance + Foreign currency bank balance + Money at call & short notice+ Investments in Government securities.

Total Deposit = Total Deposit of Non Interest Bearing Accounts + Total Deposits of interest Bearing Accounts (Local Currency +Foreign Currency)

Table 4.18 is the observed Liquid Assets to Total Deposit Ratio of these banks during the study period in numerical terms which is presented below:

Table 4.18

Liquid Assets to Total Deposit Ratio

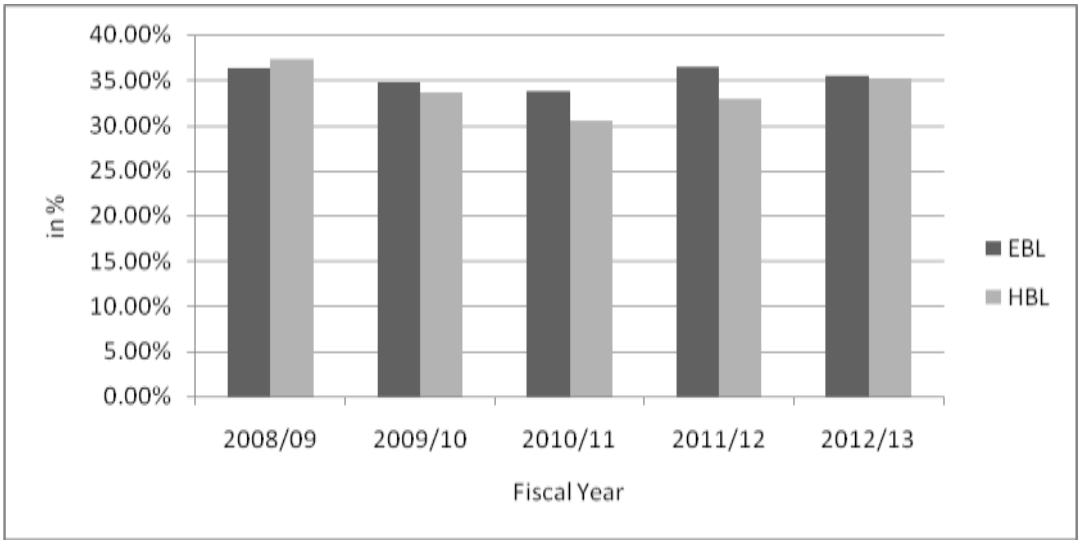
Fiscal Year	Banks	Liquid Asset "in Million"	Total Deposit "in Million"	Liquid Asset to Total Deposit Ratio
2008/09	EBL	12112.8	33322.9	36.35%
	HBL	12930.1	34682.3	37.28%
2009/10	EBL	12827.1	36932.3	34.73%
	HBL	12620.2	37611.2	33.55%
2010/11	EBL	13866.8	41127.9	33.72%
	HBL	12468.5	40920.6	30.47%
2011/12	EBL	18226.9	50006.1	36.45%
	HBL	15707.1	47730.9	32.91%
2012/13	EBL	20479.5	57720.5	35.48%
	HBL	18702.1	53072.3	35.24%
Average	EBL	15502.62	43821.94	35.35%
	HBL	14485.6	42803.46	33.89%

Source: Annual Report of EBL and HBL

Figure 4.35 is a bar diagram which represents the above tabulated numerical data which helps to compare the Liquid Assets to Total Deposit Ratio among these banks.

Figure 4.35

Liquid Assets to Total Deposit Ratio



As shown in the above table 4.18 and Figure 4.35 Liquid Assets to Total Deposit Ratio of HBL of 37.28% is the highest and EBL of 36.35% is the lowest in FY 2008/09; EBL of 34.73% is the highest and HBL of 33.55% is the lowest in FY 2009/10; EBL of 33.72% is the highest and HBL of 30.47% is the lowest in FY 2010/11; EBL of 36.45% is the highest and 32.91% of HBL is the lowest in FY 2011/12 and EBL of 35.48% is the highest and HBL of 35.24% is the lowest in the FY 2012/13 among these two banks. EBL of 35.35% has the highest liquidity position than HBL of 33.89%. Furthermore Figure 4.36 helps to find out the trend of these banks regarding Liquid Assets to Total Deposit Ratio over the last five year's period.

