

**A STUDY OF IMPLEMENTATION OF NEPAL RASTRA  
BANK'S (NRB) DIRECTIVES IN COMMERCIAL BANKS  
OF NEPAL**

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## **RECOMMENDATION**

This is to certify that the Thesis

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**A STUDY OF IMPLEMENTATION OF NEPAL RASTRA BANK'S  
(NRB) DIRECTIVES IN COMMERCIAL BANKS  
OF NEPAL**

*has been prepared as approved by this Department in the prescribed format of the  
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## **VIVA-VOCE SHEET**

We have conducted the viva –voce examination of the thesis presented

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OF NEPAL**

And found the thesis to be the original work of the student and written

according to the prescribed format. We recommend the thesis to

be accepted as partial fulfillment of the requirement for

**Master's Degree in Business Studies (M.B.S.)**

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## **DECLARATION**

I hereby declare that the work reported in this thesis entitled submitted to Office of the Dean, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirement “**A Study Of Implementation of Nepal Rastra Bank's (NRB) Directives In Commercial Banks OF Nepal**” for the Master’s Degree in Business Study (M.B.S.) under the supervision of **Mrs. Ruchila Pandey** of Shanker Dev Campus.

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Researcher

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## **LIST OF ABBREVIATION**

EBL	: Everest Bank Limited
NIBL	: Nepal Investment Bank Limited
HBL	: Himalayan Bank Limited
NABIL	: Nabil Bank Limited
C.V.	: Coefficient of Variation
CB	: Commercial Bank
FY	: Fiscal Year
NRB	: Nepal Rastra Bank
RBB	: Rastriya Banijiya Bank
No.	: Number
CRR	: Cash Reserve Ratio
RWA	: Risk Weighted Assets
BS	: Bikram Sambat
CAR	: Capital Adequacy Ratio
Rs.	: Rupees
S.D	: Standard Deviation
T.U.	: Tribhuvan University
LTD.	: Limited
BAFIA	: Bank and Financial Institution Act
SEBON	: Securities Board of Nepal
PCA	: Prompt Corrective Action
AIG	: Accord Implementation Group
ATM	: Automated Teller Machine
TU	: Tribhuvan Universit

# **CHAPTER-I**

## **INTRODUCTION**

### **1.1 General Background of the Study**

Nepal is one of the least developing countries of the world. The industrialization stage of the country is at primitive stage till now. This has added the problem in an employment opportunity in the country. Due to geographical difficulties & lack of infrastructure development of financial sector, the growths of financial sector are badly affected. Domestic crisis create huge problem in development of financial sector in Nepal. The world converted into narrow boundary. The concept of borderless country took rapid motion in those days. Liberalization, globalization as well as privatization are most common and essential part of investment and other activities in financial sector of Nepal. The open market concept creates several opportunities & threats. Rapid development in information-technology sector is also milestone for increasing investment activities. Thus, competitive environment was formed in national market as well as international market. The liberalization policy attracts foreign investor as well as national investor to invest financial sector & commercial sector, which help to raise the life standard of people. (Yadav, 2009 p:1)

Nepal Rastra Bank (NRB), the central bank of Nepal was established in 1956 AD under Nepal Rastra Bank Act, 1955 to discharge the central banking responsibilities including guiding the development of the embryonic domestic financial sector. Central bank is the supreme financial institution of the country. The government to control has empowered the central bank by law to regulate, supervise and monitor the banking sector for better economic environment. It helps governments to control financial sector through central bank. A sound and prosperous banking environment can be possible only with the proper functioning of such power. The discussion banks and other banking regulating will not be complete without a discussion of central banks. Like all central banks around the globe, Nepal Rastra Bank probably has more impact on day activities of bank any other government agencies. The primary job of a central bank is to carry out monetary police whom involves making sure that a banking and financial system function smoothly and the supply of money and credit from that system contributes to the national economics goals. (Ojha, 2012 p: 1)

As an autonomous body, it aims to stabilize the country economy using different financial tools. Furthermore it control banking sector by regulation, provision and market operation. NRB issues directives to the commercial banks instructing them to fulfill its regulatory requirement of the country. The main function of central bank is to guide the commercial bank, which are operating in country. Central Bank neither accepts deposit from the public nor gives loan to the public. It is set up make sound monetary policy ([www.nrb.org.np](http://www.nrb.org.np)).

In Nepal Ministry of finance looks after the fiscal policy where central bank looks after the monetary policy by issuing timely guidelines related to many aspects of the banks including banking operations, currency, credit and deposits mobilization with a view to develop a secured and healthy banking system and to protect the interest of the deposits holders and for the economics development of the country. Following that guideline is required by banks. Most of banks have been successful to earn profit their deposits mobilization but none of them seem to be able to invest their find in more productive sector .To meet the requirements of NRB bank must deposit certain percentage of their total deposit with NRB i.e.7% of current and saving deposits liabilities. Bank should have 2% minimum cash balance in their self vault of total currency A/C held by the bank.(NRB, rules) The cash in vault should include only local currency any foreign currency except clearing cheque etc. In banking business the volume of credit extensions much depends upon the deposits base of a bank. The deposits creating powers of commercial banks forces to raise the assets along with the liabilities side of the balance sheet. There are regular changes in this view in the modern banking industry. Thus, banks have evolved from relatively passive accepts of deposits. (Shrestha, 2004 p: 6)

Deposits are of the aspects of bank liabilities that management has influencing through deliberate action. In regard to loan classification and provision all commercial banks are supposed to categorized the loans disbursed to the customers into different group on the basis of their past due periods. Each category of the loan amount required certain percentage of it to be provision for probable loss. The provision amount is deducted from the profit. This is mainly to safeguard the money of the depositors and protect the bank from bankrupt. Similarly, according to the new amendment made on 2002, for a loan to bad, the time period of past due is one year and mire. If lay down various rules and regulation for the banks and bonus need to the

various facilities to the banks. Similarly, NRB plays significant role to make commercial banks mobilization of deposits in good productive and profitable sector so that commercial banks can have sufficient liquidity and security. (Paudyal, 2010, p: 14)

## **1.2 Origin and Emergence of Bank**

Those financial institutions that offer the widest range of financial services – especially credit, savings & payments services and perform the widest range of financial functions of any business firm in the economy is known as Bank. There are different views about the origin of Bank. The word bank is derived from Italian word “Banca”, Latin word “Bancus” & French word “Banque” all of which means a bench. Similarly others view that Bank is derived from the German word “Bach” which means a Joint fund. (Joshi, p: 60)

Regarding the origin of Bank in the world, the first bank named as The Bank of Venice, was established in Venice of Italy in 1157 A.D. Following this, “The Bank of Barcelona, Spain, established in 1401 A.D. was the second bank of the world. In Addition, the first central Bank, which was established in 1656 A.D., was “Reek Bank of Sweden” (Thapa & Neupana P: 5).

In the banking History of Nepal, Nepal Bank Limited is the first Bank which was established in 1994 B.S. Due to wider & changing roles & functions of the banks as per time & situations, it is difficult to give the concrete definition of Bank. Some of the definitions given by popular, renowned scholars are as follows.

“Bank is the one who, in the ordinary course of his business, receives money which he pays by honoring cheque of persons from whom or whose account receives”. – Dr. HL Hart.

“A Bank is an organization whose principle operation are concerned with accumulation of the temporarily idle money of the general public for the purpose of advancing to others for expenditures”. – Kent.

“A Bank collects money from those who have it to spare or who are saving it out of their incomes, and it lends this money to those who require it”.- C.R. Crowther

“Bank is an organization or place that provides a financial service.”-Oxford Dictionary.

“Ordinary banking business consists of changing cash for bank deposits & 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 or unsecured promises of Businessmen to repay etc”. Sayers.

“Bank is an organization established for the purpose of exchange money deposit lending money & participation in transactions”. – Commercial Bank Act 2031 (Nepal).

In summary, a bank can be defined as any business organization that offers acceptance of deposits, which is subject to withdrawal on demand (either through cheque or electronic transfer or both) & grants loans & credits to private individuals & business firms on commercial basis.

Crowther observed that the Modern Banking has three ancestors who are the merchant, the gold smith & the moneylender. Following is the brief description of the ancestors of Modern Banking.

Merchants: - The Merchants or Traders are entitled as the ancestors of Bank. Trading activities require remittance of money from one place to another. This is one of the important functions of a bank. There is a possibility of theft of metallic money during transportation. So, the traders with high & widespread reputation begun to issue documents, which were taken as title of money. This gave rise to the institution of “Hundi”. Hundi is the letter of transfer of money.

Goldsmith: - Goldsmiths had very sound credit standing in the society. They used to have safe to keep valuables. Fear of theft & robbery led people keep their valuables (gold, silver & metallic coins) in the custody of the goldsmiths. Goldsmiths used to charge commission for safe keeping & used to return the valuables on demand. The depositors had to visit goldsmiths for part & full withdrawal of gold, silver & coins. Gold & silver used to remain with the goldsmiths for relatively a longtime but coins had to be withdrawn from time to time.

Money Lender: - The next stage in the development of banking arose, when the goldsmith became a money lender. This development was based on the goldsmith's discovery that it wasn't necessary to hold hundred percent of the coins deposited with them. The goldsmiths soon realized that, on average, daily withdrawals were equal to daily deposits & only a contingency reserve was required for the period when withdrawals exceeded deposits.

All functions & activities performed by merchants, goldsmiths & moneylenders in the ancient time are being performed by the various types of banks in modern ways at the present time.

### **1.2.1 Emergence of Modern Banks**

The first modern bank of the world is the bank of Venice, set up in 1157 in Venice, Italy subsequently; bank of Barcelona in 1401 & Bank of Genoa in 1407 were established. The Lombard's migrated to England & other parts of Europe from Italy are regarded for their role in the development & expansion of the Modern Banking, Bank of Amsterdam set up in 1609 was very popular then the Banks of Hindustan established in 1770 is regarded as the first bank of India. Though Bank of England was set in 1694, the growth of banks accelerated only after the introduction of banking act in 1833 in United Kingdom as it allows opening joint stock company banks. These modern banks gradually replaced goldsmiths & money lenders.

The 20<sup>th</sup> century observed the development of various banking institutions highly specialized & sophisticated particularly in advanced countries like U.S.A., U.K. & others. Today various international organizations like W.B., I.M.F., and A.D.B. etc have been developed which are influencing the whole business of the modern world.

### **1.2.2 Emergence of Bank in Nepal**

The history of banking sector is rather more slow evolution. Even now, the banking system is still in the evolution phase so far as banking is concerned with debt, we may go back in the Nepalese history, where a merchant namely "Sankhdhar" is recorded. He was the person who alone paid all debts of the people existing in the country at that time. Since then he introduced a new era called "Nepal Sambat". This record proves the existence of money lending function at that time. During the course of development of borrowing, there are some steps in the direction of start of banking development in Nepal.

**Phase I:** - The establishment of “Tejarath Adda” during the Tenure of Prime Minister Ranoddip Singh in 1933 B.S. (1876 A.D.) was the first step towards the institutional development of banking in Nepal. It was fully subscribed by the government in KTM. Tejarath provided credit loans to the general public at 5% interest rate on securities i.e. gold, silver & other ornaments. Its objective was to provide credit or loans to the general public but it failed to accept deposits from them.

**Phase II:** - During the time of Chandra Shamsher (1901-1929), credit facilities of ‘Tejarath’ were extended by opening its branches. Later, ‘Tejarath’ was replaced by the first commercial bank, Nepal Bank Ltd. established on 30<sup>th</sup> Kartik 1994 B.S. is the first commercial bank in Nepal with authorized capital of 10 million rupees. Then Nepal Rastra Bank was established on B.S. 2013/01/14 as the Central Bank under the Nepal Rastra Bank Act 2012 B.S. Its function was to supervise commercial banks & to guide the basic monetary policy of the nation. In 2013 B.S., Industrial development center was established & later it was converted into Nepal Industrial Development Corporation (NIDC) in 2016 B.S. As the monetary transaction got more & more complicated on 2022.10.10, Rastriya Banijya Bank was established as a fully government owned commercial Bank. Agricultural development bank was then established on 2024.10.07 to help the agriculture side of the country.

**Phase III:** - To operate all commercial banks uniformly under single act, "commercial bank Act 2031” was enacted. According to the Nepal commercial bank Act of 2031B.S (1974 A.D.) "Commercial banks are banks that deal with money exchange, accepting deposits, advancing loans and other commercial transactions except some special functions done by specified cooperative, agriculture and industrial banks". In 2041 B.S., Nepal Government established five rural development banks under the control and supervision of Nepal Rastra Bank. The establishment of these banks helped in spreading the banking services to both urban and rural areas but banking service to the customer satisfaction was still far.

After the reestablishment of democracy, the Government has taken liberal policy in banking sector so different private banks are getting permission to establish with the joint venture of other countries. Nabil is the first joint venture bank as Nepal Arab bank. Similarly, two foreign commercial banks Nepal Indosuez Bank ltd and Nepal Grindlays Bank ltd. entered in Nepal in the form of joint venture and the trend is

continuing till today as many Nepalese owned banks are also running. Today, there are altogether 32 commercial banks in Nepal.

### **1.3 Statement of the Problem**

In Nepal Rastra Bank more than half century long history various activities were under taken Nepal Rastra Bank Act 1955 and BAFIA 2063 gives the full authority to Nepal Rastra Bank to look after Banks and financial institutions. Banks and financial institutions should be established and operate under Nepal Rastra Bank's rules and regulations before the establishment of Nepal Rastra Bank as a Central Bank of the country, the most of the people were not conscious about the banking system so, the main problem is the lack of banking knowledge itself but after the country adopted the economic liberalization policy, large number of joint venture commercial Banks, Private commercial Banks and other financial institutions started to take permission for establishment from Nepal Rastra Bank.

The questions are arise whether the directives of NRB properly followed by commercial banks and financial institutions? So, for this purpose, NRB has been issuing various directives for commercial banks.

In the emerging commercial banks working environment, NRB have to update its functions of issuing various directives regarding establishment, capital adequacy, liquidity, credit classification etc. similarly the directives regarding the provisions of reserves to be fulfill by the commercial banks are followed or not?

As the government have adapted to all out above the international banking institution to establish their branches within Nepal from 2010 as per the agreement done to be the member of WTO. The load of NRB functions in the coming days will be more challenging. NRB should do the functions of check and balance for looking after the commercial banks, capital adequacy under BASEL II which is really a challenging job. similarly the increase in the reserves provisions for commercial banks as directed by NRB should also be follow up time to time. Whether the NRB would be capable to handle the changing environment in the coming days?

Similarly other impact may be absorbed because of the changes made in directives. The directives if not properly adjust, have potential to wreck the financial system of

the nations, as they are the only tools of the NRB to supervise and monitor the bank and the financial institutions. The directives themselves are not that important unless properly implemented.

#### **1.4 Objectives of the Study**

The major objective of this study is to analyze the NRB directives to commercial bank in the modern dynamic economy. Other objectives of study are:

- To find out the role of NRB on monitoring & inspection of commercial bank.
- To find out the effectiveness of directives of NRB practically on the commercial banks of Nepal.
- To make necessary suggestions & recommendations.

#### **1.5 Limitations of the Study**

This report is for the partial fulfillment of MBS. The efforts have made the present and analyze the fact clearly, truly and within the boundary. But reliability of tools, lack of research experience, and lack of data are the primary limitation of this report.

