CHAPTER- I

INTRODUCTION

1.1 Background of the study

Capital formation is one of the important factors in economic development. The capital formation leads to increase in the size of national output, income and employment, solving the problem of inflation and balance of payment of making the economy free from the burden of foreign debts. Domestic capital formation helps in making a country self-sustainable. According to classical economists, of the main factors, which helped capital formation, was the accumulation of capital formation indeed plays a decisive role in determining the level and growth of national income, hence economic development.

Capital accumulation plays an important role in accelerating the economic growth of a nation, which is basically determined by saving and investment propensities. But the capacity to save in the developing countries like Nepal is quite low with a relatively higher marginal propensity of consumption. As a result, such countries are badly entrapped into the vicious of poverty. So, the basic problem for the developing countries is raising the level of saving and thus investment.

In order to collect the scattered meager saving and put those into productive channels, financial institution such as banks are a necessity. In the absence of such institution, the savings will not be safely and profitability utilized within the economy and will either be diverted abroad or used for unproductive consumption or speculative activities.

Bank plays a vital role in strengthening the economic structure of a country which in turn leads to the overall development of a country. In simple terms, banks are those financial intermediaries that accept deposits and grant loans. In other words,

banks are the institution which collect the scattered saving to put them into productive channels. Banks provide loan not only from deposited amount but also creates the money for loan. It is a resource mobilizing institution which accepts deposit from various sources and invest such accumulated resources in the field of agriculture, trade, commerce, industry, tourism etc. Banks are among the most important sources of short term working capital for businesses as well as long term business loans for new plant and equipments.

“Banking institutions are inevitable for the resource mobilization and all- round development of the country. It is resource for economic development; it maintains economic confidence of various segments and extends credit to people.”(Grywinshki, 1993:87)

“Ordinary banking business consists cash for bank deposits and bank deposits for cash: transferring bank deposits from one person or corporation to another: giving bank deposits in exchange for bills of exchange, government bonds, the secured promises of businessmen to repay and so forth.” (Sayers, 1986:120)

Modern banking system started in Nepal after the establishment of Nepal Bank Ltd. in 1938. Initially, it was given the authority and responsibility of central bank. However, the need for establishment of a central bank was felt with the change of time and economic scenario of the country. Hence, NRB was established of a central bank on April 26, 1956. The bank was empowered by act to have direct control over banking institution within the country. The objectives with which the central bank was set up is to ensure proper management of the issuance of Nepalese currency notes, stabilize the exchanges rates of Nepalese currency, mobilize capital for development and encouragement of trade and industry and to develop the banking system.

NRB has taken active part in setting the financial institution which in due course of time contributed a great deal in creating infrastructure for development in the field of trade, industry and agriculture. NRB has played a crucial role in the process of resource mobilization and its efficient allocation. In fact, as a catalyst for development, it has engaged itself in the development of financial infrastructure through participating in the establishment of various financial intermediaries for national development of the country. NRB has facilitated the mobilization of the small and scattered savings and their allocation to the productive channels through the development of financial institutions. The bank has also attempted to influence the flow of institutional credit away from traditional sources by providing incentives and leadership to financial institutions.

Now a days, two types of banking practices are seen namely; commercial banking and development banking also called Development Finance Institutions. The commercial banks usually make business in urban areas whereas development banks provide services in rural areas. Development finance institutions are established to provide financial services that are not usually delivered by the commercial banks. There were two development financial institutions in Nepal; one is Agriculture Development Bank, which has distinct agricultural emphasis while other, Nepal Industrial Development Corporation (NIDC) operates in the industrial sector. These specialized institutions provide financial assistance in the form of medium and long term loan, participation in equity capital, underwriting and other ancillary services. The operations of these institutions display in a sense the structure of the Nepali economy. They are often given assistance by Nepal Rastra Bank to expand their activities. The role played by development institution is to complement those of other major financial institutions in the country.

The NRB participated in setting up the Nepal Industrial Development Corporation (NIDC) as early as 1956 to function as the specialized financial institution

providing term credit for the industrial development. The bank used to provide overdraft facilities to a few selected industries. Likewise Agriculture development Bank was instituted in 1968 under the Agriculture Development Bank act 1967 by incorporating the assets and liabilities of the then cooperative Bank set up in 1963. The main function of the bank is to channel funds to the agricultural sector. The bank provides short, medium and long-term credit to individuals, cooperative societies and corporate bodies for agricultural development. Short-term loans are advanced to finance seasonal operates of inputs like seeds, fertilizer and labour services. Medium terms loans are extended for the purchase of farm machines, tools and machinery and implements for agro industries. Loans for livestock rising and warehousing loans are also made for the medium term. Projects of long gestation like tea cultivation are given long term finance.

Until 1996, only two development banks were in operation under their respective Acts, both being under the government ownership. Incorporation of development Bank Act 1996 was the landmark in the history of Nepal's private sector development banking. As a step of financial liberalization, development Bank Act was enacted in 1996 and private sectors were allowed to register and open a development bank. Hence, Nepal Development Bank Ltd, which is considered to be the first national level development bank was established in 1999 on the initiation of the private sector with an authorized capital of Nrs.320 million and issued capital of Nrs.160 million. Although, there were also Rural Development Banks, Regional Development Banks and other financial institutions already in operation, Nepal Development Bank Ltd. is the first national level development bank established on the initiation of private sector. At present there are 28 development banks including 5 national level development banks and 5 rural development banks.

According to Development Bank act 1996 “Development Banks are the institution established and operated in connection with the development of specific sectors in order to make available financial resources and technology needed for the establishment, development, expansion and increase in the capacity and productivity of agricultural, industrial, services, trade and other commercially viable and productive enterprises and thus impart dynamism to the development of the nation’s industrial, trade and agricultural sectors and mobilize available skills, labor and capital for the development of rural and urban areas.” Development banks play vital role in the economic growth of a country by initiating venture capital and providing long term financing to different industrial and development projects.

Nepal Rastra Banks regulations for inspection, supervision and issues directives in respect of the economic activities to develop a strong and competent financial system. In other words, NRB issue directives to save from the bad financial system and to save form the bad financial sector. The practice of regulating and supervising the banks and financial institution is a power full authority of the central bank to control their activities. NRB has been supporting the financial sector by carrying out various functions like regulation, supervision of banks and financial institutions and giving instructions to them fixing terms and conditions issuing the circulations, making regulation and policy, investigating whether the law, regulation and terms and conditions are complied with or not. In the course of regulating and supervising, NRB also regulates development banks. The directives issued by NRB are generally treated as prudent and development banks have to implement them. The banks should abide by the NRB directives issued under internationally accepted prudential norms and establish themselves as professional institutions. However, the slackness going in the Nepalese economy and impracticality of some of the directives issued by NRB in this scenario have raised some serious question.

1.2 Focus of the study

The study focuses on the following issues:

i. To explain the directives issued by NRB to development banks regarding:
   - Capital adequacy ratio.
   - Collection of financial resources and funds.
   - Provision regarding statutory deposit and liquidity management.
   - Provision regarding classification of loans and advances of loan loss provision.
   - .Provision regarding investments.
   - Provision regarding interest rate and recognition of interest

ii. Impact and implications of the directives on the development banks.

iii. Implementation and adherence of development banks to such directives issued by NRB.

iv. Critical appraisal of such directives.

1.3 Statement of the problem

NRB Act 1955 has given NRB the full authority to regulate, supervise and monitor commercial banks and other institution such as development banks, finance companies, co-operatives etc. Various activities have been under taken by NRB during its 50 years of history. Banks and financial institution accepts deposit from general public and advance some or all portion of such deposit in the form of loans and advances. So, NRB being the regulator and supervisor of such financial institution has been empowered with the authority to safeguard the interest of depositors. For this purpose NRB issues various directives to development banks. Such directives are amended from time to time and sometimes new directives are

also issued. It becomes the duty of development banks to comply with such directives. Despite its mandatory to be implemented, some of the directives issued are ambiguous, impractical and unsuitable at the ongoing economic scenario. So compliance to such directives is very difficult.

The directives issued to development banks by NRB have plenty of repercussions. Such directives affect not only the proper functioning and efficient management but also the profitability of the banks. This study focuses on directive and its impact on related components such as provisioning which ultimately impacts on profitability, dividend payment etc. Thus, such directives have cyclical affects which ultimately affects the dividends, tax, bonus and various other aspects of the bank. Since, directives are the tools of NRB to regulate and supervise financial institution, any impractical and vague directives might deteriorate the financial system of the nation, which in turn hampers the entire country's economy. So there is a need to find out whether such directives are followed properly or not. This study attempts to evaluate the financial performance of selected development banks of Nepal by using various financial and statistical tools such financial ratios, income and expenditure statement analysis and other necessary analysis. It gives answer to the issues such as how far these banks have been managing its position in relation to the liquidity, assets management, capital structure, capital adequacy, how sound is the operational result in relation to their profitability and so on.

1.4 Objectives of the study

NRB issues various regulations and directives to financial institutions. Likewise NRB issues such regulations to development banks as well. Such regulation and directives are issued so as to protect the interest of depositors and to make the banking sector effective. Therefore, the main objective of the study is comparative financial performance to review and make the critical assessment of the directives

issued by NRB to the development banks. Therefore, the specific objectives of this study are:

- To analyze the financial performance of selected national level developments.
- To analyze the implementation of the NRB directives by selected national level development banks.
- To analyze the norms and standards laid down by NRB to development banks.

1.5 Significance of the study

This research is basically based on the directives issued by NRB to development banks. Every development banks has to adhere to such directives. Failure to do so may attract fine and penalties as per the NRB act and development bank act. The directives are issued on the basis of monetary policies and the success of monetary policy depends on the directives of the central bank to various financial institutions which in turn affect their performance. This study aims to impart valuable insights about effects of the directives on the development banks and also the implementation and compliance thereof. It will provide necessary feedback which will help the banks to reassess and restructure various internal policies to comply with the directives. Besides, this study is expected to provide necessary recommendation to NRB for making necessary inclusion, exclusion, amendments and other changes in the directives and also to initiate procedures for effective implementation of the directives. Moreover, the analysis, recommendations and conclusions drawn from this research may help for further research studies in the subject.

1.7 Limitations of the study

The finding of the study will be subject to the following limitations: The study has the following limitations:

- Although there are many development banks like regional development bank, development banks operating under their act such as Agricultural Development Bank and Nepal Industrial Development Corporation, micro-credit development banks and other rural development banks operating under the Development Bank Act 1996, only few national development banks established under Development Bank Act 1996 are considered for the study. Therefore, the sample may not represent the entire populations.
- Among the various directives issued to development banks only selected and important ones are considered.
- Most of the materials required for the research work are in Nepali. Best effort has been made during the translation so that the meaning is what was intended to be. However, there might be some mistakes during the courses of translation.
- Since the history of private sector development banks is not so old, the analysis is done only for the past four years.
- Although the study contains both qualitative and quantitative analysis, the use of statistical tools may be limited to a certain extent because of non availability of required data in some cases.
- This study is mainly based on secondary data.

1.8 Organization of the study

This study comprises of five chapters. Given below are the headings under which the entire study has been categorized as follows:

Chapter-I

First chapter deals with introduction. This includes background, focus of the study, statement of problem, objective of study, significance of study, limitation of study and organization of study.

Chapter-II

Second chapter deals with the review of available literature. It includes review of previous unpublished Master degree thesis, books journals and articles etc.

Chapter-III

Third chapter explains the research methodology used in the study. It includes research design, population and sampling, sources of data, method of data analysis and research and research variables etc.

Chapter-IV

This is an important chapter of the study and will consist of the presentation and analysis of data.

Chapter-V

The last chapter summarizes the main conclusion that follows from the study and offers suggestion and recommendation for further improvement and conclusion of the study.

CHAPTER-II

REVIEW OF LITERATURE

This chapter highlights upon the existing literature and research related to the present study with a view to finding out what had already been explained and how the present research adds to the dimension. This has been grouped into three parts namely; conceptual review, review of related studies and thesis review.

2.1 CONCEPTUAL FRAMEWORK

2.1.1 Concept of Bank

Bank is a financial institution, which plays a significant role in the development of the country. It facilitates the growth of trade and industry and other sector of the national economy. It is a resource for economic development, which maintains the self-confidence of segments of society and extends credit to the people. A bank is a business organization that receives and holds deposits of funds from others makes loans or extends credits and transfers funds by written orders of depositors.

The more development financial system of the world characteristically falls into three parts: The central Bank, the commercial banks, development banks and other financial institutions. They are also known as financial intermediaries.

“The business in banking is one of collecting funds from the community and extending credit (making loans) to people for useful purpose. Banks have played a pivotal role in moving money from lenders to borrowers. Banking is a profit seeking business not a community charity. As a profit seeker, it is expected to pay dividends and otherwise add to the wealth of its shareholders” (Edmister, 1980:73-74)

In the Nepalese context, nowadays, three types of banks are being operated by performing their activities in different sectors, such as Centre Bank (Nepal Rastra Bank), commercial Banks and Development Banks)

2.1.2 Types of Bank

Banks can be classified into various types on the basis of their functions, ownership, domicile etc. The following are the various types of banks:

1. Central Bank

Central bank is the apex institution which controls, regulates, supervises the banking system of the country. It occupies a central position in the monetary banking structure of the country. Important functions of the central bank are: Note issue, banker, agent and financial advisor of the government: custodian of the member banks' reserve: custodian of the foreign exchange reserve, lender of the last resort, clearing, settlement and transfer: formulation and implementation of monetary and foreign exchange policy, credit control, research and publication etc. Besides these function central banks also perform developmental function to promote economic development in the country.

2. Commercial Banks

Commercial banks perform all kind of banking business and generally finance trade and commerce. In addition to the primary function of receiving deposits and lending to others, these banks undertake a wide verity of functions to assist their customers by performing agency services and general utility services. Deposits of the commercial banks generally are for short period of time, hence they involve in the short period lending activities. However, recently the commercial banks have also extended their areas of operation to medium term and long term finance. Functions of the commercial banks are: accepting deposits: advancing loan, letter of credit, guarantee, remittance, e-banking, bills, foreign exchange etc.

3. Development Banks

Scarcity of capital is a huge drawback to must developing countries. They need development banks urgently as the existing financial agencies cannot coordinate and integrate with the financial requirements. Development banks are thus established in different underdeveloped countries to suit the development need of the countries. Development banks are established for the development of certain special sector. They collect funds from share capital, debentures, long- term deposits and re-finance from central banks and provide long or medium term loan. They also play an important role in promoting investment projects, undertaking projects reports and providing technical advice and managerial services.

4. Merchant Banks

Merchant banking functions are underwriting of shares, issuance and management of shares, unit trust management. They also advise companies on mergers and acquisition, loan syndication, financial and management consultancy. Some banks and finance companies are discharging the function of merchant banking in Nepal.

5. Industrial Banks

Industrial banks have come to existence to facilitate mainly the medium and long term financial need of industries. Main functions are; they accept long term deposits; they grant long term loans to the industrialists to enable them to purchase land, construct factory building, purchase heavy machinery etc.; they help selling and underwriting shares and debentures of industries firms; they also provide information regarding the general economic position of the economy. The industrial banks are also known as investment banks.

6. Exchange Banks

Exchange banks are also commercial banks that deal in foreign exchange and specialize in financing foreign trade. They act as businessmen in buying and selling foreign currencies or claims to foreign exchange. They facilitate

international payments through sale and purchase of bills of exchange. The exchange bank grants direct loans to the exporters and importers. The exchange bank may also open a letter of credit in favor of the importer to enables the importer to meet his financial needs in foreign currency. There is no special exchange bank in Nepal but the commercial banks are performing the functions of exchange banks.

7 Saving Bank

The main purpose of saving banks is to promote saving habits among the general public and mobilize their savings. In Nepal Postal saving Bank (Hulak Bachat Bank) is doing this job.

8. Rural Banks

Rural banks are established for the development of rural economy by developing agriculture, trade, commerce and industry and other productive activities in the rural areas. In developing countries the rural poor have no adequate access to credit. Most of the rural borrowers depend on the informal sector credit by paying very high price. To overcome the problem and to make available of credit to the rural poor, these banks are established. In Nepal there are five rural development banks which are established in the five different development regions.

9. Cooperative Banks

The Co-operative Banks are institutions established with the basic principle of co-operation. The objective of such organizations is to facilitate rural credit and to promote thrift and self-help among the economically weaker sections of the society. Like commercial banks the co-operatives banks also received deposits and lend money but they lend money to their members only. They are more service oriented than profit oriented. Co-operative banks function in a given area, while commercial banks function over a wider area.

2.1.3 Concept of Central Bank

Central Bank is the supreme bank of a country. In the case of Nepal, Nepal Rastra Bank is the central bank, which was established in 1957 under the Nepal Rastra Bank Act 1956. It can accept the credit from 'Government of Nepal', commercial banks, the financial institution, government's offices and provides loan to the 'Government of Nepal', commercial banks and financial institutions when needed. It keeps monetary system stable, develops banking system, issues coins and notes and controls the credit of money. In addition to it, it has to work for the economic development of the country by soliciting the capital as an effective means for the development and supporting the industries of nation. It is called the bank of banks. The central bank is the supreme bank of monetary and banking system of the nation. This bank gives advice to the Nepal government time to time on economic and financial matters.

"Central bank is the bank who acts in accordance with government policy as guardians and controllers of a country's monetary system, issuing notes and coins to the public, and providing the chief financial link between a country's financial system and the rest of the world". (The World Book Encyclopedia, 1966:60)

"Again, the central banking in entirely different from commercial or other branches of banking and that its main aim is to serve in the public interest and not to secure profits. The function of a central bank and the obligations resting upon it are of a very special character calling for skill, experience and judgment of a kind different from those, which must be possessed by commercial banks. No banker can neglect the rules of prudence and safety, but the object of a commercial banker is to make a profit. The situation of a central bank is such that it must often undertake operations which are not only profitable, but result in losses, its aim must be the economic welfare of the country."(Shekhar & Shekhar, 1999:523).

A Central Bank is the most important financial institution of the country because it managers the expansion and contraction of money supply and economic development it the country. Central Bank is the important factor for the financial mobilization of the country. Central Bank is the government's bank world over like it is the head of monetary and banking sector. It formulates monetary policy. The central bank plays a significant role in developing country to develop the banking system for the mobilization of resources of resources and using them in the priority areas to match development plan.

Central bank is an autonomous body which safeguards public interest, contributes to economic development, and ensures economic stability by introducing monetary policy in consonance with the fiscal policy of the government.

A Central bank is a bank which constitutes the apex of the monetary and banking structure of its country and its guiding principle involve only in the public interest without regard to profit. Central banks have their own codes of rules and regulations; it may be described as the art of central banking.

2.1.4 History & Evaluation of central Bank

Until 1957, Nepalese economy faced various difficulties associated with an unstable exchange rate as well as problems created by the dual currency system. The absence of any regulatory authority further accentuated the problem. Infrastructure for development of transport and communication, agriculture, industry and trade was not developed. Moreover, there was lack of knowledge and awareness about banking system among the people.

Until mid-1940s, only metallic coins were used as a medium of exchange. It was only that the "Sadar Mulkikhana Adda" (Local treasure of the government) issued currency notes. The "mulkikhana Adda" established in 1945 at the centre and the

various “Mal Addas” (Revenues offices) in the districts also undertook the treasury functions of the government. Against the background, an urgent necessity was felt for the establishment of a central bank dedicated to the development of banking and finance to promote trade and industry, to manage the circulation of national currency and to maintain exchange rate stability. Hence, the Nepal Rastra Bank Act 1955 was formulated under the coordination of the then Principal Royal Advisor, Sardar Gunjaman Singh. The draft of the Act was presented to His Majesty’s Government and was approved on April 1956. Accordingly, the Nepal Rastra Bank (NRB) came into existence as the Central Bank of the country with an authorized capital of Rs. 10 million fully subscribed by the government. The opening ceremony of the Bank took place in a rented building “Rain Basera” at Juddha Sadak, where the Bank started its early operations.

2.1.5 Role and Need of Central Bank

A central Bank is set up with the objective of maintaining monetary stability and economic development in the country. The objective of central bank is not profit but safeguarding of public interest. As a monetary authority it managers note as well as contributes to the growth of agriculture, industry and trade, increases employment opportunities, facilitates development activities and helps the government introduce sound economic policies. In other words, the activities of the central bank are aimed towards boosting employment, production and income. The role and need of the central bank can be analyzed in following points:-

1. Establishment, Extension and Development of Financial Institution:

Prior consent of NRB is required along with a feasibility study report for any new establishment and has to meet the criteria laid down by NRB. Likewise, NRB also gives approval for extension of branches after meeting the required criteria.

An important responsibility of the central bank is to enable the monetary and credit system to fulfill the financial necessity of the economy by improving it. There should be establishment and extension of banks and financial institutions and directions to the commercial banks on the flow of loan to the priority areas. It is clear that the central bank can play an important role, be it in urban area or rural area, for the economic development of the country by the establishment and extension of the commercial banks and financial institutions. Hence the central bank is an essential weapon for the economic development of the nation.

2. Government Credit/Budget and Mobilization of Capital and Management of public debt:

One of the responsibilities of the central bank is to issue government bonds, securities properly in a right time and to maintain its stability in value and to minimize the government bond expense. In additional to it, the central bank buys and sells the government bonds and brings timely changes in the structure of government credit. The government, from time to time, makes a deficit budget to run development projects. A huge deficit budget grows inflation and small budget grows inflation and small budget doesn't provide adequate finance. In this respect, the central bank plays an important role to is supreme because it helps in the management of the national credit and money or capital market for the whole economic development.

3. Credit Control

The central bank follows different types of quantitative and qualitative methods of credit control such as bank rate policy, open market operations, variable reserve ratio, variable margin requirement etc. At present, credit has played dominant role in the medium of exchange. Therefore, it is necessary to control credit to stop economic crisis to be emerged from the over flow of credit. The main intention of credit control is to well manage exchange rate, common price rate, trade business,

monetary market & employment etc and to help the government to provide loan of beneficial terms and conditions. The quantity of currency should be kept stable according to need. There should be a constant unit of measurement of the credit measurement, to prevent adverse affect of fluctuation the value in currency because the level of price and the purchasing power of the money depend on the credit control.

4. Maintaining Balance of Payment:

Central bank plays a vital role in maintaining the balance of payment by controlling the exchange of foreign currency. The import of various goods affects the balance of payment situation. Hence, NRB not only manages foreign currencies but also controls exchange and plays a role of chief advisor of the government to fix the foreign exchange rate. NRB with the medium of different methods does the act of maintaining the stability of exchange rate of foreign currencies.

5. Maintaining Balance among Money, Demand and Supply:

The central bank plays an important in maintaining balance among money, demand and supply for the economic stability. The pace of development is stopped if supply of money is less than needed and inflationary pressure increases if the supply of money is high. The central bank controls the inflation and deflation of money by making balance between demand and supply of money. Central bank controls the inflation so that the price is not increased and adverse effect is not caused to investment.

6. Development of Agriculture, Industry and Backward Areas:

The Central Bank can play a significant role for the economic development of the country by providing and offering many opportunities to the fields of agriculture, industry and backward areas. It can be done for economic developments by

introducing effective policies and giving directions, instructions to the concerned authority.

2.1.6 Development Bank- Concept and Functions

Development banks are established for the development of certain sector. Their main source of fund is share capital, debentures, long term deposit and refinancing from central banks. Basically they provided long term loan and provide technical and other advice as will as which a typical commercial bank may not offer. Development banks are the financial institutions that provide financial services specifically motivated to provide long term finance for development projects.

Development banks should direct their financing go projects which are bankable as well as development in character. They tend to fill a conspicuous financial vacuum in least developed economies. Development banks are instrumental in raising capital in least developed economies where capital markets are not fully developed. Development banks are better placed to assume a promotional role in linking science and technology to economic and industrial development.

The rapid growth of an institution in the developing countries, known as a development bank or a development finance company, has been observes with great interest by practitioners in the field of economic development. The implicit but unstated definition of development banks used in the Business International compilation was “an institution which provided either loans and/or equity to industrial projects.” Undoubtedly this list would have been even longer if we had attempted to include financial institutions that relate to the development of agriculture, housing, cooperatives, or any other sector of a developing economy which needs finances to grow.

It seems best however, to approach the definition of development banking from a function point of view: that is, to determine whether an institution is a development bank by observing the function which it is performing or is designed to perform within developing economy. We could say, therefore, that an institution would be classified as a development bank if it were assigned to perform both banking and development functions.

The principal financial function that a development bank must perform is the provision of medium and long-term capital to economic development projects. Other financial functions of a development bank apply as much to industrial banking as to any other type of development banking and include the investment by the bank in the equity of a borrower, the guaranteeing of a loan by a third party to a borrower, the underwriting of attempts by a borrower to raise equity or debt and the services of providing broad financial contacts both within and outside of the developing country.

A financing institution which restricts its activities only to the banking functions mentioned above should not be classified as a development bank. A development bank must, in additional to its banking function, attempt to relate to certain problems of, or bottlenecks to, development, the magnitude and important of which may vary from country to country.

The main objective of development banks is to provide long-term capital for industry. It is neither feasible nor possible for commercial banks to participate in the financial of long-term requirements of industry. The disadvantages of mixed banking are well known. Though mixed banking was tried in countries like, Germany with a certain degree of success, it cannot be relied upon in a developing country like India where banking habits are still in the infant stage. At the most, our bigger banks can try in the field of term lending to a limited extent. So, certain

special institutions are necessary to handle the problem of long-term financing of industries. Such institutions are broadly known as ‘Development Banks’.

”The term ‘Development Banks’ in the broader sense is used to include both development banks proper and finance corporations. The difference between these two lies in the fact that the former are primarily concerned with long-term loan capital while the latter deal with equity capital and assume responsibility for fostering, and managing individual companies. However, in the final analysis the objective of both development banks proper and finance corporations is to provide long-term industrial finance. Hence, they may be broadly grouped as Developments Banks” (Shekhar & Shekhar, 1999:122)

The role of the Development Banks extends beyond the provision of financial and other assistance to industrial concerns. The bank can undertake promotional activities such as marketing and investment research and surveys as well as techno-economic studies. It can also provide technical and administrative assistance to any industrial enterprise for promotion, management or expansion. Above all, it has been assigned a positive role in the process of industrialization through planning, promotional of new industries to fill the gaps in the industrial structure of the country.