Figure 4.36

Liquid Assets to Total Deposit Ratio

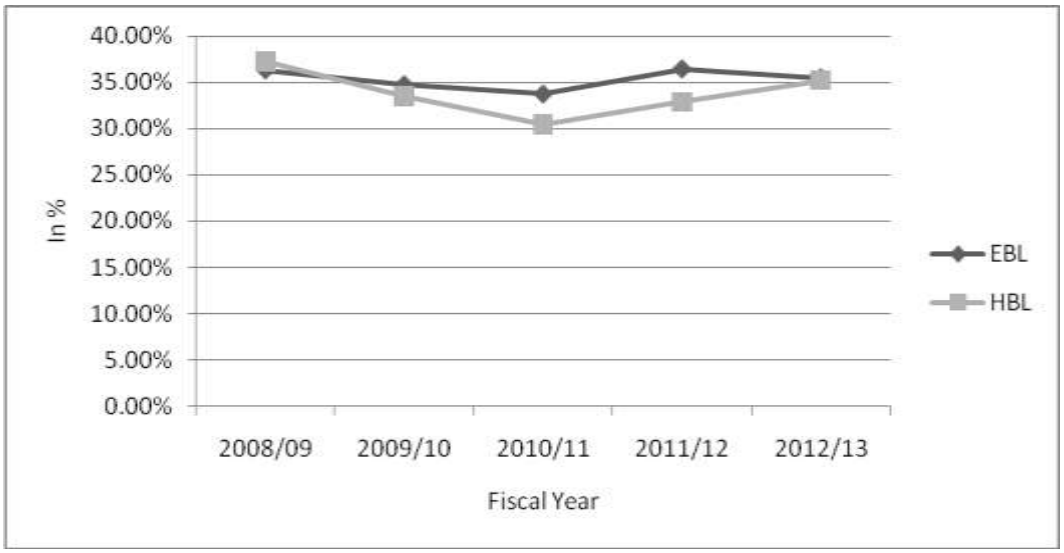


Figure 4.36 is the trend analysis of these banks over the five year's study period. As shown in the figure, Liquid Assets to Total Deposit Ratio of EBL started from 36.35% in FY 2008/09, decreasing in FY 2009/10 and in FY 2010/11, again increasing in FY 2011/12 and decreasing thereafter in FY 2012/13 and it reached to 35.24% by the end of FY 2012/13.

Likewise, Liquid Assets to Total Deposit Ratio of HBL started with 37.28% in FY 2008/09, decreasing in FY 2009/10 and 2010/11, and increasing thereafter in FY 2011/12 to 2012/13and it reached to 35.24% in FY 2012/13.

4.2.6 Sensitivity to Market Risks

These parameters refers to the risk conditions in the market such as exchange risk, interest rate risk etc., which could adversely affect earnings/or capital of the bank. Banking business is open to risks from movements in competitors prices, competitors cost of fund, foreign exchange rates and interest rates all of which need to be managed . Although Nepalese banking sector is exposed to interest rate risk and the exchange rate risk, interest rate is the focus of this study. It is primary risk in most of the commercial banks in Nepal.

This study is worked with duration gap model, which are simple method then other dollar gap and simulation analysis. Duration gap model simply measures the net quality of assets or liabilities re-pricing within a given period to estimate the likely impact changes in interest rates will have in earnings. According to NRB, duration gap analysis model adapted for minimization of liquidity risks shall also be adapted in respect of minimization of IRR. Banks shall classify the time interval of the assets and liabilities on the basis of maturity period of 0-90 days, 91-180 days, 181-270 days, 271-365 day, over the 365 days. For changing probability of estimate interest rate is normally one percent can be determined .The effect on the percent change in NII is calculated by multiplying the change in interest rate ^Ri in the i^{th} maturity bucket annualized with cumulative Gap.

If the interest rates rise on RSAs and RSAs, the positive CGAP (RSA>RSL) would project increase in the expected annual NII .However if interest rate fall when CGAP is positive, NII will fall. In General, when the CGAP or the GAP ratio is positive (RSA>RSL), the change in NII is positively related to the change in interest rates. Thus banks would want to keep CGAP positively when interest rates expected to rise. Conversely, when CGAP is negative the change in NII is negatively related to the change in interest rates. Thus banks are expected to keep CGAP negative when interest rates are expected to fall.

Gap analysis of RSAs and RSLs of sampled joint venture banks for the period FY 2008/09 to 2012/13 is made as shown in table 4.19 and 4.20 respectively EBL and HBL based on the different maturity time bucket.

In the case of EBL from 2008/09 to 2012/13, net financial assets (RSA-RSL) reprising in the short term maturity bucket ranging from 0-90days to 271-365 days was found positive. In the long-term maturity bucket (>365 days) the gap was negative in all the years .The CGAP ratio in the short term horizon was highest with 51.18% in FY 2008/09 & the lowest with 8.29%in FY 2012/13 .In long term horizon the highest CGAP ratio was 15.52%in FY 2008/09 and lowest within 10.59% in FY 2010/11. It indicates RSA and RSL in reprising in short term maturity bucket are highly sensitive to interest rate, even though it is in decreasing trend. In long term horizon is comparatively low sensitive to interest rate, when interest rate changes by 1% its impact on annual NII. In a rising interest environment the bank would profit over the 1 year time horizon as it has maintained CGAP >0 (Positive) and vice-versa.