Other limitations are:

- This study is focused on only few directives among several directives issued by NRB for commercial banks time-to-time.
- This study is based on secondary data received from NRB and other commercial bank.
- Among thirty-two commercial banks this is based on only four commercial banks.
- Past five year data from fiscal year 2007/08 to fiscal year 2011/12 is taken for study and analyze.

## **1.6 Organization of the Study**

This study has to be finished within the design offered by the research department of Shanker Dev Campus. According, the research is organized in the following five chapters.

### **❖ Chapter One :- Introduction**

First chapter will describe about the research itself by defining various aspects of NRB directives concerning to commercial banks of Nepal. This will help to develop the conceptual frame work about the research problem & subject matter.

### **❖ Chapter Two :- Review of Literature**

Review of Literature will advance the knowledge about the subject matter as well as general method of doing research in directives on some requirements, which are also defined by the finance & banking expertise.

### **❖ Chapter Three :- Research Methodology**

Research Methodology is policy & frame work not within, which we will find the best alternative for making the research effective to analyze on the topic.

### **❖ Chapter Four :- Analysis of Data**

Data Presentation & Analysis will evaluate & examine the impact & situation of directives on different section of commercial banks in Nepal.

### **❖ Chapter Five :- Summary, Conclusion & Recommendations**

Moreover, the last chapter will be the summary & conclusion of this research & remedial measures to be applied for further advancement & effectives of the directives of the central Bank, NRB to the commercial Banks of Nepal.

## **CHAPTER-II**

### **REVIEW OF LITERATURE**

#### **2.1 Conceptual Review**

There is an important role of banks in the economic growth and development of a country. To achieve an ideal economic growth and development, the banks should have strong and well-managed organization of banking system. When banking is appropriately organized, it aids and facilitates the growth of trade and industry and hence of national economy. In the modern economy, banks are considered not as dealer in money but as the leaders of development. Banks are not just the storehouse of the country's wealth but are the reservoirs of resources necessary for economic development. (Thapa, 2008 P: 26)

According to F.A. Bardford, "A bank is one who in the ordinary course of his business receives money which he repays by honoring cheques of persons from which of one whose account is receive it."(F.A. Bardford: 453)

Banking industry has acquired a key position in mobilization resources for finance and social economics development of the country. No function is more important to be economy and its constitute than financing "Bank assists both the flow of goods and service from the government .Banking provides the country with a monetary system of payment and is in important part of the financial system which makes loans to maintain and increase the level of consumption and product in the economy ."(American Institute of Banking 1972:162)

All the banks in a country are regulated by a body which is termed as Central Bank. These banks are government owned and are responsible to manage nation's currency, money supply and interest rates that are being levied to the customers of various commercial banks in the country. These banks even regulate and control the commercial banking system of the banks which is operating in their respective nations. The central banks can be referred as the authority over other banks in the country. Examples for the same are: Federal Reserve of the United State, the European Central Bank, the People's Bank of China, the Reserve Bank of India, etc.

These banks work with their primary goal which is to manage the money supply of their respective country. These banks are known by different names in different countries of the world. While many countries name it as "Bank of Country" as in England, Canada, Mexico etc. others refer to it as the "National Bank" like in Ukraine though this term is even used by various privately-owned commercial banks especially in USA. Also in many countries the word "Central" is used but again in some countries like India it is just a government-owned commercial bank. Many countries like India, Australia, New Zealand, South African etc. use the word "Reserve" to nominate their central banks. There are many countries which have state-owned banks that have entirely separate functions. These banks though have different names but they have the function and primary goal same that is to regulate monetary policy of their respective country. ([www.onlinebankwatch.com](http://www.onlinebankwatch.com))

"Bank is an institution that deals in money and its substitutes and provides other financial services. Banks accept deposits and make loans and derive a profit from the difference in the interest rates paid and charged, respectively. Some banks also have the power to create money. Commercial bank is a bank with the power to make loans that, at least in part, eventually become new demand deposits. Because commercial banks are required to hold only a fraction of its deposits as reserves, it can use some of the money on deposit to extend loans. When a borrower receives a loan, his checking account is credited with the amount of the loan; total demand deposits are thus increased until the loan is repaid. As a group, then, commercial banks are able to expand or contract the money supply by creating new demand deposits." (Encyclopedia Britannica, 2002)

Though Central Bank is viewed as one of the primary mechanisms of macroeconomic stabilization there are a number of arguments about other areas of Central Bank's involvement. This paper will explore the different areas, including the role of Central Bank in effecting monetary policy and intervening body in exchange rate trades, Central Bank as a Last Lender Resort (LLR), and Central Bank as a regulatory body of the financial sector. Prior to further discussion, it is important to stress that the role of Central Bank and the scope of its involvement may vary due to the effect of different legislations and the presence of various stakeholders. Thus, US Central Bank does not act as a regulatory body of the financial sector (Driffill et al., 2005), whereas

the intervention activity of Japan Central Bank requires the approval of other governmental bodies. (Fujiwara, 2005)

### **2.1.1 Functions of a Central Bank**

A central bank is established for public service and economic development of a country rather than profit making and it acts as an economic advisor to the government. Therefore, the functions of the central bank are different from other. Some development functions are given below:

(1) In order to achieve the objectives referred by NRB Act, the functions, duties and powers of the Bank shall be as follows:

- i. To issue bank notes and coins;
- ii. To formulate necessary monetary policies in order to maintain price Stability and to implement or cause to implement them;
- iii. To determine the system of foreign exchange rate;
- iv. To manage and operate foreign exchange reserve
- v. To issue license to commercial banks and financial institutions carry on banking and financial business and to regulate, inspect, supervise and monitor such transactions
- vi. To act as a banker, advisor and financial agent of Government of Nepal
- vii. To act as the banker of commercial banks and financial institutions and to function as the lender of the last resort
- viii. To formulate foreign exchange policies and to implement or cause to implement them
- ix. To establish and promote the system of payment, clearing and settlement and to regulate these activities and
- x. To implement or cause to implement any other necessary functions which the Bank has to carry out in order to achieve the objectives of the Bank under this Act

(2) While exercising the powers conferred by this Act or any other prevailing law the Bank shall have power to carry out other functions and take actions, which are incidental thereto.

(3) No one shall violate powers conferred on the Bank under this Act.  
([www.nrb.org.np](http://www.nrb.org.np))

### **2.1.2 NEPAL RASTRA BANK (CENTRAL BANK)**

Nepal Rastra Bank is the central Bank of Nepal. It was established set up in 2013/01/14 B.S. (26 April 1956) under the Nepal Rastra Bank act 2012 BS after it's established, it is used the Nepal note on 7<sup>th</sup> Falgun 2016 the 1<sup>st</sup> time. The main objectives established is the use of Nepalese country currency in place if Indian currency. But this act was been Nepal Rastra Bank act 2058 enacted by the parliament. To reflect this dynamic environment, objective of the bank have been recast by the new NRB act of 2058, the preamble of which lays down the objects of the bank as:

- To formulate necessary monetary and foreign exchange policies in order to maintain the stability of price and balance of payment for sustainable development of economy and manage it
- To promote stability and liquidity required in banking and financial sector
- To develop a secure, healthy and efficient system of payment
- To regulate, inspect, supervise and monitor the banking and financial system
- To promote entire banking and financial system of the Kingdom of Nepal and to enhance its public credibility ([www.nrb.org.np](http://www.nrb.org.np)).

### **Policy-Making Body of NRB**

The Board of Directors, which consists of the Governor as Chairman, Finance Secretary, two Deputy Governors, and three independent Directors, appointed by the Government of Nepal from amongst the persons renowned in the field of economics, monetary, banking, finance and commercial Law as Board members, is the policy-making body of NRB.

### **Policy Information Released by NRB**

As mandated in the NRB Act 2002, NRB prepares and publishes the annual monetary policy statement at the beginning of the fiscal year i.e. mid-July. The Bank also prepares and releases the mid-term review of monetary policy. NRB announces its policy and information through its own publications and other public media. It also releases information on other activities through circulars to concerned

agencies/institutions. The Bank publishes monthly statements of its accounts. NRB submits the annual report to the Government and publishes the same for the public. It publishes the Economic Bulletin on a quarterly basis and the Economic Report annually. NRB prepares a monthly report on macroeconomic situation which is released to the general public through news media. NRB publishes the foreign exchange rates via all available public media on a daily basis. It also publishes, on a weekly basis, the Treasury bill auction rates.

### **2.1.2.1 Monetary Policy Implementation**

The objectives of monetary policy, as mentioned in the NRB Act 2002, are geared towards maintaining domestic price stability, securing a reasonable Balance of Payments surplus and maintaining financial sector stability. With the gradual liberalization of the external sector and the adoption of a flexible exchange rate system vis-à-vis convertible currencies and the fixed exchange rate vis-à-vis the Indian rupee, the focus is given to price stability and external sector stability. Monetary cum credit aggregates are used as intermediate targets. The fixed exchange rate with Indian currency continues to be a nominal anchor of monetary policy. Excess liquidity of commercial banks is chosen as the operating target.

### **Policy Instruments**

#### ***Primary Policy Tools:***

Open market operation has been an effective monetary instrument for the monetary management in Nepal. CRR and the bank rate are used as an ex ante stance of monetary policy and has been revised considering the risk at prices. For monetary policy in 2011/12, the CRR and bank rate have been remained as 5.0% and 7% respectively. Open market operation, an ex post stance of monetary policy, is conducted every week on Government Treasury bills of various maturity periods of 28-days, 91-days, 182-days and 364-days. Outright sale and purchase auctions are done in a multiple price basis whereas repo and reverse repo auctions are conducted in multiple interest rate bases. Repo and reverse repo auctions are the collateralized window for short-term liquidity management. The maturity period for such auctions ranges from 1 to 28 days. From 2008/09, the counter-parties of monetary policy have been broadened to include development banks and finance companies. Therefore, the facilities of open market operations have been granted to development banks and

finance companies along with commercial banks. Of the total amount offered for auctions, 15% is allotted for the non-competitive bidders. Open market operations have been conducted based on the excess liquidity indicated by the liquidity monitoring and forecasting framework (LMFF). An automatic and fully collateralized standing liquidity facility (SLF) has been instituted to facilitate the domestic payment system. Commercial banks, development banks and finance companies can use this facility for a maximum period of 5 days on an interest rate determined by adding 3% Penal rate on the latest 91-day Treasury bills or the existing bank rate, whichever is the higher. The maximum standing facility that these institutions can use is limited to 90% of the collateral value.

***Other Policy Tools:***

The Bank also uses other tools such as refinancing to export based industries, sick industries, small and cottage industries and refinance to deprived sectors. The refinance rate is 1.5% for export credit in local currency, and 0.25 percentage point plus LIBOR Rate for export credit in foreign currency. ([www.nrb.org.np](http://www.nrb.org.np))

**2.1.2.2 FINANCIAL STABILITY**

NRB is the apex authority responsible for financial stability of the nation. NRB is authorized and also responsible for the regulation and supervision of commercial banks and all other financial institutions licensed by it. The Insurance Board and Securities Board of Nepal (SEBON) are the regulatory and supervisory authorities for insurance companies and Nepal Stock Exchange limited (only one stock exchange in Nepal, which is owned by the government) respectively.

**Institutional Coverage of the Financial Supervisory Authorities**

All the financial institutions undertaking banking activities are licensed and supervised by NRB. Among the financial intermediaries; commercial banks, development banks, finance companies, micro-finance development banks and other micro-finance institutions that are licensed to perform limited banking activities are under the supervision of NRB.

## **Strategy for Supervision and Monitoring of Financial Stability**

To ensure that the overall financial system in the nation is safe and sound and threats to financial stability are identified and reduced, NRB is currently using CAMELS based approach for supervision. Similarly, CAELS based offsite surveillance with early warning measures are also adopted to meet the supervisory objectives. NRB is conducting risk assessment and risk reduction approaches to ensure financial stability. NRB is gradually moving towards risk-based approach for supervision. NRB has implemented the Prompt Corrective Action (PCA) Rule to safeguard the financial system effective from mid – October 2008. Under the PCA Rule, banks and financial institutions licensed by NRB should maintain the prescribed level of capital fund; otherwise the NRB will take necessary actions promptly.

## **Plan and Progress for the Implementation of Basel II**

NRB has initiated the implementation of Basel II. In this process, a high level Basel II core preparatory committee and a working group called the Accord Implementation Group (AIG) were formed, comprising of central bank and commercial banks' officials. A quantitative impact study was also conducted. A draft for the new capital adequacy framework was published and several interactions among stakeholders were held. Subsequently, NRB introduced a new framework on a parallel basis since July 2007. With respect to the approaches, the simplest and most practical approach suitable for the Nepalese banking industry called Simplified Standardized Approach (SSA) has been selected to implement Basel II known as "Basel II Minus". The advanced approaches in Nepal's circumstances may still be a long way off although it has been planned that more advanced approaches be adopted gradually as the market attains maturity and becomes more sophisticated.

(<http://www.nrb.org.np>)

### **2.1.3 Regulation, Supervision and Monitoring System of NRB**

Promotion of financial stability, development of safe and efficient payment systems, regulation and supervision of banking and financial system and the promotion of healthy and competitive financial system are some of the objectives of functioning of Nepal Rastra Bank. To attain the above objectives Section 84 of the Nepal Rastra Bank Act 2002 has entrusted Nepal Rastra Bank with the necessary powers to perform inspection and examination of any commercial banks or obtain necessary

information for the purpose of supervision of the commercial banks. Currently the Bank Supervision Department in Nepal Rastra Bank carries out the function of supervision of all commercial banks in Nepal. Since foreign banks have their presence only in the form of Joint Venture establishments – that is in collaboration with the local entrepreneurs – Nepal Rastra Bank supervises foreign establishes in the same manner as it supervises other local banks. For the purpose of supervision, the department is required to prepare annual supervision plan for onsite examinations as well off site surveillance of the commercial banks. The same is to be approved by the Governor of the Bank. The Bank Supervision Department carries out both onsite examinations as well as off site surveillance of the commercial banks as per its annual supervision plan.

### **On site Examination**

The Bank Supervision Department can carry out onsite examination of commercial banks in Nepal by sending examination team to the commercial banks. Onsite examination can be corporate level inspection covering all aspects of functioning of commercial banks or can be targeted branch level inspection. The Department also performs follow up of the earlier examination reports by visiting the branches to ensure necessary compliance of the NRB instructions. If information as to functioning of commercial banks against the interest of depositors' or some serious irregularity is received, the Department can perform special on site examination in such cases. The Bank Supervision Department is required to carry out corporate level examination of all commercial banks at least once in a year as per its annual plan but the gap between two inspections at any time should not exceed two years. As per current policy of the Department, corporate 17 examination of all commercial banks is carried out once in a year. For the guidance of the onsite examination, an "On site inspection manual" is in force. On completion of the onsite examination examiners perform CAMELS rating of the bank which is exclusively used for the supervisory purpose and is not revealed to general public.

### **Off site supervision**

Off site supervision is a supplement to the onsite examination and is designed to act as an early warning system to identify banks with potential problems so that appropriate policies and action can be determined. Off site division of the Bank

Supervision Department is carried out in a quarterly frequency as well as annual off site review based on the reports and returns submitted by the commercial banks.

#### **Quarterly offsite review**

Off site division reviews performance of all commercial banks on quarterly basis which is submitted to the Governor of Nepal Rastra Bank. Such review involves assessment of the financial information as well as compliance of applicable rules regulations and legal provisions including NRB directives. Based on the review internal rating which is called CAELS Offsite Rating (COR) is also assigned to the banks.

