IMPACT OF NON-PERFORMING LOANS ON PROFITABILITY OF NEPALESE FINANCE COMPANIES

A Dissertation submitted to the Office of the Dean, Faculty of Management in partial fulfillment of the requirements for the Master's Degree

By

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Certification of Authorship

I hereby corroborate that I have researched and submitted the final draft of dissertation entitled “Impact of Non-Performing Loans on Profitability of Nepalese Finance Companies”. The work of this dissertation has not been submitted previously for the purpose of conferral of any degrees nor it has been proposed and presented as part of requirements for any other academic purposes.

The assistance and cooperation that I have received during this research work has been acknowledged. In addition, I declare that all information sources and literature used are cited in the reference section of the dissertation.

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Report of Research Committee

Ms. Sabita Karki has defended research proposal entitled *"*Impact of Non-Performing Loans on Profitability of Nepalese Finance Companies*"* successfully. The research committee has registered the dissertation for further progress. It is recommended to carry out the work as per suggestions and guidance of supervisor Mr. Rishi Raj Gautam and submit the thesis for evaluation and viva voce examination.

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Approval Sheet

We, the undersigned, have examined the dissertation entitled "Impact of Non-Performing Loans on Profitability of Nepalese Finance Companies" presented by Sabita Karki a candidate for the degree of master of Business Studies (MBS Semester) and conducted the Viva voce examination of the candidate. We hereby certify that the dissertation is worthy of acceptance.

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Sabita Karki

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Abbreviations

ATM	:	Automated Teller Machine
BS	:	Bikram Sambat
CAR	:	Capital Adequacy Ratio
CB	:	Commercial Banks
EBL	:	Everest Bank Limited
EPS	:	Earning Per Share
GDPR	:	GDP Growth Rate
HBL	:	Himalayan Bank Limited
INF	:	Inflation Rate
IT	:	Information Technology
JVBs	:	Joint Venture Banks
L & A	:	Loan and Advance
LIQ	:	Liquidity Ratio (Loan to Deposit Ratio)
LSIZE	:	Natural Logarithm Total Assets of Banks
NABIL	:	Nabil Bank Limited
NPL	:	Non – Performing Loan
NPLR	:	Non – Performing Loan Ratio
NRB	:	Nepal Rastra Bank
NSBL	:	Nepal SBI Bank Limited
PCBL	:	Prime Commercial Bank Limited
ROA	:	Return on Assets
ROE	:	Return on Equity
SD	:	Standard Deviation
TA	:	Total Assets
TU	:	Tribhuvan University

Abstract

This study investigates the influence of non-performing loans on profitability in Nepalese financial institutions. Secondary data was acquired from Nepalese financing businesses during 10 years (2012/13 to 2021/22). This study employed multiple regression analysis. This analysis demonstrates that SIFC's non-performing loan ratio is the best or maintains their NPLs precisely among them, indicating that SIFC has the finest lending policy. SIFC could manage their whole operations since they had the greatest ROA ratio. However, GFCL the best or most effective management in earning profit among them. The correlation analysis reveals that The correlation analysis shows that credit to deposit ratio has insignificant negative relation with profitability (ROA and ROE) of the finance companies. However, non-performing loan has significant negative relationship with profitability. Then, capital adequacy ratio and inflation rate have negative relationship with profitability of the finance companies. Moreover, size of companies has strong positive relationship with ROA and ROE of the finance companies. The regression analysis reveals that credit to deposit ratio and inflation rate have insignificant positive impact on profitability (ROA and ROE) of the finance companies in Nepal. However, non-performing loan ratio has significant negative impact on profitability (ROA and ROE) of the companies. Moreover, capital adequacy ratio has insignificant negative impact on profitability whereas, size of companies has significant positive influence on profitability (ROA and ROE) in Nepalese finance companies. Hence, it can be concluded that non-performing loan has strong impact on profitability of the finance companies in Nepal.

Keywords: *Return on assets, return on equity, credit to deposit ratio, non-performing loan ratio and inflation rate.*

CHAPTER I
INTRODUCTION

1.1 Background of the study

Due to its potential to negatively impact a company's profitability, non-performing loans have become a major concern for both academics and finance corporations. Because it displays the percentage of loan losses compared to the overall loan amount, the non-performing loans ratio (NPLR) provides insight into how finance companies manage their credit risk. In its broadest sense, a non-performing loan (NPL) is a loan for which the borrower is not fulfilling their contractual responsibilities by returning the money. A quantity of borrowed funds on which the debtor has not made scheduled payments for at least ninety days is considered an NPL in many countries and for many businesses (Nyarko-Baasi, 2018).

NPLs are significant because they have an impact on finance organizations' capacity to continue in their primary duty of generating revenue, which ultimately affects the financial stability of an economy. A significant number of non-performing loans (NPLs) in the financial system directly leads to the bankruptcy of financing businesses and an economic downturn. The reasons behind non-performing loans are typically ascribed to inadequate oversight and supervision by finance organizations, insufficient remedies for lenders, deficiencies in the regulatory framework, and a deficiency of efficient debt collection tactics (Bhattarai, 2017).

An indirect cost of low asset quality that the financing firm must incur is the time and effort required for bank management in dealing with non-performing loans (NPLs). Not only do non-performing loans (NPLs) prevent interest revenue from being earned, but they also represent a forfeited opportunity to participate in profitable ventures, thus hurting future profitability. Blocking income, as implied by non-performing loans (NPLs), limits the financing company's available cash. Financiers are thus compelled to take on greater debt, which raises their costs. In addition, NPLs pose a risk to the banking businesses' reputations. A poor credit rating impact and limited prospects for co-financing and syndication with other financial institutions are the results of a finance company's NPL problem. As a result, a large number of NPLs

may have an impact on profitability and even jeopardize the viability of financing organizations. The relationship between profitability and nonperforming loans, however, is less clear. If a company's profitability is a good indicator of its asset management, then the financial businesses may produce fewer non-performing loans. Additionally, retained earnings increase a company's capital position since profits flow into them. Alternatively, bigger profits might indicate more risk, which would eventually lead to a higher number of nonperforming loans (Bessis, 2010).

A non-performing loan is an advance for which there is a 90-day or longer overdue period of interest or principal payments, or both. When an advance or loan doesn't meet its payback terms, it's considered non-performing. As a result, loans that might fail are considered non-performing assets. The amount of non-performing loans (NPLs) is a measure of how well finance companies manage credit risk and allocate their resources to profitable industries. Credit risk is described as "possible default of a borrower to meet the obligation in accordance with the agreed terms" by the Basel Committee on Banking Supervision. Numerous finance organizations failed as a result of higher non-performing assets (Nayak et al., 2010).

In a broader sense, profitability is the extent to which a finance firm has achieved its goals and is a crucial component of finance risk management. It is the process of calculating the financial impact of a company's activities and policies. It is used to assess the overall financial health of a company over a certain time period. It may also be used to aggregately compare different industries or sectors or to compare similar companies within the same industry. The most crucial factor in determining the success of a financial firm is net profit.

The amount of non-performing loans in financial institutions may be impacted by their efficiency. This association was explained by the development of the terrible management concept. Ineffective management of the finance firm will make it less efficient and have an impact on the loan-granting procedure. Due to their inadequate assessment abilities, the management of the finance organizations may fail to carefully review the credit applications submitted by their clients. Aside from the possibility that management is ineffective at managing loan portfolios, another issue that exacerbates the situation is the asymmetry of knowledge between lenders and

borrowers. As a result, the authorized loans have worse credit ratings and a larger likelihood of default, which raises the number of nonperforming loans. Thus, a significant percentage of non-performing loans may result from finance organizations' inadequate quality management, the quality of their assets, and other issues.

The Rastra Bank of Nepal, the nation's central bank, establishes all laws and regulations that financial businesses operating in Nepal must abide by. Mobilizing deposits and using them to fund industry is the main activity of finance companies. The lending industry is often supported as it helps move money out of the system and into useful endeavors, which boosts the economy. Nevertheless, lending also entails credit risk, which results from borrowers' inability to carry out their half of the bargain during the lending transaction. It is commonly recognized that Nepal's banks and other financial institutions are dealing with an increasing amount of non-performing assets, which is becoming increasingly difficult to handle (Bhattarai, 2020). This study looks at how finance businesses' non-performing loans affect both their overall lending practices and bottom lines.