Table 4.19

Sensitivity of Market Risk of EBL

		RSA(m)	RSL(m)	GAPi (RSA-RSL) m	CGAPi (RSA-RSL) m	RSA/RSL	CGAPiRatio (CGAP/ TotalR S Asm(%)	R%	NII(m)= CGAPXR	%change in NII
2008/09	Jan-90	3651.50	1183.50	2468.00	2468.00	3.09	39.10			
	91-180	516.60	822.10	-305.50	2162.50	0.63	34.26			
	180-270	310.40	254.0	56.40	2218.90	1.22	35.15			
	271-365	713.20	647.60	65.60	2284.50	1.10	36.19	1%	22.85	0.36%
	>365	1121.00	2641.20	-1520.20	764.30	0.42	12.11	1%	7.64	0.12%
	Total	6312.70	5548.40	764.30	764.30	1.14	12.11			
2009/10	Jan-90	3651.50	1183.50	2468.00	2468.00	3.09	39.10			
	91-180	516.60	822.10	-305.50	2162.50	0.63	34.26			
	180-270	310.40	254.0	56.40	2218.90	1.22	35.15			
	271-365	713.20	647.60	65.60	2284.50	1.10	36.19	1%	22.85	0.36
	>365	1121.00	2641.20	-1520.20	764.30	0.42	12.11	1%	7.64	0.12%
	Total	6312.70	5548.40	764.30	764.30	1.14	12.11			
2010/11	Jan-90	3651.50	1183.50	2468.00	2468.00	3.09	39.10			
	91-180	516.60	822.10	-305.50	2162.50	0.63	34.26			
	180-270	310.40	254.0	56.40	2218.90	1.22	35.15			
	271-365	713.20	647.60	65.60	2284.50	1.10	36.19	1%	22.85	0.36
	>365	1121.00	2641.20	-1520.20	764.30	0.42	12.11	1%	7.64	0.12%
	Total	6312.70	5548.40	764.30	764.30	1.14	12.11			
2011/12	Jan-90	3651.50	1183.50	2468.00	2468.00	3.09	39.10			
	91-180	516.60	822.10	-305.50	2162.50	0.63	34.26			
	180-270	310.40	254.0	56.40	2218.90	1.22	35.15			
	271-365	713.20	647.60	65.60	2284.50	1.10	36.19	1%	22.85	0.36
	>365	1121.00	2641.20	-1520.20	764.30	0.42	12.11	1%	7.64	0.12%
	Total	6312.70	5548.40	764.30	764.30	1.14	12.11			
2012/13	Jan-90	6816.20	5038.90	1777.30	1777.30	1.35	8.29			
	91-180	2344.00	410.60	1933.40	3710.70	5.71	17.31			
	181-270	1684.90	505.80	1179.10	4889.80	3.33	22.81			
	271-365	3381.70	1408.90	1972.80	6862.60	2.40	32.01	1%	68.63	0.32

	>365	7212.50	11122.10	-3909.60	5953.00	0.65	13.77	1%	29.53	0.14
	Total	21439.30	18486.30	2953.00	23193.40	1.16	-			

Source: Annual Report of EBL and HBL

In the case of HBL in FY 2008/09, net financial assets (RSA-RSL) reprising in the short term maturity bucket ranging from 0-90days to 271-365 days was shortfall by Rs 305.50 million reprised in 91-180 days time bucket in the long-term maturity bucket (>365 days). In FY 2009/10 is not available in data for the purpose of analysis of the sensitivity of Market risk. So the period from 2010/11 to 2011/12 is taken for review of the study. In this period net financial assets reprising in the short term maturity bucket was found positive except FY 2010/11 and FY 2012/13, which is shortfall by Rs 98 million reprising in 1-90 days time bucket and Rs 603.20m reprising in 181-270 days, Rs 4046.90 m reprising in 270-365 days respectively. In long term maturity bucket the gap was negative all years. The CGAP ratio or the interest rate sensitive to total earning assets of the short term horizon was highest worth 52.88% in FY 2009/10 and lowest within (0.36%) in FY 2010/11. In long term horizon the highest CGap ratio is 9.82% in 2010/11 and lowest within 0.0% in FY 2011/12 and FY 2012/13. In indicates the RSAs and RSLs reprising in short term maturity bucket and highly sensitive to interest rate comparative in the long term horizon.