According to Development Bank Act 1996, development banks are established and operated in connection with the development of specific sectors in order to make available financial resources and technology needed for the establishment, development, expansions and increase in the capacity and productivity of agricultural, industrial, services, trade and other commercially viable and productive enterprises, and thus impart dynamism to the development of the nation and industrial, trade and agricultural sectors and mobilize available skills, labor and capital for the development of rural and urban areas.

“The bank may perform the following functions subject to its Memorandum and Articles of Association” (Development Bank Act, 1996: 107-108).

a. To supply loans for fixed and working and capital needed for agricultural, industrial, service, trade and other commercially viable and productive enterprises.

b. To provide guarantee for loans to be made available by any bank or financial institution to its clients.

c. To establish and operate any agricultural, industrial service, trade and other productive enterprises, and deal in their shares, debentures or bonds, or guarantee them of make arrangements for doing so.

d. To supply loans on the basis of co-financing with other banks or financial institutions, or make arrangements for doing so, according to agreements reached with them.

e. To supply loans to individuals who provide raw materials, perform market management, operating, or provide technical or management consultancy services needed for the promotion and development of projects, or make arrangements for doing so.

f. To supply loans against any security acceptable to the bank, or on he basis of hypothecation.

g. To purchase movable and immobile assets needed for land development and for the establishment and development of industrial districts of export promotion zones or other productive projects zones, and transfer the operation, management,

and ownership of projects located within the district or zone in the prescribed manner, or on lease.

h. To purchase movable and immovable assets needed for land development and for the establishment and development of residential areas, and transfer the operation, management, and ownership of such areas in the prescribed manner, or on lease.

i. To supply loans up to a specified limit without the security of any collateral to low-income families or other specified classes on the basis of collective responsibility for undertaking feasible projects.

j. To collect deposits on conditions prescribed by the Rastra Bank.

k. To mobilize capital through debentures, bonds, loan bonds, savings bonds, shares, or other financial instruments with the approval of the Rastra Bank.

l. To obtain refinance loans from the NRB, or supply loans to other banks or financial institutions, or obtain loans from them, according to need.

m. To distribute in the form of loans, funds received from 'Government of Nepal' or any other local or foreign agency for the promotion of projects.

n. To conduct or make arrangements for conducting studies, research, and surveys in respect to the establishment, operation and evaluation of projects, and provide training or consultancy services and other information.

o. To prescribe conditions and conclude agreements according to need so as to protect the interest of the bank while conducting transactions with our advancing loans to or obtaining loans from any individuals.

q. To conduct investigations to determine whether or not any loan obtained from the bank has been utilized for the purpose for which it has been obtained.

r. To supply a fresh loan against the security of the same movable or immovable assets which has already been pledged to the bank or to any other bank of financial institutions, to the extent of the total value of such security.

s. To exchange with the NRB, other banks, and financial institutions particulars, information, or notices regarding debtors or clients who have obtained loans or any other facilities.

t. To bear the preliminary expenses incurred while establishing the bank.

u. To perform other functions deemed necessary to implement the objectives of the bank.

2.1.7 Evaluation and Historical Perspective of Development Banking

The promotional role of NRB towards development finance has been recognized in the NRB Act 1955. Besides, traditional central banking functions, the Act provides that NRB should help in mobilizing capital for development and encourage trade and industry in the country. The bank is also empowered to extend financial assistance to the financial institutions engaged in agricultural and industrial credit.

Nepal Rastra Bank has endeavored to develop and strengthen term lending financial institution as well as to extend the banking services in order to cater to the diverse needs of borrowers. With a view to strengthen the financial position of

the financial institutions. NRB, besides, extending credit and refinance facilities, is also participating in the equity capital and also subscribing to debentures.

Realizing the important of financial resources in the industrial development, the NRB participated in setting up the Nepal Industrial Development Corporation as early as 1959 to function as the specialized financial institution providing term credit. The bank used to provide overdraft facilities to a few selected industries like the Birgunj Sugar Factory and the Janakpur Cigarette Factory before 1974. After the sixth amendment of the Nepal Rastra Bank Act 1955, in 1974 the bank has discontinued the practice of extending direct loans to industrial units and has channeled the loans through commercial and development banks. Towards this, investment in the equity share of the corporation amounting to Rs. 6.5 million in 1968/69 was the landmark in the history of Nepal's industrial finance.

The main objective of the NIDC is to provide financial assistance to private industrial enterprises in the form of medium to long-term loans, to participate in the equity investment and underwriting. The corporation generally finances project loans which distinguishes its activities from those of the commercial banks. The main sources of funds of NIDC are its paid-up capital, long-term loans from domestic and foreign financial institutions.

The Corporation lending to industries comprise direct loans, guarantee for loans and share participation. The bulk of the advance is through direct loans. The corporation started a modest lending of a few million rupees up to 1973, which were mainly diverted in manufacturing and hotel industry. The principal categories of industries financed by the corporation include manufacturing and hotel, which are mainly concentrated in the Central Development Region.

Agriculture Development Bank was instituted in 1968 under the Agriculture Development Bank Act 1967 by incorporating the assets and liabilities of the Cooperative Bank set up in 1963. The main functions of the bank are to channel funds to the agricultural sector. The bank provides short, medium and long-term credit to individuals, cooperative societies and corporate bodies for agricultural development.

Nepal Rastra Bank has been taking keen interest in rural credit from its early stage. A separate Agricultural Credit Fund was created in the Bank in 1959/60 and a certain portion of its profit was appropriated to this fund each year.

Agriculture Development Bank is the premier lending institution specializing in agricultural and rural credit in Nepal. Its share in the institutional rural credit supply is almost 80 percent. The Bank supplements its capital resources mainly by borrowing from domestic and foreign sources.

Beginning in 1984, Agricultural Development Bank, has been allowed to directly enter the general banking business (with certain restrictions) in selected urban areas to canalize funds to the agriculture sector. In recent years, the deposit mobilization has been the principal source of finance to the bank.

Agricultural Development Bank provides short, medium and long-term loans to individuals, cooperatives and corporate bodies for agricultural development. Short-term loans are advanced to finance seasonal operations of inputs like seeds, fertilizer and labor services. Medium term loans are extended for the purchase of farm machines, tools and machinery and implements for agro industries. Loans for livestock rising and warehousing loans are also made for the medium term. Projects of long gestation like tea cultivation are given long-term finance.

Rural Development Banks

Although various rural credit programs are in operation for more than a decade, the rural poor are either deprived from the credit facilities of they have not been able to utilize the services directed towards them. There was lack of rural orientation and effective targeting in these credit programs. Against this background a rural development banking system closely based on the German Bank Financial System of Bangladesh was introduced in Nepal in 1992, through the establishment of Rural Development Banks on a regional basis. Rural Development Bank is a new model for banking to the poor in rural area. The basic objective of the bank is to provide easy financial services to the poor. There are four Rural Development Banks established on a regional basis in Eastern, Far-western, and Mid-western Development region. All these banks have adopted the outreach model of Grameen Bank Financial System of Bangladesh. The distinctive features of these banks are that they adopt area approach, have well defined target group, and group lending approach, need no physical collateral, disburse loan at the client door-step, collect principal and savings on a weekly basis, provide services exclusively to the poor women and carry out banking and other activities in the centre located at the village.

Until 1996, only two development banks were in operation under their respective acts, both being under the government ownership, Incorporation of Development Bank Act 1996 was the landmark in the history of Nepal's private sector development Bank Act was enacted in 1996 and private sectors were allowed to register and open a development bank. As a result, Nepal Development Bank Ltd. which is considered to be the first private sector development bank was established in 1999 with its head office at Heritage Plaza, kamaladi, Kathmandu with an authorized capital of NRs.320 million and issued capital or NRs. 160 million. Although there were also Rural Development Banks, Regional Development Banks and other financial institution already in operation, Nepal

Development Bank Ltd. is the first national level development bank established on initiation of private sector. At present, there are 28 developments banks including 5 national level development banks and 5 rural developments banks.

The reason for speedy growth of development banks are higher interest rate on deposits, low administration cost, swift service, quick decision and high demand for consumer credit. In view of the growing number of development banks registered and applying for license with NRB, a high level technical committee has been constituted for more serous and detailed and study and analysis of feasibility report submitted by finance companies under the management and leadership of the deputy governor of NRB to accomplish the objective of creating a more competitive environment in the financial sector. Based on the recommendations of this high level committee, policy framework and guidelines are published to help and direct the establishment and regulation of finance companies in the country. The recommendations of this committee are also considered to determine the basis eligibility criteria to be applied while issuing license to new finance companies and also monitoring to those already establishment and have started operations.

Of the total 84 developments banks in Nepal. ADB/N and NIDC are in the field to provide wholesale credit. “Due to deteriorating security situation, commercial bank branches of rural areas are being relocated to secured places while many branches have been closed. Region and district based development banks are, therefore, expected to extend their operations to the rural areas. NRB, therefore, has given priority to those development banks interested to open their branches in the remote hills areas” (Economic Report)

The Minimum Paid-Up Capital required establishing a Development Bank as per the condition laid down by Nepal Rastra Bank is as follows:

1. National level development banks must have minimum paid up capital of Rs. 32 crores.
2. Excluding Kathmandu valley, development banks bordering minimum in 4 districts must have minimum paid up capital of Rs. 5 crores.
3. Excluding Kathmandu valley, development banks bordering minimum in 1 district and maximum 3 districts must have minimum paid up capital of Rs. 2 crores.

The maximum extent Promoters can hold the share of the bank is 70% and 30% is to be floated in the market for general public.

2.1.8 Banks and Financial Institutions Ordinance, 2010 (New Umbrella Act)

This Ordinance has been issued to amend and consolidate the existing banks and financial institutions Acts. It aims to ensure reliable and quality banking and financial intermediation services through healthy competition among banks and financial institution, safeguard and promote the interest of the depositors and people at large in the overall banking and financial system of the country. Strengthening the economic by liberalizing these institutions is also the objective of the ordinance. The ordinance also aims to facilitate the establishment, operation, management and regulation of these institutions with appropriate legal provisions. Banks and financial institutions are to be classified as A, B, C, and D and licenses are to be issued accordingly as per the minimum paid-up capital prescribed by NRB. The minimum paid-up capital of licensed institution shall be as prescribed by the Nepal Rastra Bank.

According to the Ordinance, commercial banks, the Agriculture Development, the Nepal Industrial Development Corporation, development banks, finance companies, and non-government organization working as financial intermediaries

and permitted to conduct banking business, which have been established according to current law and are in operation at the time of commencement of this Ordinance, must, within two years form the date of commencement of this Ordinance, apply to the Rastra Bank for a license to establish a bank or financial institution and conduct financial transactions under this Ordinance. The said commercial banks, Agricultural Development Bank, Nepal Industrial Corporation, development banks, finance companies and non government working as financial intermediaries shall not be considered to have been prohibited from operating the bank or financial institution and conducting financial transactions during the said time limit. In case any commercial bank, the Agricultural Development Bank, the Nepal Industrial Development Corporation or any development bank, finance company or non- governmental organization working as a financial intermediary fails to apply to the Rastra Bank for a license to establish a bank or financial institution and conduct financial transaction may not conduct financial transaction after the expiry of that time-limit.

The Rastra Bank shall classify the licensed institution into A, B, C and D classes on the basis of the minimum paid-up capital needed for a license to be issued to conduct financial transaction, and issue to the concerned bank or financial a license accordingly.

2.1.9 Review of NRB Directive to Development Banks

The banks and the financial institutions are established with the permission of the central bank. When the central bank permits to carryout transaction, it fixes various term and conditions. In addition to it, it issues necessary directions from time to time about loan, deposit liquidity, re-finance, capital fund, rate of interest and spread etc. It is very necessary to inspect their activities, after investigating whether of not the banks and financial institutions have followed the current law and the direction and instruction of the central bank to move them into 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 he amount from the public as deposits, manage the strong, and competent financial system, regulation, inspection and supervision of the banks and financial institutions is considered compulsory. Directives are one of the most effective tools used by the Nepal Rastra Bank for regulating the financial institutions. Nepal Rastra Bank has issued thirteen directives to development banks which are as follows:

Directive No. 1 - Capital Adequacy norms.

Directive No. 2 - Directive regarding collection of financial resources and funds.

Directive No. 3 - Provision regarding statutory deposit and liquidity management.

Directive No. 4 - Provision regarding classification of loans and advances of loan loss provision.

Directive No. 5 - Provision relating to single obligor limit.

Directive No. 6 - Provision regarding institutional good governance.

Directive No. 7 - Provision regarding sector-wise loan limit.

Directive No. 8 - Provision regarding investment in shares and securities.

Directive No. 9 - Provision regarding interest rate and recognition of interest.

Directive No. 10 - Provision regarding branch/organization expansion.

Directive No. 11 - Provision regarding sale of promoters share.

Directive No. 12 - Provision regarding audit and audit committee.

Directive No. 13 - Provision policy and format of financial information to be followed by development banks.

Out of these 13 directives issued to development banks, only 6 of them are considered for the study.

2.1.9.1 Directive No. 1: Capital Adequacy Ratio

The most important factor influencing solvency is capital. Capital includes equity share capital and all reserves and surplus available to equity shareholder. It is the last line of defense to meet the financial commitments of residual claimants in case a bank fails, closes or goes insolvent. Capital is the cushion between bank's unrealized assets and pending liabilities. It is basically a guarantee fund whose presence serves only maintenance purpose but absence or inadequacy is perilous. Thus, though capital is largely a dormant variable, it becomes important when realizable assets fall short of total liabilities and, therefore, size of capital should be large enough to fill up this gap/shortfall. It is necessary for a bank not only to have its capital intact but also to ensure its adequacy corresponding to volume of business. While the first objective can be accomplished by efficient operations and a sound loan portfolio, the other involves periodic increase in capital as business increases either by internal accruals and / or external funds (i.e. rising of capital from market).

Banks should have sufficient capital in relation to the volume and risky ness of their business to absorb losses without using depositors' funds. This capital investment gives owners and managers a powerful incentive to run the bank safely and soundly. Traditionally, the adequacy of the amount of capital available to buffer against losses is measured by a so called capital adequacy ratio. However, capital is simply the difference between the value of a bank's assets and its liabilities to third parties. Its calculation depends fundamentally, therefore, on the value attributed to its assets.

Development Banks have to maintain minimum capital fund on the basis of risk weighted assets.

Minimum Capital Fund to be Maintained by Financial Institutions

Table 1

Financial Institutions	Minimum Capital Fund to be Maintained (%)	
	Core Capital	Total Capital Fund
Grade "A"	6	10
Grade "B" and "C"	5.5	11
Grade "D"	4	8

Source: Nepal Rastra Bank

Core Capital (Tier 1)

The key element of capital on which the main emphasis should be placed is the Tier 1 (core) capital, which comprises of equity capital and disclosed reserves. This key element of capital is the basis on which most market judgments of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete. The BCBS has therefore concluded that capital, for supervisory purposes, should be defined in two tiers in a way, which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings. In order to rank as Tier 1, capital must be fully paid up, have no fixed servicing or dividend costs attached to it and be freely available to absorb losses ahead of general creditors. Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1.

Elements of Core Capital (Tier 1):

1. Paid up Equity Capital.
2. Irredeemable non-cumulative preference shares which are fully paid-up and with the capacity to absorb unexpected losses. These instruments should not contain any clauses whatsoever, which permit redemption by the holder

or issuer upon fulfillment of certain condition. Banks should obtain prior approval of NRB for this kind of instruments to qualify as a component of core capital.

3. Share Premium
4. Proposed Bonus Equity Share
5. Statutory General Reserve.
6. Retained Earnings available for distribution to shareholders.
7. Un-audited current year cumulative profit, after all provisions including staff bonus and taxes. Where such provisions are not made, this amount shall not qualify as Tier 1 capital.
8. Capital Redemption Reserves created in lieu of redeemable instruments.
9. Capital Adjustment reserves created in respect of increasing the capital base of the bank.
10. Dividend Equalization Reserves.
11. Any other type of reserves notified by NRB from time to time for inclusion in Tier 1 capital

Supplementary Capital (Tier 2)

The Supplementary (Tier 2) Capital includes reserves which, though unpublished, have been passed through the profit and loss account and all other capital instruments eligible and acceptable for capital purposes. Elements of the Tier 2 capital will be reckoned as capital funds up to a maximum of 100 percent of Tier 1 capital arrived at, after making adjustments referred to in 2.4. In case, where the Tier 1 capital of a bank is negative, the Tier 2 capital for regulatory purposes shall be considered as zero and hence the capital fund, in such cases, shall be equal to the core capital.

Elements of Supplementary Capital (Tier 2):

1. Cumulative and/or redeemable preference shares with maturity of five years and above.

2. Subordinated term debt fully paid up with a maturity of more than 5 years; unsecured and subordinated to the claim of other creditors, free of restrictive clauses and not redeemable before maturity.
3. Hybrid capital instruments. Those instruments which combine certain characteristics of debt and certain characteristics of equity.
4. General loan loss provision limited to a maximum of 1.25% of total Risk Weighted Exposures.
5. Exchange equalization reserves created by banks as a cushion for unexpected losses arising out of adverse movements in foreign currencies.
6. Investment adjustment reserves created as a cushion for adverse price movements in bank's investments falling under "Available for Sale" category.
7. Any other type of reserves notified by NRB from time to time for inclusion in Tier 2 capital

Supplementary capital consists of following:

- Loan loss provision for good or pass loan. However, loan loss provision for good, doubtful and substandard can also be included under the supplementary capital during the following periods.

Items to be included in supplementary capital

Table 2

Loan loss provisions to be included in supplementary capital
Good, Substandard and Doubtful
Good and Substandard
Good

- Assets Revaluation Reserve
- Investment Adjustment Reserve
- Convertible Debentures
- Subordinated Term Debt Instruments
- Other Free Reserves

Total Risk Weighted Assets

For the purpose of calculation of capital fund, the risk-weighted assets have been classified into following two components:

i. On-Balance sheet Risk-Weighted Assets.

ii. Off-Balance sheet Risk-Weighted Transactions.

(i) Risk Weighted On-Balance Sheet Assets

The On-Balance Sheet assets can be divided as shown below with assignment of separate risk weightage to different asset heading. The total risk weightage asset is determined by the multiplying the amounts shown in the balance sheet by their respective risk weights and then adding the product together.

Risk weighted on On-Balance sheet items

Table 3

S.N.	On-Balance Sheet Assets	Risk Weightage (%)
1	Cash Balance	0.00
2	Balance With Nepal Rastra Bank	0.00
3	Investment in Government Securities	0.00
4	Investment in Securities issued by NRB	0.00
5	Loan against Government Bonds, Bonds issued by NRB	0.00

6	Loan against Fixed Deposit of the Company	0.00
7	Loan against Fixed Deposit of other financial institution approved by NRB	20.00
8	Balance with Commercial Banks, Development Banks and financial Companies	20.00
9	Balance with other financial institution	20.00
10	Investment in shares, debentures and bonds	100.00
11	Investment in corporation owned by Government	100.00
12	Other Investment	100.00
13	Loans and advances and lease assets	100.00
14	Fixed Assets	100.00
15	Other Assets	100.00

(ii) Risk Weighted on Off-Balance Sheet Transactions

Off-Balance Sheet items cover the contingent liabilities. These activities are not recognized as assets and liabilities in the balance sheet. Off-Balance sheet items normally includes liability on account of party paid up shares, capital commitments, claim not acknowledge as debts, bank guarantees issued, underwriting commitments etc.

For the purpose of computation of Capital Fund, the Off-Balance Sheet items are divided as follows with assignment of separate risk weighted. Accordingly, for determining the total risk weight age on Off-balance sheet transaction, the amount of such transactions shall be multiplied by their respective risk-weights and then added together.

Risk weighted on Off-Balance sheet items

Table 4

S.N.	Off-Balance Sheet Transactions	Risk Weighted
1	Forward exchange contracts	10%
2	Short Term Trade-related contingencies	20%
3	Undertaking to provide a commitment on an off-balance sheet items	20%
4	Unsettled securities and foreign exchange transactions between bank to bank and between bank and customer	20%
5	Performance-related contingencies	50%
6	Long term irrevocable Credit Commitments	50%
7	Short term irrevocable Credit Commitments	20%
8	Direct credit substitutes	100%
9	Unpaid portion of partly paid shares and securities	100%
10	Repurchase agreements, securities lending, securities borrowing, reverse repurchase agreements and equivalent transactions	100%
11	Other Contingent Liabilities	100%

Formula for Capital Adequacy ratio:

$$\text{Capital Fund Ratio} = \frac{\text{Core Capital + Supplementary Capital}}{\text{Sum of Risk Weighted Assets}} \times 100$$

$$\text{Core Capital Ratio} = \frac{\text{Core Capital}}{\text{Sum of Risk Weighted Assets}} \times 100$$

Where,

Sum of Risk Weighted Assets = (Total On-Balance Sheet risk weighted assets + Total Off-Balance Sheet risk weighted assets.)

2.1.9.2 Directive No.2: Collection of Financial Resources and Funds

Developments banks can collect to the maximum extent of 15 times of core capital in the form of deposits, borrowing and various debt instruments. Funds can also be borrowed from banks and financial institutions, individuals, firm and company. Bank can collect following types of deposits:

a. Fixed deposit having maturity of 3 months or more.
b. Savings deposit not exceeding 20% of financial resources.
c. Recurring deposit
d. Provident fund deposits.

Funds can also be raised through the issue of debenture by obtaining prior approval of NRB fulfilling the following conditions.

- The bank should have completed at least 5 years from the data of commencement of financial business.
- At least 2 years has to be completed from the date of listing of shares of the company with stock exchange.
- The bank should be able to generate profits continuously for the period of past 3 financial years.

2.1.9.3 Directive No. 3: Provision regarding Statutory Deposit and Liquidity

Liquidity is the status and part of the assets which can be used to meet the obligation. Liquidity can be viewed in terms of liquidity stored in the balance

sheet and in terms of liquidity available through purchased funds. The degree of liquidity depends upon the relationship between cash and the liability awaiting payment. Generally, the definition of liquidity can't be found in the same way, in the countries of whole world. Because, it is known, as much as the development of the monetary sector takes place or the use of monetary devices increases, so much the definition of it goes wider. Liquidity means the whole money stock of economy.

Liquid assets comprise of:

i. Cash in Vault.
ii. Investment in government Bonds/Debentures.
iii. Investment in NRB Bonds.
iv. Balance with Commercial Banks.

Development banks are required to deposit at least 1% of the total deposits and borrowings to NRB or any other banks/financial institutions allocated by NRB. However, for any development bank located distant form NRB branch, 1% of total deposit and borrowing is to be deposited in a current account with a commercial bank and can be considered as a statutory reserve.

a. Bank shall maintain 5.5% of total deposit as liquid assets.
b. Out of 5%, at least 2% shall be kept in own vault or in a current account maintained with any commercial bank.
c. Only 90% of the fixed deposit maintained with commercial bank will be considered as liquid assets.
d. Any borrowing against fixed deposit, Government bonds or NRB bonds has to be deducted from liquid assets.
e. Liquidity ratio shall be calculated as daily average on weekly basis.

2.1.9.4 Directive No. 4: Provision Regarding Classification of Loans and advances and Loan Loss Provision.

Till now, the basic source of revenue for the development bank is interest because they are not authorized for much commission based business such as remittance, letter of credit, issuance of traveler's cheques etc. Hence, most of the portion of the bank's revenue comprises of interest on loans and advances. Thus, it is very essential for the bank to have a sound investment on such loans and advances maintaining healthy loan portfolio. In order to protect the bank from bankruptcy due to risk ness in the investment in loans and advances, NRB has issued this directive to development banks pertaining classification of loans ranging from good, substandard, doubtful and bad so that the loan loss provision can be maintained accordingly. According to this directive overdue loan amount to be recovered at Poush and Ashad end of every fiscal year in categorized as follows:

Classification of Loans and Advances and Provisioning

Table No: 5

Loan Classification	For Fiscal Year 2065/66	For Fiscal Year 2066/67 onwards	Loan Loss Provision
Good/Pass loan	Not overdue & overdue up to 3 months.	Not overdue & overdue up to 3 months.	1%
Sub-Standard	Overdue for more than 3 months up to 9 months	Overdue for more than 3 months up to 6 months	25%
Doubtful	Overdue for more than 9 months up to 2 years.	Overdue for more than 6 months up to 1 year.	50%
Bad	Overdue for more than 2 years.	Overdue for more than 1 year.	100%

(Source: Nepal Rastra Bank)

Good loan and advances are defined as performing loan and sub-standard, doubtful and bad loans and advances are defined as Non-performing loans.

2.1.9.5 Directive No. 8: Provision Regarding Investment.

Development banks can invest in government bond and NRB debenture.

- Investment can be done on shares and debentures of only those companies which already listed or are in the stated of listing within one year.
- Development banks can invest in shares and debenture of a particular company to the maximum extent of 10% of core capital. However, the total investment in such companies' shares and debentures should not exceed 30% of core capital.
- Development bank can invest shares and debentures of corporation organization where finance interest of the bank exists. The maximum extent investment in shares and debenture of a single company is 10% of core capital. However, the total investment in shares and debenture of the companies where financial interest of the bank exists should not be more than 20% of core capital.
- Development bank can underwrite on a share and debenture of a particular company up to a maximum extent of 20% of core capital and of all companies up to a maximum extent of 100% of core capital.

2.1.9.6 Directive No. 9 Provision Regarding Interest Rate

- Development banks can determine the interest rate on deposit loans and advances themselves.
- Interest rate on loans and advances cannot be determined in flat rate.
- Interest accrued on loans and advances can be recognized as income on cash basis i.e. only upon receipt of cash. Interest accrued but not received cash has to be transferred to interest suspense account. It can be recognized

as income only upon receipt of cash for interest incurred during the fiscal year.

However, interest collected within one month from the semi-annual end can be considered as interest income.