#### **Annual Balance sheet review**

The Department's off site division reviews the balance sheet of the commercial banks at the end of each financial year and issues necessary instructions based on such review; this is then published in their annual report. In the course of such review the auditor's report, audited financial statements, long form audit report preliminary, audit report and banks reply thereon are studied. Based on the review of above report consisting of the review of financial performance, compliance with Nepal Rastra Banks directives and applicable legal provisions, adverse observations of the auditors and other significant findings is prepared and necessary instructions are issued to the bank thereon (Report of NRB, 2006 P: 16-1).

#### **2.1.4 NRB Brings Guidelines for Branchless Banking**

Nepal Rastra Bank (NRB) has allowed undertaking through branchless, mobile, internet and e-card banking along with defining their area of operation to encourage the e-banking for the expansion of banking services to the unbanked population.

“NRB has brought these comprehensive regulations for branchless and mobile banking to encourage more financial institutions to take up these services instead of focusing on opening more branches,” said spokesperson for NRB Bhaskar Mani Gyanwali. The directive does not ask financial institutions to provision additional capital to provide the services but NRB has asked them to take into account potential risks involve and ways to manage them.

NRB has referred to basic banking services being provided through the use of smart cards or magnetic cards through POS machines in remote locations as branchless banking. Customers are allowed to deposit, withdraw and transfer money to and from their accounts, but the limit on transaction has to be fixed by the financial institutions themselves.

However, NRB has forbidden banks to start branchless banking operations in metropolitans, sub-metropolitans and municipalities. “These areas are already crowded with branches so there is no need of branchless services there,” pointed out Gyanwali.

The central bank has allowed financial institutions of all classes to provide banking services using mobile devices through SMS or use of mobile banking platforms. But only class A, B and C financial institutions are permitted to provide internet banking and e-card banking services to their customers.

NRB has directed financial institutions to clearly state the distribution of liabilities and compensation of the customer, bank or value added service provider in case of certain losses due to shortcomings in the part of any of the players, in the agreement letter with the customers.

Earlier regulations for branchless banking by NRB were a basic 10-point directive which was not sufficient to cover all the aspects governing mobile and branchless banking. Central bank has asked all financial institutions that are providing these services to bring these services in line with the recently published regulation within the next three months.

Branchless banking has been recognized as an important model to increase banking access to people living in geographically difficult-to-reach places in Nepal. Everest Bank, Siddhartha Bank and Mega Bank use smart cards and agents to provide financial services to rural clientele.

Kumari Bank’s Mobile Cash and Laxmi Bank’s Mobile Money use mobile network as a platform to allow banking transactions. Moreover, a multi-bank mobile banking portal — Hello Paisa — has also been launched that will allow mobile holders to

transact through mobile phones even without a bank account.

(Sources: The Himalayan Times, 21 June 2012)

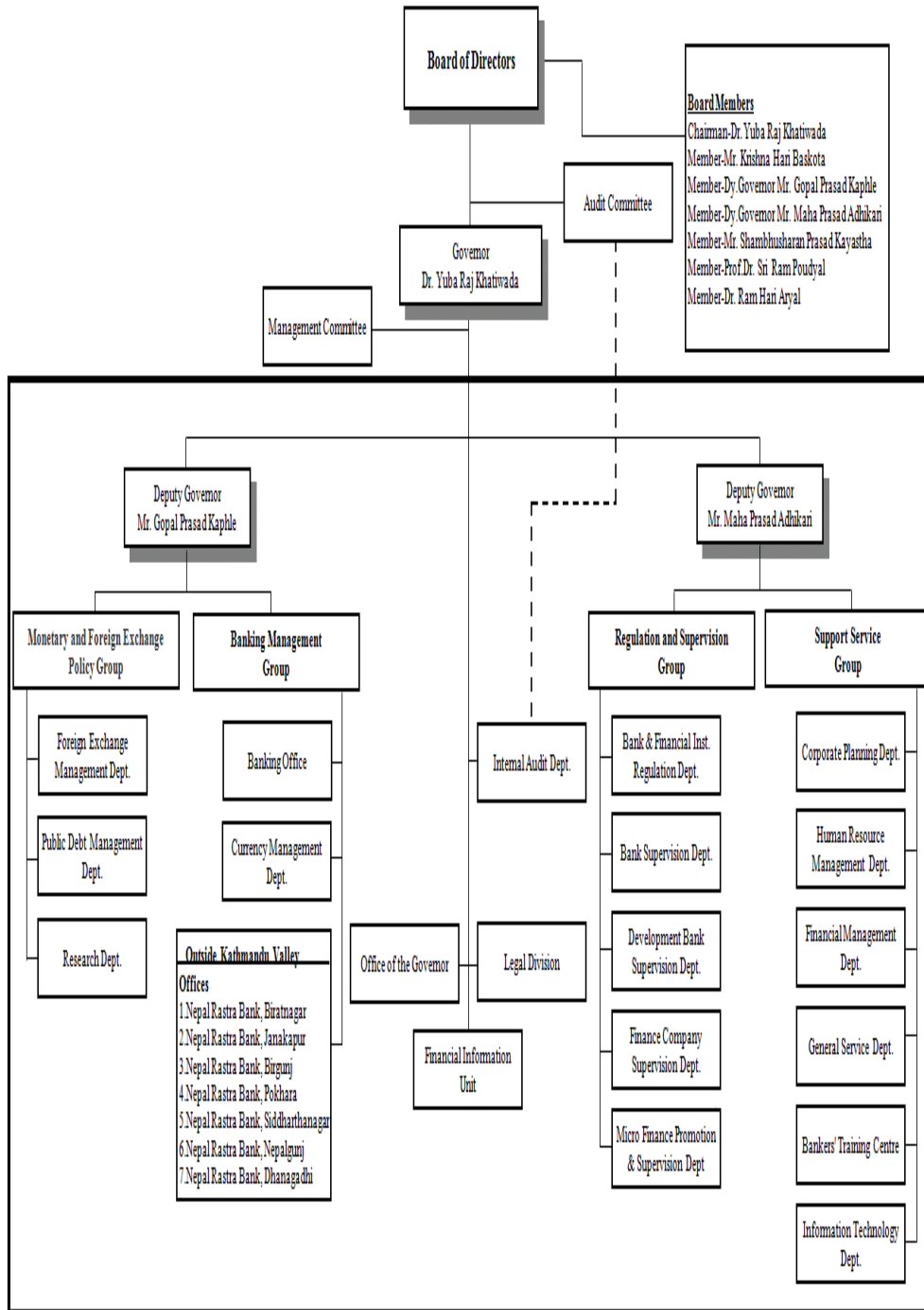
### **2.1.5 Organizational Structure of NRB:**

Nepal Rastra Bank has to accomplish a number of objectives consistent with other national economic objectives. Therefore, while designing the organization structure, special attention has paid to ensure that the banks dimensions and dynamic role are clearly reflected in it. The organizational structure of the bank has been modified from time to time as per exigencies and the banks futuristic activities. Similarly, at times the bank has acquired consultancy services from reputed foreign agencies to design its organization structure. After undergoing various changes over time, the present internal organization of the bank consists of its central office in Kathmandu with 16 departments in addition to the offices of the governor and two deputy governors. Now, Nepal Rastra Bank has 17 departments and they are as follows:

- a. Kathmandu banking office.
- b. Currency management department.
- c. Mint division
- d. Foreign exchange management.
- e. Public debt management
- f. Research department
- g. Corporate planning department
- h. Human resource management
- i. General services department
- j. Information technology department
- k. Legal division
- l. Financial management department
- m. Bankers' training center
- n. Banks and financial institutions regulation department
- o. Banks supervision department
- p. Financial institution supervision department
- q. Micro finance department

([www.nrb.org.np](http://www.nrb.org.np))

## Nepal Rastra Bank Organization Chart



### **2.1.6 The Role and Strategy of Nepal Rastra Bank**

To enhance the role of the Nepal Rastra Bank in the overall financial system of the country, it becomes necessary to think over various models, which confers greater autonomy and independence to the Nepal Rastra Bank. Thus, the Nepal Rastra Bank will work closely with the World Bank and IMF team for the amendment of the existing Nepal Rastra Bank Act, 1955 to provide sufficient autonomy in conducting monetary policy, regulation and supervision of banking and non-banking financial sector and licensing of banks and non-banking financial institution. The central bank also recognizes the critical importance of effective supervision within an appropriate regulatory framework to ensure that the banking sector fulfills its dual responsibility of protecting depositors' savings and allocating such saving in the most productive sectors for faster economic growth. The Nepal Rastra Bank would also encourage transparency in disclosing the financial information by banks particularly through the introduction of higher auditing and accounting standards that enables depositors in making prudent decision on the selection of banks they want to deal with. The Nepal Rastra Bank would also ensure that banks adopt standard practices in their operations mainly in their lending behavior and interest calculation methods. Besides this, the Nepal Rastra Bank would also need to develop policies encouraging the establishment of privately manage destitutions, industrial financing, capital market development and export financing. The establishment of credit rating agency, cooperative bank, export import bank and investment bank could be a case in point towards this direction. The government fully supports the effort of Nepal Rastra Bank in strengthening banking supervision, enforcement and regulation. The Nepal Rastra Bank would focus on the following reform measures in the financial sector.

#### **1. Reform in the Financial Sector Legislation**

The need for financial legislative reform will involve the amendment, or promulgation of a new Nepal Rastra Bank Act, Commercial Bank Act and other Financial Institutions act. Alternatively, a Financial Institutions Act, which covers both commercial banks and other deposit taking financial institutions, could be promulgated as one piece of legislation. These acts will accommodate modern and supportive regulations, especially in the area of banking supervision. Reform of ancillary financial sector legislation will also be necessary to replace the currently

highly fragmented legal system. Debt Recovery Act, Bankruptcy Act, Merger and Acquisition Act would be the major output of the reform process. The promulgation of these acts will help the consolidation of the financial sector in many ways, especially on enhancement of fair and efficiency based competition. The central bank is committed to instill strict financial discipline in order to break the default trend by enhancing competitions, efficiencies and controlling the malpractice, cartel ling & monopolistic or oligopolistic behavior.

## **2. Strengthening Bank Supervision and Inspection**

The strengthening of the supervisory capabilities of the Nepal Rastra Bank should also be initiated under the financial sector reform program. This will require the recruitment of a longer term, experienced bank Supervisor to assist the implementation of strategic plan for regulatory development, on-site supervision, Off-site supervision and the implementation of a human resource development plan. The program should improve on-site bank supervision capacity by recruiting more accountants, improving training and introducing risk rating (Credit Rating) system. However, it is worthwhile to explore other modalities of Monitoring and supervision including independent Monitoring and Supervision body. This will also extend the supervisory capacity to cover nonbanks and development banks. This is one area where technical assistance from the International Monetary Fund and World Bank could also be sought. The entire bank examination of RBB and NBL would clearly be a priority for an initial phase of enhanced banking supervision.

## **3. Restructuring and Privatization of NBL and RBB**

As the largest commercial bank, RBB has a potentially important role to play in the economy. However, political intervention, weak management, poor financial information system and ever growing bad loans have tremendously impacted on RBB's financial health. Recent auditing work has also revealed a high negative net worth, weak internal control and information systems, and poor internal financial management. In the same way, NBL has also suffered from the overall inefficiency, a negative net worth and low level of competition in the banking system. The government's policy of successively selling shares to the general public and increasing private sector representation on its board was aimed at avoiding the deteriorating situation as of the RBB. Nonetheless, NBL still does not operate like a private bank,

does not have a strategic banking partner amongst its private shareholders and lacks a strategic direction and medium term vision. Addressing these problems within NBL will be an important component of the restructuring process. Thus, after ascertaining the true financial and operational position of RBB and NBL, it will be important to employ technical support to assist in developing a strategic plan for the implementation, such as, downsizing, privatization, splitting, merger, acquisition, etc. In the same way, technical support will also be required to implement any strengthening work identified by the reform proposal, which will be working on the financial and operational position of RBB and NBL.

#### **4. Enhance Competition in the Banking Sector**

The basic purpose of reform of the NBL and RBB should be designed to correct anomaly in the banking sector, enhance competition and increase an efficient intermediary role of the banks and non-banks. The government as well as the Nepal Rastra Bank aim to foster competitive banking and nonbanking sectors in the country so as to ensure that the banking services are provided at the lowest

Possible intermediation cost. In this regard, the government will not allow the banking industry to be dominated by a single bank or group of banks. Therefore, the present ownership structure of NBL and RBB will be gradually changed by their privatization and entry of new reputed, fit and proper private sector banks and financial institutions. To ensure continuing effective competition, the Nepal Rastra Bank would permit new banks to be set up only by qualified, professional and experienced promoters. Similarly, the Nepal Rastra Bank will also relax some of the provisions in providing licenses especially for the foreign banks coming in joint venture by increasing the percentage shareholding that they can retain in a bank in Nepal above the current 50 percent. The detail criteria and qualifications, following internationally accepted standard practices, uniform criteria and norms, will be re-announced publicly by the Nepal Rastra Bank and accordingly provide licenses to new banks. Furthermore establishment of branches of internationally reputed banks will be promoted under the terms and conditions and procedures set by the NRB.

#### **5. Reform on Auditing and Accounting Capabilities**

Information on operations, performance and status of banks and other financial institutions or overall transparency of the whole financial system is highly important.

Publishing of financial statements, their performances and auditing reports etc. on a regular basis is also needed to make the financial sector more Transparent. However, the prevailing weak accounting and auditing practice has indicated that the timelines and reliability of financial data, particularly of NBL, RBB and NIDC is extremely poor. Thus, in order to operate the financial system efficiently, the accounting and auditing status of the poorly managed banks should be strengthened. To cope with this, the phase wise introduction of internationally accepted accounting and auditing standards for the banking and non-banking financial sector should be initiated. Further in respect of bank branches which cross specified ceiling of transactions, Branch audit will be made mandatory. Moreover, an appropriate environment will be created for international accounting firms to be operated in the kingdom.

#### **6. Broad-Based Banking**

The government's emphasis on broad based banking service will be met by providing adequate mix of financial services to all the needed sectors / persons. These services should be provided through appropriate private institutions at market interest rate. Alternatively, these services could be provided through proper budgetary provisions for any subsidy to be provided in any areas. The directed and subsidized lending through banking system will ultimately be phased out with the provision of alternative private financial institutions catering such services.

#### **7. Streamlining Ownership Structure**

Appropriate policy action will also be taken to avoid undue concentration on the ownership of banks and financial institutions. As such, no single person and group will be allowed to hold a controlling stake in more than one banking institution. In the case of poorly managed banks, a reputed and strategic investor will be allowed to hold controlling shares in that bank. Cross holding of capital in the commercial banking industry will be eliminated and promoters having significant shareholding will be barred from accessing financial resources from their own institutions in which they hold significant ownership.

## **8. Establishment of Bankers' Training Institute**

In addition to the aforementioned policy goals, other financial support activities should also be initiated by the Nepal Rastra Bank jointly with the coordination of all commercial banks and the government. In this regard, the NRB will endeavor to establish a separate Bankers' Training Institute, jointly financed and managed by the NRB and other banks. The newly established institute will provide ample opportunity to up-grade the working skills and research capacity of the staff involved in the commercial banks.

## **9. Restructuring of Credit Information Bureau**

To make the lending activities more prudent, the genuine credit information about the borrowers is required. In this regard, the present Credit Information Bureau would be revamped to provide effective and efficient information service. Essential technical support would also be given to the Bureau to restructure and improve its modus operandi.