Table 4.20

Sensitivity of Market Risk of HBL

Fiscal Year		RSA(m)	RSL(m)	GAPi (RSA-RSL)m	CGAPi (RSA-RSL)m	RSA/RSL	CGAPi Ratio (CGAP/Total RSA sm (%)	R(%)	NII(m)= CGAPXR	%change in NII
2008/09	Jan-90	3651.50	1183.50	2468.00	2468.00	3.09	39.10			
	91-180	516.60	822.10	-305.50	2162.50	0.63	34.26			
	180-270	310.40	254.0	56.40	2218.90	1.22	35.15			
	271-365	713.20	647.60	65.60	2284.50	1.10	36.19	1%	22.85	0.36%
	>365	1121.00	2641.20	-1520.20	764.30	0.42	12.11	1%	7.64	0.12%
	Total	6312.70	5548.40	764.30	764.30	1.14	12.11			
2009/10	Jan-90	5418.00	2715.00	2703.00	2703.00	1.10	11.05			
	91-180	5942.00	2917.00	3025.00	5728.00	2.04	23.42			
	181-270	3028.00	955.00	20736.00	7801.00	3.17	31.90			
	271-365	5553.00	470.00	5083.00	12884.00	11.81	52.68	1%	1128.84	0.53%
	>365	4515.00	15706.00	-11191.00	1693.00	0.29	6.92	1%	16.93	0.67%
	Total	24456.00	22763.00	1693.00	1693.00	1.07	6.92			
2010/11	Jan-90	6947.00	7045.00	-98.00	-98.00	0.99	-0.36			
	91-180	5972.00	2916.00	3056.00	2958.00	2.05	10.83			
	181-270	2199.00	916.00	1283.00	4241.00	2.40	15.53			
	271-365	7218.00	392.00	6826.00	11067.00	18.41	40.52	1%	110.67	0.41%
	>365	4974.00	13360.00	-8386.00	2681.00	0.37	9.82	1%	26.81	0.10%
	Total	27310.00	24629.00	2681.00	2681.00	1.11	9.82			
2011/12	Jan-90	10342.00	8076.00	2266.00	2266.00	1.28	7.69			
	91-180	6362.00	1294.00	5068.00	7334.00	4.92	24.90			
	181-270	3587.00	811.00	2776.00	10110.00	4.42	34.32			
	271-365	3494.00	852.00	2642.00	12752.00	4.10	43.29	1%	127.25	0.43%
	>365	5673.00	18425.00	-12752.00	-	0.31	0.00	1%	-	0.00%
	Total	**29458.00**	29458.00	-	-	1.00	0.00			
2012/13	Jan-90	12119.28	5486.81	6632.47	6632.47	2.21	19.33			
	91-180	7690.58	5843.49	1847.09	8479.56	1.32	24.71			
	181-270	3913.09	4516.29	-603.20	7876.36	0.87	22.95			
	271-365	3276.95	7323.85	-4046.90	3829.46	0.45	11.66	1%	38.29	0.11%
	>365	7314.97	11144.43	-3829.46	0.00	0.66	0.00	1%	0.00	0.00%
	Total	**34314.87**	**34314.87**	**0.00**	-	1.00	0.00			

Source: Annual Report of EBL and HBL

4.3 Major Findings

- Although Core Capital of these banks has increased over the study period, the Core Capital Ratio of all these banks are is in increasing trend. It is mainly due to higher percentage of the increment in the Total Risk Weight Assets. On the other hand, there is increment in supplementary capital as well as Supplementary Capital Adequacy Ratio due to the higher percentage increment in Supplementary Capital than Total Risk Weight Assets. So, while looking overall Capital Adequacy Ratio, it is in decreasing trend as Supplementary capital ratio provides only small contribution to Total Capital Adequacy Ratio. But, Core Capital Adequacy Ratio, supplementary Capital Adequacy Ratio and as well as Total Capital Adequacy Ratio of all banks are higher than that standard set by the Nepal Rastra Bank. So, all banks show the financial strength and soundness throughout the study period which indicates that the banks are applying adequate amount of internal sources of shareholder's funds with significant Core Capital Adequacy ratio throughout the study period.

- Total performing loan ratio is in increasing trend alone with the total loan and advances increases. It is due to the good loan and credit management. On the other hand, although the amount of Non- performing loan all EBL and HBL has increased the Non-performing loan ratio has decreased. The reason behind this is percentage increase of Non Performing loan is less than percentage increase in total loan and advances. In other hand we can say that banks are reducing their Sub Standard Loan, Doubtful Loan and Bad Loan by taking and implementing good credit policy. As on the one hand banks' total non-performing loan are increasing in decreasing rate on the other hand total loan and advances are increasing each year and provision on those loans are also increasing. This results in increment in loan loss provision ratio of these banks which is good for banks health. Last couple of years, loan loss provision ratio is in decreasing trend. the reason behind this is that total loan and advances are increasing each year, but on the other hand due to the decrement in non-performing loans compare to total loan and advances banks has to keep less provision on large part of its loans (i.e. for performing loan) which results the

decrement in Total loan loss provision ratio. So, there is no point for investors to worry for their safeguard.

- Although the net profit after taxes is increasing in both banks each year except HBL in FY 2012/13, the Total Expenses to total income ratio for the last couple of years of study period is in increasing trend, which is not the good sign of effective and efficient management. But later on both banks' total expenses to total income ratio is in decreasing trend. This is due to the high proportion of incensement in total expenses compare to total income. But the earning per employee of both banks is in increasing trend except for HBL in FY 2009/10. The reason for the decrement is the increment to total no of staffs of both banks and also decrement in Net profit after tax for HBL bank.