2.2 REVIEW OF RELATED STUDIES

2.2.1 Review of Articles

This article published in "The Kathmandu Post" (25 January, 2003) presents the recent development in the directives issued by NRB to development banks. Initially, development banks were not authorized to operate savings accounts. As per the NRB directives enforced from 23rd Jan, 2003 development banks are allowed to accumulate deposits through mobilization of saving accounts and operate such accounts. However, the total accumulation of deposits under the saving accounts should not exceed 20% of total financial resource of a bank.

Besides, the article also focuses on the following points:

- One percent of the total deposit to the maintained in the NRB or banks authorized by NRB. Prior to this such deposit could be maintained in any financial institutions.
- Liquid funds to be maintained at least 7% of total deposit against 10% provisioned in the previous directives.
- Individual borrowing limit extended up to 20% for the fund based loans and advances against 35% as per previous directives.
- Development banks are authorized to restructure and reschedule bad loan on the basis of convincing facts. But this step is not allowed for the loans classified under doubtful category.
- Capital adequacy ratio based on risk weighted assets would be 11% for fiscal year 2060/61 and 12% thereafter.

- Development banks can invest in shares and debentures of corporate organization or companies listed with Nepal Security Market or in the process of listing within one year. Investment in a single institution should be less than 10% of total loan investment while the total investment of the bank should be less than 30%.

2.2.2 Review of Previous Thesis

Some of the previous thesis regarding financial performance of commercial banks has been reviewed. Some of them, as supposed to be relevant for the study are presented below:

Santosh Pandey (2005) Study

This study has conducted that entitled "*Nepal Rastra Bank directives, implementation and impact on the commercial bank*". The main relating to the loan classification and provisions, single borrower limit and capital adequacy of banks. The directives, if not properly addressed have potential to wreck the financial system of the country, as they are the only tools of the NRB to not that important unless properly implemented. The implementation part depends on the commercial banks. So it is felt that there is need to find out if the directives are being followed. In case the commercial banks would deserves votes of praise because they would then be instrumental in the economic development of the country. From the study, he concluded that the new directive requires banks to re-categorize the loans into four different categories in the basis of aging. The period of past due period for the loans has been changed. Accordingly, the percentage of provision needs to be made by the banks for each category of loans. The limit for the single borrower limit on fund based and non-fund based loan have come down. This is mainly because of the previous limit for both types of loans were based on

the total capital fund while present limits are based only on the core capital which is less than the total capital fund of the bank.

S. Manandhar (2006) Study

This thesis paper entitled, "*Impact and Implementation of NRB Directives on Commercial Banks in Nepal"*. The main objectives of the study are as follows:

- To find out the importance of central bank in the modern dynamic economy.
- To find out the role of NRB on monitoring and inspection of commercial banks.
- To examine the implementation of NRB directives by commercial banks.
- To analyze the steps taken by commercial banks to fulfill the requirements of NRB directives.

From the study, he concluded that the new directive requires banks to re-categorize the loans into four different categories in the basis of aging. The period of past due period for the loans has been changed. Accordingly, the percentage of provision needs to be made by the banks for each category of loans. The limit for the single borrower limit on fund based and non-fund based loan have come down. At the moment when the country has already acceded to WTO and the regional economic integration being a seriously discussed issue, adopting international standard in the banking industry will make it efficient and competitive with the international banks.

Mila Barahi (2008) Study

This thesis paper entitled, "*A Comparative study on NRB Directives and its Implementation in Nepalese Commercial Banks"*. The main objectives of the research is to examine the implementation of NRB directives by selected

commercial banks related to capital adequacy, loan classification and provisioning in their activities. The specific objectives of the study are as follows:

- To conclude the impact of NRB directives on safety or general public deposits and on enhancement of the situation of commercial banks.
- To make a comparative study between Everest Bank Ltd., Lumbini Bank Ltd. and Nepal Bangladesh Bank Ltd. with respective to capital adequacy, loan classification and provisioning as given in the directives of NRB.

From the study, concluded that in terms of capital adequacy EBL is in a much better position than of LBL and NBBL. The bank heading forwards with a healthy growth. NRB try to avoid ambiguity in the directives that are focus there in the present directives and to come up with straight forward directives leaving loopholes the can be manipulated.

S. Pandey (2009) Study

This thesis paper entitled, *"In the thesis of Impact and Implementation of NRB Directives in Nepalese Commercial Banks"*. The main objectives of this study are as follows:

- To examine the implementation of NRB directives by commercial banks in Nepal.
- To find out the impact of NRB directives on commercial banks.
- To make necessary recommendations as far as possible to the commercial banks.

This study concluded that, NRB should issued directives only after doing the proper homework. NRB must strengthen the functioning of credit information bureau. NRB try to avoid ambiguity in the directives that are focus there in the present directives and to come up with straight forward directives leaving no loopholes that can be manipulated. This research has observed about the protection of the deposits of public because of the reduction in the loan exposure to the single unit. This thesis laid down about the changes in the directives will bring properly

to the share holders, depositors, employees and the economy of the country as a whole.

Laxmi Devi Khadka (2010) Study

This thesis paper entitled, *"NRB Unified Directives on Capital Adequacy Norms and Its Impact A case Study of SCBL, NABIL, HBL, NIBL and ADBL"*. The main objectives of this study are as follows:

- To analyze the implementation states of the directives given by NRB.
- To evaluate capital adequacy of the sample banks.
- To examine the efficiency and weakness of capital adequacy ratio.
- To examine the relation of capital fund to the other stakes of the banks.

This study concluded that, among these five commercial banks they have to increases their supplementary capital to meet the standard of supplementary capital ratio of 6% directed by NRB. In case of capital adequacy ratio it is seen that NABIL, NIBL and HBL did not meet the minimum requirement of NRB. There is no economic development in the country without capital formation and mobilization and without any guidelines to commercial banks. It is accepted worldwide that an 8% to 10% capital to deposits ratio is safe in preview of the notion, the bank had satisfactory capital to deposits ratio over the study period.

2.3 FINANCIAL PERFORMANCE

Profit is one of the indicators of sound financial performance. It is usually the result of sound business management, cost control, credit-risk management, and general efficiency of operation. Profit is essential for an enterprise for its survival and growth and to maintain capital adequacy through profit retention. Though profit is important for any business concern including joint venture banks but profit cannot be the sole objective. For example neither the banks nor the

community will be best served if the banker unreasonable sacrifices the safety of its funds or the liquidity of the banking in an effort to increase income.

Liquidity refer to the pay one hands on cash when it is needed; without to sell long-term assets at a loss in unfavorable market. Enough liquidity is needed to honor cheques and at the same time to enable its bank to make profitable loans when an opportunity arises.

A bank must maintain adequate liquidity to meet a wide range of contingencies. If bank fails to maintain adequate liquidity, it may be retained earning to the point where it can be build up the capital needed to holds its relative position in the banking structure. Excess liquidity is the loss of income. A bank must maintain adequate cash and bank balance to meet day-to-day operations as well as for remote contingencies. It measures the extent to which it can oblige its short-term obligations.

2.3.1 Ratio Analysis

Financial ratio is the mathematical relationship between two accounting figures. Ratio analysis is a part of the whole process of analysis of financial statements of any business or industrial concern especially to take output and credit decisions. Ratio analysis is a technique of analysis and interpretation of financial statement. Thus, ratio analysis is used to compare a firm's financial performance and status to that of other firm's or to itself overtime. The quantitative judgment regarding financial performance of a firm can be done with the help of ratio analysis.

Even though, there are many ratios, only those ratios have been covered this study, which are related to the performance of the bank. "Ratio Analysis is one of the most frequently used tools to evaluate the financial health, operating result and growth. Financial ratios by themselves do not indicate position of the institution. A

standard or norms is needed against which to judge them". It is powerful tool of financial analysis. "A ratio is defined as the indicator quotient of two mathematical expressions and as relationship between two or more things." (Webster's New Collegiate Dictionary, 1975:958). The study contains following ratios:

2.3.1.1 Liquidity Ratios:

The purpose of these ratios is to the solvency positions for the payment of short-term liabilities. Solvency position or liquidity denotes ability for payment of short-terms liabilities. It measures the ability of a firm to meet its short term obligations and reflect the short term financial strength or solvency of a firm. To measures the solvency position of banks, there have been some liquidity ratios which have been thought to be important.

2.3.1.1.1 Current Ratio

This ratio is calculated by dividing current assets by current liabilities. The current ratio measures the extent to which short-term assets covers the claims of short-term creditors. The current assets of a firm represent those assets that can, in the ordinary course of the business, be converted into cash within a short period of time, normally not exceeding one year. The current assets of a bank include cash & bank balance, placement, short-term investment, loans, advances and bills purchased. Similarly the current liabilities of a firm represent those liabilities that have short-term maturing obligations to be met as originally contemplated within a year. The current liabilities include borrowing, deposit liabilities, interest payable, short-term loans etc.

In general, businesses prefer to have at least one rupee of current assets for every rupee of current liabilities. However, the normal current ratio fluctuates from industry to industry. A current ratio significantly higher than the industry average could indicate the existence of redundant assets. Conversely, a current ratio significantly lowers than the industry average could indicate a lack of liquidity.

The ratio may be calculated as:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

2.3.1.1.2 Cash and Bank Balance to Total Deposits Ratio

The ratio shows the percentage of total deposit, which can be immediately discharge by the bank from its ready cash. Total of the deposits is the most important source of a bank's fund. This fund should be utilized into various sectors in a profitable manner and cash and bank balance is that part of bank's fund which has not been invested any where with a view to generating income. Excess cash and bank balance, from view point of liquidity, shows a firm's strong position and it is always harmful from viewpoint of profitability to maintain. Total deposit includes current deposits, savings deposits, fixed deposit and other deposit. Similarly, cash and bank balance includes cash in hand, cash at bank, foreign currencies held with the bank and other cash items held in different financial institutions.

$$\text{Cash and bank balance to deposits ratio} = \frac{\text{Cash and bank balance}}{\text{Deposits}}$$

Higher ratio shows higher liquidity and ability to cover deposits and vice-versa. However, too high ratio is unfit as capital will be tied up and the opportunity cost will be higher.

2.3.1.1.3 Cash and Bank Balance to Current Assets Ratio

This ratio reflects the proportion of cash and bank balance out of total current assets. This ratio reveals the quantity of cash and bank balance maintained by the

firm out of its total current assets. It is calculated by dividing cash and bank balance by total current assets.

$$\text{Cash and bank balance to current assets ratio} = \frac{\text{Cash and bank balance}}{\text{Total current assets}}$$

Cash and bank balance are highly liquid assets than other current assets.

2.3.1.2 Activity/Turnover/Utilization Ratio

Activity ratios are concerned with measuring the efficiency in assets management. Some time, these ratios are called efficiency ratios or assets utilization or turnover ratio. Because they indicate the speed with which assets are converted or turned over into sales. This ratio involves a relationship between sales. The greater the rate of turnover of conversion, the more efficient the utilization and management of assets. The funds of creditors and owners are invested in various assets to generate sales and profit. Activity ratios are employed to evaluate the efficiency which the firm manages and utilizes its assets. The ratio indicates whether the funds employed have been used efficiently in the business activity or not. These ratios are also called turnover ratios because they indicate the speed with the assets are converted or turned over into profit generating assets. Following ratios are used under activity ratio.

2.3.1.2.1 Loans and Advances to Total Deposits Ratio

This ratio shows whether the banks are efficient to utilize the outsiders' fund (i.e. total deposit) for the purpose of profit generating on the loans and advances thus provided. In other words, this ratio states to what extent the firms are able to utilize the depositor's fund to earn profit by loans and advances.

Generally higher ratio reflects higher efficiency of in utilizing outsiders' fund and vice-versa. This ratio can be computed by dividing the total amounts of loans and advance by total deposited funds.

Loans and advance to total deposits ratio = $\frac{\text{Loans and Advances}}{\text{Total deposits}}$

Loans and advance refers to the total amount of loan and advance and overdraft (i.e. in local currency plus convertible foreign currencies) and total deposits refers the total of all kinds of deposits.

2.3.1.2.2 Loan and Advances to Fixed deposits Ratio

This ratio represents how many times the funds are used for loans and advances against fixed deposits. Fixed deposits are long-term interest bearing obligations and loan and advance are the main sources of earning of the bank. This ratio can be computed by dividing loans and advance by fixed deposits.

Loans and advance to fixed deposits ratio = $\frac{\text{Loans and advance}}{\text{Fixed deposits}}$

A high ratio indicates idle cash balances; meaning is not being utilized properly. Actually the fixed deposits are expected to utilize for the disbursement of long term loans and advance.

2.3.1.2.3 Total Investment to Total Deposit ratio

Investment is one of the major elements that impact in the profitability. Total investment refers to the utilization of the bank's deposit in the different investments such as Government bond, NRB debenture, investment in marketable securities such as treasury bills, shares of listed companies etc. This ratio measures the extent to which the financial companies are successful in mobilizing the deposit of the public towards different securities. Usually, banks invest some portion of their total deposit towards highly liquid securities so that it can be easily disposed in the stage of financial crunch or in the case of high yielding investment opportunity comes on the way. It is the ratio between total investment and total deposit thus can be representing as follows:

Total Investment to total deposit ratio = $\frac{\text{Total Investment}}{\text{Total Deposit}}$

2.3.1.3 Leverage/Capital Structure Ratio

The long-term creditors would judge the soundness of a firm on the basis of long term financial strength measured in terms of its ability to pay the interest regularly as well as repaying the installment of the principal on due dates. It represents the long-term solvency of a firm. There are two aspects regarding long-term solvency of a firm. a) Ability to repay the principal when due b) regular payment of the interest. According to this, long-term creditors calculated what portion constitutes the equity and borrowed finds in total capital of a firm. This ratio can be calculated from the balance sheet of a firm. Creditors are hesitant in supporting the firm if equity /owner's portion is less than the borrowed fund in capital structure of a firm. This ratio highlights the long-term financial health, debt servicing capacity and strength and weakness of the firm. There are different ratios, which justify the long-term financial solvency of a firm. The related leverage ratios are:

2.3.1.3.1 Debt Equity Ratio/Debt to Net Worth Ratio

This ratio reflects the relationship between borrowed funds and owner's capital. It refers to the relative proportion of debt and equity in financing the assets of a firm. The relationship between outsider's claims and owner's capital can be shown in different funds invested by the owners. So, it is the test of the financial strength of the Company. It can be computed by dividing total debt by total equity.

Total debts to equity ratio = $\frac{\text{Total Debt}}{\text{Total equity/ Net Worth}}$

A total debt refers to all deposits, bills payable, borrowing from other bank and other liabilities. Total equity refers to paid up capital, reserve and surplus and undistributed profit.

Simply high debt to equity ratio is unfavorable for the firm. Because creditors have more claim on the company. They should be paid interest as principal at due time by the firm. So, if a firm raises excess debt, company's cash out flow exceeds the cash inflow. If the firm is for some time unable to pay interest, the creditors can take legal action on the firm, due to which the firm may reach liquidation.

On the other hand, very low debt equity ratio is also unfavorable from the shareholders' point of view; shareholders want excess use of debt in the firm with low rate of interest but high return from that debt. When the return is high than the cost, the shareholders will be benefited. So an appropriate mix of capital structure is needed to employ by a firm so that the wealth of the shareholders can be maximized.

2.3.1.3.2 Total Debts to Total Assets Ratio

This ratio reflects the claims of outsiders and owners on the total assets of the firm. It also measures the financial security to the outsiders. It is also like a debt equity ratio. Higher ratio indicates higher financial risk as well as increasing claims of outsider on the total assets of a firm. This ratio can be computed by dividing total debts by total assets.

$$\text{Total debts to total assets ratio} = \frac{\text{Total Debts}}{\text{Total assets}}$$

Total debts represent long-term debt and current liabilities whereas total assets represent all the assets of balance sheet.

2.3.1.3.3 Capital Adequacy Ratio

Capital is important for an organization. In fact, the most important factor influencing solvency is capital. Capital includes equity share capital and all reserves and surpluses available to equity shareholders. Adequate capital is required to the efficient operation and functioning of the firm. Holding too little capital may have inefficiency in paying liabilities of a firm similarly, holding excess capital than required may have higher holding cost and low return from investment.

So a firm should maintain an optimum level of cash. For maintaining optimum cash, NRB directs the development banks to increase or decrease or fix a certain percentage of capital funds out of total deposits. The capital adequacy ratio can be calculated by using the formula as prescribed by NRB.

2.3.1.4 Profitability Ratio

Profitability ratio is one of the main indicators to analyze the financial performance of a firm. It shows the overall efficiency of the business concerns. Profitability also indicates public acceptance of the product and shows that the firm can produce competitively. This ratio can be computed on the basis of either sales or investment. Shareholders, government, tax collectors, employees and all concerned with the company are generally concerned with the profitability of the company. This ratio gives the answer to following questions.

- Does the firm adequate earn the profit?
- What rate of return does it represent?
- What is the rate of profit for various divisions and segments of the firm?
- What is the earning per share?
- What amount was paid as dividends?
- What is the rate of return to equity holders

In this study, this ratio can be computed on the basis of investment so it is also known as return on investment ratio. Here return refers to return on assets, return on capital employed and return on shareholders 'equity.

2.3.1.4.1 Return on Net Worth/Total Equity Ratio

This ratio measures, how much profit is earned by utilizing funds of total equity by the firm. It measures the earning power of the company against owner's investment. Total shareholders' equity consists of preference share capital, ordinary shareholders equity consisting of equity share capital, share premium, reserve and surplus less accumulated losses. This ratio can be computed as Net profit after taxes divided by average total shareholders' equity.

$$\text{Return on net worth/total equity ratio} = \frac{\text{Net Profit after Taxes}}{\text{Net worth/total equity}}$$

Higher ratio indicates the sound management and efficiency of a firm and vice-versa.

2.3.1.4.2 Return in Assets Ratio (ROA)

This ratio is related on net profit after tax and total assets. It evaluates the efficiency of a company in utilization and mobilization of the assets and it's survival. How efficiently the assets is of a firm able to generate more profit are measured by this ratio provides the foundation necessary for a company to deliver a good return on equity. A company without a good return on total assets is almost impossible to generate a satisfactory ROA.

$$\text{Return on total assets ratio} = \frac{\text{Net profit after tax}}{\text{Total assets}}$$

Higher ratio indicates higher efficiency in utilization of asset of the firm and vice-versa.

2.3.1.4.3 Return on Total deposits Ratio

This ratio measures the level of net profit after tax by using total deposits. It reveals the relationship between net profit after tax and total deposits with an ability of a firm to utilize maximum of deposits to earn much profit. This ratio examines the capability of the management to mobilize and utilize the deposit for generating profit. Generally, higher ratio indicates better utilization of deposits and vice-versa. This ratio can be computed by dividing the NPAT by total deposits.

$$\text{Return on total deposits ratio} = \frac{\text{Net profit after tax}}{\text{Total deposits}}$$

2.3.1.4.4 Return on Investment (ROI)

ROI measures the capacity of the company to generate profit out of its total investment. It reflects only those attributes of the firm's performance which are actually under the control of the firms operating management. Here return denotes net profit after tax and investment includes both long-term and short-term investment. It can be computed by:

$$\text{Return on Investment (ROI)} = \frac{\text{Net profit after tax}}{\text{Total Investment}}$$

2.3.1.4.5 Total Interest Earned to Total Assets Ratio

This ratio indicated how much interest mobilizing the assets in the banks has generated. Interest is the main source of income of banks. Interest is received from

generally loans and advance, overdraft and investment in securities. This ratio can be computed as interest earned divided by total assets.

$$\text{Total Interest earned to total assets ratio} = \frac{\text{Total Interest earned}}{\text{Total assets}}$$

Higher ratio indicates higher efficiency in the mobilization of resources and ability in interest earning and vice-versa.

2.3.1.4.6 Total Interest Paid to Total Assets Ratio

This ratio measures the percentage of total interest paid on liabilities with respect to total assets. The total interest paid includes total interest expenses on total deposits, loans and advances, borrowings and other deposits. Higher ratio indicated high interest expenses on funds and vice versa. This ratio can be computed as total interest paid dividing by total assets.

$$\text{Total Interest paid to total assets ratio} = \frac{\text{Total Interest paid}}{\text{Total assets}}$$

2.3.1.5 Other Ratio

Different types of ratios have been discussed already. Besides, some of the following are to be considered the performance of a firm.

2.3.1.5.1 Earning per share

Apart from the rate of return, the profit ability of a firm, from the point of view of the ordinary shareholders, is the Earning per share (EPS). It measures profit available to the equity holders on per share basis. It is calculated by dividing the profit available to the shareholders by the number of outstanding shares. This profit represents the net profit after tax and preference dividends.

Earning per share ratio = Profit after tax

Total number of shares

2.3.1.5.2 Interest Paid to Interest Income

This ratio reveals the proportionate relationship between interest paid on different liabilities and interest income from different sources. Higher ratio indicates the bank has paid higher amount of interest on liabilities in relating to interest income and vice versa.

Interest paid includes interest paid on deposits and borrowing and interest income includes the interest from loan, advance, over draft, investment on government securities and debenture, money at short call and inter bank loan. Following formula is used to calculate interest paid to interest income.

Interest paid to interest income = Interest paid

Interest income

2.3.1.5.3 Loan Loss Ratio

This is also an important ratio for development banks' lending portfolio should be effective, other wise there may chance of not recovered if loan and advance, over drafts. Some times, even the management of bank may be confused about the recovery of loans and advances. So a certain portion of amount is kept in bank as provision on loan and advances, overdraft. If this ratio increases, then the bank may suffer loss and vice-versa. This ratio can be calculated by dividing general loan loss provision by total loan advanced.

Loan loss ratio = General loan loss provision

Total loans & advances

2.3.1.5.4 Non-performing Assets/ Total Loans & Advances ratio

This ratio measures the relationship between the total bad loans and the total loans and advance of the bank. Non-performing assets include the loans categorized under substandard, doubtful and bad as per the Nepal Rastra Bank directives and the total loan and advance outstanding of the bank. Since the ratio states the proportion of non performing loans in respect to total loans, the lower ratio indicated better investment and vice-versa.

$$\text{Non-performing assets to total loans and advances} = \frac{\text{Non performing assets}}{\text{Total loans and advances}}$$

Chapter III
RESEARCH METHODOLOGY

3.1 Introduction

The different aspects of this thesis work under the subject of "Nepal Rastra Bank directives to development banks and their financial performance" have already been mentioned in the previous chapters. An introduction relation to the thesis work is made in the first chapter and relevant literatures are reviewed in the second chapter. The "Research Methodology", which is used to analyze for collection of data, are mentioned in this chapter.

Research Methodology adopted in this chapter is the set of various instrumental approaches used in achieving the predetermined objective as stated in the earlier chapters. It count on the resources and techniques available and to the extent of their reliability and validity in this chapter follows some limited but crucial steps aimed to achieve the objectives of the research. Research methodology refers to the various sequential steps (along with a rational of each such step) to be adopted by researcher in studying a problem with certain objective in view.

Though limited to some conventional boundaries to research has something to offer call the concerned "Research Methodology is a way to systematically solve the research problem. It may be understood as a science of studying how research is done significantly. It is necessary for the researcher to know not only the research methods/techniques but also the methodology. Researchers not only need to know how to develop certain indices or tests, how to calculate the mean, mode, the research techniques but they also need to know which of these methods or techniques are relevant and which are not what would they mean and indicate and why. (Kothary, 1994. page10)

3.2 Research Design

Decision regarding what, where, when, how much, by what means concerning an enquiry or a research study constitute a research design. “A research design is the arrangement of conditions for collection and analysis of data in manner that aims to combine relevance to the research purpose with economy in procedure” In fact the research constitutes the blueprint for the collection, measurement and analysis of data. As such the design includes an outlines of what the researcher will do from writing the hypothesis and its operational implications to the find analysis of data.

A research design, bearing the techniques and systematic steps of research, helps to collect various information required to researcher thesis writing or any investigation. In the lack of the research design, the functional process on researches in never achieved.

“After the research study has been formulated, the next logical steps are to construe the research design which refers to the entire process of planning and carrying out a research study. The research design asks what approach to the problem should be taken. What methods will be used? What strategies will be most effective? Identification, selection and formulation of a research problem may be considered as the planning stage of a research. The remaining activities refer to the designs, operation and completion of the research study” (Wolf and Pant, 1999. page 53)

3.3 Sources of Data

Mainly, the study is conducted on the basis of the secondary data. The data required for the analysis are directly obtained from different financial statements, annexure of concerned banks annual reports. Supplementary data and information are collected from number of institutions and regulating authorities like NRB,

Nepal Stock Exchange Ltd., Ministry of Finance, budget speech of different fiscal years, economic survey and national planning commission etc.

All the secondary data are compiled, processed and tabulated in the time series as per the need and objectives. Formal and informal talks with the concerned authorities of the banks were also helpful to obtain the additional information of the related problem. Likewise, various data and information are collected from the economic journals, periodical, bulletins, magazines, websites and other published and unpublished reports and documents from various sources

3.4 Population and Sample

A population is most studies usually consists of large group because of its large size it is fairly difficult to collect detailed information from each member of population. Rather than collecting information from each member, a sub-group is chosen which is believed to be representative of population. This sub-group is called a sample and the method of choosing this sub-group is done by sampling. The sampling allows the researcher more choosing this sub-group is done by sampling. The sampling allows the researcher more time to make an intensive study of a research problem.

At present, there are 83 development banks operating in Nepal. Due to time and resource factors, it is not possible to study all of them regarding the study topic. All the development banks that are operating in Nepal are considered as the population. From all the development banks of Nepal, only one national level development banks are selected as sample for the purpose of the study.