## **10. Establishment of Assets Reconstruction Company**

The program would also initiate an appropriate plan to improve loan recovery and reduce Non Performing Loan of banking and non banking financial institutions. Hence, efforts will be made to initiate an Assets Reconstruction Company in the coming fiscal year to improve the loan portfolio status of the banking system.

## **11. Revamping Research and Financial Monitoring Strength of the Central Bank**

In order to keep the policy makers well abreast of the financial market condition and for facilitating prudent decision making, the research and statistical wings of the Nepal Rastra Bank would be strengthened.

## **12. Broadening and Deepening the Financial System in Nepal**

It is also felt that there is an important need to establish an environment in which a broad range of financial institutions and financial instruments are developed. Nevertheless, the commercial banking is likely to remain the largest component of the financial system for some time, there is also a need to develop debt and equity markets, leasing companies, venture capital facilities, further strengthen the stock market, insurance markets, micro-finance, pension and provident funds, and so on.

Thus, the establishment of a broad range of instruments into which savers can deposit their funds as well as a broad range of lending instruments, involving both debt and equity, will also assist the overall development of the economy.

### **13. Meeting Sectoral Financing Requirements**

As the country is overwhelmingly based on rural economy, it has also been envisaged to ensure that the adequate financial services are provided to support the activities of this sector. Moreover, other sectoral needs, such as industrial financing, housing finance and so on, would also be provided on the competitive Cost.

### **14. Other Measures**

The NRB has also envisaged announcing a specific time bound plan to restructure Agricultural Development Bank and Nepal Industrial Development Corporation in the next phase. Meanwhile, the government feels that the establishment of a sound and properly regulated banking system is the key principle and the regulation of deposit taking institution is fundamental. Thus, appropriate measures would also be introduced to regulate all deposit taking institutions as the commercial banks.

### **15. Establishment of Development Banks at Regional Level**

Efforts will also be made to augment the flow of rural credit by giving priority to establish development banks at regional and local level. However, the general thrust of the government will be less government involvement in the financial sector.

### **16. Strengthening of Rural Development Banks**

The NRB will also undertake organizational and financial strengthening programs for rural development banks established with the objectives of alleviating poverty in the rural areas. Recognizing the importance of rural sector and development finance, the government aims the development of rural credit and development finance via the private sector, including divestiture of such rural and development financial institutions currently owned or controlled by HMG and/or NRB.

### **17. Establishment of Credit Rating Agency**

The NRB will also put efforts in establishing Credit Rating Agency in the coming fiscal year so as to make the debt instruments more confidential and trustworthy to the

potential investors, and it is expected that it will contribute to the development of capital market in the country.

## **18. Timetable**

The implementation of the aforesaid regulations and reform policies will be initiated from the next fiscal years. (Nepal FSTA project 2002: 50-54)

### **2.2.1 Meaning of Commercial Bank**

According to commercial Bank act 2031 BS of Nepal defined that “A commercial banks is one which exchanges money, deposits money, accepts deposits , grant loans and performs commercial banking functions and which is not a bank meant for cooperative , agriculture , industries or for specific, purpose.”

(Commercial bank act 2031bs:1)

A commercial bank is a type of financial intermediary and a type of bank. Commercial banking is also known as business banking. It is a bank that provides checking accounts saving account, and money market accounts and that accepts time deposits. Commercial banking may also be seen as distinct from retail banking, which involves the provision of financial services direct to consumers. Many banks service offer both commercial and retail banking services. (Timilsena, 2010P:30)

“Banking is the business of providing financial services to consumers and businesses. The basic services a bank provides are checking accounts, which can be used like money to make payments and purchase goods and services; savings accounts and time deposits that can be used to save money for future use; loans that consumers and businesses can use to purchase goods and services; and basic cash management services such as check cashing and foreign currency exchange. Commercial banks specialize in loans to commercial and industrial businesses. Commercial banks are owned by private investors, called stockholders, or by companies called bank holding companies.” (Microsoft Encarta Reference Library, 2003)

The main objectives of a commercial bank are to earn profit by collecting the fund scattered around the general public, and mobilizing it. So, the main functions of commercial banks happen to be collecting deposits from general public and lending

loans to various economic sectors that require financing. Commercial banks make profit by charging a bit higher interest rate in loans than they pay to depositors. So the main source of income of commercial banks is interest income.

### **2.2.2 Brief introduction of selected commercial Banks**

There are 32 commercial banks in Nepal, out of which only 4 commercial banks Nepal Investment Bank Ltd. (NIBL), Nabil Bank Ltd. (NABIL), Everest Bank Ltd. (EBL) and Himalayan Bank Ltd. (HBL) are selected for study. The study focuses on "Implementation of Nepal Rastra Bank's (NRB) Directives in the commercial banks of Nepal." including past 5 years data from fiscal year 2007/08 to 2011/12.

#### **2.2.2.1 Nepal Investment Bank Ltd (NIBL)**

Nepal Investment Bank was established in 1986 at the name of Nepal Indosuez Bank Ltd. as a 2<sup>nd</sup> joint venture Bank under the company act 1964. This is managed by Banque Indosuez, Paris in accordance with joint venture & technical services agreement signed between its & Nepalese promoters. Banque Indosuez hold 50% of total capital & Nepalese promoters hold other half portion which include government organization holding 30% & general public holding 20% of the total capital. The main objective of the Bank is to provide loan & advances to the agriculture, commercial & industrial to provide modern banking services to the people the paid up capital of bank for the year 1989/90 was Rs. 30 millions. Later the name of this bank is changed as Nepal Investment Bank Ltd. ([www.nibl.com.np](http://www.nibl.com.np))

#### **2.2.2.2 Nabil Bank Ltd. (NABIL)**

Nepal Arab Bank Ltd. is the first JVB's which is established in 1984 under the company Act 1964. Dubai bank Ltd. was the initial foreign joint venture partner with 50% equity investment. The shares owned by Dubai bank Ltd. were transferred to Emirates Bank international Ltd. Dubai by virtue of its annexation with the later. Later an Emirate Bank international, Dubai sold its entire 50% equity holding to National bank Ltd. of Bangladesh. National Bank Ltd. Bangladesh is managed the Bank is accordance with the technical service agreement signed between it's the bank a June 1995. Later on the name of this Bank is changed as NABIL Bank Ltd. ([www.nabilbank.com](http://www.nabilbank.com))

### **2.2.2.3 Everest Bank Ltd. (EBL)**

Everest Bank Ltd. was established in 1992 as a joint venture bank with Punjab National Bank Ltd. (India) with the objective of extending professionalized banking services to various section of society in the kingdom of Nepal & there by contribute in the economic development of the country. It's earnings per share is very high. ([www.everestbankltd.com](http://www.everestbankltd.com))

### **2.2.2.4 Himalayan Bank Ltd. (HBL)**

Himalayan Bank Limited (HBL) is the largest private sector commercial bank of Nepal in terms of deposit base, loan portfolio and capital base. In July 2003 and again in July 2005 the Bankers Almanac ranked HBL as country's no. 1 bank. For the year 2005, it was ranked at 2368 in the worldwide ratings, which are fifty positions ahead of its nearest competitor in the country. Himalayan Bank Limited was incorporated in 1992 by a few distinguished business personalities of Nepal in partnership with Employees Provident Fund and Habib Bank Limited, one of the largest commercial bank of Pakistan. Banking operation commenced from January 1993. It is the first commercial bank of Nepal whose maximum shares are held by the Nepalese Private sector. Besides commercial banking services, the Bank also offers industrial and merchant banking services. ([www.himalayanbank.com](http://www.himalayanbank.com))

## **2.2.3 Functions of Commercial Bank**

Commercial banks perform various functions which are as follows:

- 1. Accepting Deposits:** Receiving deposit is the first function of commercial bank. It accepts idle and scattered saving of the public and institutions as deposit under the following three accounts:
  - (a) Current account
  - (b) Saving account
  - (c) Fixed deposit account.

**a) Current Account:** - It is an account under which the account holders can deposit and withdraw their money at any time according to their requirement. This account is mainly open for those traders and business organizations who need money frequently. This account is open for safety of money and no interest is provided to depositors by the bank. There is no restriction of the number of withdrawals and deposits for depositors. But minimum balance should be maintained as per the rule of the bank for withdrawals.

**(b) Saving Account:** - It is an account in which depositors can deposit their amount frequently but with limited withdrawal facility. Saving account is managed by bank to collect small and scattered amounts of savings of the people. To encourage saving the bank provides a certain percent of interest per annum.

**(c) Fixed Deposit Account:** - Under this account, the depositor deposits the amount for a fixed period of time. The depositor cannot withdraw the amount before the expiry of the specified time period. The bank provides higher rate of interest to the depositors than saving account.

**2. Granting Loans:** - Commercial banks provide loan to the traders' investors, industrialists, and farmers against the security deposit of valuable properties. They provide short-term, mid-term and long-term loan by charging certain rate of interest. Thus, the commercial bank utilizes the collected deposit amount from the depositors into profitable and productive sectors as loan.

**3. Transfer of Money:** - Commercial bank provides the service of transferring the fund from one place to another place as per the request of its customers. Commercial bank issues cheque, demand draft, mail transfer, T.T., L.C., credit cards, traveler's cheque, etc., for remittance of money from one place to another. Bank charges a certain amount of service charge, i.e. commission for its services.

**4. Exchanging Foreign Currencies:** - To fulfill the requirements of foreign traders regarding foreign currency, the commercial banks exchange foreign currencies on the direction of the central bank of the nation. This promotes foreign trade.

**5. Opening L.C. and Issuing Credit Instruments:** - Commercial bank helps the importer to import goods from foreign countries by opening L.C. account. L.C., i.e. letter of credit is the guarantee given to the exporter on behalf of the local trader or

importer to pay the value of goods imported. Beside this, the commercial bank issues traveler's cheque, credit cards, bank draft and demand drafts for the purpose of making easy and safe payment.

**6. Buying and Selling Shares and Debentures :-** On the request of customers, commercial bank helps in issuing of shares, purchase and sell of the securities like, shares, debentures through stock exchange and capital markets. Thus, it helps to issue capital which helps to promote trade and industries.

**7. Creating Credit:** - Commercial bank has its own lending policy. So, it creates credit, i.e. advance more amount of loan than the deposits it has at a given point of time. It is one of the important functions of the commercial bank.

**8. Agency Functions:** - Commercial bank is the agent of its customers. It performs a number of agency functions on behalf of its customers taking commission. The main objective of Good such agency functions are to attract the customers. Some agency functions are as follows:

- Remittance of money on behalf of customers.
- Purchase and sale of securities on the request of clients.
- Collection and acceptance of credit instruments.
- Receiving and making payment of incomes and expenses on behalf of customers.
- ATM facilities.
- Debit card and credit card facilities.

**9. Other Miscellaneous Functions:** - Besides the above mentioned functions, commercial bank provides the following services:

- Safety of valuable goods/properties,
- Locker facilities for its clients,
- Issue of guarantee and work as referee of its clients to third parties,
- Issue of gift cheques and vouchers,
- Collecting and providing financial information  
(Rana, 2012 P: 3)

## 2.3 Review of Related Studies

### 2.3.1 Articles Review

In this section, attempt has been made to review some relevant articles in different economic/finance journals, The World Bank Bulletins, dissertation papers, magazines, newspapers and other related literature.

Shrestha, (2006) in his article “*Portfolio Management in commercial Bank, Theory and practice*” has emphasized that portfolio management is essential for individual and institutional investors. Though in the case of small investor as they are not left with much of an option it may be limited to small savings, but for large investors, diversification through investment in mutual funds, shares, debentures should be practiced as any rational investor would seek to derive the maximum return on investment although assuming some risk at the same time. A best mix of investment assets fulfilling the under mentioned aspects are preferred by prudent (large) investors. Higher return which is comparable with alternative opportunities available not undermining the risk taking capability of the investor.

Shrestha, (2006) in his article entitled “*Financial Liberalization Index for Nepal*” conclude that the financial liberalization index for Nepal has been constructed by including eight different policy measures implemented during the liberalization process. The liberalization index is based on principal component method and also takes into account the partial liberalization policy measures. Previous studies failed to properly include this part. Most of the past studies either treated the partial financial liberalization as the full liberalization or excluded it by taking only the full liberalization date. This is misleading, especially during the impact evaluation. The financial liberalization index for Nepal shows that the decade of 1984–1994 was the period during which most of the financial liberalization measures were implementation in Nepal.

Yadav, (2007) in his article “*The growing trend of consumer banking*” summarized some newly adopted policy by the commercial banks in favors of consumer. While long term investment opportunities remain uncertain in the country, the Nepalese banks are starting to diversity the loans in order to reduce excess liquidity and other

financial risks. Nepalese banks are moving towards a new era of banking so that the relatively recent concept of consumer banking is swiftly becoming popular and flourishing among the middle to high national shareholders private companies to corporate houses and national to multinational companies. The banks are offering all kind of personal as well as commercial facilities. These days, Nepalese banks are coming up with new product and consumer package on a regulator basis. They are increasing collaborating with the international banks too, embracing their banking models, learning lesson from their traditional and latest concept and keeping up to date with the new technologies coming in, hence giving added facilities to the consumers too, Nepalese bank rapidly expanding their each through the country are expanding their service hours keeping the customer's convenience in mind

Thapa (2008) in his articles "*Nepal banking system: can on the mess be managed*" in journal stated that the joint venture banks have been earning a huge profit not from fund based lending but from investing outside. That is why, there banks have been less interested to lending aggressively in the domestic market. Economics activities have slowed down in Nepal for several years; however, commercial banks have not lowered their lending rate to revitalize the economy. On the contrary, the commercial banks have been discouraging the deposit to get rid of excess liquidity. In addition, new avenue that is investing abroad has been opened for the commercial banks to earn profit rather than motivating them to invest locally.

### **2.3.2 Directives Review**

Nepal Rastra Bank has issued twenty-one directives on the code of conduct for board director and employees of banks and non-banks financial institutions (unified directives). These directives are issued as authorized by section 79 of the NRB act. The section 79 of NRB act read as "The bank may issue directives from time to time to commercial banks and financial institutions regarding banking operations, currency and credits. It shall be the duty of commercial bank and financial institutions to comply with such directives." These kinds of directives as such are new from the regulator side. Ethical standard in any financial institutions is normally set at the time of establishment of the entity. Such regulation may be governed by the personal rule in the case of employee and law or by oath to the directors.

The tools described in the directives main objectives are to control and monitor the financial institutions of the country and this research consist mainly focus on the directives of NRB. In present situation, NRB issues directives regularly and comes out with new directives. Directives relating to the banking regulation and prudential norms comprise 21 directives which are as follows.

1. Provisions Relating to Capital Adequacy
2. Provisions Relating to Classification of Loans/advances and Loan Losses
3. Provisions Relating to Single Borrower and Limitation of the Sectoral Credit and Facilities
4. Provisions Relating to Accounting Policies and Format of Financial Statements
5. Provisions Relating to Mitigation of Risks in Transactions of Licensed Institutions
6. Provisions Relating to Good Corporate Governance
7. Provisions Relating to Timeframe for Implementation of Regulatory Directives Issued in connection with Inspection and Supervision
8. Provisions Relating to Investment
9. Provisions Relating to Filing of Statistical Returns by Licensed Institutions to Nepal Rastra Bank
10. Provisions Relating to Transfer or Sale of Promoters Shares of licensed institution
11. Provisions Relating to Consortium Financing
12. Provisions Relating to Credit Information and Blacklisting
13. Provisions Relating to Compulsory Reserve/Statutory Liquidity
14. Provisions Relating to Opening of Branch/Offices
15. Provisions Relating to Interest Rates
16. Provisions Relating to Collection of Financial Resources
17. Provisions Relating to Lending to Deprived Sector
18. Provisions Relating to Amalgamation, Merger and Upgrading
19. Provisions Relating to Know Your Customers
20. Provisions Relating to Subsidiary Companies
21. Miscellaneous Provisions

(Source: [www.nrb.org.np](http://www.nrb.org.np))

### 2.3.3 Review of the Past Thesis

Shrestha, (2007) in his thesis entitled *“Profitability Analysis of Standard Chartered Bank Nepal Limited and NABIL Bank Limited”*

The objectives are specified as below:

- To analyze the profitability analysis of Standard Chartered Bank Nepal Limited and NABIL Bank Limited.
- To highlight various profitability ratios relating to financial performance.
- To perform trend analysis of profitability of these selected banks and make a projection of coming year.
- To suggest and recommend both the banks to improve their profitability.