- ROE of all EBL is in increment trend in general whereas HBL is in decreasing trend in FY 2008/09 and both EBL and HBL are in increasing FY 2009/10 then after both EBL and HBL are decreasing in 2010/11 but EBL increased in 2012/13 whereas HBL constantly decreased. The reason for EBL and HBL for the decrement in ROE is the percentage change in NPAT is less than the percentage change in shareholders' fund compare to previous year, For HBL there is decrement in profit than previous year. Similarly ROA of both banks is in fluctuating but in general in increasing trend. ROA of EBL is increasing in FY 2009/10 till 2011/12; HBL is decreasing in FY 2009/10 and increasing in 2010/11. And it is continuously decreasing till FY 2012/13. The reason behind is as similar as to the ROE. But the earning per share of both banks is in increasing trend except HBL in 2012/13. The reason for this is that there is increment in no of shares in FY 2012/13 for HBL and also there is decrement in net profit after tax for HBL. Likewise, decrement in Market Price per Share in the beginning fiscal years of both banks, there is decrement in P/E ratio of both banks. Lastly, the un-even increment trend in net profit after tax and total earning assets of all banks the net interest margin ratio is also in fluctuating trend.
- All the liquidity ratio of banks is in very much fluctuating trend. This may be the reason of liquidity risk associated with it and NRB directions regarding the

liquidity and deposits. There is increment in total deposit as well as in cash at vault, cash and bank balance, investment in government in security and also in liquid assets. Although, all those variables are increased over the study period, but in un-even pattern, it caused to fluctuate in trend line of all the ratios. Among these two banks HBL has the highest liquidity ratio which is the safe from the liquidity side.

CHAPTER- V
SUMMARY, CONCLUSION AND RECOMMENDATIONS

Introduction

This chapter deals with three aspects of the study: summary, conclusion and recommendations. The first aspect summarizing the whole study, the second draw the conclusion based upon findings and the last one forwards the recommendation for the banks on their weak parts.

5.1 Summary

The study was conducted with the objective to analyze and compare the financial performances of Everest Bank Limited (EBL) and Himalayan Bank Limited (HBL) in the framework of CAMELS over the five year period from FY 2008/09 to 2012/13 following a descriptive and analytical research design prescribed by UFIRS and in accordance to BASEL accord. The study is based on secondary data. For the analysis of the study, annual reports and financial statement of EBL and HBL are used as the major sources of data out of 30 commercial banks. CAMELS are a common method for analyzing the health of individual institution, to quantify the performance and the financial condition of the firm. It was designed by regulatory authorities and this study scrutinizes the financial performance of EBL and HBL as regards to CAMELS i.e. Capital Adequacy, Asset Quality, Management Quality, Earning Quality and Liquidity. The analysis of financial statement are done to obtain a better insight into the bank's position and performance, Various financial and statistical tools have been used in this study to get the meaningful result and to meet the research objectives.

Various materials were reviewed in order to build up the conceptual foundation and reach to the clear destination of research. During the research the areas that formed part of the conceptual review were; historical development of financial system and evolution of commercial banks in Nepal, concept of commercial banks, function of commercial banks, approach to supervision, financial performance approaches, components of CAMELS, New Basel Capital Accord, NRB norms. Besides these,

review of journals articles and review of dissertations were carried out under research review.

The analysis has been made to compare the company's ratios with NRB and international standards. The Core Capital Adequacy Ratio above the NRB standard of EBL and HBL show the protection and security to creditors and depositors and financial soundness of the company. The supplementary capital adequacy ratios of these banks are as per NRB standard in all the years in the review period which leads to conclude that the banks are running with adequate capital. The higher observed capital adequacy ratios of EBL thorough the study period shows the higher internal sources and comparatively strong financial position and higher security to depositors that that of HBL.

The non performing loan ratio is below the international standards i.e. 5% of both banks. It reflects the good performance of the banks in mobilizing loan and advances. The lower NPL ratio of HBL shows the better proportion of performing loans and risk of default (credit) than that of EBL. The lower and average loan loss ratio of EBL in FY 2009/10 and 2010/11 during the operation of initial period of EBL shows the lower risky asset of EBL in the volume of loan and advances than that of HBL but while looking the trend overall average loan loss ratio of HBL shows the lower risky asset of HBL in the volume of loan and advances than that during the study period is constant and tend to be low than that of EBL.

The management quality proxy ratio, the lower average total expenses to total income ratio of EBL shows the better operation of the bank and better profitability than HBL. Another management quality proxy ratio, earning per employee of both banks are in increasing trend. The higher average of the earning per employee of EBL over last five years means the better management system and efficiency of staffs of EBL than that of HBL.

The return on equity of EBL is highest among these two banks and above the benchmark of 15% set by World Bank where as return on equity of HBL is nearly about the 15% in FY 2009/10 and others are above 15% in remaining fiscal years. But

in overall they are in increasing trend. On the other hand return on asset of all the these two banks are in increasing trend with fluctuation but at the end of the study period assets of the EBL seem to be used in better way to generate profit than other bank. Similarly, EPS of both banks are in increasing trend but EBL has much more highest EPS than another bank. Likewise P/E ratios of both banks are in increasing trend but at the end of study period HBL has highest P/E Ratio.Net interest Margin of both banks are volatile but EBL has the highest NIM at the end of FY 2012/13.