The samples are as follows:

a) Sanima Bikash Bank Ltd (SBBL)

b) Manakamana Development Bank Ltd. (MKDBL)

3.5 Method of Analysis

Financial statement such as Profit & Loss statement and balance sheet of concerned development banks has been analyzed. Financial statement analysis is a process of evaluating the relationship between components/parts of financial statement to obtain a better understanding of firm's position and performance. "It is designed to determine the relative strength and weakness of a company whether the firm is financially sound and profitable relative to other firms in industry and whether it's position is improving or deteriorating over the time" (Brigham, 1982:226)

In this study, various financial, accounting and statistical tool have been used to achieve the objective of the study. The analysis of data will be done according to the pattern of data available. The financial tools have been used as well as performance analysis of development banks with respect to the directives laid down by development banks is studied. They are as follows:

3.5.1 Financial Tools

The hidden facts put forth by financial statements will be analyzed using financial tools such as ratio analysis as shown below:

3.5.1.1 Ratio Analysis

Ratio analysis is the proportion of two mathematical expressions which shows the relationship between two or more things. This study contains following ratios:

3.5.1.1.1 Liquidity Ratio

Liquidity ratios are used to analyze whether the bank can meet its short term obligation on demand of the depositors and creditors. Liquidity can be measured by using following ratios:

3.5.1.1.1.1 Current Ratio

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

3.5.1.1.1.2 Cash and Bank Balance to Deposits Ratio

$$\text{Cash and bank balance to deposits ratio} = \frac{\text{Cash and bank balance}}{\text{Deposits}}$$

3.5.1.1.1.3 Cash and Bank balance to Current Assets Ratio

$$\text{Cash and bank balance to current assets ratio} = \frac{\text{Cash and Bank balance}}{\text{Total current assets}}$$

3.5.1.1.2 Activity/Turnover/Utilization Ratio

Activity ratios can be measured by calculating following ratios:

3.5.1.1.2.1 Loans and Advances to Total Deposits Ratio

$$\text{Loans and advances to total deposits ratio} = \frac{\text{Loans and advance}}{\text{Total deposits}}$$

3.5.1.1.2.2 Loan and Advance to Fixed Deposits Ratio

$$\text{Loans and advance to fixed deposits ratio} = \frac{\text{Loans and advance}}{\text{Fixed deposits}}$$

3.5.1.1.2.3 Total Investment to Total Deposit Ratio

$$\text{Total investment to total deposit ratio} = \frac{\text{Total investment}}{\text{Total deposit}}$$

3.5.1.1.3 Leverage/Capital Structure Ratio:

The related leverage ratios are as follows:

3.5.1.1.3.1 Debt Equity Ratio/Debt to Net Worth Ratio

$$\text{Total debts to equity ratio} = \frac{\text{Total debt}}{\text{Total equity (Net worth)}}$$

3.5.1.1.3.2 Total Debts to Total Assets Ratio

$$\text{Total debts to equity ratio} = \frac{\text{Total debts}}{\text{Total assets}}$$

3.5.1.1.3.3 Capital Adequacy Ratio

This ratio can be calculated by using following formula as prescribed by NRB.

3.5.1.1.4 Profitability Ratio

The following ratios can be analyzed under profitability ratio:

3.5.1.1.4.1 Return on Net worth/Total Equity Ratio

$$\text{Return on net worth/Total equity ratio} = \frac{\text{Net profit after tax}}{\text{Net worth/total equity}}$$

3.5.1.1.4.2 Return on Assets Ratio (ROA)

$$\text{Return on total assets ratio} = \frac{\text{Net profit after tax}}{\text{Total assets}}$$

3.5.1.1.4.3 Return on Total Deposits Ratio

$$\text{Return on total deposits ratio} = \frac{\text{Net profit after tax}}{\text{Total deposits}}$$

3.5.1.1.4.4 Return on Investment (ROI)

$$\text{Return on Investment} = \frac{\text{Net profit after tax}}{\text{Total investment}}$$

3.5.1.1.4.5 Total Interest Earned to Total Assets Ratio

$$\text{Total interest earned to total assets ratio} = \frac{\text{Total interest earned}}{\text{Total assets}}$$

3.5.1.1.4.6 Total Interest Paid to Total Assets Ratio

$$\text{Total Interest paid to total assets ratio} = \frac{\text{Total Interest paid}}{\text{Total assets}}$$

3.5.1.1.5 Other Ratio

Some of the ratios other than the above mentioned are to be considered for analyzing the performance of a company.

3.5.1.1.5.1 Earning Per Share

$$\text{Earning per share ratio} = \frac{\text{Profit after tax}}{\text{Total assets}}$$

3.5.1.1.5.2 Interest Paid to Interest Income

$$\text{Interest paid to interest income} = \frac{\text{Interest paid}}{\text{Interest income}}$$

3.5.1.1.5.3 Loan Loss Ratio

$$\text{Loan loss ratio} = \frac{\text{General loan loss provision}}{\text{Total loans \& advances}}$$

3.5.1.1.5.4 Non-performing Assets/Total Loans & Advances Ratio

$$\text{Non-performing assets to total loans and advances} = \frac{\text{Non performing assets}}{\text{Total loans \& advance}}$$

3.5.2 Statistical Tools Used

Statistics (as used in sense of data) are numerical statement of facts capable of analysis and interpretation and the science of statistics is a study of the principles and method used in collection, presentation analysis and interpretation of numerical data in any sphere of inquiry. (Elhance, 1994:16) in the present study, following statistical tools have been used to draw one meaningful conclusion.

a) Mean or Average ($\overline{X}$):

An average is value, which represents a group of values. It shows the characteristics of the whole group. Generally the average value lies somewhere in between the two extremes, i.e. the largest and the smallest items. It is also known as simple average.

$$\overline{X} = \frac{X_1 + X_2 + X_3 + \ldots + X_n}{N}$$

Or, $\overline{X} = \frac{X}{N}$

b) Standard Deviation (σ):

Karl Pearson introduced the standard deviations concept in 1823. It is by for most important and widely used measure of studying dispersion. Standard deviation is also known as root mean square deviation for the reason that is the square root means of the square deviations from the arithmetic mean, which is denoted by the small Greek letter sigma. "The standard deviation measures the absolute dispersion or variability of the distribution; for the greater the amount of dispersion or variability the greater the standard deviations, for the greater will be the magnitude of the deviation of the values from their mean. A small standard deviation means a high degree of uniformity of the observation as well as Homogeneity of a series; a large standard deviation means just the opposite." (Gupta; 1991) In this, standard deviation is calculated for selected dependent and independent variables specified in the model presented above.

$$S\tan dard\ devation\ (\pm_x) = \sqrt{\frac{x^2}{n} - \left(\frac{x}{n}\right)^2}$$

$$\text{Standard deviation } (\pm_y) = \sqrt{\frac{y^2}{n} - \left(\frac{y}{n}\right)^2}$$

3.5.3 Analysis of NRB Directives

Various directives issued by NRB to development regarding Capital Adequacy Ratio, collection of financial resources and funds, statutory deposit and liquidity, classification of loans and advances and loan loss provision, single obligor limit, sector wise loan limit, provision regarding investment and interest rates are analyzed.

CHAPTER- IV

DATA PRESENTATION AND ANALYSIS

This chapter of thesis presents the data, facts figures relating to different aspects of MKDBL and SBBL. This chapter reveals the analysis as well as interpretation of relevant and available data of selected development banks according to the research methodology mentioned in the previous chapter. These available data are translated, analyzed and interpreted so that financial performance of banks can be done easily.

4.1 CAMEL Rating System

It is usual to measure the performance of banks using financial ratios. Often, a number of criteria such as profits, liquidity, asset quality, attitude towards risk, and management strategies must be considered. In the early 1970s, federal regulators in USA developed the CAMEL rating system to help structure the bank examination process. In 1979, the Uniform Financial Institutions Rating System was adopted to provide federal bank regulatory agencies with a framework for rating financial condition and performance of individual banks (Siems and Barr; 1998). Since then, the use of the CAMEL factors in evaluating a bank's financial health has become widespread among regulators. Piyu (1992) notes "currently, financial ratios are often used to measure the overall financial soundness of a bank and the quality of it management. Bank regulators, for example, use financial ratios to help evaluate a bank's performance as part of the CAMEL system". The evaluation factors are as follows;

C → Capital adequacy

A → Asset quality

M → Management quality

E → Earnings ability

L → Liquidity.

Each of the five factors is scored from one to five, with one being the strongest rating. An overall composite CAMEL rating, also ranging from one to five, is then developed from this evaluation. As a whole, the CAMEL rating, which is determined after an on-site examination, provides a means to categorize banks based on their overall health, financial status, and management. The Commercial Bank Examination Manual produced by the Board of Governors of the Federal Reserve System in U.S describes the five composite rating levels as follows (Siems and Barr, 1998).

CAMEL = 1 an institution that is basically sound in every respect.

CAMEL = 2 an institution that is fundamentally sound but has modest weaknesses.

CAMEL = 3 an institution with financial, operational, or compliance weaknesses that give cause for supervisory concern.

CAMEL = 4 an institution with serious financial weaknesses that could impair future viability.

CAMEL = 5 an institution with critical financial weaknesses that render the probability of failure extremely high in the near term.

4.2 RATIO ANALYSIS

The term ratio refers to the numerical or quantitative relationship between two variables. Important ratios can be calculated from the balance sheet, profit and loss account and thus calculated financial ratios can be useful for analyzing and assessing the performance and position of the bank, which reflect the relative

strength and position of the bank over others. The ratio analysis can be analyzed by using following tools:

4.2.1 Liquidity Ratios:

It is very important for a firm to be able to meet its obligations as they become due. Failure to meet its obligation timely due to insufficient liquidity will record the goodwill and the creditor's confidence. Liquidity ratio measures the ability of a firm to meet its short term obligations and reflect the short term financial solvency of a firm. NRB has directed all the banks to maintain adequate Cash Reserve Ratio.

To measure the bank's ability to meet depositors demand or the probability that cash will be continuously available to meet its maturing obligations, various liquidity ratios are calculated as shown below:

4.2.1.1 Current Ratio:

It is the ratio of total current assets to total current liabilities calculated by dividing the company's current assets by current liabilities. Higher the current ratio, higher the liquidity position of the company. It is concerned with the assets and liabilities that can be converted into cash within one year. Current assets of the bank refers to cash and near cash items (i. e. cash and bank balance, money at call and short notice, investment in government's bond and NRB debenture, investment in marketable securities and other assets such as interest receivables, miscellaneous current assets). Current liabilities refers to deposits i. e. saving, current call and short deposit, other bill's payable and miscellaneous liabilities.

The following table shows the current ratio of SBBL and MKDBL

Current Ratio (in times)

Table No: 6

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Current Assets**	**Current Liabilities**	**Current Ratio**	**Current Assets**	**Current Liabilities**	**Current Ratio**
2005/06	976,891.67	774,996.36	1.26	339,078.90	778,666.09	0.44
2006/07	2,466,258.85	2,147,225.06	1.15	298,774.07	689,072.25	0.43
2007/08	3,602,078.57	3,385,893.88	1.06	245,728.51	582,715.97	0.42
2008/09	5,526,447.96	4,923,504.61	1.12	237,154.41	525,298.66	0.45
2009/10	6,833,329.43	6,205,295.36	1.10	828,476.09	433,608.85	1.91
Mean			1.14			0.73
Standard Deviation			0.1			0.59

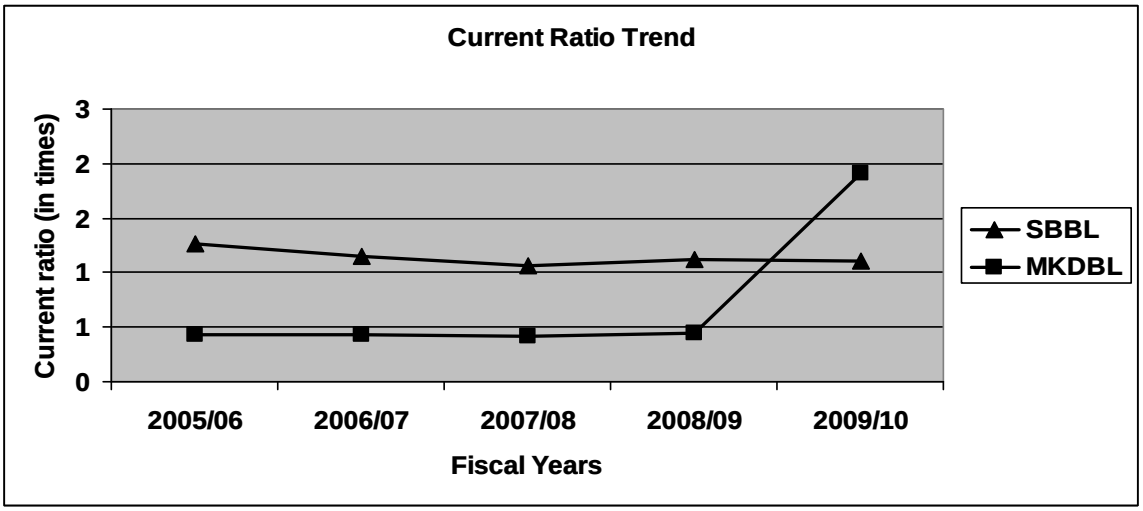
Source: Annual Report of SBBL & MKDBL

This table shows that the current ratio of SBBL under the study period has ranged between 1.16 in 2005/06 and 1.10 in 2009/10 where as MKDBL ratio during the period of 2005/06 is 0.44 which then gradually increases to 1.91 during the period of 2009/10. The mean current ratio for SBBL and MKDBL is 1.14 and 0.73 respectively. Likewise, standard deviations for these development banks are 0.10 and 0.59 respectively.

Current assets and current liabilities show the short term obligation of the firm. If we analyze the current ratio of both banks for the fiscal 2005/06 and 2009/10, the current ratio seems to pretty higher then the normal standard. The NRB directives played the major role in happening so. Current ratio of both banks does not seem to be on a healthier side but it cannot be concluded the liquidity position of both banks to be poor because this ratio reflects the quantity and not the quality of assets and second reason that it does not distinguish between the types of current assets. Both banks are following aggressive policy.

The trend of current ratio of SBBL and MKDBL has been presented below:

Figure No.: 1



4.2.1.2 Cash and Bank balance to Deposits Ratios

Cash and bank balance to deposits ratio measures the capacity of the banks to meet unexpected demand made by the depositor's i. e. current account holders, saving account holders, and other margin account holders. Higher ratio shows bank balance includes total cash in hand and total cash at bank, similarly deposits include all type of deposits. The following table shows the cash and bank balance to deposits ratio of MKDBL and SBBL.

Cash and Bank balance to Deposits Ratio (in Percentage)

Table No: 7

Amount in 000's

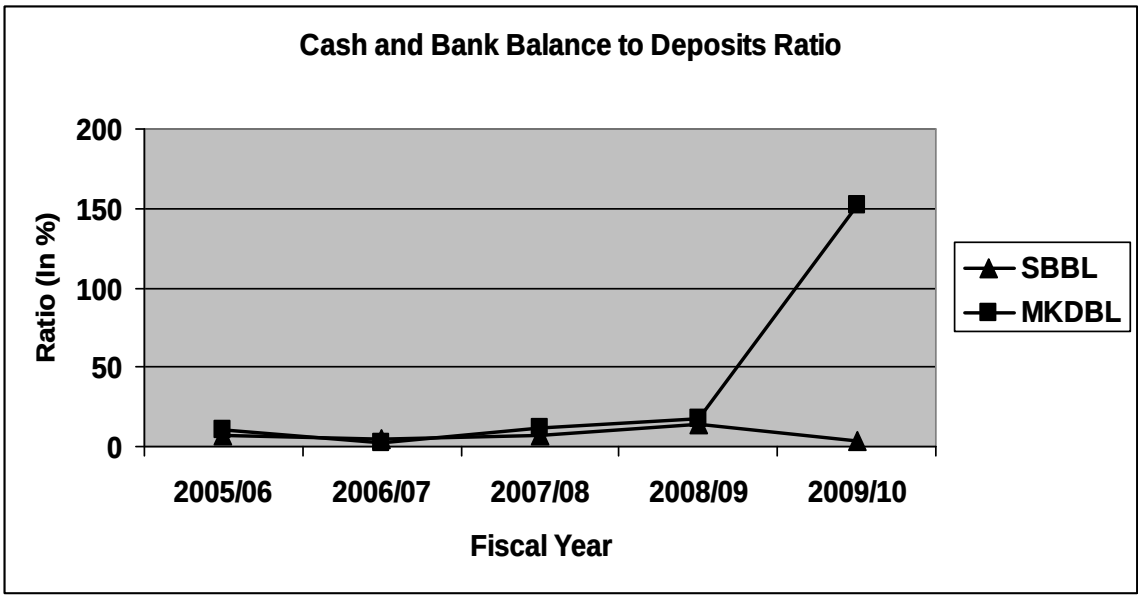
SBBL				MKDBL		
Fiscal Year	**Cash and Bank Balance**	**Total Deposit**	**Ratio (%)**	**Cash and Bank Balance**	**Total Deposit**	**Ratio (%)**
2005/06	48,884.86	749,996.36	6.52	78,777.71	778,666.09	10.12
2006/07	81,656.72	1,822,705.06	4.48	18,456.17	680,087.18	2.71
2007/08	209,088.80	2,880,871.38	7.26	69,431.29	582,715.97	11.92
2008/09	632,814.99	4,417,504.61	14.33	93,574.08	525,298.66	17.81
2009/10	228,437.57	5,760,495.36	3.97	661,421.04	433,608.85	152.54
Mean			7.31			39.02
Standard Deviation			3.72			56.96

Source: Annual Report of SBBL & MKDBL

The above table reveals that the ability of MKDBL to cover the unexpected demand of the depositor is better than SBBL. This ratio of SBBL has ranged between 3.97% in 2009/10 which is lowest and 14.33% in 2008/09 which is highest among the over the study period, where as, ratio of MKDBL has ranged between 2.71% in 2006/07 which is lowest and 152.54% in 2009/10 which is highest among the over the study period. The mean ratio of SBBL is 7.31% and MKDBL is 39.02% respectively. The standard deviation of SBBL (3.72%) is better than the standard deviation of MKDBL (56.96%), which reveals that the liquidity position of SBBL in order to serve the customers is better than that of MKDBL. However, SBBL is holding greater amount of idle cash, which can have adverse effect in the profitability. Similarly, MKDBL is efficient in cash management but however requires increasing the portion of cash to meet needs of customers (deposit holders). Another reason for high or low ratio can be due to the loan (principal and interest) recovered. A good loan recovery helps the bank to maintain proper liquidity.

The trend of cash and bank balance to deposit ratio of SBBL and MKDBL has been presented below.

Figure No.: 2



4.2.1.3 Cash and Bank Balance to Current assets Ratio

This ratio reflects the portion of cash and bank balance to current assets. Cash and bank balance are highly liquid assets other current assets. It represents what percentage of current assets is in the form of cash. The following table shows the ratio of MKDBL and SBBL.

Cash and Bank Balance to Current Assets ratio (in percentage)

Table No: 8

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Cash and Bank Balance**	**Current Assets**	**Ratio (%)**	**Cash and Bank Balance**	**Current Assets**	**Ratio (%)**
2005/06	48,884.86	976,891.67	5.00	78,777.71	339,078.90	23.23
2006/07	81,656.72	2,466,258.85	3.31	18,456.17	298,774.07	6.18
2007/08	209,088.80	3,602,078.57	5.80	69,431.29	245,728.51	28.26
2008/09	632,814.99	5,526,447.96	11.45	93,574.08	237,154.41	39.46
2009/10	228,437.57	6,833,329.43	3.34	661,421.04	828,476.09	79.84
Mean			5.78			35.39
Standard Deviation			2.99			24.67

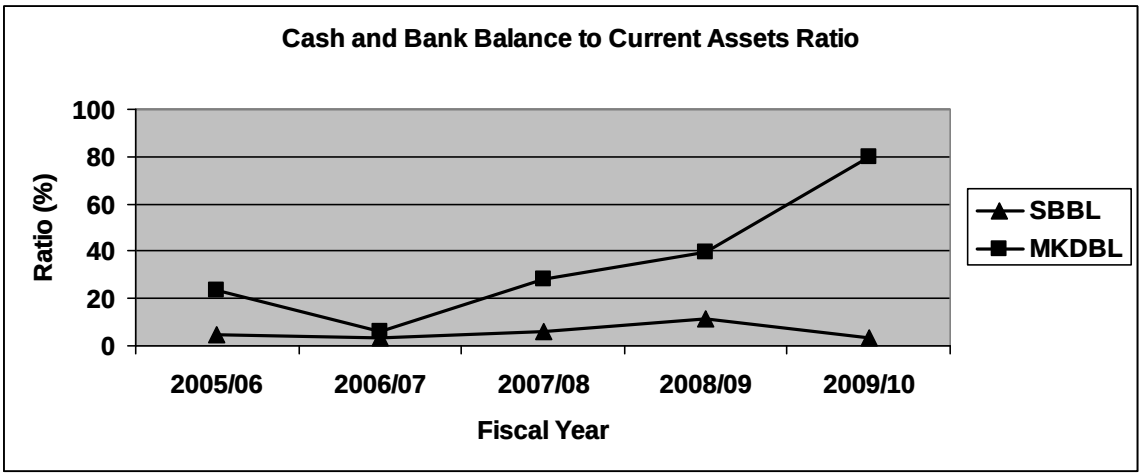
Source: Annual Report of SBBL & MKDBL

The above table shows that the cash and bank balance to current assets ratio of SBBL ranges between 3.34% in 2009/10 to 11.45% in 2008/09 and mean ratio is 5.78% and standard deviation is 2.99%. Likewise this ratio of MKDBL has ranged between 6.18% in 2006/07 to 79.84% in 2009/10 and means ratio is 35.39% and standard deviation is 24.67%. The ratio is in fluctuating trend for SBBL and increasing trend for MKDBL. Thus it reveals that the liquidity position of MKDBL is better but it is holding idle cash where SBBL is utilizing cash in profit generating fields. However holding less cash and bank balance can have negative impact on the goodwill and reputation of the bank to fulfill the demand of the profit holder. From the above table, it can be concluded that development banks

maintain significant amount of their current assets in the form of cash in hand and cash at bank.

The trend of cash and bank balance to current assets ratio of SBBL and MKDBL has been presented below:

Figure No.: 3



4.2.2 Activity / Turnover / Utilization Ratio

This ratio measure the efficiency of management in utilizing assets /funds in profit generating field and available assets are utilized. This ratio is called turnover or efficiency or assets utilization ratio. If available assets are not properly utilized the management fails to increase profit, investment will not generate sufficient production and sales cannot make a returnable profit. In this study efficiency ratios are computed to determine the banks efficiency in utilizing available resources (Deposits). The activity ratio for development banks computed under this heading are shown and interpreted as follows:

4.2.2.1 Loans and Advance to Total Deposit Ratio

This ratio measures the extent to which development banks successfully utilizing outsider's funds in profits generating purpose by extending for use of loan and advances. This ratio is also called C/D ratio (credit- deposit ratio). C/D ratio reflects higher efficiency to the utilization of outsider's fund and vice- versa.

Here, loan and advances refers to total of loans and advance and total deposit refers to total of all kinds of deposits.

Loans and Advances to Total Deposits Ratio (in percentage)

Table No.: 9

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Loan and Advances**	**Total Deposit**	**Ratio (%)**	**Loan and Advances**	**Total Deposit**	**Ratio (%)**
2005/06	758,632.67	749,996.36	101.15	250,001.19	778,666.09	32.11
2006/07	1,501,916.52	1,822,705.06	82.40	816,754.71	680,087.18	120.10
2007/08	2,533,376.50	2,880,871.38	87.94	678,188.45	582,715.97	116.38
2008/09	4,036,986.19	4,417,504.61	91.39	580,778.83	525,298.66	110.56
2009/10	5,145,148.95	5,760,495.36	89.32	503,395.94	433,608.85	116.09
Mean			90.44			99.05
Standard Deviation			6.13			33.61

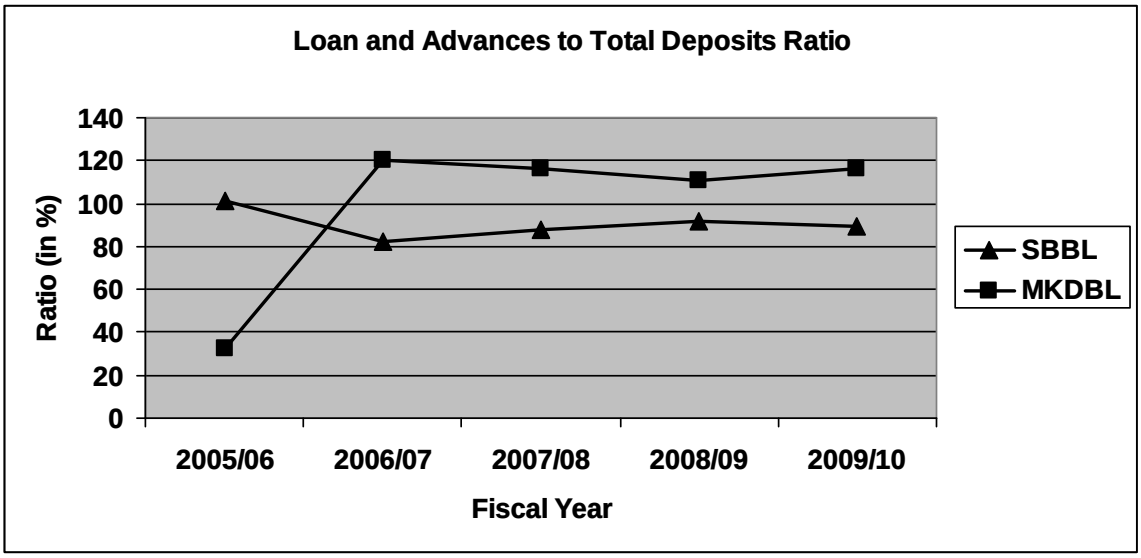
Source: Annual Report of SBBL & MKDBL

The above table shows that this ratio of SBBL is fluctuating trends. The loan and advances to total deposits ratio of SBBL is ranged from 82.40% during the period of 2006/07 to 101.15% in 2005/06. The mean ratio is 90.44% and standard deviation is 6.13%. Likewise, MKDBL ratio is ranged from 32.11% in 2005/06 to 116.38% in 2007/08. The mean ratio is 99.05% and standard deviation is 33.61%. The above table reflects the amount invested in loans and advances from the total deposits collected. The mean ratio of 90.44% SBBL indicates the portion of deposit is invested in loans and advances and remaining portion in some other

assets. Lower ratio represents lower deposit portion being invested in loan and advances.

It is to keep in mind that loan and advances are the highest return yielding sector for a bank. If the ratio is comparatively lower than it can be understood that there is no investment opportunity and bank has investing in the sector yielding comparatively less return.