1.2 Problem statement

The primary service area for financial organizations is lending, which accounts for the majority of their income and earnings. Therefore, in order to provide efficient credit services and meet the overall goals of the financial company, it is imperative that a strong credit evaluation and management system be used. According to Berger and DeYoung (1997), inadequate management within financial institutions leads to loans of low quality, which in turn raises the percentage of non-performing loans and lowers profitability. NPA in the loan portfolio has an impact on operational effectiveness, which has an impact on the firms' profitability, liquidity, and solvency situation.

NPLs have an impact on the bank's profitability and liquidity, which are crucial elements of the bank's overall effectiveness. Income is reduced when NPLs are provisioned for more. Once more, mismatches in the maturities of assets and liabilities put banks at risk for liquidity problems that damage their reputation and credit rating as a whole (Badar & Yasmin, 2013). Due consideration should be paid to

the factors that contribute to non-performing loans (NPLs) due to the detrimental impact they have on the existence of banks and other financial institutions.

Kingu et al. (2018) stated that the quantity of non-performing loans has a negative correlation with Tanzanian commercial banks' profitability levels. The findings strengthen the theories of knowledge asymmetry and poor management. The study's conclusions have management and theoretical ramifications for professionals and decision-makers. Islam (2018) asserted that the independent factors have a highly substantial impact on profitability. The profitability of the company was adversely correlated with both NPLs and LLPs held by commercial banks, with LLPs having a statistically significant negative influence on profitability. If banks want to be as profitable as possible, they should keep their level of LLPs and NPLs as low as possible.

Gabriel et al. (2019) stated that there was a statistically significant negative impact on return on assets (ROA) from the non-performing loans to total loans ratio (NPL/TLR) and the cash reserve ratio (CRR). These findings demonstrated that Nigerian commercial banks' ability to make money will be negatively impacted by a large percentage of non-performing loans. Singh et al. (2021) showed that the NPL of banks is significantly impacted by GDP, ROA, bank size, and inflation, but not significantly by CAR. Put differently, this study demonstrated a positive and noteworthy impact of GDP on NPL, whereas the majority of studies indicate a negative effect. It shows that even if there were no appreciable changes in income growth, there is a large increase in the expansion of Nepalese banks when GDP growth increases. As a result, the NPL of commercial banks is positively and significantly impacted by GDP growth.

Bhattarai (2017) revealed that NPL ratio has a negative impact on ROA but a favorable impact on ROE. The study also looked at how the NPL ratio affected the profitability of Nepalese commercial banks. Gnawali (2018) has also looked at the detrimental impact of nonperforming loans on the profitability of Nepalese commercial banks. As a consequence, the profitability of Nepalese government banks was shown to be negatively correlated with bank size, non-performing loan to total loan (NPLTL), and the percentage of non-performing loans (NPL).

Pant (2018) discovered that the return on equity and bank size alone have a negligible connection. Three findings may be drawn from this study: first, banks' bankability to earn interest revenue improves as their net interest margin does, increasing their profitability. Furthermore, when the size of the asset rises, poor management practices also increase since the bank must manage larger activities, which further reduces profitability. Secondly, an increase in non-performing loans erodes interest revenue, which lowers profitability. Bhattarai (2020) examined tahat there is a considerable negative correlation between ROE and the NPL, CAR, and LIQ. Likewise, there is a strong positive correlation between SIZE and ROE. With regard to ROE, the INF has a favorable but negligible result. The investigation came to the conclusion that the variables NPL, CAR, LIQ, and SIZE had a significant impact on profitability. Profitability is not greatly impacted by the INF. Nonetheless, nonperforming loans have a significant negative impact on profitability.

The results of empirical research on several financial institutions showed that there is no clear correlation between non-performing loans and profitability. Therefore, the purpose of this study is to empirically analyze how non-performing loans affect the profitability of financial organizations in Nepal. For that reason, the following research topics have been highlighted by this study;

- What is the pattern of non-performing loan and profitability of finance companies in Nepal?
- What is the relationship between non-performing loan and profitability of the finance companies in Nepal?
- What is the impact of non-performing loan ratio, credit to deposit ratio, capital adequacy, size of the finance company and inflation rate on profitability of finance companies in Nepal?

1.3 Objectives of the study

The main objective of this study is to analyze the effect of non-performing loan on profitability of finance companies in Nepal. The other specific objectives are as follows;

- To examine the pattern of non-performing loan and profitability of finance companies in Nepal.

- To analyze the relationship between non-performing loan and profitability of the finance companies.
- To analyze the impact of non-performing loan ratio, credit to deposit ratio, capital adequacy ratio, size of the finance company and inflation rate on profitability of sample finance companies.

1.4 Rationale of the study

This study primarily aims to tackle the fundamental aspects of the given topic. Additionally, the researcher makes an effort to address the effects and support the accomplishment of organizational objectives. The researcher also believes that the result of this research would have the following contributions;

- Increase the reader's understanding of how nonperforming loans affect an organization's capacity to make money.
- Permit the finance firm and the borrowers to create and execute a strong creditworthiness system in order to reduce the amount of nonperforming loans.
- Make authorities, executives, and clients aware of their individual roles and responsibilities in achieving shared objectives.
- Make it possible for managers to understand what is required of them while handling loans from various businesses.
- Some highlights for more research and studies in related fields are made possible by this study.

1.5 Limitations of the study

The study has some limitations. The main limitations of the study are as follows:

- There are 17 finance companies operating in Nepal so far, but only five finance companies namely Shree Investment & Finance Company Limited (SIFC), Manjushree Financial Institution Limited (MFIL) and Goodwill Finance Company Limited (GFCL), Pokhara Finance Limited (PFL), Progressive Finance Limited (PROFL) are taken for the proposed study.
- This study concentrates only on impact of non-performing loans on finance company profitability and ignores the other financial aspects.
- The period of the study is limited from fiscal year 2012/13 to 2021/22.

- The study is basically based on secondary data, articles, publication and journals of the respective finance companies.
- In this study, only non-performing loan ratio, credit to deposit ratio, liquidity ratio, size of finance company and inflation rate have been taken for independent variables and ignored other variable like GDP growth rate, lending rate, loan growth, capital adequacy ratio and leverage ratio etc.

CHAPTER II
LITERATURE REVIEW

It is a necessary and essential step in every research project. It entails going over research papers or other pertinent claims in the relevant field of study in order to become aware of all previous studies, their shortcomings, and their findings so that new research may be carried out. This chapter covers the examination and review of a few relevant books, articles, published and unpublished works in various economic journals, bulletins, magazines, newspapers, the yearly financial statements of the relevant companies, NRB guidelines and directives, prior theses on related topics, and searches of websites pertaining to the subject.

2.1 Theoretical review

2.1.1 Theories of non-performing loans

Three theories/foundation of non-performing loans have been explained by Brooks (2008) as follow;

2.1.1.1 Agency theory

Scholars Ross (1973) and Mitnick (1973) stated that working independently and nearly concurrently, were the first to openly suggest and start developing a theory of agency. Although the fundamental ideas behind both theories are identical, Ross (1973) created the economic theory of agency, and Mitnick (1973) developed the theory of agency. The ways that the techniques employ comparable ideas under various assumptions might really be considered as complimentary.

The agency theory is becoming more and more common as a means of understanding an organization's financial performance. The idea aims to explain the interaction that often exists between an organization's owners—those who own its stock—and management of the business. According to the notion, there is an agency conflict. Generally speaking, an organization's management is viewed as an agent hired by the investors to increase stockholder value through sound financial performance. Therefore, it is required of the management to work in the owners' best interests and improve the company's financial success (Ross (1973).