The higher Cash at vault to Total deposit ratio, Cash and Bank balance to Total Deposit ratio, Investment in Gov. Security to Total Deposit ratio and Liquid Asset to total Deposit Ratio of EBL shows that the liquidity position of EBL is stronger than HBL.

5.2 Conclusion

Based on the findings, following conclusion have been drawn from the study on Everest Bank Limited (EBL) and Himalayan Bank Limited (HBL) in the framework of CAMELS Analysis.

Although Core Capital Adequacy Ratio of both banks is in fluctuating but in decreasing trend through the study period, Core Capital Adequacy Ratio of both banks is above the NRB standard. It reveals that the bank have adequately maintained its internal sources or Core Capital in the past five year's period and have strictly followed the NRB rules and Regulations. The higher CCAR of EBL throughout the study period shows EBL's better protection and security to its creditors and depositors and higher financial strength than HBL. Similarly, Supplementary Capital Adequacy Ratio of both banks are also within the NRB norms during the review period which reveals that the banks are running with adequate capital through the study period and has strictly followed the NRB directives i.e. Supplementary Capital should not be more than Core Capital of the company. In case of Supplementary Capital Adequacy Ratio EBL has the highest ratio than HBL but overall Capital Adequacy Ratio of EBL is the highest than that of HBL which shows higher internal sources and comparatively strong financial position and higher security to depositors even in case of liquidation. In the point of view all EBL are financially sound and strong.

Although the Non Performing Loan Amount of both banks are increasing but in comparison to Total Loan and Advances it is getting lower and lower each year and below 5 percent of internal standard. So, this decreasing non performing loan ratio shows that banks are very much conscious and aware of non-performing loans and adopting appropriate policies to manage this problem and to increase good quality of assets. In this study HBL has the lowest Non performing loan ratio among all these two banks that indicates very conscious and better position regarding distribution of good loans. Similarly, loan loss provision is made on total loan and advances and total loan and advances of all these banks are increasing every year. But, loan loss provision ratio of both banks is decreasing in last couple of years although total loan and advances amount increases. So, it can therefore, concluded that banks has placed efficient credit management while distributing loans by which they are increasing volume of good loans and by taking appropriate recovery policy and efforts they are decreasing its non performing loan. Also increasing loan loss ratio (and above 100 percent) of both banks shows that in case of any loan becoming default out of non-performing loans bank can easily handle it and will be safe from the liquidation.

The higher average total expenses to total income ratio shows the better operation of the bank. But from the middle of the study period the trend line of total expenses to total income ratio increases. It is due to the increase in operating expenses and also increment in net interest income in decreasing trend. So, last couple of year total expenses to total income ratio of both banks are increasing which is not good for banks. On the other hand earning per employee of all banks is increasing which shows the sign of good management system, regarding human resources, even though the numbers of employees in both banks are increasing. Among these two banks EBL has the highest earning per employee. Similarly, efficiency ratio of both banks is in decreasing trend except EBL in year 2010/11. This indicates that productivity of all bank's are increasing in general as this decreasing efficiency ratio shows that for 1 dollar income it is spending less and less and saving more each year. From this efficiency ratio point of view EBL is in better position.

The increasing ROE of both banks shows the positive sign to their investors but only crossing above the bench mark of 15 percent EBL presents it as dominant. Similarly in case of ROA, the trend line is in increasing in general and it has crossed the bench mark of 1.5% set by the World Bank which is a bad signal for investors and shareholders. Earnings per Share and P/ E Ratio of all both banks are in increasing trend. Although the no of shares increased, due to the increment in Net profit after tax EPS of both banks has increased and EBL has highest among them. The Net interest Margin ratio of all both banks is in fluctuating trend and has met the bench mark of 3 to 4 percent as prescribed by the World Bank. But in general it seems that both banks have well managed its assets and liabilities.

The cash at vault to total deposit ratio of both banks are in fluctuating trend but EBL has the highest among these two banks. Similarly cash and bank balance to total deposit ratio of both banks are in also is in fluctuating trend and in this case also EBL has highest cash and bank balance ratio to total deposit ratio. Also investing huge amount in Government security, EBL presents itself as most secured from the liquidation risk among these two banks.

5.3 Recommendation

The following recommendations are made based on the conclusions as suggestion to overcome the weakness as regard to financial performance of Everest Bank Limited (EBL) and Himalayan Bank Limited (HBL).

The Core Capital Adequacy Ratio of both banks are as per NRB standard over the review period but are in decreasing trend which also results decrease in Total Capital Adequacy Ratio and if it continuous goes down, NRB may provide directions to maintain at the mark. So recommendation is provide and maintain stable (if possible increase) core capital adequacy ratio and open eye for future circumstances.
The assets quality ratio of both banks seems to be satisfactory level and being better each year. So, the recommendation is to maintain non performing loan ratio as lower as possible and try to give additional attention in recovering the doubtful and loss loan in future and try to increase its performing loan ratio near to 100 percent.