Figure No.: 4



4.2.2.2 Loans and Advances to Fixed Deposits Ratio

This ratio indicates how much of loan and advances are granted against fixed deposits. Fixed deposits are the higher interest rate payable deposits. Initially, development banks were allowed to accept only fixed deposit as a result they had to pay higher interest rate to attract depositors. Therefore, development banks deposit portfolio consists of significant fixed deposits that bear high interest in comparison to the on going market trends. Hence, development bank should utilize the fixed deposit properly.

The following table displays the ratio of loan and advance to fixed deposits of MKDBL and SBBL:

Loans and Advances to Fixed Deposits Ratio (in percentage)

Table No.: 10

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Loan and Advances**	**Fixed Deposit**	**Ratio (%)**	**Loan and Advances**	**Fixed Deposit**	**Ratio (%)**
2005/06	758,632.67	234,213.75	323.91	250,001.19	640,221.52	39.05
2006/07	1,501,916.52	1,149,684.39	130.64	816,754.71	534,601.64	152.78
2007/08	2,533,376.50	1,704,041.12	148.67	678,188.45	461,681.01	146.90
2008/09	4,036,986.19	2,227,581.70	181.23	580,778.83	400,246.76	145.11
2009/10	5,145,148.95	2,870,651.01	179.23	503,395.94	1,067,000.00	47.18
Mean			192.73			106.20
Standard Deviation			68.29			51.64

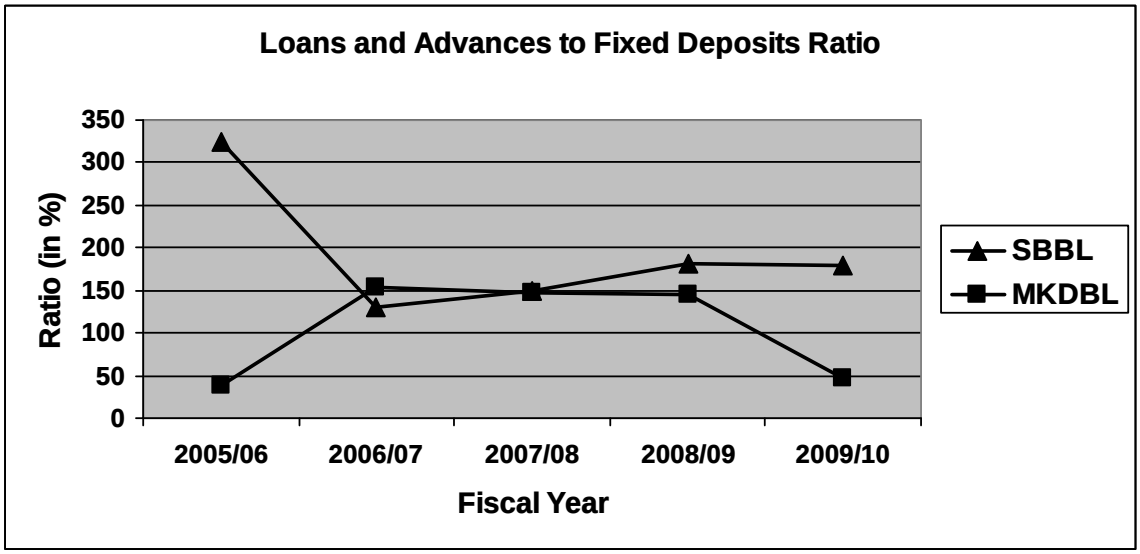
Source: Annual Report of SBBL & MKDBL

From the above table it can be observed that this ratio of the both banks is fluctuating merely over the study period. In the case of SBBL this ratio has ranged between 130.64% in 2006/07 to 323.91% in 2005/06 and means ratio is 192.73%. The standard deviation of SBBL is 68.29% during the study period. Likewise, the ratio of MKDBL has also ranged from 39.05% in 2005/06 to 152.78% in 2006/07. The mean ratio is 106.20% and standard deviation is 51.64%.

Thus, the above table clearly indicates that most of loan and advances of both the banks are financed fixed deposits. Higher the ratio is better for the company. For the year 2005/06, the ratio of SBBL is 323.91% which indicates the fixed deposits alone has been insufficient for accumulation of deposits. In other words, usually fixed deposits bear higher interest rate than other deposits, so it is beneficial for the bank to mobilize the fixed deposits for advancing loans.

The trend of loan and advances to fixed deposits ratio of SBBL and MKDBL has been presented below:

Figure No.: 5



4.2.2.3 Total Investment to Total Deposit Ratio

This ratio implies the utilization of firms deposit toward government securities, shares and debentures and other securities rather than in lending activities. Higher ratio indicates the banks ability to mobilize in investing activities where as low ratio indicates the banks ability to mobilize deposits on lending activities. The following table shows the total investment to total deposit ratio of the two development banks.

Total Investment to Total Deposits Ratio (in percentage)

Table No.: 11

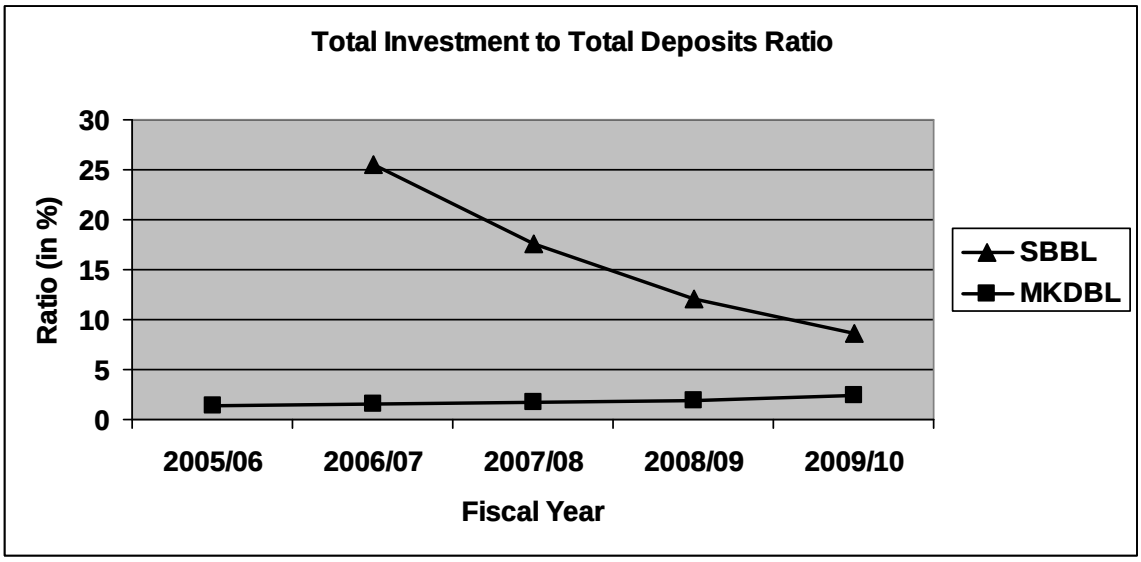
Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Total Investment**	**Total Deposit**	**Ratio (%)**	**Total Investment**	**Total Deposit**	**Ratio (%)**
2005/06	-	749,996.36	-	10,300.00	778,666.09	1.32
2006/07	466,271.20	1,822,705.06	25.58	10,300.00	680,087.18	1.51
2007/08	508,143.42	2,880,871.38	17.64	10,300.00	582,715.97	1.77
2008/09	530,725.00	4,417,504.61	12.01	10,300.00	525,298.66	1.96
2009/10	495,609.74	5,760,495.36	8.60	10,425.00	433,608.85	2.40
Mean			12.77			1.79
Standard Deviation			8.59			0.37

The above table indicates the ratio of SBBL has ranged between 8.60% in 2009/10 to 25.58% in 2006/07 and means ratio is 12.77%. During the period of 2005/06 there no investment of SBBL. The standard deviation of SBBL is 8.59% during the study period. Likewise, the ratio of MKDBL is in increasing from 1.32% in 2005/06 to 2.40% in 2009/10. The mean ratio is 1.79% and standard deviation is 0.37%. It indicates that MKDBL was not so efficient in mobilizing the deposit in investment and was actually active in lending activities. After that the ratio surged, an indicator that either the liquidity was high or there was no appropriate sector for lending activities. On the other hands, SBBL has decline of the ratio indicates the company was running short term deposits fund as a result it compelled the bank to withdraw the fund from investment sector and put in lending activates.

The graphical presentation of total investment to total deposits ratio of SBBL and MKDBL is shown below:

Figure No.: 6



4.2.3 Leverage / Capital Structure Ratio

This ratio is calculated to judge the long – term financial position of the firm. This ratio indicates mixture of funds provided by the owners and lenders, i.e in the form of debt and equity. Debt is more risky form firm's point of view. The firm has a legal obligation to pay interest to debt holders, irrespective of the profit or loss incurred by the firm. The firm with low leverage ratio is subject to lower risks and lower return as well. This ratio of institution highlights the long term financial position, debt servicing capacity and strength and weaknesses of the firm. The following ratios are examined under these headings:

4.2.3.1 Debt Equity Ratio/ Debt to Net worth Ratio

This ratio is calculated by dividing total debt by total equity. This ratio measures the proportion of external liability in the total capital of the firm. It is calculated to measure the firm's obligation to creditors in relation to the funds invested by the owners. In this study, total debt refers to all depositors, bills payable, borrowing made from other banks and other liabilities.

Similarly, total equity refers to paid up capital, reserve and surplus and undistributed profit. Generally, very high debt to ratio is unfavorable to the business firm because debt gives third parties legal claims over the company. Therefore, an appropriate mixture of debt and equity capital should be maintained by the firm for maximization of owner's wealth (shareholders).

The following table shows the ratio of total debt to equity of MKDBL and SBBL.

Debt Equity Ratio/ Debt to Net worth Ratio (in times)

Table No.: 12

Amount in 000's

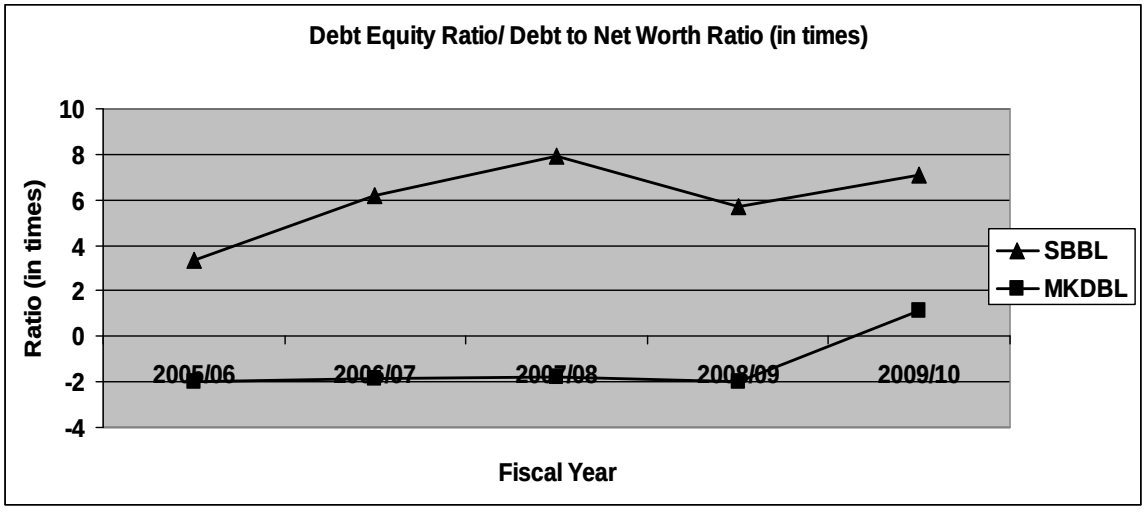
SBBL				MKDBL		
Fiscal Year	**Total Debt**	**Net Worth**	**Ratio (Times)**	**Total Debt**	**Net Worth**	**Ratio (Times)**
2005/06	777,690.78	233,040.61	3.34	802,480.83	-402,297.09	-1.99
2006/07	2,158,964.59	347,766.89	6.21	702,367.17	-379,769.24	-1.85
2007/08	3,408,072.11	431,056.36	7.91	600,496.56	-335,847.30	-1.79
2008/09	4,973,555.04	869,560.89	5.72	546,785.48	-270,310.42	-2.02
2009/10	6,276,724.00	881,194.76	7.12	463,941.33	401,840.39	1.15
Mean			6.06			-1.30
Standard Deviation			1.56			1.23

Source: Annual Report of SBBL & MKDBL

The above table shows the debt to equity ratio of the SBBL and MKDBL. This ratio of SBBL is ranged between 3.34 in 2005/06 to 7.91 in 2007/08. The average ratio is 6.06 and standard deviation is 1.56. On the other hand MKDBL debt equity ratio is -1.99 in 2005/06 and 1.15 in 2009/10; there is high fluctuation ratio of the MKDBL. The mean ratio is -1.30 and standard deviation is 1.23. The net worth of MKDBL is negative during the period of four years but positive in 2009/10. The net worth is negative because excess loan loss provisioning has to be kept. Higher the debt equity ratio, higher the risk to the creditor.

The trend of total debt to equity ratio of SBBL and MKDBL has been presented below:

Figure No.: 7



4.2.3.2 Total Debt to Total Assets Ratio

This ratio measures the relationship between financial contribution of outsiders and owners on total assets of the firm. It measures the proportion of debt out of total assets of the firm. It also provides security of outsider to pay their regular interest, dividend and principal within prescribed time. This ratio is similar as debt to equity ratio. Higher debt ratio indicates higher financial risk as well as increasing claims of outsiders in total assets and lower ratio indicates lower financial risk as well as decreasing claims of outsiders over the total assets of the firm. Here, total debt refers to short term loan, long term loans and all kinds of deposits and other liabilities and total assets include all the assets that are in the assets side of balance sheet of the firm.

The following table shows total debt to total assets of MKDBL and SBBL.

Total Debt to Total Assets Ratio (in percentage)

Table No: 13

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Total Debt**	**Total Assets**	**Ratio (%)**	**Total Debt**	**Total Assets**	**Ratio (%)**
2005/06	777,690.78	1,010,731.40	76.94	802,480.83	416,248.09	192.79
2006/07	2,158,964.59	2,506,731.48	86.13	702,367.17	322,597.92	217.72
2007/08	3,408,072.11	3,839,128.47	88.77	600,496.56	264,649.26	226.90
2008/09	4,973,555.04	5,845,136.97	85.09	546,785.48	276,475.06	197.77
2009/10	6,276,724.00	7,238,558.76	86.71	463,941.33	865,781.72	53.59
Mean			84.73			177.75
Standard Deviation			4.08			63.33

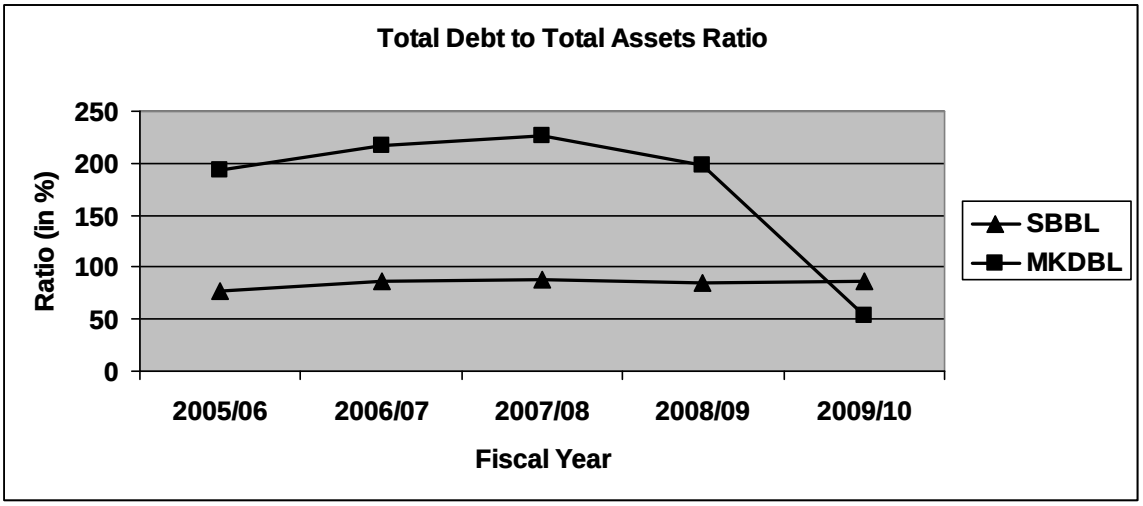
Source: Annual Report of SBBL & MKDBL

The above table shows that the total debt to total assets ratio of SBBL and MKDBL. This ratio of both banks is very high. The ratio of SBBL is 76.94% in 200/06 and 86.71% in 2009/10. The mean ratio is 84.08% and standard deviation is 4.08%. On the other hand this ratio of MKDBL ranged between 53.59% in 2009/10 which is lowest ratio to 226.90% in 2007/08 which is highest ratio. The mean ratio is 177.75% and standard deviation is 63.33%.

The total debts includes short- term and long- term loan as well as various types of deposits, the ratio may not reflect the actual portion of debt in total assets of the firm. Higher flow of deposit influences this ratio.

The trend of total debt to total assets ratio of SBBL and MKDBL has been presented below:

Figure No.: 8



4.2.3.3 Capital Adequacy Ratio

This ratio measures the portion of firm's capital fund with respect to total deposit in case of every bank this ratio is considered to be more important. Banks should maintain the capital fund according to their requirement. If banks have been holding more capital than their minimum requirement, can cause them to have higher holding cost and low return at the same time holding too little amount of capital than required may have disadvantage of inadequacy and shortage of fund.

So, in this context Nepal Rastra Bank directs the development banks to increase or decrease by fixing their percentage of capital fund out of total deposit. According to NRB's directives, development banks required to maintain their capital fund as prescribed by NRB from time to time. If the banks are unable to meet this rate, they would increase paid up capital or transfer a part of profit to general reserve to meet the requirement. This ratio is calculated as per the risk weighted assigned by NRB on different balance sheet and off- balance sheet items.

Here, capital fund includes total of paid up capital, Reserve and surplus and undistributed profit and total deposit includes total of current deposits, plus saving

deposits plus fixed deposits plus call and other deposits. These ratios of both the sample banks have been presented as follows:

Capital Adequacy Ratio (in percentage)

Table No: 14

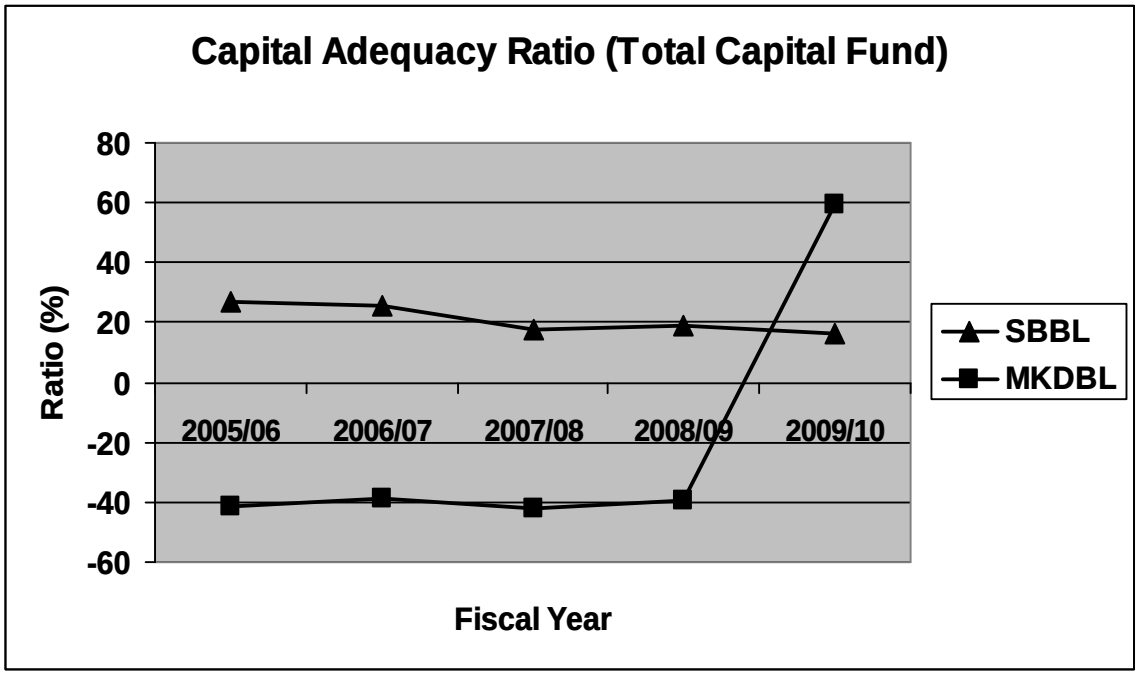
	Minimum Required		SBBL		MKDBL	
Fiscal Year	**Total Capital Fund**	**Core Capital Fund**	**Total Capital Fund**	**Core Capital Fund**	**Total Capital Fund**	**Core Capital Fund**
2005/06	11%	5.50%	26.72%	25.86%	-41.42%	-44.36%
2006/07	11%	5.50%	25.58%	25.58%	-38.66%	-44.76%
2007/08	11%	5.50%	17.73%	16.76%	-41.90%	-42.01%
2008/09	11%	5.50%	19.02%	18.10%	-39.60%	-39.76%
2009/10	11%	5.50%	16.51%	15.56%	59.71%	59.36%

Source: Annual Report of SBBL & MKDBL

The table shows that the capital adequacy ratio of SBBL and MKDBL. The SBBL has been able to meet the minimum capital adequacy ratio for all the five year. This ratio of SBBL is 26.72% in 2005/06 and 16.51% in 2009/10. On the other hand, the MKDBL has been below the minimum capital ratio for all four years and positive in 2009/10. This ratio is negative during the period of 2005/06, 2006/07, 2007/08 and 2008/09, which indicates that the risk of insolvency has been gradually shifting away from the capital to the depositors.

The trend of capital adequacy ratio (Total Capital Fund) of the SBBL and MKDBL has been presented below:

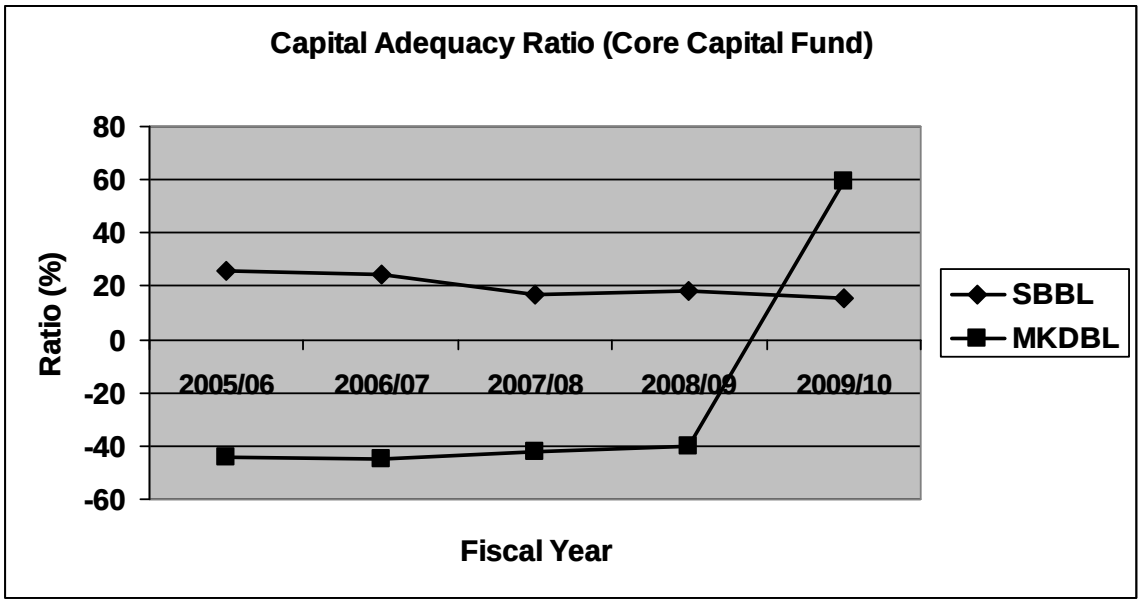
Figure No.: 9



However, in case of capital fund ratio with respect to core capital fund, SBBL was able to meet the minimum required ratio of 5.50% in all year. But on the other hand MKDBL has not able to meet the minimum required ratio. This ratio is negative during the period of 2005/06, 2006/07, 2007/08 and 2008/09 but positive in 2009/10.

The graphical representation of capital adequacy ratio (Core Capital Fund) of the SBBL and MKDBL has been presented below:

Figure No.: 10



4.2.4 Profitability Ratio

Profit is one of the main objectives of every business houses, be it financial or non financial. The profit is the key element for financial institution to survive and grow over the long run. However profitability is a measuring rod of financial performance of every company. This ratio indicates the degree of success in achieving desired profit levels of working funds. These ratios are of two types: those showing profitability in relation to sales and those showing profitability in relation to investment. In this study profitability ratios are computed by relating the profit of bank to its investment. Such ratios are known as return on investment. Many ratios are determined under this heading.

4.2.4.1 Return on Net Worth / Total Equity Ratio

This ratio measures the profit earned by the development banks utilizing owner's equity there by generating return to satisfy the owners. Higher ratio indicates sound management and efficiency.

Here, NPAT refers to net profit after tax from profit and loss account, and net worth refers to paid up capital, reserve and surplus and undistributed profit. The following table shows return on equity of MKDBL and SBBL.