2.1.1.2 Deflation theory

The following chain of events happens when the debt bubble bursts: debt liquidation, which is followed by distressed selling and a contraction of deposit currency when loans from finance businesses are repaid. The decrease in deposits results in a decrease in prices, which in turn causes a further decline in the net worth of businesses. This causes bankruptcies, which forces the struggling businesses to cut back on labor, trade, and output. These cycles result in complex fluctuations in interest rates as well as a decline in the value of money. The complex disruptions mentioned above can be summed up as internal and external factors affecting the over-indebtedness that exists between creditors and borrowers, or both, which can exacerbate loan defaults (Salas & Saurina, 2002).

2.1.1.3 Financial theory

The financial instability theory, as it is often called, made an effort to comprehend and explain the features of a financial crisis. According to the hypothesis, when corporate cash flow exceeds the amount required to pay off debt during successful times, speculative frenzy ensues. Shortly after, loans become more than borrowers can repay with their incoming earnings, which ultimately leads to a financial crisis. Finance businesses and lenders reduce credit availability as a result of such speculative borrowing bubbles, even to enterprises that can afford loans, and the economy consequently declines (Moti et al., 2012).

According to the hypothesis, there are three categories of borrowers that add to the total amount of insolvent debt: The "hedge borrower" can use the present cash flows from assets to pay off debt (principal and interest). The cash flow from investments for the "speculative borrower" can pay off the principle amount as well as the interest owed on the loan, but the borrower must continually roll over the debt. The "Ponzi borrower" takes out a loan with the expectation that the asset's value will increase and allow them to refinance it. However, their cash flow from investments is insufficient to cover their interest or principal payments; their only source of income is the asset's appreciation. This study is supported by financial theory. A hedge borrower would have a normal loan and be repaying both principal and interest; a speculative borrower would have a watch loan, which means that the loan's principal or interest is due and unpaid for 30 to 90 days or has been rolled over into a new loan; and a Ponzi

borrower would have a substandard loan, where the principal is actually increasing and the interest amount is not being covered. The principal sources of payments are insufficient to cover the loan's servicing costs. There is a 90-day grace period on the loan, but not a 180-day grace period. Because watch loans and substandard loans are nonperforming loans, financial theory may be applied to this research.

2.1.1.4 Asymmetric information theory

This idea applies to circumstances in which knowledge is incomplete. It specifically happens when two parties have disparate amounts of knowledge. An issue in financial markets like lending and borrowing is asymmetric information. In these markets, the borrower is far more knowledgeable than the lender about his financial situation. This hypothesis was initially introduced by Akerlof (1970) in the simple book "The Market for Lemons." It is the single most significant work in the body of knowledge on information economics. Mirrlees (1996) studied the information asymmetry pertaining to information access between those involved in the process of making economic decisions.

Information sharing lowers adverse selection by giving financial institutions better access to applicant credit data (Pagaon & Jappelli, 1993). Auronen (2003) explained the idea of asymmetric information suggests that it might be challenging to differentiate between good and bad borrowers, potentially leading to issues with moral hazards and adverse selection. According to the idea, the party in the market with greater knowledge about the particular good being traded—in this example, the borrower—is better positioned to negotiate favorable terms with the other party, the lender, in this scenario (Auronen, 2003). As a result, the party with less knowledge about the particular object being transacted is in a position to decide whether to proceed with the transaction correctly or incorrectly.

In finance organizations, there has been a notable build-up of non-performing loans due to adverse selection and moral hazard. Managers of finance businesses may be more knowledgeable than other stakeholders about how nonperforming loans affect their profitability. In this instance, they may use provisions for losses on non-performing loans for profit smoothing, or they might not report non-performing loans.

2.1.2 Companies specific factors causing nonperforming loans

When identifying non-performing loans (NPLs), macroeconomic variables—which are thought of as external pressures impacting the banking sector—should not be the only consideration. On the other hand, the general characteristics of the financial industry as well as the unique policy decisions made by a given finance company regarding its attempts to increase efficiency and enhance risk management are anticipated to have a significant impact on the development of non-performing loans. A few scholarly works have investigated the relationship between NPLs and company-specific variables. The literature study on company-specific factors that contribute to nonperforming loans is located in the next section.

2.1.2.1 Rapid loan growth

Research suggests that there is a correlation between fast credit expansion and loan delinquencies. Bessis (2002) investigated American banks, she discovered a correlation between non-performing loans and credit growth. Analogously, statistics on the growth rate of total loans and charge-offs in the US between 1950 and 1992 demonstrate a trend of rising lending rates preceding rising loan losses. During times of economic boom, risk-neutral lenders lend more because they anticipate higher returns from investment projects, which raises the expected returns from all loan clients.

While loan contractions are considered to indicate a tightening of criteria, supply-side explanations of the increase of financial institution loans often reflect a relaxing of underwriting requirements. Therefore, poor loan performance attributable to the loose underwriting standards follows the expansion in loan size.

2.1.4.2 High interest rate

Significantly greater default or non-performing loan rates would be faced by finance organizations with high interest rates. High interest rates that finance businesses charge are linked to loan defaults, (Sinkey, 2002). Panel regression study performed showed that financial factors such as cost of credit have a major influence on non-performing loans (Conradie & Fourie, 2002).

2.1.4.3 Lenient credit terms

Inadequate consideration of the credit terms throughout the credit sanctioning process may result in subpar loan performance. Bessis (2002) provides evidence that permissive credit conditions affect non-performing loans (NPLs) in their analysis on the US banking sector from 1984 to 2003. According to this study, catastrophe myopia, herd behavior, moral hazard, and agency issues are the causes of the leniency and may encourage bank managers to take on excessive risk and lend during boom periods.

When researching Indian finance organizations, Machiraju (2001) discovered that the conditions of credit also influence the incidence of nonperforming loans. Because public opinions of their success, as demonstrated by short-term profitability, have a significant impact on their reputations, finance firm managers tend to make short-term decisions. If managers don't increase credit while the economy is growing and finance business revenues are rising, their reputations suffer. Some loans will go to borrowers that have a larger default risk as a result of this herd mentality than otherwise. In an effort to reduce total lending risk, it is also advised that management of finance companies modify their lending rules in response to shifting market conditions.

Poor finance company management, which includes loose lending criteria, was the main cause of finance company collapse in the early 1980s, according to the Office of the Comptroller of the Currency (OCC, 1988). According to an FDIC analysis of the causes of the banking crises in the 1980s and early 1990s, a number of variables, including managerial, legislative, regulatory, and economic ones, contributed to the banking crises (FDIC, 1997).

The FDIC analysis reveals an important finding: bank managers modified their lending policies in response to shifts in the economy, boosting lending during periods of economic and sectoral growth and decreasing lending during periods of economic downturn. Furthermore, according to the FDIC report, bank managers may have responded to competition from other bankers by loosening lending standards, which in turn may have increased loan defaults.

2.1.4.4 Credit orientation

Public orientation and the growth of the financial industry go hand in hand. According to Machiraju's (2001) panel regression research of Indian finance organizations, credit orientation has a considerable impact on the loan default rate.

2.1.4.5 Cost efficiency

According to Sinkey (2002) taking risks increases a company's operational efficiency. It is said that managers who are risk averse are prepared to forfeit lower profits in exchange for lower risk, particularly when their wealth is contingent on the financial company's success. They will monitor the loans more closely and pay more for them, which will have an impact on the operational efficiency metric. Consequently, a finance corporation with lower efficiency may really own a portfolio with lower risk. It is also demonstrated that NPLs might be explained by operating efficiency.

2.1.4.6 Poor loan follow-up (Monitoring)

It is important to conduct routine loan quality monitoring, maybe in conjunction with an early warning system that can notify regulatory bodies of possible finance firm stress, in order to maintain a stable financial system and avert systemic catastrophes. Therefore, it is not necessary to overstate the importance of paying attention to the borrower in order to ensure loan performance. Borrowers have a propensity to pay more attention to their debts when they think they received superior treatment. A portion of loan failures can be attributed to debtors receiving less attention. Finance businesses are recommended to make timely loan payments. Rarely do financial institutions suffer financial losses as a result of poor lending decisions in the beginning. The financing businesses only create a loss after issuing a warning, even in situations when they are aware of larger risks (Machiraju, 2001).