The total expenses to total income ratio of both banks seems to be decreasing till the middle of the study period and there after increases except EBL in FY 2010/11. So it is recommendation to the management of the banks to try to reduce the operating as well as non-operating expenses and by exploring new schemes and packages to its regular and non regular customers and try to increase its operating income which will cause to decrease in total expenses to total incomes ratio so that will increase bank's profitability.

The earning quality ratios of both banks like return on equity and return on assets are in increasing trend but are below the bench mark set by the World Bank except of EBL in return on Assets. So, both banks are recommended to increase its yield as its net profit to gain the trust of the equity holder and stakeholder as the most important measure for any firm is profitability and no firm grow and survive in ling run without profitability. To increase profit of the bank it is recommended that bank should minimized its operating cost by increasing the operating efficiency of its employeesm.

Liquid assets of the commercial banks play an important role to meet the day to day and short term obligation. If liquid assets of the banks are not maintained properly then there is a high probability of banks going to liquidation. The liquidity ratio of EBL seems to be satisfactory among these two banks but HBL should be careful and try to increase liquidity position by increasing total cash to total deposit, cash and bank balance to total deposit, investment in government security to total deposit and liquid assets to total deposit ratios.

Appendix-1

List of Licensed Commercial Banks

S.No.	**Commercial Banks**	**Established Date(A.D.)**	**Head Office**
1.	Nepal Bank Limited	1957	Kathmandu
2.	Rastriya Banijya Bank	1966	Kathmandu
3.	NABIL Bank Ltd.	1984	Kathmandu
4.	Nepal Investment Bank Ltd.	1986	Kathmandu
5.	Standard Chartered Bank Ltd.	1987	Kathmandu
6.	Himalayan Bank Ltd.	1993	Kathmandu
7.	Nepal SBI Bank Ltd.	1993	Kathmandu
8.	Nepal Bangladesh Bank Ltd.	1993	Kathmandu
9.	Everest Bank Ltd.	1994	Kathmandu
10.	Bank Of Kathmandu Ltd.	1995	Kathmandu
11.	Nepal Credit & Comm. Bank Ltd.	1996	Bhairawa
12.	Lumbini Bank Ltd.	1998	Narayangadh
13.	Nepal Ind. & Commercial Bank Ltd.	1998	Biratnagar
14.	Machhapuchre Bank Ltd.	2000	Pokhara
15.	Kumari Bank Ltd.	2001	Kathmandu
16.	Laxmi Bank Ltd.	2002	Birgunj
17.	Siddhartha Bank Ltd.	2002	Kathmandu
18.	Agricultural Dev. Bank Ltd.	1967	Kathmandu
19.	Grand Bank Nepal Ltd.	2008	Birgunj
20.	Citizens Bank International Ltd.	2007	Kathmandu
21.	Prime Commercial Bank Limited	2007	Kathmandu
22.	Sunrise Bank Limited	2009	Kathmandu
23.	NMB Bank Ltd.	2009	Kathmandu
24.	KIST Bank Ltd.	2009	Kathmandu
25.	Janata Bank Nepal Ltd.	2009	Kathmandu
26.	Megha Bank Ltd	2009	Kathmandu
27.	Civil Axis Bank Ltd.	2010	Kathmandu
28.	Century Commercial Bank Limited	2011	Kathmandu
29.	Sanima Bank Limited	2011	Kathmandu
30	Global IME and Commerz & Trust Bank Ltd.	2013	Kathmandu

Source: Annual Report 2013, NRB

Appendix-2

Capital Adequacy Ratio

Fiscal Year	Banks	Total Capital Fund "in Million"	Total Risk Adjusted Asset "in Million"	Capital Adequacy Ratio
2008/09	EBL	2703.8	25619.7	10.55%
	HBL	3845.2	34905.9	11.02%
2009/10	EBL	3257.1	30240.4	10.77%
	HBL	4218.4	39357.1	10.72%
2010/11	EBL	3605.8	34583.5	10.43%
	HBL	4711.2	44124.5	10.68%
2011/12	EBL	4574.7	41525.3	11.02%
	HBL	5283.9	47934.9	11.02%
2012/13	EBL	5777.6	49834.1	11.59%
	HBL	6414.4	55520.6	11.55%
Average	EBL	3983.8	36360.6	10.87%
	HBL	4894.62	44368.6	10.99%

Appendix-3

Tier I (Core) Capital Adequacy Ratio

Fiscal Year	Banks	Core Capital "in Million"	Total Risk Adjusted Asset "in Million"	Core Capital Ratio
2008/09	EBL	1981.6	25619.7	7.73%
	HBL	3074.4	34905.9	8.81%
2009/10	EBL	2537.09	30240.4	8.39%
	HBL	3414.6	39357.1	8.68%
2010/11	EBL	2927.2	34583.5	8.46%
	HBL	3916.9	44124.5	8.88%
2011/12	EBL	3990.9	41525.3	9.61%
	HBL	4600.2	47934.9	9.60%
2012/13	EBL	4639.8	49834.1	9.31%
	HBL	4972.2	55520.6	8.96%
Average	EBL	3215.32	36360.6	8.70%
	HBL	3995.66	44368.6	8.99%