Return on Net Worth / Total Equity Ratio (in percentage)

Table No: 15

Amount in 000's

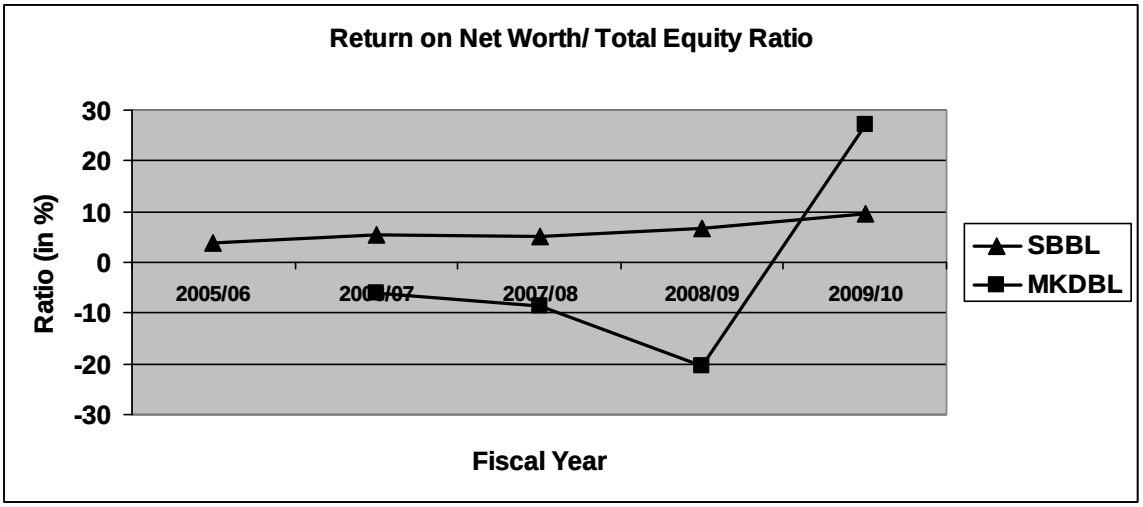
SBBL				MKDBL		
Fiscal Year	**Net Profit**	**Net Worth**	**Ratio (%)**	**Net Profit**	**Net Worth**	**Ratio (%)**
2005/06	8,785.75	233,040.61	3.77	-530,853.63	-402,297.09	-
2006/07	18,748.43	347,766.89	5.39	22,527.85	-379,769.24	-5.93
2007/08	21,485.72	431,056.36	4.98	29,391.94	-335,847.30	-8.75
2008/09	57,759.77	869,560.89	6.64	54,811.88	-270,310.42	-20.28
2009/10	85,737.99	881,194.76	9.73	109,405.81	401,840.39	27.23
Mean			6.10			-1.93
Standard Deviation			2.03			17.67

Source: Annual Report of SBBL & MKDBL

The above table shows that the return on net worth/ total equity ratio of SBBL and MKDBL. This ratio of SBBL is ranged between 3.77% in 2005/06 to 9.73% in 2009/10. The mean ratio is 6.10% and standard devotion is 2.03%. On the other hand, this ratio of MKDBL is negative during the period of three year and 27.23% in 2009/10. The both net worth and net profit is negative for the period of 2005/06 for MKDBL, its not relevant calculating this ratio for this year. The mean ratio is -1.93% and standard deviation is 17.67% of MKDBL.

The trend of return on total net worth /total equity ratio of SBBL and MKDBL has been presented below:

Figure No.: 11



4.2.4.2 Return on Total Assets Ratio (ROA)

This ratio measures the management ability to utilize all the assets of a firm for profit generating activities. It provides the foundation necessary for a company to deliver a good return on equity. Higher ROA ratio indicates higher efficiency in the utilization of total assets and vice versa. These ratios of both banks are presented in the following table:

Return on Total Assets Ratio (in percentage)

Table No: 16

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Net Profit**	**Total Assets**	**Ratio (%)**	**Net Profit**	**Total Assets**	**Ratio (%)**
2005/06	8,785.75	1,010,731.40	0.87	-530,853.63	416,248.09	-127.53
2006/07	18,748.43	2,506,731.48	0.75	22,527.85	322,597.92	6.98
2007/08	21,485.72	3,839,128.47	0.56	29,391.94	264,649.26	11.11
2008/09	57,759.77	5,845,136.97	0.99	54,811.88	276,475.06	19.83
2009/10	85,737.99	7,238,558.76	1.18	109,405.81	865,781.72	12.64
Mean			0.87			-15.39
Standard Deviation			0.20			56.22

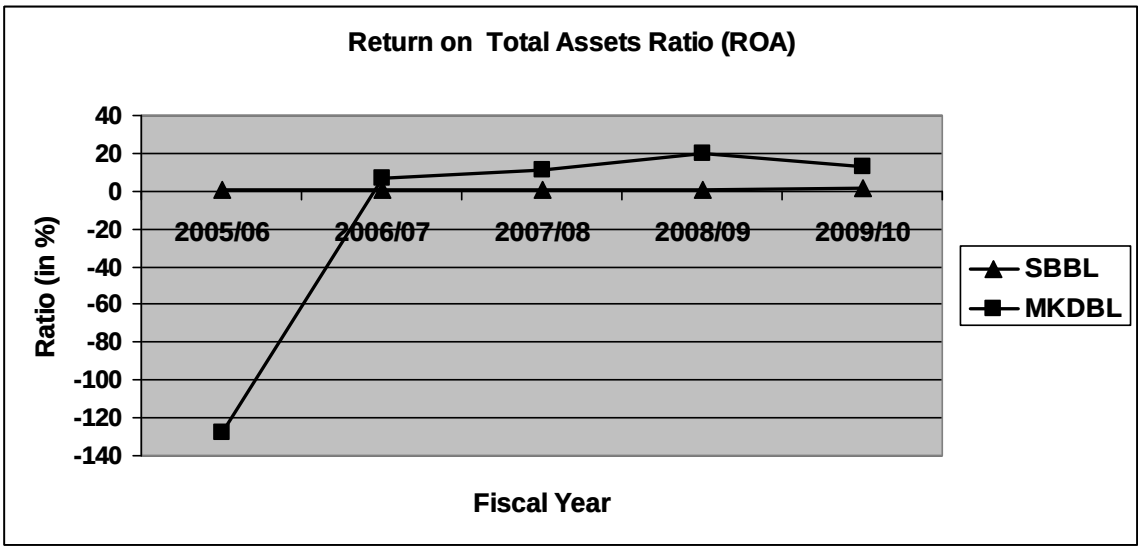
Source: Annual Report of SBBL & MKDBL

The table shows that this ratio of SBBL ranged between 0.56% in 2007/08 to 1.18% in 2009/10 and mean ratio is 0.87%. Likewise, ratio of MKDBL ranged

between -127.53% in 2005/06 to 19.83% in 2008/09 and the average ratio is -15.39%. The mean ratio of SBBL is higher than MKDBL. The standard deviation of SBBL is 0.20% and MKDBL is 56.22% respectively. It indicates that MKDBL has made poor utilization of overall resources, whereas, SBBL has been successful in better utilization of resources which reveals the better performance of the latter. However, both banks do not seem to be utilizing their assets more efficiently. So the banks are required to increase the rate of return on total assets by making investment in higher return sectors.

The trend of return on total assets ratio of SBBL and MKDBL has been presented below:

Figure No.: 12



4.2.4.3 Return on Total Deposits Ratio

This ratio of measures the degree of net profit after tax earned by using total deposits. This ratio shows how efficiency the management is utilizing its deposits in profit generating activities. This is an important ratio as the earning is made by the efficient and effective utilization of these deposits. Higher ratio indicates better utilization of deposits and vice versa. The following table shows the ratio of return on total deposits of MKDBL and SBBL.

Return on Total Deposits Ratio (in percentage)

Table No: 17

Amount in 000's

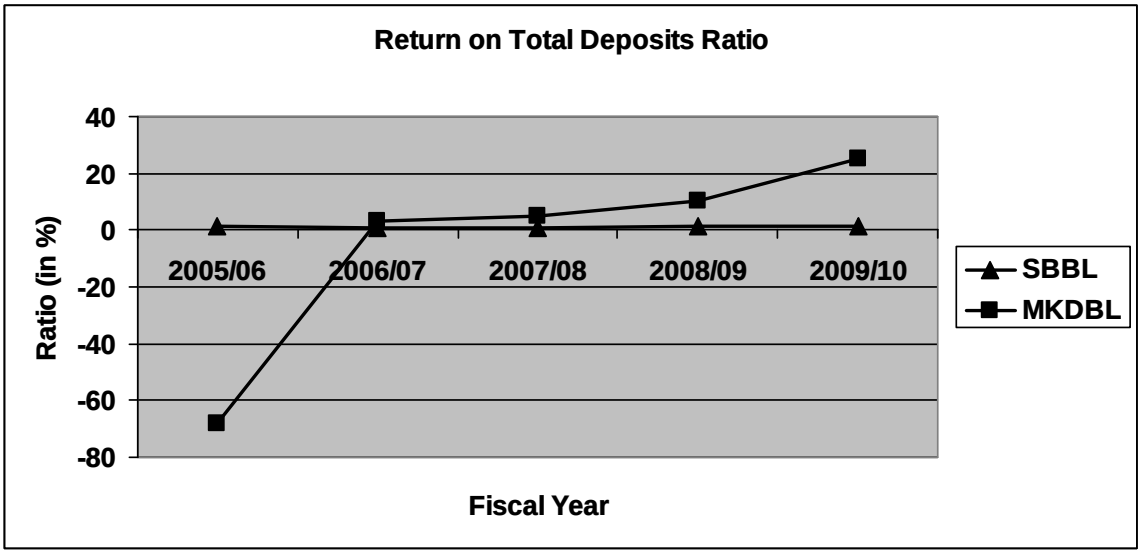
SBBL				MKDBL		
Fiscal Year	**Net Profit**	**Total Deposits**	**Ratio (%)**	**Net Profit**	**Total Deposits**	**Ratio (%)**
2005/06	8,785.75	749,996.36	1.17	-530,853.63	778,666.09	-68.17
2006/07	18,748.43	1,822,705.06	1.03	22,527.85	680,087.18	3.31
2007/08	21,485.72	2,880,871.38	0.75	29,391.94	582,715.97	5.04
2008/09	57,759.77	4,417,504.61	1.31	54,811.88	525,298.66	10.43
2009/10	85,737.99	5,760,495.36	1.49	109,405.81	433,608.85	25.23
Mean			1.15			-4.83
Standard Deviation			0.26			32.59

Source: Annual Report of SBBL & MKDBL

The above table shows that the net profit to total deposit ratio of SBBL ranged between 0.75% in 2007/08 to 1.49% during the period of 2009/10 which is the highest return ratio. The mean ratio of SBBL is 1.15% and standard deviation is 0.26%. Similarly, net profit to total deposit ratio of MKDBL ranged between -68.17% in 2005/06 to 25.23% in 2009/10. MKDBL return on deposit is in increasing trend. The mean ratio is -4.83% and standard deviation is 32.59% during the period of the study.

The trend of return on total deposits ratio of the SBBL and MKDBL has been presented below:

Figure No.: 13



4.2.4.4 Return on Investment (ROI)

This ratio measures the capability of the company to generate profit out of the total investment. In other word, it states how well the company has been able to earn the return on the total investment made. Higher the ratio, higher is the return and vice versa. The following table shows the ratio of return on investment of both sample banks.

Return on Investment Ratio (in percentage)

Table No: 18

Amount in 000's

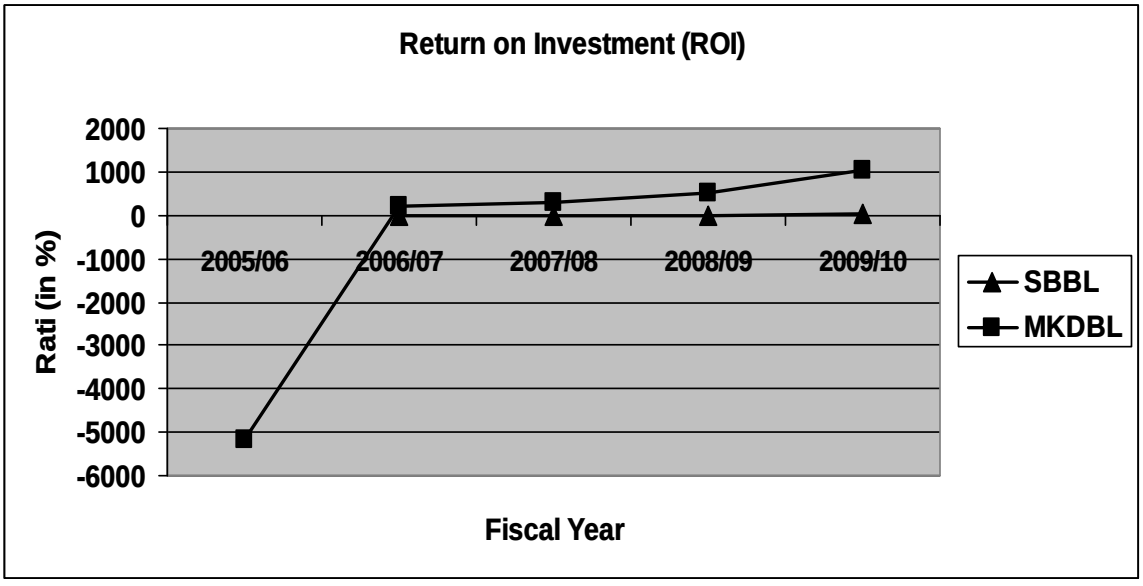
SBBL				MKDBL		
Fiscal Year	**Net Profit**	**Total Investment**	**Ratio (%)**	**Net Profit**	**Total Investment**	**Ratio (%)**
2005/06	8,785.75	-	-	-530,853.63	10,300.00	-5153.92
2006/07	18,748.43	466,271.20	4.02	22,527.85	10,300.00	218.72
2007/08	21,485.72	508,143.42	4.23	29,391.94	10,300.00	285.36
2008/09	57,759.77	530,725.00	10.88	54,811.88	10,300.00	532.15
2009/10	85,737.99	495,609.74	17.30	109,405.81	10,425.00	1049.46
Mean			7.29			-613.65
Standard Deviation			6.10			2288.83

Source: Annual Report of SBBL & MKDBL

The above table shows the return on investment of SBBL and MKDBL during the period of 2005/06 to 2009/10. There is no investment of SBBL in 2005/06. This ratio of SBBL is ranged between 4.02% in 2005/06 to 17.30% in 2009/10. This ratio is increasing trend of SBBL. The mean ratio is 7.29% and standard devotion is 6.10%. It indicates that the management has been able to utilize the fund for investment efficiently. On the other hand, this ratio of MKDBL is negative in 2005/06 i.e. -5153.92%. There is high fluctuation of this ratio of this bank. The invest amount is same during the period of 2005/06, 2006/07, 2007/08 and 2008/09. It indicates that the management has not been able to utilize the fund for investment efficiently.

The graphical representation of return on investment of SBBL and MKDBL is shown below:

Figure No.: 14



4.2.4.5 Total Interest Earned to Total Assets Ratio

This ratio shows the interest generated by mobilizing the assets in the banks. Interest occupies significant place of income for the banks. Generally, banks earn interest through the provisional of gains and advances, overdrafts and investment in securities. Higher the ratio indicates higher efficiency in the mobilization of resources and ability of interest earning and vice- versa. Here, interest earned includes interest earned from loans and advances, money at call or short notice and total assets refer to total assets shown on the balance sheet. The ratio of both banks presented in the following table:

Total Interest Earned to Total Assets Ratio (in percentage)

Table No: 19

Amount in 000's

	SBBL			MKDBL		
Fiscal Year	**Interest Earned**	**Total Assets**	**Ratio (%)**	**Interest Earned**	**Total Assets**	**Ratio (%)**
2005/06	60,828.44	1,010,731.40	6.02	103,903.41	416,248.09	24.96
2006/07	124,802.21	2,506,731.48	4.98	55,407.12	322,597.92	17.18
2007/08	219,753.09	3,839,128.47	5.72	51,520.49	264,649.26	19.47
2008/09	358,552.75	5,845,136.97	6.13	38,355.61	276,475.06	13.87
2009/10	615,644.50	7,238,558.76	8.51	78,136.13	865,781.72	9.02
Mean			6.27			16.90
Standard Deviation			1.19			5.35

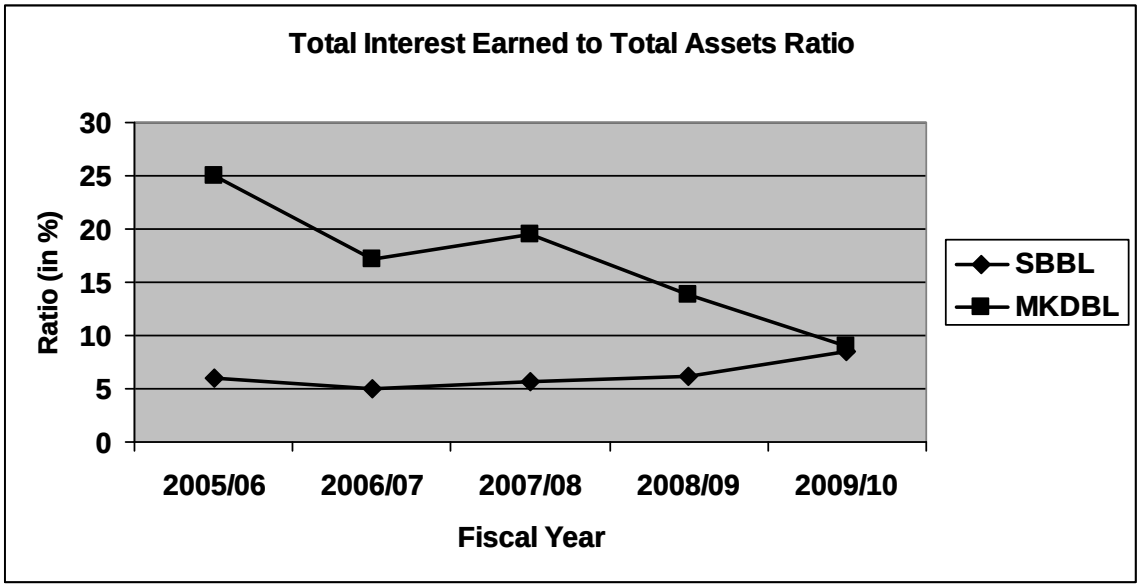
Source: Annual Report of SBBL & MKDBL

The above table shows that total interest earned to total assets ratio of SBBL is in fluctuating trends. This ratio of SBBL is ranged between 4.98% in 2006/07 to 8.51% in 2009/10. The mean ratio is 6.27% and standard deviation is 1.19% of SBBL. Likewise, MKDBL's ratio is in decreasing trend with 24.96% in 2005/06 and 9.02% in 2009/10. The mean interest earned to total assets ratio of MKDBL

is 16.90% and standard deviation is 5.35%. This shows that MKDBL is able to utilize its assets successfully to earn more interest than SBBL.

The trend of interest earned to total assets ratio of SBBL and MKDBL has been presented below:

Figure No.: 15



4.2.4.6 Total Interest paid to Total Assets Ratio

This ratio indicates the percentage of interest paid for undertaking the different types of liabilities. Banks usually pays interest to the depositors for different types of deposits held with the bank. The higher ratio indicates higher interest expenses with respect to total assets and vice versa. The ratio of total interest paid to total assets ratio is shown in the following table:

Total Interest paid to Total Assets Ratio (in percentage)

Table No: 20

Amount in 000's

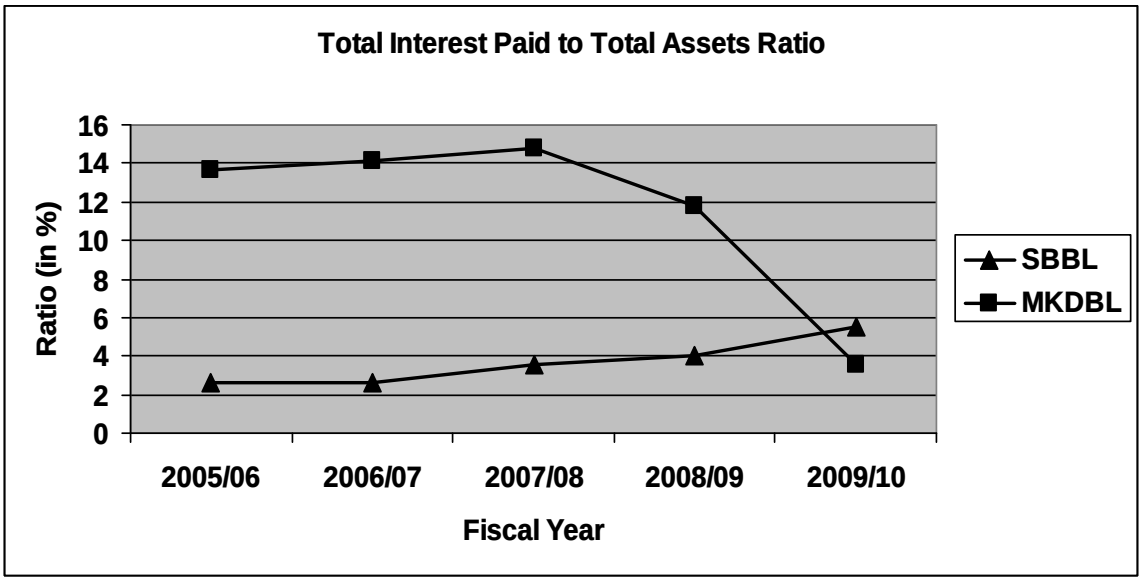
SBBL				MKDBL		
Fiscal Year	**Interest Paid**	**Total Assets**	**Ratio (%)**	**Interest Paid**	**Total Assets**	**Ratio (%)**
2005/06	26,152.92	1,010,731.40	2.59	56,740.28	416,248.09	13.63
2006/07	66,749.68	2,506,731.48	2.66	45,482.46	322,597.92	14.10
2007/08	138,015.76	3,839,128.47	3.59	39,050.85	264,649.26	14.76
2008/09	235,894.80	5,845,136.97	4.04	32,637.26	276,475.06	11.80
2009/10	399,298.08	7,238,558.76	5.52	30,730.05	865,781.72	3.55
Mean			3.68			11.57
Standard Deviation			1.07			4.13

Source: Annual Report of SBBL & MKDBL

The above table shows that total interest paid to total assets MKDBL has the highest average ratio during the study period. The ratio of SBBL is increasing trends, 2.595 in 2005/06 and 5.52% in 2009/10. The average ratio is 3.68% and standard deviation is 1.07%. Likewise, the ratio of MKDBL is decreasing trend. The total interest paid to total assets ratio of MKDBL is 13.63% in 2005/06 and 3.55% in 2009/10 which is the lowest ratio among during the period of study. The mean ratio of MKDBL is 11.57% and standard deviation is 4.13%

The ratio calculated in the above table indicates that MKDBL is paying higher interest to the depositors than SBBL. In other words, it can also be said that SBBL is in better position than MKDBL for interest expenses point of view. SBBL is successful to collect fund from less expensive source than MKDBL. The trend of total interest paid to total assets ratio of SBBL and MKDBL has been presented below:

Figure No.: 16



4.2.5 Other Ratios:

There are various other ratios used widely relating to the financial aspects of the company. Although various ratios have been calculated and analyzed for the sake of completeness some other indicators have also been considered in this section.

4.2.5.1 Earning Per Share (EPS)

Earning per share is one of the most widely quoted statistics when there is a discussion of company's performance of share value. It is the profit after tax divided by the number of common shares outstanding. This ratio measures how much earning does the common shareholders get for every share held. This ratio of the banks presented in the following table:

Earning Per Share (EPS in NRS.)

Table No: 21

Amount in 000's

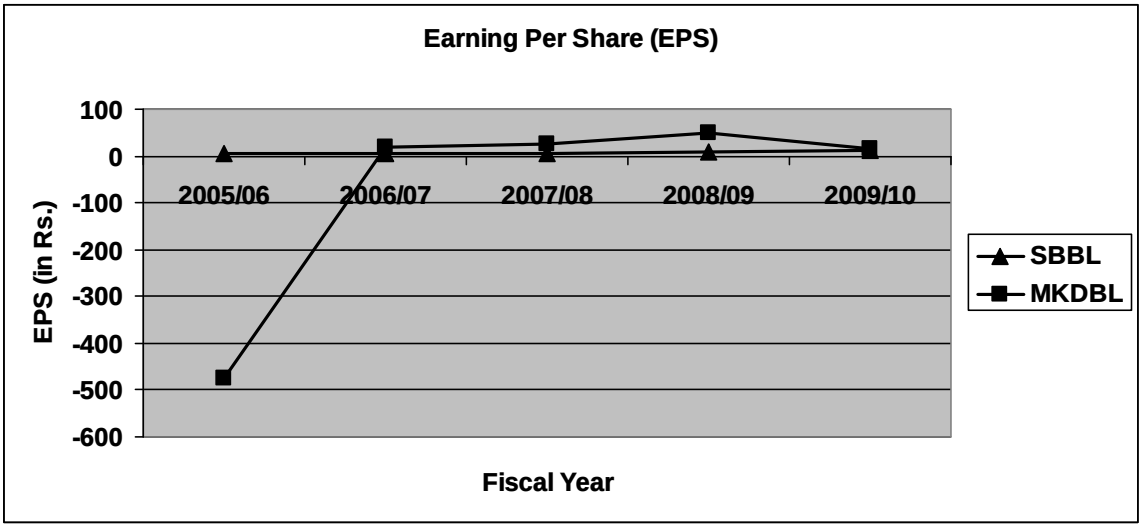
SBBL				MKDBL		
Fiscal Year	**Net Profit**	**No. of Shares**	**EPS (Rs.)**	**Net Profit**	**No. of Shares**	**EPS (Rs.)**
2005/06	8,785.75	2,240.00	3.92	-530,853.63	1,120.00	-473.98
2006/07	18,748.43	3,200.00	5.86	22,527.85	1,120.00	20.11
2007/08	21,485.72	3,840.00	5.60	29,391.94	1,120.00	26.24
2008/09	57,759.77	7,667.66	7.53	54,811.88	1,120.00	48.94
2009/10	85,737.99	8,064.00	10.63	109,405.81	7,000.00	15.63
Mean			6.71			-72.61
Standard Deviation			2.27			201.01

Source: Annual Report of SBBL & MKDBL

The above table shows the earning per share of SBBL and MKDBL during the period of 2005/06 to 2009/10. The earning per share of SBBL is an increasing trend. The EPs of SBBL is ranged between Rs. 3.92 in 2005/06 to Rs. 10.63 in 2009/10. The mean EPS is Rs. 6.71 and standard devotion is 2.27. It shows that SBBL has better signal from investor's point of view. On the other hand EPS of MKDBL is negative in 2005/06 because the net profit is negative. The EPs is ranged between -473.98 in 2005/06 to 48.94 in 2008/09. However, EPS does not reveal how much amount out of the earning paid to the owners as dividend or how much of the earning are retained in the business.