Finance businesses lose more money as a result of their failure to keep an eye on the belongings of their borrowers and to identify warning signals in a timely manner. Finance businesses will not recognize the risk of loss if they do not pay enough attention to the borrowers and how they are using the money. In order to ensure that the loan funds are being used for the intended purpose and that the lending decision's underlying assumptions are still valid, it is necessary to supervise a loan. Finance businesses must determine if the borrower's characteristics, ability to repay the loan,

capital contribution, current market circumstances, and the value of the collateral acquired at the time of loan approval are still the same in order to achieve these goals. As previously mentioned, a financing firm has many options for keeping an eye on the borrower. One way to monitor a borrower's financial health is to regularly review the account activities, go at the stock statements, and determine the security value.

Among the strategies used by finance businesses to monitor their loans is occasional visits to the borrower in order to get insight into the state of the borrower's company operations and, consequently, provide guidance as needed. It is evident that efficient credit monitoring entails investigating a range of business activities, such as loan operations, determining if the firm is correctly managed, and ensuring that the business climate is suitable for conducting business. Ongoing observation makes it more likely that the business will address a financial company's issue and supply information more voluntarily. A finance organization that constantly monitors a business's condition can frequently identify risks or possibilities for the business and can quickly approve loan requests (Bessis, 2002).

2.1.4.7 Poor risk assessment

When deciding whether to offer substandard and dubious loans, the management and auditors of financial businesses are primarily concerned with risk and the methods by which it may be recognized, measured, and reduced. A loan is never completely risk-free. Any loan has the potential to cause loss for the lender, regardless of how well it is secured or who the borrower is. The interest margin and other conditions imposed at the beginning of the loan should typically represent the degree of risk to which a loan is vulnerable and the possibility of loss that varies.

A finance company evaluates a borrower's quality based on a number of factors, including past and projected profit performance, the strength of its balance sheet (capital and liquidity, for example), the nature of the product and market for it, the political and economic climate of the nation in which it is based, the caliber and stability of its management, and its overall standing and reputation. The financing firm must ascertain the objective of the loan, evaluate its viability, and ascertain how the money needed to pay interest and return capital will be replenished (Conradie & Fourie, 2002).

The inability of finance organizations to collect historical data, decentralized information systems, and inexperienced portfolio managers to detect, quantify, and control regional and industrial risk often results in a lack of effective risk management strategies. They must thus base their decisions mostly on their own experiences, which leads to inadequate risk management strategies for both concentrated and systemic risks.

2.1.4.8 Lack of strict admittance exit policies

Finance businesses, swayed by the notion of obsessively seeking market share, fail to implement comprehensive and stringent market admittance regulations, so undermining the primary risk of gatekeeping and diminishing the market orientation effect of admittance policies. Officers from finance companies paid little attention to the authenticity and integrality assessment of associated information during the pre-loan inquiry. When granting short-term credit, they fail to disclose the genuine purpose of the loan, and the evaluation is too optimistic and fails to account for the possible impact of changing associated circumstances. Additionally, the market has not been thoroughly examined, and the state of firm operation management is not well understood. Inadequate risk reevaluation; erroneous assessments; incomplete coverage of loan risk; ineffective identification of group customer and connected firm risk. The aforementioned elements harm the loans early on (Bessis, 2002).

Additionally, some finance companies operate in a manner different from the review materials, such as signing loan contracts prior to loan approval, issuing letters of credit, or accepting finance company acceptance prior to approval; consolidated credit is not fully realized, and credit to some group members is not included in the consolidated credit management. These companies also fail to take into account the fact that the loan procedures are incomplete or detailed and that there are insufficient review materials. Some give credit in ways that are prohibited by law, such as offering loans above their authority, dividing large sums of money into smaller amounts to get around the authority restriction, approving finance companies to fund businesses on a rolling basis, or offering discounts without any prior trading experience.

The majority of the issues in this case have to do with receiving guarantees from unsuitable organizations, having a high loan-to-value ratio, offering loans without registering property or transferring collateral, firms guarantying one another, and having credit processes that are illegally faulty, among other issues. Additionally, there are issues with loan contracts that are not fulfilled and terms that are not met (Machiraju, 2001).

2.1.3 Impact of non-performing loan

It has a direct impact on financing organizations' profits. It will eventually have an impact on financial organizations' overall performance. Additionally, it has an impact on the competitiveness and liquidity of finance businesses in the public and private sectors, as well as bankers' psychological attitudes regarding extending and extending loans.

Finance businesses, investors, and consumers are directly impacted by an increase in non-performing assets. It has a detrimental effect on the nation's commercial and economic conditions. It produces two different kinds of impacts (Batra & Dass, 2003).

A) Internal impact

Any company enterprise's primary goal is profitability, and finance organizations are no exception. To boost profitability, however, financing organizations are unable to mobilize non-performing assets. They must also set aside money from their earnings and other resources for dubious obligations. For this reason, financing businesses' profits declined and they can even experience losses. Share capital therefore turns into capital deficiency and capital degradation. When a financial company has a low capital or capital adequacy ratio, the central bank may take appropriate measures. Finance businesses must raise their provision for questionable loans as non-performing assets rise, and they must regard the profit as profit if the loan is repaid. The financing corporation must pay income tax as profit if the provision for questionable debts exceeds five percent of the entire loan amount. Thus, it directly affects financing businesses' cash flow. As a result, the financial company's earnings and the use of human resources have both been impacted.

B) External impact

The public deposits are accepted by the financial companies, who then lend money for various uses such as company operations. Finance businesses are unable to reimburse their clients for their deposited funds when a loan fails to provide interest, so turning it into a non-performing asset. The public will no longer support and believe in the financial businesses if they are unable to repay the money that was deposited. Not just that, but furthermore. In order to pay for deposits, financing businesses must take out loans at higher interest rates, which has a direct impact on their profitability and can ultimately cause them to fail or dissolve. It has an impact on the nation's economy and monetary system as well.

C) Impact on profitability

The financing company's profitability is adversely affected by non-performing assets (NPAs). The idle assets owned by financial businesses that don't bring in any money are known as non-performing assets. As a result, we might argue that when NPAs become idle resources, they lower the profitability of financing organizations. Not only has it decreased the financial firms' profits, but it also has the potential to cause customers to lose trust and support.

D) Impact on the outlook of banker towards credit delivery

The modern banking industry's mentality is to shield its clients from all danger and become ambivalent about new lending. Due to this, credit growth has been negatively impacted relative to deposit growth, resulting in an industry-wide low C/D ratio of about 60%. It is clear that the presence of collateral security will, at most, change a loan given to a productive sector into an investment against real estate, but it won't keep the account from becoming non-performing. The most illiquid assets are real estate and further blocked assets, and NPA in these advances tends to last a long time. The future success of nationalized financial businesses is at a standstill and requires an immediate resolution to this looming threat (Shrestha, 2004).

E) Excessive focus on credit risk management

The primary commercial impact of non-performing assets (NPAs) is that it causes credit risk management to take precedence over other facets of a financial company's operations. As a result, the financing company's entire apparatus would be focused on

recovery efforts rather than growing its clientele. Carrying expenses on non-income earning assets would be necessary for a financial firm with a high proportion of non-performing assets. Additional repercussions include decreased interest income, high provisioning, pressure on capital adequacy and profitability, a progressive decline in the capacity to meet cost increases over time, increased pressure on net interest margin (NIM) and consequently decreased competitiveness, a steady depletion of capital resources, and more difficulty in adding capital. Reputational hazards resulting from increased disclosures about the amount and movement of non-performing assets, provisions, etc., are among the less well-known consequences. The psychological effects of a "play safe" mentality and risk aversion, as well as decreased morale and a reluctance to make choices can have non-quantifiable consequences for employees in financial businesses at all levels of management.

Managers of enterprises have lost their innate talent and understanding due to twenty years of controlled and directed banking practices around loan supply. The nationalization of banking did not result in an abundance of skilled labor. External to the daily operations and issues of the Nepalese financial industry were the NRB and Finance Ministry, which provided directive inputs and course guidance. Instead of encouraging initiative and skill, the system fostered nepotism and corruption. Nepalese financial organizations are facing significant challenges in transitioning from antiquated, traditional methods and beliefs to contemporary, professional business ethics and corporate good governance.