The major findings are as follows:

- SCBNL had more consistent operating efficiency ratio than NABIL bank limited during the study period.
- Both of the banks data showed that more than 90% of their total liabilities paid interest. These banks showed that smaller portion of their interest bearing liabilities paid as interest expenses.
- Both the banks’ weighted average cost of deposit ratio was found to be at decreasing rate.
- NABIL bank had lower EPS than SCBNL, which indicated that the performance of SCBNL was better than NABIL.
- SCBNL was paying more dividend than NABIL bank limited during the study period. The amount of dividend was almost double for SCBNL than NABIL. It meant that NABIL was in need of fund, so it was paying fewer dividends and adding more amounts under the head of retained earnings.
- Among the total income, more than 75% of the income came from interest sector. That indicated the main source of income was interest for both the banks.
- The operating expenses ratio over total expenses comprised of more than 40% for both the banks.
- NABIL had fluctuating return on total assets than SCBNL. SCBNL had higher return on equity than NABIL. Return on equity of NABIL was more

fluctuating than that of SCBNL. SCBNL had higher return on equity ratio than that of NABIL.

- SCBNL had also higher interest earned to total asset ratio than NABIL.
- The total interest income to total earning assets ratio of both the banks were found decreasing over the years, which indicates a negative sign to the bank's performance.
- NABIL bank's net profit margin ratio was higher than that of SCBNL. Similarly, net interest margin of NABIL was also higher than that of SCBNL.

Joshi, (2008) conducted a study on, "*A Comparative Study on Financial Performance of Nepal SBI Bank Ltd and Nepal Bangladesh Bank Ltd*". Major objectives and findings of the research are given below:

**Major Objectives:**

- To highlight various aspects of relating to financial performance of NB Bank and NSBI Bank.
- To analyze various aspects of relating to financial performance through the use of appropriate financial tools.
- To show the cause of change in cash position of the two banks.

**Major Findings:**

- Average current ratio of NSBI Bank is greater than that of NB Bank. Therefore, the liquidity position of NSBI Bank is in normal position.
- Turnover ratio of NB Bank has better than that of NSBI Bank in terms of loans and advances. It shows NB Bank has better utilization of resources income generating activities than NSBI Bank.
- Despite the fluctuating trend in the ratio of cash and bank balance to total deposit NSBI Bank is more efficient than NB Bank in cash management i.e. it is more able to keep more cash balance against its various deposits.
- Going through net profit to total deposit ratio, it can be said that NB Bank seems to be more successful in mobilizing its customers saving in much more productive sector.

Manandhar, (2008) has conducted a study on, "*A Comparative study on Performance analyze of Top Five Commercial Banks of Nepal*". The main objective of the study is to analyze and compare liquidity, profitability, stability and market value position among the top five commercial banks.

**Major Objectives:**

- To trace out the trend of loan and advances.
- To find out the relationship between deposits and loans and advances, and deposits and net profit.
- To analyze the trend of profit and dividend distribution.

**Major Findings:**

- EBL and NIBL have been getting lower net profit out of total income with comparison to all the banks.
- EBL comparatively fails to maintain operating ratio on total assets where as NIBL did best. HBL, EBL and NIBL have been suffering from ineffectively using the total fund. So they are getting lower return than SCBNL and NABIL.
- All the top five commercial banks have been earning sufficient interest income on loan and advances. It means they have been high utilizing the loan and advances.
- NABIL has been providing comparatively greater cash dividend on share capital in a consistency manner too. SCBNL and NIBL have been providing lower cash dividend in inconsistency manner too. SCBNL has been providing dividend on share capital comparatively greater than other banks in a consistency manner.
- NABIL has also been providing better dividend in a consistency manner to some extent too. As a lower average, NIBL has not provided dividend on share capital NABIL shows greater inconsistency too.

Tiwari, (2009) has conducted research on, "*Financial Performance Analysis as Tools for Profit Planning (Everest Bank Ltd, NABIL Bank Ltd and Bank of Kathmandu)*". Researcher had the following major objectives:

### **Major Objectives:**

- To find out the relationships between total investment, loan and advances, deposits, net profit and outside assets.
- To identify the investment priority sectors of commercial banks
- To assess the impact of investment on profitability.

### **Major Findings:**

- Average current ratio of EBL is higher than that of NABIL and slightly lower than BOK. In general, the current ratio of banks over the period has been able to meet the short term obligations and has satisfactory liquidity position.
- Investment on government securities to current assets of EBL is average in comparison to NABIL and BOK which states that EBL's investment on government securities is slightly poor than that of NABIL and BOK.
- Investment on shares and debenture to total working fund ratios of EBL, NABIL and BOK are in fluctuating trends over the study period.
- Return on loans and advances ratio of EBL is higher than BOK and is lower than NABIL. Similarly, total interest earned to total outside assets of NABIL is lowest as compared to EBL and BOK.
- The growth ratio of total deposits, total loan and advances, total investment and net profit of EBL is increasing over the study period.
- Net profits of all three banks are in increasing trends over the study period. It shows these banks are utilizing their resources in proper way.

Khatri, (2010) conducted study on “*A Comparative Study of Financial Performance of Nepal investment Bank Ltd and Everest Bank Ltd*” and attempted to analyze the financial performance of selected banks using various statistical and financial tools.

**Major objectives:**

- To evaluate the liquidity and efficiency of assets management position of the concern banks.
- To examine the area on which the banks have been utilizing their assets through the analysis of their financial performance.
- To examine and analyze the growth rates of variable components of the banks.
- To evaluate the profitability position of the concern bank.
- To assess the fund mobilization and investment areas of the banks which would contribute to draw their core strengths and areas to be worked on.

**Major Findings:**

- Current ratio of NIBL is slightly higher than that of EBL and ratio of NIBL is consistent than that of EBL.
- Cash and bank balance to total deposits of NIBL is higher than that of EBL. It shows NIBL has better liquidity position in comparison to EBL.
- NIBL has been more successful in identifying profitable investment sector and increasing its earnings whereas EBL has focused on investing in risk free assets.
- Return on total working fund of EBL is higher than that of NIBL.
- Growth rate of total investment of NIBL is in fluctuating trend whereas growth trend of total investment of EBL is in increasing trend,
- Deposit, loan and advances, total investment and net profit of both banks are in increasing trend.

Bhandari, (2010) has conducted research on, *"A Comparative Financial Performance Analysis of Himalayan Bank Ltd and Everest Bank Ltd"*.

Researcher has conducted this study to accomplish following objectives:

**Major Objectives:**

- To analyze and compare the financial strength and weakness as of the sample financial institutions.

- To determine the financial performance through the use of appropriate financial and statistical tools.
- To evaluate the financial position of HBL and EBL.

### **Major Findings:**

- Current ratios of both banks are below than normal standard. But the average current ratio of EBL is higher than that of HBL. Average cash and bank balance to deposit ratio of EBL is higher than that of HBL.
- Total debt to shareholder's equity of EBL is lower than that of HBL. High total debt to shareholders equity ratio refers that the use of debts by the banks helps to enhance the rate of return of shareholders fund.
- Average total debt to total assets of HBL is higher than that of EBL over the study period.
- Average loan and advance to total deposit ratio of EBL is almost same to HBL. It shows that both banks have better utilization of deposits at same level.
- Investment to total deposit ratio of HBL is higher than that of EBL. It shows HBL is utilizing its deposits more on investment.
- Net profit to total deposit ratio of EBL is higher than that of HBL. It can be said that EBL seems to be more successful in mobilizing its customers saving in much more productive sector as compared to HBL.

Chapagain, (2011) has conducted research on, "*A Study of Financial Performance Analysis of Nepal Electricity Authority*". Objectives and major findings of this study are as under:

### **Major Objectives:**

- To examine financial strength and weakness of NEA.
- To examine the performance of NEA through financial analysis.
- To find out the resolutions of the financial problems.

## Major Findings:

- NEA's liquidity position is not very satisfactory. Though the current ratio is satisfactory, the analysis of quick ratio shows the problem in the liquidity position.
- Average total assets turnover ratio is less. There is under utilization of the existing assets. Efficient utilization of assets can generate additional income without additional cost.
- NEA has lacking is SWOT analysis to improve the overall performance of NEA.
- The average collection period of NEA is high which confirms that receivable management is the problematic area of NEA. Due to relatively longer collection period, the debtor's turnover ratio is low.
- Net profit to sales position is poor and in most of the years losses were recorded from the operation. It has not been able to pay interest charges on long term debts from its operation and EBIT was also unsatisfactory.
- Average return on total assets of NEA for the study period is not satisfactory.
- Debt of NEA has increased during the study period. This shows that financial position of NEA is not in good position.

Ojha, (2012) in his thesis "*Directive of NRB on Investment policy of Commercial Bank of Nepal*" with the objective of

- To analyze the liquidity practice of NIBL.
- To analyze the relationship between total deposit and loan and advance, total deposit and total investment.
- To make the trend value analysis of Investment policy and its projection for next five year.
- To find out whether NRB guideline is actually being implemented

The major findings of his study are:

- The mean ratio of cash and bank balance to total deposit is 13.53%. A analysis shows that the ratio are in the fluctuating trends. The bank should not hold excessive cash since it is an idle reserve ratio is 14% in any bank but according to the situation of the market. However, the liquidity position in the study is good.
- The mean ratio of cash & bank balance to current assets is 11.6%. The cash & bank balance to current assets ratios are in fluctuating trends. It indicates that liquidity position is unstable in this regard.
- The mean ratio of investment on government securities to current assets is 7.33%. Investment in government securities of the NIBL has decreasing trend but in the last two year of the study there is increase in the ratio.
- The mean ratio of loan & advances to current asset is 65.33%. Analysis shows NIBL has followed the decreasing trend in loan & advance to current assets ratio. This too depicts that NIBL have mobilized 65.33% of its fund as loan & advances with respect to current assets.
- The mean ratio of loan & advances to total deposits is 79.86%. The ratio of loan & advances of NIBL has increasing trend. In the five year study NIBL have mobilized more than 75% in average of total deposit in loan & advances, which sounds excellent.
- The total investment of NIBL has maintained the decreasing trend in respect of total deposit. The mean ratio of it is 18.88%. NIBL has been able to utilize only approx. 18% of the total deposit as investment.
- The mean ratio of the loan & advances to total working fund is 69.59%. The NIBL has increasing trend of loan & advance in respect of total working fund. Analysis shows that NIBL has been utilizing approx. 69% of the working as loan and advances.
- The mean ratio of investment in government securities to total working funds is 7.88%. The ratio of it has decreasing increasing trend. NIBL has invested only limited percentage of total working fund in government securities i.e. approx.7%.
- Analysis shows that ratio of investment in share and debenture to working fund has fluctuating trend. The mean ratio of it is 0.13%, which is comparatively a small percentage of total working funds. NIB L has very less

stable regarding investment in share & debenture. NIBL has invested only limited fund in share & debenture with respect to total working fund.

- Analysis shows that loan loss provision of NIBL has decreasing trend but in the last year of the study there is slightly increasing in the ratio percentage. The mean ratio of loan loss provision is 1.93%. In this regards, NIBL is not uniform and less stable. The performance of NIBL in terms of recovery of loan is not satisfactory and effort should be made for timely recovery of loan.

### **2.3.4 Research Gap**

Investment in different sectors is made on the basis of the directives and instructions of Nepal Rastra Bank as well as the investment policy and guidelines of the concerned commercial bank itself. Commercial banks should follow these directives and circulars. Furthermore, their own investment guidelines and policies should be in line with NRB directives and circulars. Therefore, the up to date study over the change of time frame has been a major concern for the researcher, concerned organization as well as the banking industry as a whole. This study covers the more recent financial data, NRB guidelines and instructions than those of studies previously conducted.

Portfolio management is the major part of the bank's investment policy and it is the major concern of stakeholders to know the portfolio behaviors of the bank. To reduce the default risk of credit, there should be the optimum diversification of loan and advance. This study puts its effort to find out the proportion to total loan and advances of the bank disbursed to different sectors of economy and analysis the diversification of its investment.

Not much more research study has been conducted in this topic. A very few study based on only one bank has been conducted before 2003, but this study is based on comparative analysis of four listed commercial banks namely NABIL, EBL, NIBL and HBL up to the financial year 2011/12. So, this research work is very much centered to identify responsible causes, to analyze them and recommend improvement measures for the betterment of the banks under study and to analyze the emerging competitive environment banking sector.

## **CHAPTER-III**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

Research Methodology is a composed by two words “Research” & “Methodology”. Research is a systematic & organized effort to investigate a specific problem that needs a solution while methodology is the research method used to test the hypothesis. Therefore, research methodology is a way to systematically solve the research problem (Kothari, 1990:10).

##### **3.1.1 Research Methodology**

Research methodology consists of research design, procedure of data collection and tools and techniques of data analysis etc. It covers quantitative methodology using statistical & financial tools. But the study is mainly based on secondary data collection from NRB & respective annual reports from different commercial banks the nature of data and method of analysis used in the study used are described below.

##### **3.1.2 Research Design**

A research design is the arrangement of condition for collection and analysis of the data in manner that aims to combine relevance to the research purpose with economy in procedure. Research design is used to convert to gathered information into spatial form. The present study is mainly based in two types of research design.

##### **Descriptive**

Descriptive research design describes the nature and pattern of Nepalese Commercial Sector & Implementation of NRB’s Directives on Commercial Bank of Nepal in the changing competitive banking environment.

## **Analytical**

Analytical research design is a tool to convert raw data or raster data to spatial data. It means that the collected crude data remain information less therefore the analytical research design is used to change the uninformative data into spatial form. For the analysis, we tabulate the raw data in columnar and other form. Then, the data will be meaningful. Several statistical & financial tools & techniques are used to analyze the data.

### **3.2 Population & Sampling**

Population refers to the entire group of people or things of interest that the researcher wishes to investigate. The population represents the leading five commercial banks of the country.

The sample of five commercial banks is taken for the study which covers 12.5% of the total population.i.e.4 commercial banks out of 32 commercial banks in operation within the country.

### **3.3 Sources and Nature of Data**

This study is mainly based on secondary data. The major sources of secondary data collections are as follows:

- Annual Reports of sample banks.
- Websites of sample banks.
- NRB bulletins, reports, article and website.
- Published studies, reports and articles of various authors.
- Thesis, research of various student of Tribhuvan University.
- Journal published and unpublished reports from Central library TU, Shanker Dev Campus library.
- Various periodicals, newspapers and websites.

### **3.4 Data Collection Techniques**

The following are the data collection techniques which are used to collect primary and secondary data for the study are: Studies various books, booklets, magazines, published reports, computer data, bank internet & periodicals.