Appendix-4

Tier II (Supplementary) Capital Adequacy Ratio

Fiscal Year	Banks	Supplementary Capital "in Million"	Total Risk Adjusted Asset "in Million"	Supplementary Capital Ratio
2008/09	EBL	722.3	25619.7	2.82%
	HBL	770.8	34905.9	2.21%
2009/10	EBL	720.05	30240.4	2.38%
	HBL	803.7	39357.1	2.04%
2010/11	EBL	678.7	34583.5	1.96%
	HBL	794.3	44124.5	1.80%
2011/12	EBL	583.8	41525.3	1.41%
	HBL	683.8	47934.9	1.43%
2012/13	EBL	1137.9	49834.1	2.28%
	HBL	1442.3	55520.6	2.60%
Average	EBL	768.55	36360.6	2.17%
	HBL	898.98	44368.6	2.02%

Appendix-5

Performing Loan Ratio

Fiscal Year	Banks	Total Performing Loan "in Million"	Total Loan & Advances "in Million"	Performing Loan Ratio
2008/09	EBL	24351.5	24469.6	98.58%
	HBL	24968.2	25179.6	99.16%
2009/10	EBL	28112.6	28156.4	99.84%
	HBL	28098.9	29123.5	96.48%
2010/11	EBL	31553.3	31661.8	99.66%
	HBL	31576.5	32968.3	95.78%
2011/12	EBL	36309.5	36618.8	99.16%
	HBL	35217.3	35968.5	97.91%
2012/13	EBL	43921.6	44197.7	99.38%
	HBL	39871.2	41057.4	97.93%
Average	EBL	32849.7	33020.86	99.32%
	HBL	31946.42	32859.46	97.45%

Appendix-6

Non Performing Loan Ratio

Fiscal Year	Banks	Total Non Performing Loan "in Million"	Total Loan & Advances "in Million"	Non Performing Loan Ratio
2008/09	EBL	117.9	24469.6	0.48%
	HBL	551.3	25179.6	2.19%
2009/10	EBL	43.7	28156.4	0.16%
	HBL	1024.8	29123.5	3.52%
2010/11	EBL	108.5	31661.8	0.34%
	HBL	1391.8	32968.3	4.22%
2011/12	EBL	307.5	36618.8	0.84%
	HBL	751.2	35968.5	2.09%
2012/13	EBL	276.2	44197.7	0.62%
	HBL	1186.2	41057.4	2.89%
Average	EBL	170.76	33020.86	0.49%
	HBL	981.06	32859.46	2.98%

Appendix-7

Loan Loss Coverage Ratio

Fiscal Year	Banks	Total Loan Loss Provision "in Million"	Total Non Performing Loan "in Million"	Loan Loss Coverage Ratio
2008/09	EBL	584.88	117.9	496.08%
	HBL	726.4	551.3	131.76%
2009/10	EBL	599.78	143.7	417.38%
	HBL	1143.1	1024.8	111.54%
2010/11	EBL	604.2	108.5	556.87%
	HBL	1401.3	1391.8	100.68%
2011/12	EBL	705.9	307.5	229.56%
	HBL	1003.04	751.2	133.53%
2012/13	EBL	804.6	276.2	291.31%
	HBL	1333.6	1186.2	112.43%
Average	EBL	659.87	190.76	398.24%
	HBL	1121.49	981.06	117.99%

Appendix-8

Total Expenses to Total Income Ratio

Fiscal Year	Banks	Total Expenses "in Million"	Total Income "in Million"	Total Expenses to Total Income Ratio
2008/09	EBL	1833.5	2557.8	71.68%
	HBL	1893.29	2922.83	64.78%
2009/10	EBL	2626.7	3500.7	75.03%
	HBL	3132.26	3711.49	84.39%
2010/11	EBL	3744.9	4228.8	88.56%
	HBL	3986.34	5001.55	79.70%
2011/12	EBL	3627.9	5483.07	66.17%
	HBL	4173.11	5727.65	72.86%
2012/13	EBL	3249.3	7796.5	41.68%
	HBL	3670.15	5643.03	65.04%
Average	EBL	3016.16	4713.37	68.62%
	HBL	3371.03	4601.31	73.35%

Appendix-9

Earning per Employee

Fiscal Year	Banks	Net Profit after Tax "in Million"	No of Employees	Earning Per Employee "in Million"
2008/09	EBL	638.7	534	1.20
	HBL	635.9	591	1.08
2009/10	EBL	831.8	568	1.46
	HBL	508.8	577	0.88
2010/11	EBL	931.3	583	1.60
	HBL	893.1	647	1.38
2011/12	EBL	1090.6	625	1.74
	HBL	958.6	793	1.21
2012/13	EBL	1471.1	643	2.29
	HBL	943.7	830	1.20
Average	EBL	992.7	590.6	1.66
	HBL	788.02	687.6	1.15

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