F) Excess liquidity lending default

The challenge of growing liquidity in the System faces Nepal's finance industry. Additionally, the Rastriya Banijya Bank (RBB) is lowering different interest rates in order to increase system liquidity. Finance businesses can increase lending to reduce surplus liquidity, but they often avoid doing so because of the significant default risk. The majority of industrialized economies mandate that all finance organizations maintain minimum liquid and cash reserves, which are broadly categorized into the Cash Reserve Ratio (CRR) and the Statutory Liquidity Ratio (SLR), in order to encourage specific norms for sound banking activities. A rate cut (a drop in RR, for example) results in less money being kept in NRB's vaults and adds even more money to the system. However, nearly all financial businesses are dealing with issues related

to nonperforming assets, bad loans, narrowing margins, etc. As a result, they are hesitant to lend money to corporations. As such, however in its monetary policy NRB notifies the bankers no longer joyfully receive rate decrease but such news.

G) High cost of fund due to NPAs

Increasing non-performing assets (NPAs) frequently make it harder for legitimate borrowers to get financing from financial businesses. Either the financing business is unwilling to give the necessary cash to legitimate borrowers, or if it does, it does so at a very high cost in order to make up for the lender's losses from the large percentage of non-performing assets. As a result, corporations frequently choose to obtain money through commercial papers (CPS), where financing companies charge a higher interest rate on working capital.

2.2 Empirical review

Adebisi and Benjamin (2015) investigated the impact of non-performing loans on firm profitability: a focus on the Nigerian banking industry. The study looked at how non-performing loans affected Nigerian banks' bottom lines. The present body of research on the profitability and quality of banks was prompted by the rise in non-performing loans (NPL) in Nigerian banks. Even if the banking sector has undergone changes to guarantee efficient financial institutions, non-performing loans still have an impact on bank owners' money. For a period of seven (7) years (2006–2012), secondary data from the NDIC's Annual Report and Statement of Accounts were used in this study. Regression analysis was done on the data using statistical methods. The first finding showed that there is no correlation between Nigerian banks' Return on Assets (ROA) and Non-performing Loans (NPL). This indicates that the amount of NPL has no impact on the enterprises' asset values. The second finding indicated a correlation between Nigerian banks' Return on Equity (ROE) and Non-performing Loans (NPL), which has an impact on shareholders' desire to maximize their wealth.

Bhattarai (2017) investigated effect of non-performing loan on the profitability of commercial banks in Nepal. This study used pooled data from fourteen commercial banks with 77 observations from 2010 to 2015 to investigate the impact of non-performing loans on the profitability of Nepalese commercial banks. The calculated

regression findings show that while the non-performing loan ratio has a favorable impact on shareholders' return (ROE), it has a negative impact on total bank profitability (ROA). Furthermore, the findings demonstrate that bank profitability (ROA, ROE) is significantly positively impacted by bank size. Cost per loan, however, only significantly positively correlates with total bank profitability (ROA). It is unlikely that the rate of growth in the GDP only benefits shareholders' returns (ROE). This study shows that the nonperforming loan ratio and other factors, such as bank size, cost per loan asset, and gross domestic product growth rate, have an impact on the profitability of Nepalese commercial banks.

Islam (2018) evaluated loan loss provisioning for non-performing loans and its impact on the profitability of commercial banks in Bangladesh. In order to place LLPs and NPLs at the optimal level for company performance, this study tried to assess the effects of LLP maintenance for NPLs on profitability. As a measure of a bank's profitability, the dependent variables in this research are Net-Interest Income to Total Assets and Non-Interest Income to Total Assets. Three independent variables—the Gross NPL to Total Loans Outstanding, the Loan Loss Provision Maintained, and the Surplus/(Shortfall) resulting from the needed loan provisioning—are used to assess the dependent variables using Least Square Multiple Regression. The outcome demonstrated that the independent factors had a very large impact on profitability. The profitability of the company was adversely correlated with both NPLs and LLPs held by commercial banks, with LLPs having a statistically significant negative influence on profitability. If banks want to be as profitable as possible, they should keep their level of LLPs and NPLs as low as possible.

Pant (2018) investigated non-performing loans and bank profitability: study of joint venture banks in Nepal. The study's goal was to examine the macroeconomic and bank-specific factors that contribute to non-performing loans and how they affect profitability. For seven joint ventures, secondary data is collected between 2006 and 2017. In order to determine the impact of several explanatory factors on the non-performing loans of the sampled banks, this study uses a multiple regression equation. The characteristics that are special to banks include the loan to deposit ratio, net interest margin, capital sufficiency, and the size of the bank as determined by total assets. Analogously, the macroeconomic factors encompass GDP expansion, inflation,

and the banking sector's lending concentration as determined by the Herfindahl-Hirschman Index. An example of both an independent and dependent variable is a non-performing loan. The goal of the first step is to identify its drivers, and the variable that emerges as important in the process is identified as the one that impacts profitability. Findings indicate that the non-performing loan is determined by both bank size and net interest margin, with the former having a strong and positive link and the latter having a negative one. The macroeconomic factors, however, are unrelated. Additionally, it is discovered that the profitability is significantly impacted when the net interest margin, bank size, and non-performing loans are utilized as independent variables. When considering solely the size of the bank, there is a negligible correlation between it and return on equity. This study yielded three conclusions, which are: Initially, when banks' net interest margins expand, so does their potential to profit from interest revenue, increasing bankability. Second, a rise in non-performing loans erodes interest revenue, which lowers profitability. Lastly, because the bank must manage enormous activities, poor management practices also grow in proportion to the size of the asset, which hurts profitability.

Gnawali (2018) analyzed non-performing asset and its effects on profitability of Nepalese commercial banks. This study looked at how Nepalese commercial banks' profitability was affected by non-performing loans. The dependent variables are return on equity and return on assets. The following are the independent variables that have been chosen: non-performing loans, loan loss provisions, capital adequacy ratios, ratios of loan loss provisions to total loans, ratios of total loans to total deposits, and firm size. The secondary data used in this study were gathered from a variety of Banking and Financial Statistics publications, the Bank Supervision Report issued by Nepal Rastra Bank, and the annual reports of the banks. With 24 and 80 observations per bank, respectively, the study spans the years 2010 to 2017 for three government banks and ten nongovernment banks. To determine the significance and effect of non-performing loans on the profitability of Nepalese commercial banks, regression models were estimated. The study's main conclusion is that, in the context of Nepalese government banks, non-performing loans have a negative effect on return on assets. The non-performing loan factors, such as size and non-performing loan to total loan (NPLTL), have a negative correlation with the government bank's return on assets (ROA). The

findings indicate that the profitability of Nepalese government banks will decrease with greater nonperforming loan (NPL) percentages, lower nonperforming to total loan (NPLTL), and smaller bank sizes. The capital adequacy ratio (CAR), firm loan loss provision (LLP), and total loan to total deposit ratio (TLTD) of government banks are all shown to have a positive correlation with the profitability of the companies, or return on assets (ROA).

Kingu et al. (2018) investigated impact of non-performing loans on bank's profitability: empirical evidence from commercial banks in Tanzania. This study used the information asymmetry theory and the poor management hypothesis to investigate how non-performing loans affected banks' profitability. This study used panel data from 16 Tanzanian commercial banks from 2007 to 2015 to employ a causality research approach. Multiple regression analysis estimate techniques and descriptive statistics were used in the investigation. Similarly, the Ordinary Least-Squares (OLS) regression approach was employed, followed by an examination of the Fixed Effects (FE) and Random Effects (RE) hypotheses. According to the study, Tanzanian commercial banks' profitability is inversely correlated with the number of non-performing loans they have. The findings strengthen the theories of knowledge asymmetry and poor management. The study's conclusions have managerial and theoretical ramifications for practitioners and decision-makers.