### **3.4.1 Data Processing Techniques**

In data processing procedure, we have tabulate classify and analyze the data to give information. The obtained data are presented in various forms like tables, diagrams and charts with supporting statistical interpretations. The detail calculations, which cannot show in the body part of the report, are presented in annexes at the end.

## **3.5 Tools Used**

### **3.5.1 Credit-Deposit Ratio (C.D Ratio)**

If 75% of amount deposited by the customers are invested in various sectors, it is considered satisfactory. It is good sign. This ratio shows the efficiency of the CB to use the liquidity during a particular time. The ratio helps to find out the liquidity position as well as the prediction for the need of additional capital for the CBs. If the given ratio is not maintained by the CBs, there is a scarcity of cash & there is a lack of capital.

### **3.5.2 Cash Reserve Ratio (CRR)**

It is the proportion of the deposit liabilities that commercial banks are required to keep as a cash deposit with the NRB. The level of CRR influences the commercial banks' credit creation capacity. If there is a higher rate of CRR, then the CBs need to keep the higher portion of deposits for CRR purpose with the central bank. As such, they have less deposit for lending purpose. Hence, the higher CRR squeezes the money expansion in the economy. Conversely, the low CRR rate means CBs need to keep less of the deposits so that they can lend more, resulting in the expansion of money supply in the economy. Moreover, CRR also serves as a measure for smoothing payment system as a prudential measure by avoiding sudden liquidity crunch in the banking system.

### **3.5.3 Provision of General Reserve Fund**

The “A” class financial institution should maintain a general reserve fund. This reserve should be maintained until the amount reached the double of the paid-up capital. Every year, the financial institution should allocate at least 20% of the particular year’s net profit.

### **3.5.4 Adequacy of Capital Fund on RWA**

The importance of the Adequacy of Capital Fund on RWA has increased after the implementation of the BASEL-II by NRB in the recent year. It had mentioned the rate of at least 11% of Tier 1 Capital & Tier 2 capital based on total RWA of the banks.

The concept of capital adequacy aroused after the enactment of the Federal Deposit Insurance Corporation Improving Act of 1991. This act aims to ensure that regulations take action appropriate to overcome the degree of capital short-fall. Capital adequacy of the CBs was defined at least 10% of Tier 1 Capital & Tier 2 capital based on total RWA of the banks.

But, under BASEL Report, Capital Adequacy Ratio<sup>1</sup> consists of (i) Tier 1 Capital Ratio that shows relationship between Tier 1 Capital & total RWA. (ii) Tier 2 Capital Ratio shows relationship between Tier 2 Capital & total RWA.

## **CHAPTER-IV**

### **DATA PRESENTATION AND ANALYSIS**

Prior to 1988, there was no uniform international regulatory standard for setting bank capital requirements. In 1988, the Basel Committee on Banking Supervision (BCBS) developed the Capital Accord, which is known as Basel I, to align the capital adequacy requirements applicable especially to banks in G-10 countries. Basel introduced two key concepts. First, it defined what banks could hold as capital, as well as designating capital as Tier 1 or Tier 2 according to its loss-absorbing or creditor-protecting characteristics. The second key concept introduced in Basel I was that capital should be held by banks in relation to the risks that they face. The major risks faced by banks relate to the assets held on balance sheet. Thus, Basel I calculated banks' minimum capital requirements as a percentage of assets, which are adjusted in accordance to their riskiness and assigning risk weights to assets. Higher weights are assigned to riskier assets such as corporate loans, and lower weights are assigned to less risky assets, such as exposures to government. ([www.nrb.org.np](http://www.nrb.org.np))

The BCBS released the "International Convergence of Capital Measurements and Capital Standards: Revised Framework", popularly known as Basel II, on June 26, 2004. This framework was updated in November 2005 and a comprehensive version of the framework was issued in June 2006. Basel II builds significantly on Basel I by increasing the sensitivity of capital to key bank risks. In addition, Basel II recognizes that banks can face a multitude of risks, ranging from the traditional risks associated with financial intermediation to the day-to-day risks of operating a business as well as the risks associated with the ups and downs of the local and international economies. As a result, the new framework more explicitly associates capital requirements with the particular categories of major risks that banks face. The new capital framework also recognizes that large, usually internationally active banks have already put in place sophisticated approaches to risk measurement and management based on statistical inference rather than Judgment alone. ([www.nrb.org.np](http://www.nrb.org.np))

Thus, the framework allows banks, under certain conditions, to use their own 'internal' models and techniques to measure the key risks that they face, the probability of loss,

and the capital required to meet those losses. In developing the new framework, the Basel Committee wanted to incorporate many elements that help promote a sound and efficient financial system over and above the setting of minimum capital requirements. With this in mind, the Basel II framework incorporates three complementary 'pillars' that draw on the range of approaches to help ensure that banks are adequately capitalized in commensurate with their risk profile. The Basel Committees on Banking Supervision's (BCBS) recommendations on capital accord are important guiding framework for the regulatory capital requirement to the banking industry all over the world and Nepal is no exception. Realizing the significance of capital for ensuring the safety and soundness of the banks and the banking system, at large, Nepal Rastra Bank (NRB) has developed and enforced capital adequacy requirement based on international practices with appropriate level of customization based on domestic state of market developments. The existing regulatory capital is largely based on the Basel committee's 1988 recommendations. With a view of adopting the international best practices, NRB has already expressed its intention to adopt the Basel II framework, albeit in a simplified form. In line with the international development and thorough discussion with the stakeholders, evaluation and assessment of impact studies at various phases, this framework has been drafted. This framework provides the guidelines for the implementation of Basel II framework in Nepal. Reminiscent of the International convergence of capital measurements and capital standards, this framework also builds around three mutually reinforcing pillars, viz. minimum capital requirements, supervisory review process and disclosure requirements. ([www.nrb.org.np](http://www.nrb.org.np))

#### **4.1 Regulation, Supervision and Monitoring System of Central Bank**

Promotion of financial stability, development of safe and efficient payment systems, regulation and supervision of banking and financial system and the promotion of healthy and competitive financial system are some of the objectives of functioning of Nepal Rastra Bank. To attain the above objectives Section 84 of the Nepal Rastra Bank Act 2002 has entrusted Nepal Rastra Bank with the necessary powers to perform inspection and examination of any commercial banks or obtain necessary information for the purpose of supervision of the commercial banks. Currently the Bank Supervision Department in Nepal Rastra Bank carries out the function of

supervision of all commercial banks in Nepal. Since foreign banks have their presence only in the form of Joint Venture establishments – that is in collaboration with the local entrepreneurs – Nepal Rastra Bank supervises foreign establishes in the same manner as it supervises other local banks. For the purpose of supervision, the department is required to prepare annual supervision plan for onsite examinations as well off site surveillance of the commercial banks. The same is to be approved by the Governor of the Bank. The Bank Supervision Department carries out both onsite examinations as well as off site surveillance of the commercial banks as per its annual supervision plan.

### **On site Examination**

The Bank Supervision Department can carry out onsite examination of commercial banks in Nepal by sending examination team to the commercial banks. Onsite examination can be corporate level inspection covering all aspects of functioning of commercial banks or can be targeted branch level inspection. The Department also performs follow up of the earlier examination reports by visiting the branches to ensure necessary compliance of the NRB instructions. If information as to functioning of commercial banks against the interest of depositors' or some serious irregularity is received, the Department can perform special on site examination in such cases. The Bank Supervision Department is required to carry out corporate level examination of all commercial banks at least once in a year as per its annual plan but the gap between two inspections at any time should not exceed two years. As per current policy of the Department, corporate 17 examination of all commercial banks is carried out once in a year. For the guidance of the onsite examination, an "On site inspection manual" is in force. On completion of the onsite examination examiners perform CAMELS rating of the bank which is exclusively used for the supervisory purpose and is not revealed to general public.

### **Off site supervision**

Off site supervision is a supplement to the onsite examination and is designed to act as an early warning system to identify banks with potential problems so that appropriate policies and action can be determined. Off site division of the Bank Supervision Department is carried out in a quarterly frequency as well as annual off site review based on the reports and returns submitted by the commercial banks.

### **Quarterly offsite review**

Off site division reviews performance of all commercial banks on quarterly basis which is submitted to the Governor of Nepal Rastra Bank. Such review involves assessment of the financial information as well as compliance of applicable rules regulations and legal provisions including NRB directives. Based on the review internal rating which is called CAELS Offsite Rating (COR) is also assigned to the banks.

### **Annual Balance sheet review**

The Department's off site division reviews the balance sheet of the commercial banks at the end of each financial year and issues necessary instructions based on such review; this is then published in their annual report. In the course of such review the auditor's report, audited financial statements, long form audit report preliminary, audit report and banks reply thereon are studied. Based on the review of above report consisting of the review of financial performance, compliance with Nepal Rastra Banks directives and applicable legal provisions, adverse observations of the auditors and other significant findings is prepared and necessary instructions are issued to the bank thereon (Report of NRB, 2006 P: 16-1).

## **4.1.1 Financial Analysis**

This is an analytical chapter, where the researcher has analyzed and evaluated those major financial items, which are mainly related to Credit-Deposit Ratio, Cash Reserve Ratio, Provision of General Reserve Fund, and Adequacy of Capital Fund on RWA of Nabil Bank, Everest Bank, NIBL, Himalayan Bank.

### **4.1.1.1 Credit-Deposit Ratio (CD Ratio):**

CD ratio is one of the most important indicators of the CBs financial performance as prescribed the central bank of Nepal, NRB. It shows the actual liquidity position of the CBs. If 75% of amount deposited by the customers are invested in various sectors, it is considered satisfactory.

We have,

$$CD\ Ratio = \frac{Total\ Credit}{Total\ Deposit} \times 100$$

The table shows the ratio of total credit to total deposit of commercial banks for five years from 2008 to 2012.

**Table 4.1**  
**Total Credit-Total Deposit Ratio**

<b>F/Y</b>	<b>Nabil</b>	<b>EBL</b>	<b>NIBL</b>	<b>HBL</b>	<b>By NRB</b>
2007/08	66.59	75.13	70.58	56.57	75
2008/09	66.94	76.49	78.36	60.97	75
2009/10	73.87	71.67	77.61	71.59	75
2010/11	69.52	74.61	80.48	74.39	75
2011/12	76.53	75.51	81.36	77.14	75
<b>A.M.</b>	70.53	74.68	77.67	68.1	
<b>S.D.</b>	3.91	1.63	3.7	7.96	
<b>C.V.</b>	5.53	2.17	4.76	11.68	

(Source: Appendix 1)

In the above sample CBs, in average, except the CD ratio of Nabil & HBL, others CD ratios are in the strong position. According to the C.V. analysis, the CD ratio of EBL is seen most consistent among the sample banks as its C.V. is seen the least among the sample CBs. There is not any standard for C/D Ratio in Nepal, a ratio of 75% can be accepted to be adequate. As the C/D Ratio of NRB the commercial banks are maintaining their activities in several years.

#### **4.1.1.2 Cash Reserve Ratio (CRR)**

The level of CRR influences the commercial banks' credit creation capacity. If there is a higher rate of CRR, then the CBs need to keep the higher portion of deposits for CRR purpose with the central bank. As such, they have less deposit for lending purpose. Hence, the higher CRR squeezes the money expansion in the economy. Conversely, the low CRR rate means CBs need to keep less of the deposits so that they can lend more, resulting in the expansion of money supply in the economy.

We have,

$$CRR = \frac{\text{Total Cash and Bank Balance}}{\text{Total Deposit}} \times 100$$

The table shows the ratio of total cash & bank balance to total deposit of commercial banks for five years from 2007/08 to 2011/12.

**Table 4.2**

**Total Cash & Bank Balance to Total Deposits Ratio**

<b>F/Y</b>	<b>Nabil</b>	<b>EBL</b>	<b>NIBL</b>	<b>HBL</b>	<b>BY NRB</b>
2007/08	5.99	13.15	9.97	0.58	5.5
2008/09	8.37	11.13	10.89	4.55	5.5
2009/10	9.03	18.49	16.96	8.79	5.5
2010/11	3.02	21.17	13.61	10.28	5.5
2011/12	3.04	14.89	16.24	7.24	5.5
<b>A.M.</b>	5.89	15.77	13.53	6.29	
<b>S.D.</b>	2.54	3.63	13.53	3.43	
<b>C.V.</b>	43.12	23.01	3.02	54.53	

(Source: Appendix 2)

In average, NIBL have maintained the higher level of CRR with 13.53% among the sample CBs & Nabil have maintained the least level of CRR with 5.89%. According to the C.V. analysis also, the level of the CRR of NIBL is seen the most consistent during the past five F/Y. For the liquidity of banks, NRB regulates the CRR and maintains it in several years.

**4.1.1.3 Provision for General Reserve Fund:**

Every year, the financial institution should allocate at least 20% of the particular year's net profit as a general reserve fund according to the NRB rules & directives regarding the provision for general reserve.

The table shows the ratio of General Reserve Fund & Net Profit of commercial banks for five years from 2007/08 to 2011/12.

**Table 4.3****Provision for General Reserve Fund Ratio**

<b>F/Y</b>	<b>Nabil</b>	<b>EBL</b>	<b>NIBL</b>	<b>HBL</b>
2007/08	12.61	20	19.43	20
2008/09	20.09	20	21.22	20
2009/10	20.07	20	21.56	20
2010/11	19.99	20	23.25	20
2011/12	20.03	20	17.76	16.85
<b>A.M.</b>	18056	20	20.56	19.37
<b>S.D.</b>	2.97	0.00	1.88	1.25
<b>C.V.</b>	16.01	0.00	9.13	6.48

(Source: Appendix 3)

From the above table, we see that the sample CBs have been able to maintain the provision of general reserve fund every F/Y. But only, the NIBL& Nabil has not been capable to maintain the GRF as per the NRB directives since the F/Y 2007/08 & 2011/12. Similarly, the GRF of Nabil was seen only 12.61% in the F/Y 2007/08. According to the C.V. analysis also, the level of the GRF of HBL & EBL are seen the most consistent during the past five F/Y.

**4.1.1.4 Adequacy of Capital Fund on RWA:**

Capital adequacy ratio is the foremost tool to analyze the capital fund of a bank. The capital adequacy ratio is based on total risk-weighted assets (TRWA) of the bank. Capital adequacy ratios are a measure of the amount of a bank's capital expressed as a percentage of its risk weighted credit exposures. This ratio is used to examine adequacy of total capital fund and core capital, which is yielded by the following formulas:

To measure the adequacy of total capital fund:

$$\text{Capital Fund Ratio} = \frac{\text{Total Capital Fund}}{\text{TRWA}}$$

To measure the adequacy of core capital=

$$\frac{\text{Core Capital}}{\text{TRWA}} \times 100\%$$

**Table 4.4**

**Adequacy of Capital Fund on RWA of NIBL**

<b>F/Y</b>	<b>% of Tier 1</b>	<b>% of Tier 2</b>	<b>TCF on RWA</b>
2007/08	7.9	4.26	12.17
2008/09	7.71	3.57	11.28
2009/10	8.56	2.68	11.24
2010/11	8.5	2.05	10.55
2011/12	8.77	2.14	10.91
<b>A.M.</b>	8.29	2.94	11.23

(Source: www.nibl.com.np)

From above table we see, that NIBL has been capable to maintain the required capital as directed by NRB but in the year 2010/11 & 2011/12 has not been capable to maintain. It has been capable to maintain the sufficient amount of Tier I & Tier II capitals as directed by NRB in other years. This shows the banks least exposure to the risk in the coming days.