The trend of EPS of the SBBL and MKDBL has been presented below:

Figure No.: 17



4.2.5.2 Interest Paid to Interest Income Ratio

This ratio of banks reveals the proportionate relationship between interest paid to different liabilities and interest income made from different sources. Higher the ratio indicates that the banks has paid higher amount of interest on liabilities in relation to interest income and vice versa. In this study, interest paid includes interest paid on deposits and borrowing. Similarly, interest income includes the interest from loan and advance, money at call or short notice. This ratio of both sample banks over the study has been tabulated below:

Interest Paid to Interest Income Ratio (in percentage)

Table No: 22

Amount in 000's

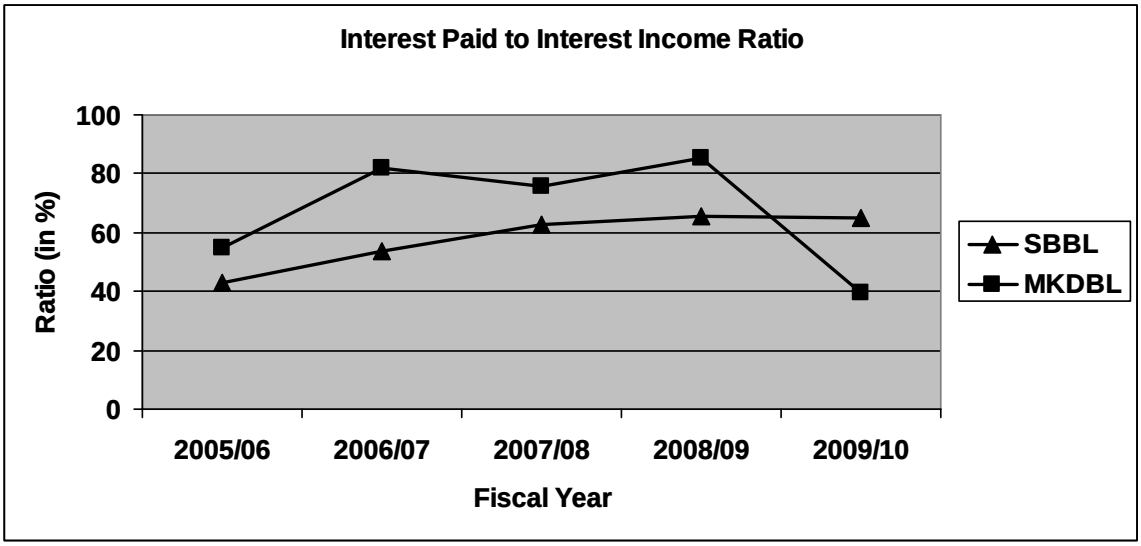
SBBL				MKDBL		
Fiscal Year	**Interest Paid**	**Interest Income**	**Ratio (%)**	**Interest Paid**	**Interest Income**	**Ratio (%)**
2005/06	26,152.92	60,828.44	42.99	56,740.28	103,903.41	54.61
2006/07	66,749.68	124,802.21	53.48	45,482.46	55,407.12	82.09
2007/08	138,015.76	219,753.09	62.80	39,050.85	51,520.49	75.80
2008/09	235,894.80	358,552.75	65.79	32,637.26	38,355.61	85.09
2009/10	399,298.08	615,644.50	64.86	30,730.05	78,136.13	39.33
Mean			57.99			67.38
Standard Deviation			8.66			17.62

Source: Annual Report of SBBL & MKDBL

The above table reflects that interest paid to interest income ratio of SBBL and MKDBL. The interest paid to interest income ratio of SBBL is ranged between 42.99% in 2005/06 to 65.79% in 2008/09. The average ratio is 57.99% and standard deviation is 8.66%. Like wise, this ratio of MKDBL is 39.33% in 2009/10 which is the lowest ratio and 85.09% in 2008/09 which is highest ratio during the period of the study. The mean ratio of MKDBL is 67.38% and standard deviation is 17.62%. The mean ratio of MKDBL is higher than the SBBL.

The trend of interest paid to interest income ratio of SBBL and MKDBL has been presented given below:

Figure No.: 18



4.2.5.3 Loan Loss Ratio

This ratio describes the proportion of provision for loss to the loan. It is very important for the bank to have a good investment in a loan because a poorly administered loan portfolio usually has significant negative impact on the earning and capital of the banks. Provision of loan loss leads to loan profit and decrease in the capital. The loan loss ratio indicates the adequacy of allowance for loan and trend in the collection of loan and the performance in loan portfolio. It is obtained by dividing the loan loss provision by the total loan. Higher this ratio indicates that the performance of the bank in terms of recovery of loan is low and vice-versa. This ratio of both the banks is presented in the following table.

Loan Loss Ratio (in percentage)

Table No: 23

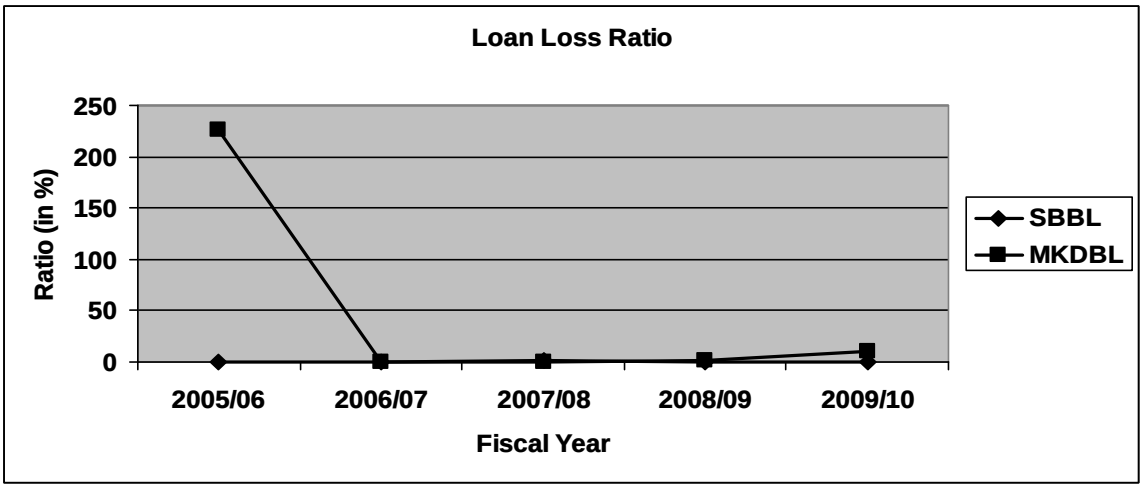
Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Loan Loss Provision**	**Loan and Advance**	**Ratio (%)**	**Loan Loss Provision**	**Loan and Advance**	**Ratio (%)**
2005/06	5,164.92	758,632.67	0.68	566,494.34	250,001.19	226.60
2006/07	7,432.84	1,501,916.52	0.49	-	816,754.71	0.00
2007/08	20,582.15	2,533,376.50	0.81	-	678,188.45	0.00
2008/09	19,844.88	4,036,986.19	0.49	5,150.00	580,778.83	0.89
2009/10	11,351.94	5,145,148.95	0.22	50,108.81	503,395.94	9.95
Mean			0.54			47.49
Standard Deviation			0.20			89.63

Source: Annual Report of SBBL & MKDBL

The table shows that loan loss provision to loan and advance ratio SBBL and MKDBL. This ratio of SBBL during the period of the study ranged between 0.22% in 2009/10 to 0.68% in 2005/06. The mean ratio of SBBL is 0.54% and standard deviation is 0.20%. Whereas, this ratio of MKDBL is 226.60% in 2005/06 which is the highest ratio and there is no loan loss provision during period of 2006/07 and 2007/08. The mean ratio is 47.49% and standard deviation is 89.63%. The trend of loan loss provision to loan and advance ratio SBBL and MKDBL has been presented given below:

Figure No.: 19



4.2.5.4 Non- performing Assets/ Total Loans & Advances Ratio

This ratio states the proportion of the total bad loans with respect to the total loans and advance of the bank. Good loans are performing assets and non- performing assets include the loans categorized under substandard, doubtful and bad as per the Nepal Rastra Bank directives. Lower ratio indicates better investment and vice-versa. The ratios of both the banks are presented in the following table below:

Non- performing Assets/ Total Loans & Advances Ratio (in percentage)

Table No: 24

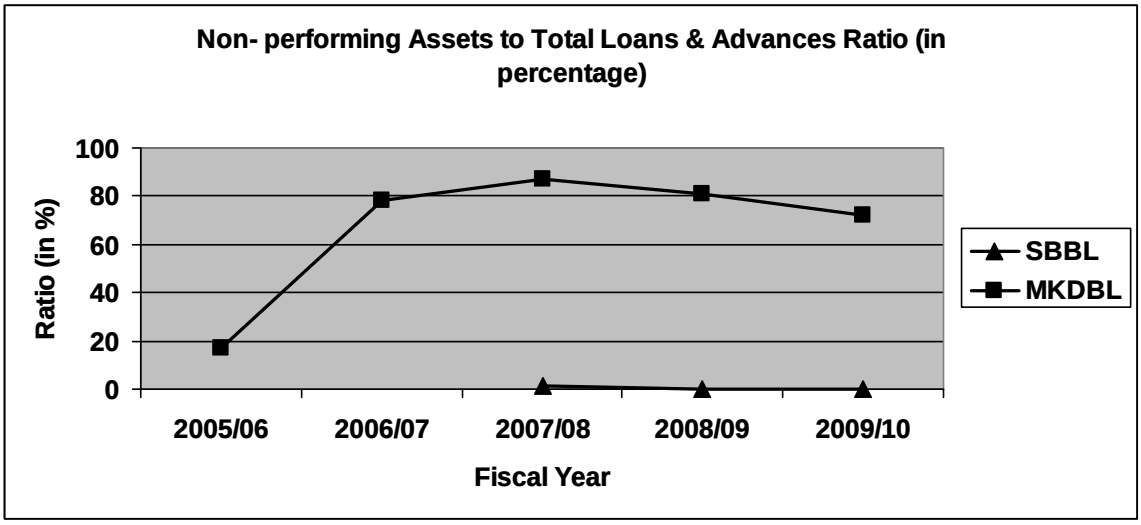
Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Non-performing Loan**	**Loan and Advance**	**Ratio (%)**	**Non-performing Loan**	**Loan and Advance**	**Ratio (%)**
2005/06	-	758,632.67	-	42,224.23	250,001.19	16.89
2006/07	-	1,501,916.52	-	638,854.48	816,754.71	78.22
2007/08	38,326.41	2,533,376.50	1.51	591,036.22	678,188.45	87.15
2008/09	7,068.36	4,036,986.19	0.18	471,397.65	580,778.83	81.17
2009/10	4,358.84	5,145,148.95	0.08	364,444.20	503,395.94	72.40
Mean			0.59			67.16
Standard Deviation			0.65			25.58

Source: Annual Report of SBBL & MKDBL

The above table shows that the non-performing loan to total loans and advances ratio of SBBL and MKDBL. This ratio of SBBL is decreasing trend, the ratio was 1.51% in 2007/08 and 0.08% in 2009/10. The mean ratio is 0.59% and Standard ratio is 0.65%. On the other hand, this ratio of MKDBL is fluctuating trends. This ratio of MKDBL is ranged between 16.89% in 2005/06 to 87.15% in 2007/08. The mean ratio is 67.16% and standard deviation is 25.58%. The graphical representation of the non-performing loan to total loans and advances ratio of SBBL and MKDBL is shown below:

Figure No.: 20



4.3 ANALYSIS OF NRB DIRECTIVES:

4.3.1 <u>Directive No. 1:</u> Capital Adequacy Ratio

Banks should have sufficient capital in relation to the volume and risk ness of their business to absorb losses without using depositor's funds. This capital investment gives owners and managers a powerful incentive to run the bank safely and soundly. Traditionally, the adequacy of the amount of capital available to buffer against losses is measured by a so called capital adequacy ratio. However, capital is simply the difference between the value of a bank's assets and its liabilities to

third parties. Its calculation depends fundamentally, therefore on the value attributed to its assets. Development banks have to maintain minimum capital fund on the basis of risk weighted assets. The capital adequacy ratios of SSBL and MKDBL are shown below:

Capital adequacy ratios of SSBL and MKDBL (in Percentage)

Table No: 25

	Minimum Required		SBBL		MKDBL	
Fiscal Year	**Total Capital Fund**	**Core Capital Fund**	**Total Capital Fund**	**Core Capital Fund**	**Total Capital Fund**	**Core Capital Fund**
2005/06	11%	5.50%	26.72%	25.86%	-41.42%	-44.36%
2006/07	11%	5.50%	25.58%	25.58%	-38.66%	-44.76%
2007/08	11%	5.50%	17.73%	16.76%	-41.90%	-42.01%
2008/09	11%	5.50%	19.02%	18.10%	-39.60%	-39.76%
2009/10	11%	5.50%	16.51%	15.56%	59.71%	59.36%

Source: Annual Report of SBBL & MKDBL

The total capital fund required as per the NRB directives to development banks is meet by SBBL during the period of five years. NRB has directed SBBL to provide information regarding the present development going on towards improvement of capital adequacy is through increase in equity capital. Since this is a permanent form of capital, it will lead to decrease in earning per share (EPS). Therefore, the most easy and least costly way of increasing the capital fund would be to increase the supplementary capital as it would be a temporary source of capital.

Since, the total capital fund required as per the NRB directives to development banks has not meet by MKDBL during the period of four years. The both total capital fund and core capital fund is negative for the year 2005/06, 2006/07, 2007/08 and 2008/09 but positive in 2009/10. This is because of the huge amount of loss incurred during this period.

4.3.2 Directive No. 2: Collection of Financial Resources and Fund

Development banks can collect to the maximum extent of 15 times of core capital in the form of deposits, borrowing and various debt instruments. Core capital consists of paid- up capital, share premium, non redeemable preference share, general reserve and retained earning. The following table shows the status of collection of financial resources and funds of both the banks:

Collection of Financial Resources and Funds

Table No: 26

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Fund Raised**	**Core Capital Fund**	**Times**	**Fund Raised**	**Core Capital Fund**	**Times**
2005/06	749,996.36	228,389.91	3.28	778,666.09	-402,297.10	-1.94
2006/07	1,822,705.06	342,535.94	5.32	680,087.18	-379,776.75	-1.79
2007/08	2,880,871.38	430,991.56	6.68	582,715.97	-335,854.81	-1.74
2008/09	4,417,504.61	829,566.27	5.33	525,298.66	-270,325.32	-1.94
2009/10	5,760,495.36	879,394.01	6.55	433,608.85	401,806.24	1.08

Source: Annual Report of SBBL & MKDBL

The table shows that SBBL and MKDBL have raised fund within the prescribed by NRB. This ratio of SBBL is ranged between 3.28 in 2005/06 and 6.55 in 2009/10. On the other hand, the ratio of MKDBL is negative during the period of 2005/06, 2006/07, 2007/08 and 2008/09 which indicates that the bank is prohibited for collecting any further deposits because of its negative core capital. So far, both banks have not raised the fund through the use of debentures.

4.3.3 Directive No. 3: Provision regarding Statutory Deposit and Liquidity

Development banks are required to maintain 5.5% of their total deposit in the form of liquid assets. Development banks are required to deposit at least 1 % of the total deposits and borrowings to NRB or any other banks/ financial institutions allocated by NRB. Out of 5.5% at least 2% shall be kept in own vault or in a current account maintained with any commercial banks. Liquid assets comprise of cash vault, investment in government bonds/ debentures, investment in NRB bonds and balance with commercial banks. The following table gives the clear picture of the liquidity status of SBBL and MKDBL:

Statutory Deposit and Liquidity

Table No: 27

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Cash and Bank Balance**	**Total Deposit**	**Ratio (%)**	**Cash and Bank Balance**	**Total Deposit**	**Ratio (%)**
2005/06	48,884.86	749,996.36	6.52	78,777.71	778,666.09	10.12
2006/07	81,656.72	1,822,705.06	4.48	18,456.17	680,087.18	2.71
2007/08	209,088.80	2,880,871.38	7.26	69,431.29	582,715.97	11.92
2008/09	632,814.99	4,417,504.61	14.33	93,574.08	525,298.66	17.81
2009/10	228,437.57	5,760,495.36	3.97	661,421.04	433,608.85	152.54
Mean			7.31			39.02
Standard Deviation			3.72			56.96

Source: Annual Report of SBBL & MKDBL

The above table states that the both banks have complied with the minimum liquidity requirement as directed by NRB. The excess liquidity maintained by both the banks indicates that there are additional funds for further deployment of funds. It is the indication that the fund of the company has not been managed properly. Effective fund management would help reduce the cost of borrowing and would yield higher return if deployed in the productive sectors.

4.3.4 Directive No. 4: Provision Regarding Classification of Loans and Advances and Loan Loss Provision

As per the NRB directives to development banks, loan loss provision is to be made depending upon the categorization of the disbursed loans and advances. The loan is categorized on the basis whether the interest and principal are recovered as per the schedule. Failure to recover the dues as per the loan repayment schedule within the prescribed time will attract provisioning. At present, the loans are categorized into pass/good, substandard, doubtful and bad category. The following table shows the classification of loans and advances and loan loss provision regarding the SBBL and MKDBL:

Loan Classification and Loan Loss Provisioning

Table No: 28

Loan Categorization

Amount in 000's

	SBBL				MKDBL			
Fiscal Year	**Good Loan**	**Substandard**	**Doubtful**	**Bad**	**Good Loan**	**Substandard**	**Doubtful**	**Bad**
2005/06	758,632.67	-	-	-	774,489.43	25,777.09	5,767.56	10,679.59
2006/07	1,501,916.52	-	-	-	176,680.94	99,516.26	38,775.62	500,562.61
2007/08	2,471,462.37	34,049.58	4,276.83	-	86,708.22	84,752.19	32,407.34	473,876.68
2008/09	4,029,917.83	3,296.21	-	3,596.95	109,337.79	15,765.32	26,347.93	429,284.40
2009/10	5,140,790.10	718.04	2,970.55	670.26	138,951.74	24,900.00	4,500.00	335,044.20

Source: Annual Report of SBBL & MKDBL

Loan Loss Provisioning

Amount in 000's

	SBBL				MKDBL			
Fiscal Year	**Good Loan (1%)**	**Substandard (25%)**	**Doubtful (50%)**	**Bad (100%)**	**Good Loan (1%)**	**Substandard (25%)**	**Doubtful (50%)**	**Bad (100%)**
2005/06	7,586.33	-	-	-	1,99.34	7,985.16	23,412.51	549,181.75
2006/07	15,019.17	-	-	-	1,767.81	139.91	24,879.06	19,387.81
2007/08	24,714.62	8,512.40	2,138.42	-	867.33	21,188.05	16,203.67	473,876.68
2008/09	40,299.18	824.05	-	3,772.15	1,093.38	3,941.33	13,173.96	429,284.40
2009/10	51,407.90	179.51	1,485.27	6,70.26	2,277.23	6,225.00	2,250.00	336,013.66

Source: Annual Report of SBBL & MKDBL

The quality of lending is reflected in loan loss provision. Smaller the provision, healthier is the loan portfolio and higher is the profitability of the bank. There is no substandard, doubtful and bad loan of the SBBL during the period in 2005/06 and 2006/07. The table shows that the both banks have maintained provision as per NRB directives issued to development banks.

4.3.5 Directive No. 8: Provision Regarding Investments

According to the directives issued by NRB, development banks can invest in government bonds and NRB debentures. Apart from that investment can also be done on shares and debentures of only those companies which we already listed or are in the stated of listing within one year. Moreover, development bank can invest in shares and debentures of a particular company to the maximum extent of 10% of core capital. However, the total investment in such company's shares and debentures should not exceed 30% of core capital. The following table displays the ratio of investments and core capital of SBBL and MKDBL:

Investment in Shares and Debentures

Table No: 29

Amount in 000's

SBBL				MKDBL		
Fiscal Year	**Investment in Shares/ Debentures**	**Core Capital**	**Ratio (%)**	**Investment in Shares/ Debentures**	**Core Capital**	**Ratio (%)**
2005/06	-	228,389.91	0.00	10,300.00	-402,297.10	-2.56
2006/07	-	342,535.94	0.00	10,300.00	-379,776.75	-2.71
2007/08	-	430,991.56	0.00	10,300.00	-335,854.81	-3.07
2008/09	1,000.00	829,566.27	0.12	10,300.00	-270,325.32	-3.81
2009/10	1,000.00	879,394.01	0.11	10,425.00	401,806.24	2.59

Source: Annual Report of SBBL & MKDBL

The above table shows that the ratio of investment in shares and debentures and core capital of SBBL and MKDBL. The investments of SBBL and MKDBL have below the minimum prescribed limit of 30% as per the NRB directives. The investment amount of MKDBL is same during the period of 2005/06, 2006/07, 2007/08 and 2008/09. On the other hand SBBL has not investment in shares and debentures during the period of 2005/06, 2006/07 and 2007/08.

4.3.6 <u>Directive No. 9:</u> Provision Regarding Interest Rate

Development banks are authorized and fix the interest rate on deposits and loans and advances themselves. However, the interest rate cannot be determined in flat rate. Interest accrued on loans and advances can be recognized as income on cash basis i.e. only upon receipt of cash. Interest accrued but not received in cash has to be transferred to interest suspense account. It can be recognized as income only upon receipt of cash for interest incurred during the fiscal year. However, interest

collected within one month from the semi- annual end can be considered as interest income.

The following table shows the interest accrued and the interest suspense of SBBL and MKDBL:

Interest Suspense to Interest Receivable Ratio (in percentage)

Table No: 30

Amount in 000's

	SBBL			MKDBL		
Fiscal Year	**Interest Suspense**	**Interest Receivables**	**Ratio (%)**	**Interest Suspense**	**Interest Receivables**	**Ratio (%)**
2005/06	1,946.43	60,828.44	3.20	54,868.24	103,903.41	52.81
2006/07	2,354.95	124,802.21	1.89	32,353.76	55,407.12	58.39
2007/08	5,678.15	219,753.09	2.58	47,883.53	51,520.49	92.94
2008/09	5,313.93	358,552.75	1.48	40,589.79	38,355.61	105.82
2009/10	9,748.03	615,644.50	1.58	40,478.89	78,136.13	51.81

Source: Annual Report of SBBL & MKDBL

The above table reveals that that during the year 2005/06, 3.20% of the interest receivable of SBBL was transferred to interest suspense account, rest 96.80% was recovered. On the other hand, this ratio is ranged between 51.81% in 2009/10 to 105.82% in 2008/09. The main reason for this is initially the time of three months was allowed to recover the interest from the due date. If the bank has failed to recover then the uncovered amount was to be transferred to interest suspense account. The interest accrued would be recognized as income only after receipt of cash. The NRB issued new directives to recover the interest within one month from the year/semi- year end. As a result of this the amount of interest suspense is higher percentage of the interest receivable of MKDBL during the period of the study. It is to be noted that the interest suspense of MKDBL is higher on its side. This indicates that the company should initiate measures for recovering interest

outstanding from the borrowers. On the other side, SBBL was able to maintain interest suspense to 1.48% to 3.20% of the total interest receivables. In comparison to MKDBL, the interest recovery of SBBL is quite satisfactory, however still plenty of efforts is to be made for interest recovery by MKDBL.

4.4 Major Findings of the Study:

The major findings of the study derived on the basis of analysis of financial data of SBBL and MKDBL are given below:

1. Liquidity Ratio

The liquidity analysis of SBBL and MKDBL has been done by using different financial tools. The current ratio reveals that SBBL has better ratio for the period of 2005/06 in comparison to the MKDBL for the same period of the time. The mean ratio of SBBL is higher than that of MKDBL. MKDBL's current ratio is 0.44 in 2005/06 and increased in 2009/10 i. e. 1.91. The reason for such decline is due to the authority to mobilize savings account granted to development banks. This created the current liabilities as a result the ratio declined sharply in comparison to the earlier years.

The cash and bank balance to deposit ratio is in fluctuating trend for both banks. The mean ratio of MKDBL is higher than that of SBBL. It states that MKDBL has maintained higher liquidity in terms of cash and bank balance out of the total deposits.

Likewise, cash and bank balance to current assets ratio of MKDBL is higher than that the SBBL. The mean ratio of MKDBL is higher than that of the SBBL. It means that significant portion of current assets is maintained by MKDBL in the form of cash and bank balance. The standard current ratio is to be laid down by both banks. The above analysis shows that MKDBL has a strong liquidity position than that of SBBL.

2. Activity/ Turnover/ Utilization Ratio

The loans and advances to total deposits ratio indicates that MKDBL has highest ratio than that of SBBL. In other words, proportion of loans and advances to deposit is higher of MKDBL. Higher ratio indicates that efficient utilization of deposits for high yielding loans and advances. The mean ratio of SBBL is 90.44% where as MKDBL is 99.05%.

Likewise, loans and advances to fixed deposits ratio are highest of SBBL than the MKDBL. The total investment to total deposits ratio of SBBL is also higher than MKDBL. The above finding indicates that SBBL has utilized maximum portion of the total deposits towards lending activities, whereas MKDBL has utilized un investing activities.

3. Leverage/ Capital Structure

Analysis of leverage or capital structure ratios shows that the capital structure of SBBL is highly levered. SBBL has been utilizing more debt and less equity as a result it is turning out to be a risky project. The net worth of MKDBL is negative during the period of 2005/06, 2006/07, 2007/08 and 2008/09 which has increased the risk of bankruptcy. On the other hand, SBBL is less risky as its debt equity ratio is considerably lower which indicates the less utilization of debt and higher utilization of equity.

From the above analysis it can be concluded that MKDBL is using higher debt and is considered to be risk project and has failed to maintain the adequate capital fund. SBBL, on the other hand is less risky project as it has maintained its capital fund adequately and less levered.