Gautam (2018) analyzed impact of non-performing loans on profitability of Nepalese commercial banks. This study looked at how non-performing loans affected Nepalese commercial banks' profitability during 2007–2008 and 2017–2018. Return on assets (ROA) and return on equity (ROE) are the dependent variables, while the independent variables are the credit to deposit ratio (CDR), net profit to loan and advance (NPLA), interest income to loan and advance (IILA), and non-performing loan to total loan (NPTL). The annual reports of the individual banks are the source of the data. Based on 100 observations from ten distinct Nepalese commercial banks, the study was conducted. Regression models have been used to examine how non-performing loans affect Nepalese commercial banks' profitability. The credit to deposit ratio, net profit to loan and advances, nonperforming loan to total loan, and interest income to loan and advance all have positive beta coefficients when it comes to return on assets. Similarly, the beta coefficient is negative for the non-performing loan to total loan and

interest income to loan and advances on return on equity, but positive for the credit to deposit ratio, net profit to loan, and advances. The non-performing loan to total loan ratio, the credit to deposit ratio, the net profit to loan and advance ratio, and the interest income to loan and advance ratio are significant factors that impact the profitability of Nepal's commercial banks, it may be inferred.

Gabriel et al. (2019) analyzed effect of non-performing loans on the financial performance of commercial banks in Nigeria. The study looked at how non-performing loans affected Nigerian commercial banks' ability to make money from 1985 to 2016. Multiple regression analysis was used in the study to examine data gathered from publications published by the Nigeria Deposit Insurance Corporation (NDIC) and the Central Bank of Nigeria (CBN) for a range of years. According to the study's findings, Return on Asset (ROA) was statistically significantly impacted negatively by both the Cash Reserve Ratio (CRR) and the Non-Performing Loans to Total Loans (NPL/TLR). These findings indicate that Nigerian commercial banks' financial performance will be negatively impacted by a large percentage of non-performing loans. As a result, the study suggests that Nigeria's regulatory bodies establish and foster an atmosphere that enables commercial banks to implement effective risk management strategies.

Martiningtiyas (2020) examined the effect of non-performing loans on profitability in banking sector in Indonesia. Analyzing the impact of non-performing loans on bank profitability was the aim of this study. Profitability is the dependent variable in this study, while non-performing loans is the independent variable. The control variables used in this analysis include size, gross domestic product, capital adequacy ratio, and liquidity ratio. Using purposive selection, this study examines 26 conventional banks that were listed between 2009 and 2017 on the Indonesian Stock Exchange. The study's findings demonstrate that the variable of non-performing loans significantly lowers bank profitability. The profitability of banks is significantly positively impacted by the liquidity ratio and the gross domestic product, but not much by the capital adequacy ratio.

Bhattarai (2020) investigated effects of non-performing loan on profitability of commercial banks in Nepal. This study looks at how non-performing loans affect the

profitability of commercial banks in Nepal. Panel data from twelve commercial banks was gathered during a five-year period, from 2013–2014 to 2017–2018, totaling sixty observations. The data has been analyzed using the multiple regression model. To assess profitability, the fixed effect model, random effect model, and pooled ordinary least square model have all been used. The profitability metric, return on equity (ROE), was considered the dependent variable, whereas the independent variables were inflation (INF), non-performing loans (NPL), capital adequacy ratio (CAR), liquidity (LIQ), and bank size (SIZE). Three distinct models' results showed that ROE is significantly and adversely correlated with NPL, CAR, and LIQ. Likewise, there is a strong positive correlation between SIZE and ROE. With regard to ROE, the INF has a favorable but negligible result. The investigation came to the conclusion that the variables NPL, CAR, LIQ, and SIZE had a significant impact on profitability. Profitability is not greatly impacted by the INF. Nonetheless, nonperforming loans have a significant negative impact on profitability. Sincere payments for over ninety days have been received by the bankers. It also rationally affects the country's economy.

Koten (2021) investigated determination of the relationship between non-performing loans and profitability in the Turkish banking system with panel regression analysis. This study used panel regression analysis to ascertain how non-performing loans affected the profitability of both public and private banks in the Turkish banking sector. In this study, panel regression analysis was used to estimate the impact of non-performing loans/total loans and loan/deposit ratio on the return on assets for the 2010.Q1–2020.Q4 period for 3 publics, 8 private, and 16 foreign capital banks in the banking system. The Hausman test indicated that the Fixed Effects Model was appropriate for the first-order stationary data, and the assumptions were determined by analyzing the results of the Greene heteroscedasticity test and the Wooldridge autocorrelation test. The study produced a statistically significant association that led to a 23 percent reduction in the ratio of non-performing loans to total loans in the Return on Assets. Conversely, there is a statistically significant 11.5 percent correlation between the loan/deposit ratio and the return on assets. According to this analysis, a bank's profitability would decline as its non-performing loan portfolio grows.

Amin et al. (2021) investigated effects of non-performing loan on financial performance: a hypothetical evaluation on all scheduled banks in Bangladesh. Determining the effect of non-performing loans (NPLs) on the financial performance of all Bangladeshi listed banks is the aim of this study. The yearly reports from Bangladesh Bank are taken into consideration for gathering data that has been analyzed using the OLS and VAT models, as well as the STATA 11 (statistical software) Unit Root Test, Heteroscedasticity Test, and Normal Distribution Test. All independent variables, such as NPLR, CAR, INF, and PMR, are statistically significant to explain the dependent variable, ROA, according to an analysis of the OLS regression.

Collakua and Aliu (2021) analyzed impact of non-performing loans on bank's profitability: empirical evidence from commercial banks in Kosovo. The nature of NPL and its effect on the profitability of commercial banks were the main subjects of this investigation. In order to accomplish our aim, we used monthly time series data covering the period of July 2010–July 2019 to undertake a quality analysis. Profit was determined by measuring Return on Assets as a function of the ratio of non-performing loans, liquidity risk (credit to deposit ratio), and bank size as control factors. This was done using the conventional profit theory. Multivariable linear regression was used in this work to estimate the profit function. Regression results demonstrate a substantial negative link between NPL and ROA for the Kosovo bank sector, supporting the study's findings that NPL has a meaningful impact on commercial banks' profitability. The credit to deposit ratio, or liquidity risk, has a negative correlation with bank profitability, but one that is not statistically significant. Ultimately, there is a positive and statistically significant association between bank size and bank profitability (ROA). Bank size has a significant influence in improving financial performance and can act as an amortization in the event that a bank experiences loan default.

Uddin (2022) analyzed the effect of non-performing loan on state-owned commercial banks' profitability with operating efficiency as mediating variable. The purpose of the study was to look at how non-performing loans affected profitability while controlling for operating efficiency. Path analysis, multiple regression analysis, and descriptive data analysis are the methods employed. According to the study,

operational efficiency has a small but negative influence on profitability, whereas nonperforming loans have a positive but minor effect on operating efficiency. The statistical analysis examining the direct impact of non-performing loans on profitability demonstrates that, even in the presence of operating efficiency, non-performing loans have a substantial and adverse influence on profitability. Operating efficiency has no mediating impact on the connection between non-performing loans and the profitability of state-owned commercial banks, according to the PROCESS Macro mediation effect findings.

Rusli and Fitriana (2023) investigated the effect of non-performing loans (NPL) to the bank profitability during the Covid-19 Pandemic: case study of Buku III bank in Indonesia. This research investigated the impact of non-performing loans on bank profitability amidst the Covid-19 pandemic. Additionally, a case study of seven Indonesian Buku III banks—Bank HSBC Indonesia, Bank Tabungan Negara, Bank DBS Indonesia, Bank Permata, Bank Mega, Bank DKI, and Maybank Indonesia—that provided financial data from 2019 to 2021 was undertaken. The research using SPSS version 25 reveals that partially non-performing loans, or NPLs, have little impact on the profitability of banks, as shown by ROA and ROE. However, the same circumstance can also be seen in the analytical test findings, which show that non-performing credit variables—that is, NPLs—have no effect on bank profitability as measured by ROA and ROE.