**Table 4.5**

**Adequacy of Capital Fund on RWA of EBL**

<b>F/Y</b>	<b>% of Tier 1</b>	<b>% of Tier 2</b>	<b>TCF on RWA</b>
2007/08	7.82	3.38	11.2
2008/09	9.04	2.4	11.44
2009/10	8.52	2.82	11.34
2010/11	8.39	2.38	10.77
2011/12	8.46	1.97	10.43
<b>A.M.</b>	8.45	2.59	11.04

(Source: www.everestbankltd.com)

From above table we see, that EBL has been capable to maintain the required capital as directed by NRB, but in the year 2011/12 bank cannot able to maintain. It has been capable to maintain the sufficient amount of Tier I & Tier II capitals as directed by NRB. This shows the banks least exposure to the risk in the coming days.

**Table 4.6**

**Adequacy of Capital Fund on RWA of NABIL**

<b>F/Y</b>	<b>% of Tier 1</b>	<b>% of Tier 2</b>	<b>TCF on RWA</b>
2007/08	10.4	1.64	12.04
2008/09	8.75	2.35	11.1
2009/10	8.74	1.96	10.7
2010/11	8.77	1.73	10.5
2011/12	8.83	1.75	10.58
A.M.	9.09	1.89	10.99

(Source: www.nabilbank.com)

Nabil has not been capable of maintaining the adequacy of Capital Fund on RWA on FY 2010/11 & 2011/12 as directed by NRB. According to the recent NRB directives regarding the capital adequacy, every CBs have to maintain at least 11% of Tier 1 Capital & Tier 2 capital based on total RWA of the banks. From above table we see, that Nabil has been capable to maintain the required capital as directed by NRB only the FY 2007/08 & 2008/09.

**Table 4.7**

**Adequacy of Capital Fund on RWA of HBL**

<b>F/Y</b>	<b>% of Tier 1</b>	<b>% of Tier 2</b>	<b>TCF on RWA</b>
2007/08	9.61	1.51	11.13
2008/09	9.36	3.06	12.42
2009/10	8.81	2.21	11.02
2010/11	8.68	2.04	10.72
2011/12	8.88	1.80	10.68
A.M.	9.06	2.12	11.19

(Source: www.himalayanbank.com)

From above table we see, that HBL has been capable to maintain the required capital as directed by NRB. It has been capable to maintain the sufficient amount of Tier I & Tier II capitals as directed by NRB. But in 2010/11 & 2011/12 HBL cannot able to

maintain the capital adequacy ratio. This shows the banks least exposure to the risk in the coming days.

#### 4.2 Loan Loss Provisions

The ratio of loan loss provision to total loan describes the quality of assets that the commercial banks are holding loan loss provision is the summation of provision made against all types of loans as per the NRB direction. The NRB directives direct to make the provision of 1%, 25%, 50% & 100% for good loans, sub-standard loans, doubtful loans & bad loan respectively. Loan loss provision in fact is the cushion against future contingency created by the total provision presented in the profit & loss A/C & definitely decreases the profit of bank. The more of the loan loss provision, suggests two definite things more of total loan or more of bad loan. Since, according to NRB directives, 1% provision is to be provided for all good loans too, it does acquire a huge portion of the total loans loss provision. The lower ratio signifies the good quality in the total volume of total loans. Similarly, the higher ratio signifies relatively more risky assets the volume of loans and advance & also possibility of increment of non-performing loans in future.

We have,

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

**Table 4.8**

#### **Loan Loss Provision to Total Loan Ratio (For Nabil Bank)**

FY	Pass	Restructured	Substandard	Doubtful	Bad
2007/08	11.2%	9.26%	47.31%	49.20%	86.46%
2008/09	0.14%	28.47%	48.78%	49.95%	88.16%
2009/10	1.01%	16.63%	38.89%	51.41%	90.99%
2010/11	1.03%	12.46%	25%	50%	98.97%
2011/12	1.03%	12.25%	25%	49.99%	99%

(Source: Appendix 4)

Nabil Bank has maintained to sufficient loan loss provision for NRB directive. Pass loan (Good loan), Restructured, Substandard, Doubtful Loan is capable to maintain by Nabil Bank but Bad Loan is not capable to maintain.

**Table 4.9**

**Loan Loss Provision to Total Loan Ratio (For EBL)**

FY	Pass	Restructured	Substandard	Doubtful	Bad
2007/08	0.99%	12.5%	25%	50%	10%
2008/09	1%	12.5%	25%	50%	100%
2009/10	1%	12.49%	25%	50%	100%
2010/11	1%	12.49%	24.99%	49.99%	% 100
2011/12	1%	12.49%	24.99%	50%	100%

(Source: Appendix 4)

EBL has maintain to sufficient loan loss provision for Pass loan (Good loan), Restructured, Substandard, Doubtful Loan & Bad Loan for NRB directive. EBL is maintaining every year for loan loss provision sufficient amounts as per NRB directive.

**Table 4.10**

**Loan Loss Provision to Total Loan Ratio (For NIBL)**

FY	Pass	Restructured	Substandard	Doubtful	Bad
2007/08	10.01%	12.5%	25%	50%	100%
2008/09	10%	12.5%	25%	50.2%	100%
2009/10	3.77%	12.61%	12.49%	49.99%	100%
2010/11	10.35%	12.49%	24.99%	50%	100%
2011/12	10.01%	-	24.99%	49.99%	100%

(Source: Appendix 4)

NIBL has maintain to sufficient loan loss provision for Pass loan (Good loan), Restructured, Substandard, Doubtful Loan & Bad Loan for NRB directive. EBL is maintaining every year for loan loss provision sufficient amounts as per NRB directive.

**Table 4.11**  
**Loan Loss Provision to Total Loan Ratio (For HBL)**

FY	Pass	Restructured	Substandard	Doubtful	Bad
2007/08	1%	30.82%	25.49%	50%	99.48%
2008/09	10.15%	45.29%	25%	50%	99.95%
2009/10	1.01%	38.99%	44.18%	50.86%	99.52%
2010/11	1.01%	12.49%	38.91%	50%	99.86%
2011/12	1.01%	41.72%	25.01%	49.99%	100%

(Source: Appendix 4)

HBL has maintain to sufficient loan loss provision for Pass loan (Good loan), Restructured, Substandard, Doubtful Loan & Bad Loan for NRB directive. EBL is maintaining every year for loan loss provision sufficient amounts as per NRB directive.

The Credit/Deposit Ratio (CD Ratio) is one of the most important ratios for commercial banks. This ratio shows how effectively the banks have been using the fund they collected from the depositors. The capital deposit ratios of selected commercial banks are satisfactory in the FY 2007/08 to 2011/12. Nepal there is no such norms or Statius to legalize this requirement. There is not any standard for CD ratio in Nepal, a ratio of 75% can be accepted to be adequate. Still, it can be said that the CD ratio that the commercial banks are satisfactory.

CRR influences the commercial bank's credit creation capacity. CRR determined and monitors by Nepal Rastra Bank. If there is higher rate of CRR, commercial banks need to keep higher portion of deposit for CRR purpose. It directly affects the profitability of commercial banks. As above we calculate the CRR of selected commercial banks for five years from 2007/08 to 2011/12 and most of the selected commercial banks maintain the CRR as maintained by NRB at different time period.

According to the NRB rules & directives regarding the provision for general reserve every year all financial institution should allocate at least 20% of the particular year's profit. Reserve fund maintained of selected commercial banks for five years from 2007/08 to 2011/12 are accepted to be adequate.

The capital adequacy ratio is based on total risk-weighted assets. The sum of core and supplementary capital is measured to be total capital fund. For the purpose of calculation of capital fund, the risk-weighted assets have been classified in to two parts; on-Balance sheet Risk-weighted Assets and off-Balance sheet Risk-weighted Items. The capital adequacy ratio would measure the total capital fund on the basis of total risk-weighted assets. According to NRB directives, commercial bank should maintain their CAR 11% according to BASEL-I up to fiscal year 2007/08 and 10% according to BASEL-II. All commercial banks should maintain CAR. This is created to protect the interest of the depositors. In the event of non-fulfillment of CAR in any quarter, the bank shall fulfill the shortfall amount within next six month. It is found that all selected banks are quite successful in maintaining capital adequacy as prescribed by NRB.

The NRB directives direct to make the provision of 1%, 25%, 50% & 100% for good loans, sub-standard loans, doubtful loans & bad loan respectively.

## **CHAPTER-V**

### **SUMMARY, CONCLUSION & RECOMMENDATION**

#### **5.1 Summary**

The main reason of the business fluctuation of modern times is the expansion and contraction of money and credit. In modern economics, there is the circulation of credit money many times more than the volume of bank note and coins. The central bank, the highest monetary authority of the country should, therefore, control the volume of money and credit for business stability. Since the bank notes are issued by the central bank, it can directly control the volume of money. However, the central bank controls credit through indirect measures. Hence, in an ordinary sense, the policy of the central bank related to the control of money and credit is known as monetary policy. Based on this policy, the central bank of every country makes & gives directives to the different types of financial institutions for their effective & smooth operation for the economic benefits of the country.

NRB has also updated the financial institution establishment policy with changes where necessary to ensure financial sector stability. Directives have been served to these institutions to increase their paid-up capital base with a view to ensure bank's capacity to bear possible risks of their banking transactions & to encourage merges when necessary. Accordingly, the new licensing policy in place requires having paid-up capital of Rs.2 billion for new commercial banks ("A" class financial institutions) to open. The concept of regional banks has been eliminated. Paid-up capital base for development banks & finance companies has also been raised. Such capital requirement for micro-finance companies to open, however, has not been changed with a view to encourage micro-finance companies to expand. According to the new licensing policy, providing proof of mandatory paid-up capital base by June/July 2010 is a pre-condition for those which have submitted proposals to open new finance institutions. This provision has been made considering the entry of Nepal in WTO. In case of operating financial institutions, they are required to comply with this provision by June/July 2013. Provisions such as individuals intending to invest in

these institutions require to proof of tax clearance, & they are not blacklisted by the CIC been made effective.

As a regulator of country's financial & banking institutions, NRB always directly & indirectly advised banks & financial institutions to increase their financial base. The plan for capital enhancement is one of the best solutions to increase capital strength of banks & complying Basle Accord. The global mantra of facing competition lies in growing big. This is not survival of the fittest alone, survival of "biggest & fittest" is the new theory formed under globalization of world finance.

Banks should pump billions, & still better if they can pump it in hard foreign currencies. This idea of curious policy makers is an example of how the whole banking system is dragged up for competition. The volume of competition & the way it could take place in future are just a matter of guess now. The government & the NRB as a banker's bank want all public banks, private banks & joint venture banks to be financially strong & healthy because there are lot of challenges & opportunities in coming days.

To maintain financial stability, inspection & supervision system has been made more effective in addition to the updated regulatory works. The time-to-time different directives to the financial institutions by the NRB have been also an effective tool. Following this, a separate monitoring committee has been established to cater for the banks in problem & in-depth supervision & monitoring of such banks has been started. As per the policy of preparing annual reports timely inspection & supervision is done by NRB. To improve the weaknesses & shortcomings observed in the course of supervision, timely directives based on the inspection reports are being issued to the concerned banks & financial institutions. Providing preliminary clearance to the banks prior to approval of their financial statement publication has also been started. Provision of compensation payment for failure to maintain the mandatory cash reserve level & failure to provide deprived class loans has been enforced.

Banks & financial institutions are the backbone of the economic development of a country. They have promoted industrialization & economic development by channeling the public deposit into these sectors. The establishment of the new bank & financial institutions leads more competition in the banking market. To win the competition, banks provide more facilities to the customers with modern technology.

At the same time, the probability of loss becomes significant to banks, which are running behind in the competition. In case of insolvency, the public depositors as well as the shareholders of the bank may suffer significantly. It will adversely affect the overall banking sector. Therefore, the supervisory & monitoring of banks & financial institutions is essential to find out the solvency position & take corrective action in time when needed. For this purpose, the central bank of the country, NRB monitors & gives directives to CBs & financial institutions after supervision & inspection.

## **5.2 Conclusions**

Banks & financial institutions in Nepal will have to benchmark themselves against some of the best in the world, for a strong & resilient banking & financial system. Therefore, banks need to go beyond peripheral issues & tackle significant issues like improvements in profitability, efficiency & technology, while achieving economies of scale through available cost effective solutions. These are some of the major issues that need to be addressed by banks in recent scenario, for their success & not just survival, in the changing milieu.

Adequate capital reserve is necessary for financial institutions to minimize risks. Financial crisis faced by the Southeast Asian countries in 1997-98 due to inadequate capital reserve is a living memory. BASEL II guides the capital-structuring requirement, which has been implemented. Accordingly, the banks & finance institutions are required to maintain capital adequacy at 11.0% starting from F/Y 2005/2006.

Another directive of NRB to licensed banks & financial institutions deals with the financial statement. Starting from F/Y 2005/2006, they are required to open capital adjustment fund to meet mandatory minimum paid-up capital by allocating a minimum of 10% of paid-up capital from their profit. For financial institutions not earning profit, they are required to comply with this provision by managing resources from whatsoever sources at their disposal.

In the interest of financial stability, inactive loan amount should be below 5% of total loan. In Nepal, inactive loan amount is high in the banking sector particularly because of some clients being delinquent. Victims of high inactive loan amount are the

government-owned banks. Among the measures taken so far to reduce the level of inactive loan, blacklisting has proved more effective.

CD Ratio is one of the most important indicators of the CBs financial performance as prescribed the central bank of Nepal, NRB. It shows the actual liquidity position of the CBs. If 75% of amount deposited by the customers are invested in various sectors, it is considered satisfactory. It is good sign. In the above sample CBs, in average, except the CD ratio of Nabil & HBL, others CD ratios are in the strong position. According to the C.V. analysis, the CD ratio of EBL is seen most consistent among the sample banks as its C.V. is seen the least among the sample CBS.

The level of CRR influences the commercial banks' credit creation capacity. If there is a higher rate of CRR, then the CBs need to keep the higher portion of deposits for CRR purpose with the central bank. As such, they have less deposit for lending purpose. Hence, the higher CRR squeezes the money expansion in the economy. Conversely, the low CRR rate means CBs need to keep less of the deposits so that they can lend more, resulting in the expansion of money supply in the economy.

In average, NIBL have maintained the higher level of CRR with 9.876% among the sample CBs & Nabil have maintained the least level of CRR with 5.336%. According to the C.V. analysis also, the level of the CRR of NIBL is seen the most consistent during the past five F/Y.

Every year, the financial institution should allocate at least 20% of the particular year's net profit as a general reserve fund according to the NRB rules & directives regarding the provision for general reserve. This provision of general reserve fund helps the CBS to keep in the secured side in crisis of fund.

We see that the sample CBs have been able to maintain the provision of general reserve fund every F/Y. But only, the NIBL has not been capable to maintain the GRF as per the NRB directives since the F/Y 2007/08. Similarly, the GRF of Nabil was seen only 12.67% in the F/Y 2007/08. According to the C.V. analysis also, the level of the GRF of HBL is seen the most consistent during the past five F/Y.

According to the recent NRB directives regarding the capital adequacy, every CBs have to maintain *at least 11%* of Tier 1 Capital & Tier 2 capital based on total RWA of the banks. Nabil has been capable of maintaining the adequacy of Capital Fund on

RWA as directed by NRB. The TCF on RWA of Nabil in average is seen capable to maintain the required capital as directed by NRB. EBL, NIBL & HBL has been capable to maintain the required capital as directed by NRB. It has been capable to maintain the sufficient amount of Tier I & Tier II capitals as directed by NRB. This shows the banks least exposure to the risk in the coming days.