4. Profitability Ratio

Profitability ratio indicates the degree of success in achieving desired profit by the companies. Return on net worth/ total equity ratio, return on total assets, return on

total deposits, return on investment is higher of SBBL in comparison to that of MKDBL.

Likewise, mean ratio of total interest earned to total assets is higher of MKDBL than that of SBBL. The mean ratio of total interest paid to total assets ratio is also higher of MKDBL than that of SBBL.

From the above analysis, profitability position of SBBL is stronger than that of MKDBL. The higher ratio of MKDBL in total interest earned to total assets and total interest paid to total assets ratio indicates that MKDBL has greater income from interest on loans and advances and pays more interest on deposits as well than SBBL.

5. Other Ratios

The other ratios of these development banks reveal that interest paid to interest income ratio is higher of MKDBL which means that interest expenses is higher of MKDBL than that of SBBL. Loan loss ratio of MKDBL is also higher. Loan loss ratio provides a cushion for banks in case of borrower's default in payment of loans and ensures the continued solvency of the banks. SBBL has been able to maintain a pretty healthy loan loss ratio. Non- performing assets to total loans and advances ratio is also higher of MKDBL which indicates that the percentage on non- performing assets on total loans and advances is higher than SBBL. Likewise SBBL has higher performance for growth in earning per share than MKDBL.

Analysis of NRB Directives:

Directive No. 1: Capital Adequacy Ratio

SBBL has been able to maintain the minimum required capital fund; both total capital fund and core capital fund. On the other hand, except in the year 2009/10, MKDBL has not been able to maintain the minimum required capital fund; both total capital fund and core capital fund. NRB has directed MKDBL to provide

information regarding the present development going on towards improvement of capital adequacy ratio.

Directive No. 2: Collection of Financial Resources and Fund

Both banks have raised the fund within the limit prescribed by NRB. Since the core capital of MKDBL is negative for the year 2005/06, 2006/07, 2007/08 and 2008/09. It is prohibited from collecting any additional deposit and making any disbursements unless the capital adequacy comes within the prescribed limit.

Directive No. 3: Provision regarding Statutory Deposit and Liquidity

Both the development banks, SBBL and MKDBL have maintained the adequate liquidity. Of the mandatory requirement of 5.5% of the total deposits to be maintained as liquid assets, both the banks have been able to maintain the liquidity in the mandatory requirement.

Directive No. 4: Provision Regarding Classification of Loans and Advances and Loan Loss Provision

Both the banks have classified the loans and advances into different four categories as NRB directives into pass/good, substandard, doubtful and bad category and adequate loan loss provision has been kept. The MKDBL has suffered huge loss during the period in 2005/06.

Directive No. 8: Provision Regarding Investments

Development bank can invest in shares and debentures of a particular company to the maximum extent of 10% of core capital. However, the total investment in such company's shares and debentures should not exceed 30% of core capital. The investments of SBBL and MKDBL have below the minimum prescribed limit of 30% as per the NRB directives.

Directive No. 9: Provision Regarding Interest Rate

The NRB issued new directives to recover the interest within one month from the year/semi- year end. As a result of this the amount of interest suspense is higher percentage of the interest receivable of MKDBL during the period of the study. It is to be noted that the interest suspense of MKDBL is higher on its side. This indicates that the company should initiate measures for recovering interest outstanding from the borrowers. On the other side, SBBL was able to maintain interest suspense to 1.48% to 3.20% of the total interest receivables. In comparison to MKDBL, the interest recovery of SBBL is quite satisfactory, however still plenty of efforts is to be made for interest recovery by MKDBL. The increase in interest suspense has adverse affect in the profitability of the banks.

CHAPTER V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

Various facts and matters required for the study has been discussed and explored in the preceding chapters. Analytical assessment of various aspects of the financial performance of development banks has been done by using some important financial as well as non financial tools. After completing the basic analysis required for the study, the final and most important task of the researcher is to enlist finding and give recommendation for further improvement. This would help to provide necessary feedbacks to the top management of the development banks as well as NRB to initiate action and proceed for further improvement. The research has been conducted to find errors and mistakes and initiate to correct them for further growth and improvement.

5.1 Summary

The development of any country largely depends upon its economic development. Capital formation is the prerequisite in setting the overall pace of the economic development of a country. Well- organized financial system contributes a lot to the process of capital formation by converting scattered saving into meaningful capital investment in order to aid industry, trade, commerce and agriculture for the economic development of the nation. The financial institutions play dominant role in the process of economic development. Banks are indispensable elements in these systems. Development banks contribute immensely towards mobilizing and allocating resources efficiently, developing capital markets for attracting long-term productive investments promoting industrialization and creating more opportunities for increased production- productivity and employment generation etc. Development banks furnish necessary capital needed for trade, industry and

other venture capital that in turns lead to the overall development of the economy as well as development of the country.

This study focused in the NRB directives issued to development banks and the financial performance of development banks of the thirteen directives issued to development banks only main directives are considered for the study. An attempt has been made to analyze the implementation and impact of directives on the financial performance of development banks. Besides, this study also covers the financial performance of the two development banks namely SBBL and MKDBL. An effort has been made to highlight the hidden implications of the figures portrayed in the balance sheet of the development banks by interpreting their cause effect relationship with regards to their financial performance and to identify their contribution to the national economy. After the study, the conclusion and findings of the financial performance of development banks with regard to their key financial variables and based on the findings of the analysis; provide specific suggestion which will be beneficial for these banks as well as for the entire economy. The financial statement of only five years i.e. from 2005/06 to 2009/10 has been examined to fulfill the objectives of the study.

5.2 Conclusions

The increasing trend of the important variables of the financial performance like net profit, loan and advance, total deposit, net interest and earning per share reflect the overall improving performance of SBBL. The liquidity position of SBBL is stronger than that of MKDBL. Activity/ utilization ratio of SBBL is also better than that of MKDBL since SBBL has utilized the major portion of the total deposits towards investment activities whereas MKDBL has utilized major portion of the deposits towards lending activities. Similarly, profit position of SBBL is also stronger than MKDBL; MKDBL has incurred a great loss in the year 2005/06.

During the analysis, it has been observed that MKDBL has violated the NRB regulations in many occasions. It has not been able to maintain the capital adequacy ratio as prescribed by NRB and has not kept adequate loan loss provision. Likewise, it has not followed the regulations regarding investments. As a result, NRB has directed SBBL has to maintain additional provision accordingly.

NRB's directive is responsible to some extent for incurrence of such a heavy loss of MKDBL in 2005/06. It is because of the loan loss provision made as per the categorization of the loan. Such provision has to be deducted from the income which directly affects the profitability of the banks. The main objective of the directives regarding provision which made MKDBL incur loss is to make aware the bank from providing bad loans. This not only protects the bank from bankruptcy ratio strengthens the banks financial position. Loan related provisions protect the banks from liquidation. The accounting policy of NRB to make business transparent, true and fair will help to win the trust of concerned people such as shareholders, depositors, employees etc. It will help improve reputation of the banks and increase the goodwill.

A banks performance can not be judge solely in terms of the profit it has earned by maintaining adequate liquidity and safety, but it should also be evaluated on the ground of the contribution it has made to the community, to the government as well as national economy. It means the banks should come forwarded with the national priorities like more fund mobilization and services to maximum customers, developing skills and expertise in the local staffs, earring satisfactory profit and discharging their accountability towards the counter and the economy.

5.3 Recommendations

On the basis of the analysis done above, following recommendations can be provided to SBBL, MKDBL and Nepal Rastra Bank.

5.3.1 Recommendations to SBBL and MKDBL

On the basis of the analysis of the two development banks done earlier, the recommendations presented below will definitely be helpful to overcome the weakness and inefficiency and to improve present financial performance position of SBBL and MKDBL.

1. SBBL and MKDBL must identify the quality of current assets and current liabilities to develop their own standard current ratio. The fluctuation of ratio must be stabilized after proper diagnosis of the quality, such as the prevailing interest rates, supply and demand position of loans, saving and investment situations. Significant portion of MKDBL current assets is kept as cash and bank balance. MKDBL should focus in investing short term marketable securities which yield more return than merely maintaining cash and bank balance.
2. Loan and advances to total deposits ratio of SBBL is comparatively less than that of MKDBL. It is recommended that SBBL increases the loans and advances. It is also recommended for MKDBL to increase the loans and advances and reduce fixed deposits since they are high interest bearing funds and focus should be made towards savings and margin accounts which is comparatively less costly than the fixed deposits.
3. It is recommended MKDBL should be more serious improve the efficiency in utilizing its deposits in loan and advances rather than in investment for generating the profit. Usually, loans and advances are the high yielding investment sector than any other sectors.
4. It is recommended for to avoid the excessive use of debt capital. High leverage cost of capital can be considered as positive development if the

increased debt can be invested on income generating performing assets. Failure in advancing loans and advances to new profitable sector against this high cost bearing debt may lead ultimately to liquidity crisis or bankruptcy. Therefore, it is recommended to increase equity capital of MKDBL by issue of shares, increasing general reserves and maintaining more retained earning.

5. Capital adequacy of MKDBL is below the minimum prescribed limit by NRB in 2005/06, 2006/07, 2007/08 and 2008/09. Therefore, an effort should be made to increase the capital adequacy ratio bring it with the prescribed limit. The capital adequacy can be increased by increase in core capital through increase in share capital which is a permanent source of capital. This however, would eventually lead to the decrease in earning per share. So, to prevent the shareholders interest an effort should be made towards increase in supplementary capital as it is temporary source of capital.
6. Profit is essential for the survival and growth of banks. Banks should be careful in increasing profit in real sense to maintain the confidence of shareholders, depositors and its customers. SBBL has been able to generate profit in all the five years of study period. Comparatively SBBL profit ability position is better than that of MKDBL. Therefore, MKDBL is recommended to utilize its risky assets and focus in the loan recovery to reduce the provision substantially and gain highest profit margin. There has been a huge financial loss to MKDBL in the year 2005/06, so it is very important to adopt a firm policy and focus towards receiving the organization.
7. In order to mobilize the deposits in the productive sectors, they have to act according to the plans and the policies of the government and help in the overall development of the country. It is recommended for the both banks to expand their branches in rest part of the country so that it would help in

the overall development of the country through mobilization of savings in the form of loans and advances. Besides, they should come forward to generate new service ides to run income generating programs, to bring women development programs to take part in the priority sector development programs and poverty alleviation programs.

8. SBBL and MKDBL are using high cost bearing fixed deposits therefore, they should try to reduce them and increase the margin account and savings deposits for the reduction of its operational expenses. They should find out for loopholes in their operations and eliminate the unnecessary costs.
9. While analyzing the financial performance, it is seen that the major source of revenue of both the banks is interest. Hence, both the banks should focus on non- fund i. e. guarantee business and other commission based business such as merchant banking activities, invest in hydropower project rather than simply relying on loans and advances.
10. In Nepal, no differential treatment has been extended to the commercial banks and development banks, at least from the government's side, so development banks should come forward to show what they can contribute for the development of the country. One of the present national priorities is small entrepreneur's development. The national level development banks are present concentrating in the urban areas under wholesale credit only with big clients, big groups in trade and industry, manufactures and services related to tourism industries, subsidiaries of multinational companies operating in Nepal etc. They should divert their business strategy and should also focus towards development of rural areas and retail banking. They should come forwards to increase the number of clients, develop entrepreneurship, diversify their business with large number of small investors and come forwards to meet the national objectives by mobilizing more entrepreneurs.

5.3.2 Recommendations to Nepal Rastra Bank

It seems that NRB has been a bit harsh on the development banks with the stringent directives issued to them in the existing deteriorating economic scenario. NRB should effectively monitor the impact and implementation of the directives. Besides, the directives issued should be reassessed and reanalyzed and further amendments should be made, if necessary. On the basis of the study, the recommendations to the NRB are presented below:

1. The NRB issues directives to protect the interest of deposit holders and to uplift the banking sector of Nepal to international standards. However, such directives should be issued only after doing proper homework, consolation and interaction with different banking experts. The impact of directives on the bank itself, investors, shareholders, depositors should be seriously studied and frequent amendments should be avoided. Besides, the regulation issued should be practical. The worldwide accepted regulations may be applicable in the Nepalese context.
2. At present, the regulation issued to development banks are quite similar to the regulations issued to commercial banks. It is not logical since commercial banks are authorized to carry out commission based activities to generate income other than lending, whereas the income generating activities of development banks are restricted to few. Therefore, the regulations issued to development banks should be liberal than that of commercial banks. Besides, the major financing of development banks is towards long term project. The existing regulation relating to provision discourages development banks towards long term financing.
3. Though there is a credit Information Bureau for obtaining for obtaining credit information of different clients, NRB should also initiate for establishment of credit rating agencies. Credit rating of

parties should be given due consideration in making loan loss provision.

4. NRB should make an effort to segregate the sector of financing to commercial banks and development banks specifically. The existing trend in the banking industry is that every bank trends to target to big corporate clients. Since, the cost of fund of commercial banks is comparatively low than that of development banks and commercial bank can enter into any segment of financing, it is very difficult for development banks to compete with commercial banks. Therefore, the area of financing should be segregated for commercial banks and development banks.
5. Adequacy of collateral is a prime consideration for approval of loans. The valuation of collateral is an important aspect of lending transactions. Development banks have their own set of enlisted valuators but are not regulated by NRB. Therefore, NRB should frame a policy to register qualified valuators and should follow the proper guidelines while offering services to development banks as a valuator.

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Appendix- I

Company Profile

Sanima Bikas Bank Limited (SBBL)

Sanima Bikas Bank Limited was established in 26 November 2004 by the enterprising and dynamic Non Resident Nepalese (NRN) with a vision to mobilize required resources for the national development process. Head office of Sanima Bikas Bank limited is Nagpokhari, Kathmandu. Sanima is the first private sector national level Bikas Bank in the country to be capitalized at NPR 320 million (equivalent to USD 4.5 million). The current shareholding pattern of the Bank constitutes of promoters holding 70% and general public holding 30%.

We value our customers and our policies are adapted to meet the best interest of our costumers and our stakeholders by catering pragmatic and reliable services. As our slogan suggests, we have put in all our efforts to insure that our customers make the best out of our services, in the simplest way possible. Hassle free banking is what we are proud to be offering. The Bank has been in forefront in the country for mobilizing its resources in financing hydro power projects. The mission of the bank is to provide banking and financial solutions in a simplified way with customer focus while adding value to stakeholders' interests.

Capital Structure of SBBL

Authorized Capital: Rs. 2,10,00,00,000

Issued Capital: Rs. 2,01,60,00,000

Paid-up Capital: Rs. 2,01,60,00,000

Ownership structure of SBBL

Manakamana Development Bank Limited (MDBL)

Manakamana Development Bank Limited was established in 19 June 2001. Head office of Manakamana Development Bank limited is Annapurna Arcade-II, 2nd Floor, Durbar Marge, Kathmandu. In the midst of cut-throat competition in the banking sector, Manakamana Development Bank Ltd. has entered the market with a new management era. Bank has to create professional niche in the financial market. Being a highly result oriented institution, the bank focused on diversifying services to cope with the market demand & the ever changing consumer wants. With new equity investors, new capital structure, renowned board members and a professional management team, we are here to make our presence felt.

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

successfully embarked on a multi-pronged strategy of consolidation, administrative streamlining, human resource up-skilling, strategic cost management, focused non-performing assets management, balance sheet and treasury management and controlled asset growth, in tandem with strengthening the credit culture as well as strategic marketing and sales.

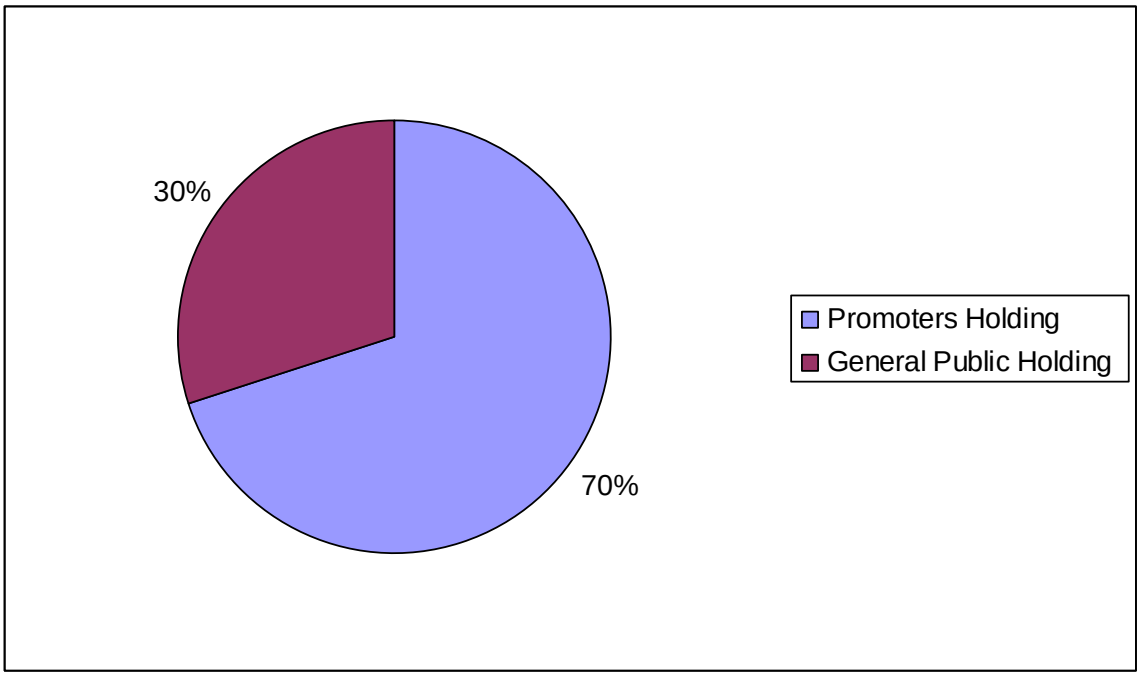
Capital Structure of MDBL

Authorized Capital: Rs 4,000,000,000

Issued Capital: Rs. 2,000,000,000

Paid-up Capital: Rs. 1,000,000,000

Ownership structure of MDBL



Appendix- II

List of Development Banks in Nepal

S.No.	Names	Operation Date (A.D.)	Head Office	Paid up Capital (Rs. In Million)
1	Nepal Industrial Development Corporation	6/15/1959	Durbar Marg, Kathmandu	415.8
2	Nepal Development Bank Ltd.	1/31/1999	Kamaladi, Kathmandu	320
3	Uddyam Development Bank Ltd.	11/11/1999	Tandi, Chitawan	50
4	Malika Development Bank Ltd.	12/19/1998	Dhangadhi, Kailali	204.2
5	Siddhartha Development Bank Ltd.	8/20/1998	Tinkune, Kathmandu	645
6	United Development Bank Ltd.	3/16/2002	Jeetpur, Bara	80.2
7	Manakamana Development Bank Ltd.	6/19/2001	Durbar Marg, Kathmandu	1000
8	Narayani Development Bank Ltd.	10/17/2001	Ratna Nagar, Chitawan	43.7
9	Pashimanchal Development Bank Ltd.	3/2/2003	Butawal, Rupandehi	336.5
10	Sahayogi Bikas Bank Ltd.	10/21/2003	Janakpur, Dhanusha	45
11	Pashupati Development Bank Ltd.	1/1/2004	Banepa, Kavre	200
12	Karnali Bikash Bank Ltd.	2/14/2004	Nepalgunj, Banke	80
13	Triveni Development Bank Limited	7/26/2004	Bharatpur, Chitawan	115
14	Annapurna Development Bank Limited	8/23/2004	Banepa, Kavre	672
15	Bhrikuti Bikas Bank Limited	8/19/2004	Butawal, Rupandehi	232.6
16	Shubhechchha Bikas Bank Limited	9/14/2004	Narayangadh, Chitawan	48
17	Bageshowri Development Bank Limited	10/19/2004	Nepalgunj, Banke	49.5

18	Sanima Bikas Bank Limited	11/26/2004	Nagpokhari, Kathmandu	806.4
19	Gaurishankar Development Bank Ltd.	11/29/2004	Kawasoti, Nawalparasi	200
20	Gorkha Bikas Bank Limited	12/1/2004	Putalisadak, Kathmandu	660.8
21	Gandaki Bikas Bank Ltd.	1/19/2005	Pokhara, Kaski	100
22	Infrastructure Development Bank Ltd.	4/29/2005	Banepa, Kavre	649.9
23	Business Development Bank Ltd.	5/10/2005	Pokhara, Kaski	210
24	Biratlaxmi Bikas Bank Limited	5/11/2005	Biratnagar, Morang	60.5
25	Excel Development Bank Ltd.	7/21/2005	Anarmani, Jhapa	80
26	Western Development Bank Ltd.	9/15/2005	Ghorahi, Dang	50
27	Himchuli Bikas Bank Limited	11/7/2005	Pokhara, Kaski	438.5
28	Arniko Development Bank Ltd.	7/6/2006	Dhulekhel, Kavre	200
29	NDEP Development Bank Ltd.	7/17/2006	Kamaladi, Kathmandu	512
30	Clean Energy Development Bank Ltd.	9/6/2006	Sitapaila, Kathmandu	320
31	Miteri Development Bank Ltd.	10/13/2006	Dharan, Sunsari	45.1
32	Tinau Bikas Bank Ltd.	10/13/2006	Butwal, Rupandehi	62.6
33	Rising Development Bank Ltd.	12/18/2006	Narayangadh, Chitawan	54.2
34	Muktinath Bikas Bank Ltd.	12/18/2006	Pokhara, Kaski	65
35	Sewa Bikas Bank Ltd.	2/25/2007	Butawal, Rupandehi	100
36	Kankai Bikas Bank Ltd.	5/4/2007	Damak , Jhapa	40
37	Public Development Bank Ltd.	6/7/2007	Birjunj , Parsa	150
38	Ace Development Bank Ltd.	8/15/2007	Narayanchaur, Kathmandu	750.5
39	Mahakali Bikas Bank Ltd.	8/18/2007	Mahendranagar, Kanchanpur	20
40	Sangrila Bikas Bank Ltd.	8/26/2007	Pokhara, Kaski	79.8
41	Bhargab Bikas Bank Ltd.	8/30/2007	Nepalgunj, Banke	37.5

42	Vibor Bikas Bank Ltd.	10/4/2007	Tripureshwor, Kathmadu	680
43	Resunga Bikas Bank Ltd.	9/26/2007	Tamghas, Gulmi	30.6
44	Rara Bikas Bank Ltd.	9/30/2007	Birendranagar, Surkhet	23.3
45	Diyalo Bikas Bank Ltd.	10/1/2007	Banepa, Kavre	100
46	Country Development Bank Ltd.	10/4/2007	Banepa, Kavre	224
47	Kasthamandap Development Bank Ltd.	10/25/2007	New Road, Kathmandu	320
48	Alpine Development Bank Ltd.	10/5/2007	Hetauda, Makawanpur	100
49	Nilgiri Bikas Bank Ltd.	10/12/2007	Beni, Myagdi	50
50	Corporate Development Bank Ltd.	10/25/2007	Birjung, Parsa	140
51	Kamana Bikas Bank Ltd.	9/29/2007	Lekhnath, Kaski	130
52	City Development Bank Ltd.	10/19/2007	Pokhara, Kaski	200
53	Garima Bikas Bank Ltd.	11/23/2007	Waling, Sangja	200
54	Biswo Bikas Bank Ltd.	11/21/2007	Pokhara, Kaski	240
55	Pathibhara Bikas Bank Ltd.	11/21/2007	Urlabari, Morang	50
56	Professional Bikas Bank Ltd.	10/17/2007	Banepa, Kavre	70
57	Kabeli Bikas Bank Ltd.	11/15/2007	Dhankuta	20
58	Purnima Bikas Bank Ltd.	5/20/2008	Sidhardhanagar, Rupandehi	70
59	Jyoti Development Bank Ltd.	8/25/2008	Kamalpokhari, Kathmandu	740
60	Shine Development Bank Ltd.	2/22/2009	Butawal, Rupandehi	60
61	Bagmati Development Bank Ltd.	3/23/2009	Hariwon, Sarlahi	14
62	Hamro Bikas Bank Ltd.	4/19/2009	Nuwakot	21
63	Kakre Bihar Bikas Bank Ltd.	5/15/2009	Surkhet	12
64	Pacific Development Bank Ltd.	7/26/2009	Beshishahar, Lamjung	19.5
55	Civic Development Bank Ltd.	8/13/2009	Dhadingbesi, Dhading	14
66	International Development Bank Ltd.	9/4/2009	Taku, Kathmandu	448
67	Kanchan Development Bank Ltd.	9/19/2009	Mahendranagar, Kanchanpur	70

68	Gulmi Bikas Bank Ltd.	9/24/2009	Tamghas, Gulmi	14
69	Bright Development Bank Ltd.	10/8/2009	Panouti, Kavre	98
70	Matribhumi Bikas Bank Ltd.	10/9/2009	Sindhulimadi, Sindhuli	15.4
71	Innovative Development Bank Ltd.	11/13/2009	Sidhardhanagar, Rupandehi	66.4
72	Jhimruk Bikas Bank Ltd.	12/14/2009	Pyuthan	12
73	Metro Development Bank Ltd.	12/16/2009	Pokhara, Kaski	70
74	Raptibheri Bikas Bank Ltd.	1/15/2010	Nepalgunj, Banke	60
75	Gaumukhi Bikas Bank Ltd.	1/25/2010	Bijuwar, Pyuthan	14
76	Nepal Consumer Development Bank Ltd	2/5/2010	Pokhara, Kaski	140
77	Khandbari Development Bank Ltd.	3/5/2010	Khandbari, Sankhuwasava	17.5
78	Tourism Development Bank Ltd.	3/18/2010	Thamel, Kathmandu	400
79	Mission Development Bank Ltd.	6/15/2010	Butwal, Rupandehi	70
80	Surya Development Bank Ltd.	7/18/2010	Bhimeshwor, Dolkha	14
81	Mount Makalu Development Bank Ltd.	7/21/2010	Basantapur, Terathum	14
82	Sindhu Bikas Bank Ltd.	9/9/2010	Barhabise, Sindhupalchowk	51
83	Social Development Bank Ltd.	10/13/2010	Naxal, Kathmandu	382.7

Source: Nepal Rastra Bank