2.3 Research gap

Study gaps in relevant prior research are referred to as research gaps. Limited study has been done on the effect of non-performing loans on the profitability of financial organizations by various experts, researchers, and students. The region not addressed by earlier research is crucial. They only discovered a small number of results; more testing, as well as the modification of relevant factors, are required to draw more firm conclusions regarding the non-performing loan and profitability.

There is a research gap in the time period and sample firms between this study and earlier research. Furthermore, earlier research relied mostly on data spanning five years. The data included in this study spans the last 10 years. Three financing

businesses serve as the only basis for this investigation. In addition, multiple regression analysis is used in this study to analyze explanatory variables that were not examined in earlier research, such as the size of the financing firm, the inflation rate, the credit to deposit ratio, the non-performing loan ratio, and the capital adequacy ratio. Thus, this work aims to close the aforementioned research gap.

CHAPTER - III
RESEARCH METHODOLOGY

The methodical process of solving an issue by systematic information gathering, recording, analysis, interpretation, and reporting regarding the many aspects of a phenomena under study is known as research methodology. The procedures and methods used throughout every part of the investigation are described in the research methodology of this work. The population and sample, data sources, study strategy, variable definitions, and data analysis techniques are all covered in this chapter.

3.1 Research design

A research design is a comprehensive strategy, scheme, or program. The study used a descriptive and causal research design for its research methodology. The descriptive research design is used to explain the features of the sample firms and includes descriptive statistics such as mean, standard deviation, minimum and maximum values of variables. Regression analysis, correlation analysis, and determining the strength and direction of the association between dependent and independent variables are all conducted using a causal comparative study methodology.

3.2 Population and sample, and sampling design

At present, there are 17 commercial finance companies operating in Nepal (till May, 2023). They constitute the population. Among of them, only three finance companies are selected namely; Shree Investment & Finance Company Limited (SIFC), Manjushree Financial Institution Limited (MFIL), Goodwill Finance Company Limited (GFCL), Pokhara Finance Limited (PFL), Progressive Finance Limited (PROFL) are selected as sample for the study of the effect of non-performing loan on profitability of finance companies on the basis of purposive sampling method. These sample finance companies are top five in profitability in the present context and managing non-performing loan. Moreover, these finance companies are chosen due to the availability of data.

3.3 Nature and sources of data, and instrument of data collection

The secondary data is used by the research to achieve its goals. Secondary data are those that have previously been gathered or utilized by another party and are made public through published statistics found in journals, newspapers, magazines, annual reports, and other publications. A main piece of data loses its uniqueness and becoming secondary once it is utilized. The primary source of data for this study is secondary data, specifically the annual reports of the relevant financing businesses. In addition to the yearly reports, several additional data sources, such as newspapers, magazines, economic journals, NRB reports, and study plan documents, have also been used.

3.4 Method of analysis

To make the study more specific and reliable, the researcher uses following types of tools for analysis;

Descriptive Statistics

This study explains the nature, features, and trend of these variables over the sample period using a summary of descriptive data related to the non-performing loan ratio and its effect on the profitability of Nepalese financing organizations. Descriptive statistics are used to characterize the features of non-performing loans and their effect on profitability for sample finance companies from 2012/13 to 2021/22, including mean, standard deviations, minimum and maximum values of variables like credit to deposit ratio, non-performing loan ratio, capital adequacy ratio, bank size, and inflation rate.

Correlation coefficient (r)

One statistical approach for examining the relationship between two variables is correlation. The intensity and direction of a linear relationship between two variables are measured by the number r, often known as the linear correlation coefficient. In honor of its creator, Karl Pearson, the linear correlation coefficient is also frequently referred to as the Pearson product moment correlation coefficient. If a change in one variable's value seems to be connected to or associated with a change in another variable, then two or more variables are said to be correlated. Correlation analysis is

the suitable statistical method for identifying a link when it is quantitative in character and condensing it into a short formula.

$$\text{Correlation Coefficient (r)} = \frac{n\Sigma xy - \Sigma x\Sigma y}{\sqrt{n\Sigma x^2 - (\Sigma x)^2}\sqrt{n\Sigma y^2 - (\Sigma y)^2}}$$

The value of 'r' is such that -1 < r < +1.The +ve and -ve signs are used for positive linear correlations and negative linear correlations, respectively.

Positive correlation: If 'x' and 'y' have a perfect positive linear correlation, 'r' is +1.

Negative correlation: If 'x' and 'y' have a perfect negative linear correlation, 'r' is -1.

No correlation: If there is no linear correlation or a weak linear correlation, 'r' is close to 0.

Multiple regressions analysis

By fitting a linear equation to observed data, multiple linear regression aims to predict the connection between two or more explanatory factors and a response variable. The dependent variable y has a value for each value of the independent variable x. The link between the explanatory factors and the dependent variables of finance firm profitability, namely return on equity (ROE) and return on assets (ROA), will be examined by regression analysis. The explanatory variables are independent variables, which are taken from finance company specific (internal) factors such as size of finance company (SIZE), non-performing loan ratio (NPLR), credit to deposit ratio (CDR), capital adequacy ratio (CAR) and external factor i.e. inflation rate.

Regression analysis model

The model estimated in this study assumes that the finance company profitability measures ROA and ROE depend on finance company specific variables. Therefore, the following model has been employed for the study of relationship and effect of the study variables.

Model 1: $ROA = \beta_0 + \beta_1 CDRit + \beta_2 NPLR_{it} + \beta_3 CAR_{it} + \beta_4 SIZE_{it} + \beta 4 INFit + e_{it}$ (1)

Model 2: $ROE = \beta_0 + \beta_1 CDRit + \beta_2 NPLR_{it} + \beta_3 CAR_{it} + \beta_4 SIZE_{it} + \beta 4 INFit + e_{it}$ (2)

Where:

ROA_{it} = Return on assets of finance company i^{th} for the time period t

ROE_{it} = Return on equity of finance company i^{th} for the time period t

CDR_it = Credit to deposit ratio for time period t

$NPLR_{it}$ = Non-performing loan ratio for time period t

CAR_{it} = Capital adequacy ratio of finance company i^{th} for the time period t

$SIZE_{it}$ = Size of the finance company (total assets) i^{th} for the time period t

INF_{it} = Inflation rate for the time period t

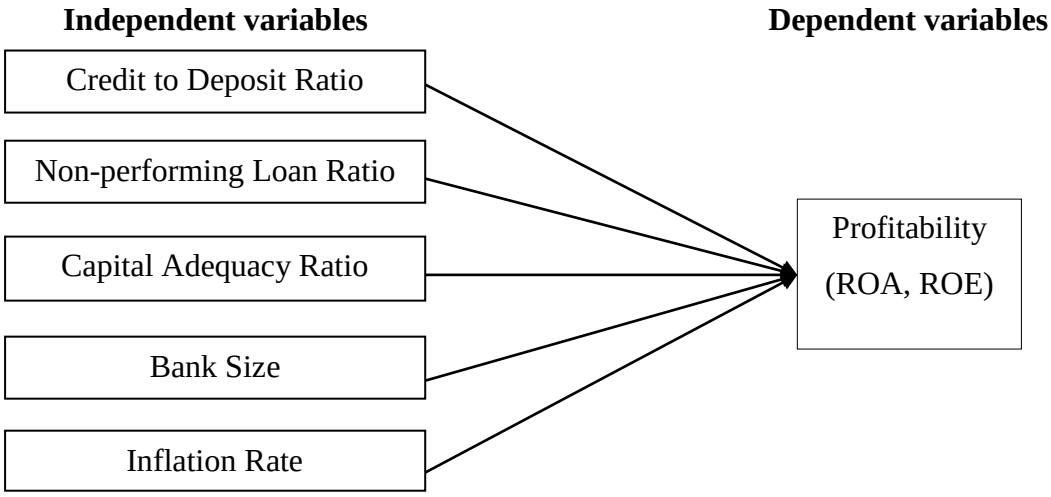
β_0 = The intercept (constant)

β_1, β_2, β_3, β_4, β_5 = The slope which represents the degree with which finance company performance changes as the independent variable changes by one unit variable.

e = error component

3.5 Research framework and definition of the variables

From the theoretical and empirical literature reviews, the following conceptual framework of the study is developed by the researcher.