According to the NRB directive regarding to the loan loss provision every CBs have to classify the total credit amount into five categories namely: Pass (Good), restructured, sub-standard, doubtful & bad loans. They are classified according to their recovery level & payment of loan & advance by the customers to the banks. In the study, we found that every sample CBs we have taken have strictly followed the NRB directives on loan loss provision & kept according to standard level as prescribed by the NRB. This helps to keep the CBs in the safe side & escape from the credit risk.

### **5.3 Recommendations**

1. Proper co-ordination among the NRB, SEBON, & NEPSE should be continued in the coming days for the proper follow of the directives of the all autonomous bodies.
2. NRB has to encourage the simultaneous growth of a sound & competitive financial system in the country. Such objective supports the promotion of momentum policy with stabilization driving economic development of the country.
3. The central bank of the country, NRB has to review its directives time-to-time according to the requirement of the economic situation of the country.
4. Strict action should be taken by the NRB to the CBs who have not followed the directives as prescribed by it.
5. The loan defaulters should be taken into strict legal action in the joint effort of the NRB, Loan Recovery Tribunal, GON & the concerned CBs.

6. As, Nepal has entered into WTO, & government has decided to let the foreign banks to enter into the Nepalese market, the capital requirement for the establishment of new CBs should be strictly follow-up by the local CBs also.
7. Information-technology aid should also be taken by the central bank to make the effective & efficient flow of information to the financial institutions.
8. Proper provision of collection of capital fund required should be made by the central bank. The mode of collection should also be properly mentioned in the act by the central bank.
9. Loan loss provision & the classification of the loans by the CBs should be continued in the coming days to protect from the crisis.
10. Consistency in the indicators should be made among the CBs as far as possible by the central bank, NRB using its authorities & flowing effective directives.
11. Proper implementation of bills & acts namely: Bankruptcy Act, 2063, Credit Rating Institution Bill, Assets Management Corporation Bill, Trustee Bill, Anti-Money Laundering Bill should be passed as soon as possible by GON & also be implemented with the co-ordination of NRB.
12. NRB should not only issue directives for the sake of issuing them but a proper homework needs to be done to combat the problems associated with the directives. It should not happen as the directives related to L/C, where prior study was not done & within a few days of the issuance of the directives, they had to be amended.
13. NRB should be more practicable while issuing the directives to the CBs. Directives should be straight forward, reasonable & with no loopholes with context to the country & not just to fulfill the duty of the central bank only but also as the care-taker of the economy of the country.

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# Appendix

## Appendix 1

### Credit- deposit Ratio

**For Nabil Bank**

(Rs. 000)

FY	Total Deposit	Total Credit	CD Ratio(X)	$(x - \bar{X})^2$
2007/08	23342285	15545778	66.59	16.81
2008/09	31915047	21365053	66.94	14.06
2009/10	37348255	27589933	73.87	10.11
2010/11	4641070	32268873	69.52	1.36
2011/12	49696112	3834097	76.53	34.10

(Source: www.nabilbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = \frac{353}{5} = 70.69$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 3.90$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 5.53\%$$

**For EBL**

FY	Total Deposit	Total Credit	CD Ratio(X)	$(x - \bar{X})^2$
2007/08	18186253	13664081	75.13	0.20
2008/09	23976298	1833985	76.49	3.27
2009/10	33322946	23884673	71.67	9.06
2010/11	36932310	27556356	74.61	0.01
2011/12	41127914	31057691	75.51	0.68

(Source: www.everestbankltd.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 74.68$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 1.63$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 2.17\%$$

**For NIBL**

FY	Total Deposit	Total Credit	CD Ratio(X)	$(x - \bar{X})^2$
2007/08	24488855	17286427	70.58	46.62
2008/09	34451726	26996652	78.36	0.46
2009/10	46698100	36241206	77.61	0.01
2010/11	50094725	40318308	80.48	7.85
2011/12	50138122	41095514	81.36	13.55

(Source: www.nibl.com.np)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 77.67$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 3.7$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 4.76\%$$

**For HBL**

FY	Total Deposit	Total Credit	CD Ratio(X)	$(x - \bar{X})^2$
2007/08	30048417	1697997	56.57	132.94
2008/09	31842789	19417520	60.97	50.89
2009/10	34682306	24793155	71.45	11.49
2010/11	37611202	27980628	74.39	39.56
2011/12	40920627	31566976	77.14	81.72

(Source: www.himilayanbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 68.10$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 7.96$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 11.68\%$$

## Appendix 2

### Cash & Bank Balance to Total Deposit Ratio For Nabil Bank

FY	Cash & Bank Balance	Total Deposit	Ratio (%)	(X - $\bar{X}$ ) <sup>2</sup>
2007/08	1399824	23342285	5.99	0.01
2008/09	2671139	31915047	5.99	6.15
2009/10	3372511	3734825	8.37	6.15
2010/11	1400096	46410700	3.02	8.24
2011/12	1512016	49696112	3.04	8.12

(Source: www.nabilbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 5.89$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 2.54$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 43.12\%$$

**For EBL**

FY	Cash & Bank Balance	Total Deposit	Ratio (%)	$(x - \bar{X})^2$
2007/08	2391419	18186253	13.15	6.86
2008/09	2667970	23976298	11.13	21.53
2009/10	6164369	33322946	18.49	7.39
2010/11	7818813	36932310	21.17	29.16
2011/12	6122861	41127914	14.89	0.77

(Source: www.everestbankltd.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 15.77$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 3.63$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 23.01\%$$

**For NIBL**

FY	Cash & Bank Balance	Total Deposit	Ratio (%)	$(x - \bar{X})^2$
2007/08	2441514	2448856	9.97	12.67
2008/09	375492	34451726	10.89	6.96
2009/10	7918004	46698100	16.96	11.76
2010/11	6825890	50094725	13.61	6.91
2011/12	8140371	50138122	16.24	7.34

(Source: www.nibl.com.np)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 13.5$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 3.02$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 22.32\%$$

**For HBL**

FY	Cash & Bank Balance	Total Deposit	Ratio (%)	$(x - \bar{X})^2$
2007/08	1757340	30048417	0.58	32.60
2008/09	1448141	31842789	4.55	3.03
2009/10	3048525	34682303	8.79	6025
2010/11	3866489	37611202	10.28	15.92
2011/12	2964650	40920627	7.24	0.91

(Source: www.himalayanbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 6.29$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 3.43$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 54.53\%$$

### Appendix 3

#### Provision for General Reserve Fund Ratio

#### For Nabil

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	85000	673960	12.61%	35.40
2009	150000	746468	20.09%	2.34
2010	207000	1031053	20.07%	2.28
2011	228000	1141051	19.98%	2.01
2012	268000	1337745	20.03%	2.16
N=5			$\sum X=92.78\%$	$\sum (X - \bar{X})^2=44.19$

(Source: www.nabilbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 18.56\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 2.97$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 16.01\%$$

#### For EBL

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	59281	296409	20%	0.00
2009	90244	451218	20%	0.00
2010	127747	638732	20%	0.00
2011	166354	831765	20%	0.00
2012	186261	931303	20%	0.00
N=5			$\sum X=20\%$	$\sum (X - \bar{X})^2=0.00$

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 20\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 0.00$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 0.00$$

**For NIBL**

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	100280	516056	19.43%	1.48
2009	139800	655856	21.22%	0.32
2010	180123	835980	21.56%	0.83
2011	253189	1089170	23.25%	6.76
2012	235328	1324498	17.76%	8.35
N=5			$\sum X = 103.22\%$	$\sum (X - \bar{X})^2 = 17.74$

(Source: www.nibl.com.np)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 20.65$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 1.88$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 9.13\%$$

**For HBL**

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	98364	491822	20%	0.39
2009	127173	635888	20%	0.39
2010	150566	752834	20%	0.39
2011	101759	508798	20%	0.39
2012	150566	893115	16.85%	6.35
N=5			$\sum X=96.85\%$	$\sum (X - \bar{X})^2=7.91$

(Source: www.himalayanbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 19.37\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 1.25$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 6.48\%$$

**Appendix 4**

**Loan Loss Provision**

**For Nabil for F/Y2007/08**

Types	TLAC	LLP	Ratio
Pass	15638484	175502	1.12%
Restructured	862477	79841	9.26%
Sub-standard	119704	56636	47.31%
Doubtful	14471	7119	49.20%
Bad	44117	38145	86.46%

**For Nabil for F/Y2008/09**

Types	TLAC	LLP	Ratio
Pass	21587743	29174	0.14%
Restructured	10631	3026	28.47%
Sub-standard	66111	32305	48.78%
Doubtful	42575	21265	49.95%
Bad	52288	46096	88.16%

(Source: www.nabilbank.com)

**For Nabil for F/Y2009/ 10**

Pass	27774194	280444	1.01%
Restructured	7196	1197	16.63%
Sub-standard	113305	44073	38.89%
Doubtful	45756	23525	51.41%
Bad	65755	59837	90.99%

(Source: www.nabilbank.com)

**For Nabil for F/Y 2010/11**

Pass	32543427	335416	1.03%
Restructured	1260	157	12.46%
Sub-standard	59020	14755	25%
Doubtful	22730	11365	50%
Bad	404530	400400	98.97%

**For Nabil for F/Y 2011/12**

Pass	38215636	384882	1.01%
Restructured	22142	2713	12.25%
Sub-standard	170212	42553	25%
Doubtful	104659	52329	49.99%
Bad	392836	388911	99%

(Source: [www.nabilbank.com](http://www.nabilbank.com))

**For EBL for F/Y 2007/08**

Pass	13750623	137506	0.99%
Restructured	218884	27360	12.5%
Sub-standard	4218	1057	25%
Doubtful	2353	1176	50%
Bad	106607	106667	100%

(source: [www.everestbankltd.com](http://www.everestbankltd.com))

**For EBL for F/Y 2008/09**

Pass	18555269	185552	1%
Restructured	153852	19231	12.5%
Sub-standard	6306	1576	25%
Doubtful	745	372	50%
Bad	120257	120257	100%

(Source: [www.everestbankltd.com](http://www.everestbankltd.com))

**For EBL for F/Y2009/ 10**

Pass	24248590	242485	1%
Restructured	102979	12872	12.49%
Sub-standard	1360	340	25%
Doubtful	28514	14257	50%
Bad	88110	88110	100%

(source: www.everestbankltd.com)

**For EBL for F/Y2010/ 2011**

Pass	28030839	280308	1%
Restructured	81854	10231	12.49%
Sub-standard	15469	1367	24.99%
Doubtful	12633	6316	49.99%
Bad	25602	25602	100%

(source: www.everestbankltd.com)

**For EBL for F/Y 2011/2012**

Pass	31553441	315534	1%
Restructured	14207	1775	12.49%
Sub-standard	73101	18275	24.99%
Doubtful	4176	2088	50%
Bad	16915	16915	100%

(source: www.everestbankltd.com)

**For NIBL for F/Y 2007/08**

Pass	17309513	173495	10.01%
Restructured	37614	4701	12.5%
Sub-standard	96893	24572	25%
Doubtful	86049	43084	50%
Bad	239028	236817	99.07%

(Source: www.nibl.com.np)

**For NIBL for F/Y 2009/10**

Pass	36576257	381198	3.77%
Restructured	36992	4661	12.61%
Sub-standard	10765	2691	24.99%
Doubtful	11485	5742	49.99%
Bad	191656	191656	100%

(Source: www.nibl.com.np)

**For NIBL for F/Y 2010/11**

Pass	40674106	420840	10.35%
Restructured	20299	2537	12.49%
Sub-standard	55710	13927	24.99%
Doubtful	10994	5497	50%
Bad	187329	187329	100%

(Source: www.nibl.com.np)

**For NIBL for F/Y 2011/2012**

Pass	4142411	416063	10.01%
Restructured	-	-	-
Sub-standard	22782	5695	24.99%
Doubtful	4159	2079	49.99%
Bad	368341	368341	100%

(Source: www.nibl.com.np)

**For HBL for F/Y 2007/08**

Pass	16697714159	167225322	1%
Restructured	454394398	140064491	30.82%
Sub-standard	72076059	18349848	25.46%
Doubtful	194976256	97488128	50%
Bad	374562991	372599028	99.48%

(Source: www.himalayanbank.com.np)

**For HBL for F/Y 2008/09**

Pass	19357600250	19649075	10.15%
Restructured	344783696	156137866	45.29%
Sub-standard	53919981	13479995	25%
Doubtful	214476314	107238157	50%
Bad	208832928	208746594	99.95%

(Source: www.himalayanbank.com.np)

**For HBL for F/Y 2009/10**

Pass	24666641	247686	1.01%
Restructured	301588	117613	38.99%
Sub-standard	167831	74157	44.18 %
Doubtful	194699	99025	50.86%
Bad	188779	187880	99.52%

(Source: www.himalayanbank.com.np)

**For HBL for F/Y 2010/11**

Pass	27915637	282483	1.01%
Restructured	183285	22910	12.49%
Sub-standard	122760	46818	38.14 %
Doubtful	220519	110259	50%
Bad	681551	680653	99.86%

(Source: www.himalayanbank.com.np)

**For HBL for F/Y2011/ 12**

Pass	31576522	318132	1.01%
Restructured	188464	78620	41.72%
Sub-standard	216053	54038	25.01%
Doubtful	73457	36728	49.99%
Bad	9137733	913773	100%

(Source: www.himalayanbank.com.np)

## Annex-IV

### Calculation of GRF of Sample CBs

For Nabil

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	85000	673960	12.61%	35.40
2009	150000	746468	20.09%	2.34
2010	207000	1031053	20.07%	2.28
2011	228000	1141051	19.98%	2.01
2012	268000	1337745	20.03%	2.16
N=5			$\sum X = 92.78\%$	$\sum (X - \bar{X})^2 = 44.19$

(Source: www.nabilbank.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 18.56\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 2.97$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 16.01\%$$

**For EBL**

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	59281	296409	20%	0.00
2009	90244	451218	20%	0.00
2010	127747	638732	20%	0.00
2011	166354	831765	20%	0.00
2012	186261	931303	20%	0.00
N=5			$\sum X=20\%$	$\sum (X - \bar{X})^2=0.00$

(Source: www.everestnbankltd.com)

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 20\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 0.00$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 0.00$$

**For NIBL**

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	100280	516056	19.43%	1.48
2009	139800	655856	21.22%	0.32
2010	180123	835980	21.56%	0.83
2011	253189	1089170	23.25%	6.76
2012	235328	1324498	17.76%	8.35
N=5			$\sum X=103.22\%$	$\sum (X - \bar{X})^2=17.74$

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 20.65$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 1.88$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 9.13\%$$

**For HBL**

F/Y	GRF	NP	GRF Ratio(X)	$(X - \bar{X})^2$
2008	98364	491822	20%	0.39
2009	127173	635888	20%	0.39
2010	150566	752834	20%	0.39
2011	101759	508798	20%	0.39
2012	150566	893115	16.85%	6.35
N=5			$\sum X = 96.85\%$	$\sum (X - \bar{X})^2 = 7.91$

(Source: [www.himalayanbank.com.np](http://www.himalayanbank.com.np))

$$(A.M.) = \bar{X} = \frac{\sum X}{n} = 19.37\%$$

$$(S.D.) = \sqrt{\frac{\sum (X - \bar{X})^2}{n}} = 1.25$$

$$(CV) = \frac{S.D.}{Mean} \times 100 = 6.48\%$$