Source: Bhattarai (2017); Nyarko-Baasi (2018); Martiningtiyas (2020); Bhattarai (2020); Collakua and Aliu (2021) and Uddin (2022)

Figure 1. Research framework

Credit to deposit ratio

CDR As its name suggests, the loan to deposit ratio is calculated by dividing the entire amount of loans and advances by the total amount of deposits. In order to continue its regular business activities, a lending institution that takes deposits has to maintain a particular level of liquidity. Most of the loans it makes to its clients aren't regarded as liquid, therefore they're investments that take longer to mature. In order to guarantee that any necessary funds may be obtained quickly, finance companies may decide to retain a portion of their non-lending investments in short-term securities in addition to the minimum required reserves. One measure of credit risk is the ratio (TLA/TD) of total loans and advances to total deposits. It concerns how much money

finance businesses get in the form of deposits compared to the amount they take out in the form of loans. If the loans are used to secure borrowers, the finance business will earn higher interest the more money it has loaned out. Deposits represent the financing company's obligations to the depositors. In order to pay for depositor accounts, a sound finance firm has a large number of safe loans that generate a large amount of revenue (interest) (Pokharel & Pokharel, 2020).

Non-performing loan ratio

The non-performing loan ratio (NPLR) is one of the most important indicators of credit risk and financial stability. A rise in NPLR is thought to indicate that finance companies' credit policies have failed, that their earnings have decreased, and that the financial crisis was largely caused by these factors (Bhattarai, 2017). Due to the fact that NPLR shows the percentage of nonperforming loans in the whole loan portfolio, it is also seen as an indicator of how finance organizations handle their credit evaluation. If the borrower is still making payments on the loan, the term "nonperforming loan" is more commonly used to describe late payments than default. But the likelihood of a loan being fully repaid is negligible after it enters non-performance (Bhattarai, 2017).

Capital adequacy ratio

The capital of a financing firm is gauged by the capital adequacy ratio, or CAR. It is given as a proportion of the risk-weighted credit exposures of a financial firm. One of the characteristics unique to finance companies that affects how profitable they are is capital. Capital is the amount of cash on hand that finance businesses may use to maintain their operations and serve as a safety net in the event of unfavorable circumstances. According to Uddin (2022), the capital adequacy ratio significantly boosts profitability. Bhattarai (2020), however, discovered a sizable detrimental effect of the capital adequacy ratio on profitability. The capital adequacy ratio is computed by dividing the total assets by the capital fund. Nepal's commercial banks and financing firms are required by the NRB guidelines to have their capital adequacy ratio above 11 percent.

Size of the finance companies (Size)

The natural logarithm of a finance company's total assets determines its size. Size has been considered an internal independent variable unique to finance firms in this study since it affects the profitability of finance companies. Collakua and Aliub (2021) discovered that a company's size positively impacted its profitability. According to the study's findings, huge businesses cut expenses because of the economies of scale that come with their size. Big financial firms can also acquire money more affordably.

Inflation rate (INF)

A rise in inflation lowers the actual rate of return on assets overall, not just on money, claims a contemporary theory of information asymmetry in the credit market. Credit market frictions are made worse by the projected decline in real returns. Credit is rationed as a result of these market frictions, and credit rationing gets worse as inflation increases. As a result, there are negative effects on capital and long-term investment, less loans are made by the banking sector, and resource allocation is less effective. In turn, when inflation rises, so do the amounts of liquid or short-term assets held by economic actors, such as financial businesses. The yearly gross inflation rate was employed as a stand-in for inflation.

Return on assets (ROA)

A financial measure called return on assets (ROA) indicates how much profit (or percentage of return) a business is making relative to its total resources. The net income for the year divided by the total assets—typically the average value during the year—is the return on assets, or ROA. The return on assets (ROA) of a finance firm is an indicator of the management's capacity to turn a profit on the assets used by the company in its operations. Given that it shows the returns on the assets a finance business has, this ratio is perhaps the most significant one for evaluating the effectiveness and operational performance of finance firms. It demonstrates how well assets are managed to produce profits. According to Bhattarai (2020), the return on total assets (ROA) after interest and taxes is determined by dividing net income by total assets. This ratio is computed by dividing net profit after taxes by the total amount of assets.

Return on equity (ROE)

The most often used internal performance indicator of shareholder value is the ratio of return on equity, or ROE. The return to shareholders on their equity is known as return on equity. According to Bhattarai (2020), return on equity (ROE) is a metric used to assess a company's performance that indicates how much profit it makes using the capital that shareholders have contributed. the proportion of stockholder equity that represents the amount of net income returned. The net income for the entire fiscal year is calculated after distributions to preferred shares and before dividends paid to common stockholders. Net profit after taxes is divided by the average total shareholder equity fund to arrive at this percentage.

CHAPTER - IV
RESULTS AND DISCUSSION

The primary objective of this study is to look at non-performing loans and how they affect the profitability of finance businesses in Nepal, as the researcher covered in the earlier chapters. As a consequence, this chapter, which is divided into three sections, deals with the findings and their analysis. The study's variables were the subject of descriptive and correlation analyses in the first section; the assumptions of the linear regression model were fulfilled in the second section; and the regression's findings were given in the third section. For additional statistical analysis, the ratio of the designated dependent and independent variables as well as the ratio scale measurement were computed using data analysis techniques. The statistical analysis of the gathered data was conducted with the assistance of SPSS version 26.

4.1 Results

4.1.1 Structure and pattern of variables

Using financial and statistical methods and the last ten years' worth of data from a sample of finance organizations, the structure and pattern of the variables have been examined. This research looks at the credit to deposit ratio, non-performing loan ratio, capital adequacy ratio, company size, return on equity, and return on assets in order to analyze the structure of five finance businesses.

4.1.1.1 Credit to deposit ratio

The credit to deposit ratio, or total credit divided by total deposits, is used to calculate this ratio. In order to continue its regular business activities, a lending institution that takes deposits has to maintain a particular level of liquidity. One measure of profitability is the loan to deposit ratio (CDR). It concerns how much money finance businesses get in the form of deposits compared to the amount they take out in the form of loans. As long as the loans are used to secure debtors, the more money the corporation has given out creates more interest income.

Table 1

Structure and pattern of credit to deposit ratio of sample finance companies

(In percent)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	83.67	86.38	81.44	68.64	80.78
2013/14	76.79	79.85	79.12	85.07	84.29
2014/15	73.17	81.95	74.96	83.59	82.07
2015/16	79.62	83.73	79.15	81.57	84.41
2016/17	77.50	99.72	84.39	107.51	89.73
2017/18	80.09	83.03	94.64	63.33	90.83
2018/19	80.54	73.26	90.30	91.02	90.30
2019/20	74.32	88.04	88.26	85.25	83.02
2020/21	71.33	72.19	69.53	90.37	77.57
2021/22	84.10	87.06	81.13	81.70	88.41
Mean	78.11	83.52	82.29	83.80	85.14
SD	4.29	7.84	7.42	12.11	4.50
CV	5.49	9.39	9.01	14.45	5.28

Source: Appendix –I

Table 1 reveals that the credit to deposit ratio of sample finance companies in Nepal. The ratios of all finance companies are in fluctuating trend. The highest credit to deposit ratio is 107.51 percent of PROFL in fiscal year 2016/17 and also the lowest the ratio is 63.33 percent of PROFL in fiscal year 2017/18. The highest average ratio of PFL is 85.14 percent. The lowest average credit to deposit ratio is 78.11 percent of GFCL. It can be concluded that PFL is the most successful among them to mobilize its total deposit as loan and advances and acquiring high profit. The standard deviation of GFCL is lowest among them which mean GFCL has the lowest risk among the sample finance companies. By the coefficient of variation of the ratios, it can be concluded that PFL has seen the most consistent in the ratios with the lowest CV of 5.28 percent among them.

4.1.1.2 Non-performing loan ratio

The success of financial businesses is directly impacted by the quality of their loan portfolio. Losses from past-due loans are the biggest risk a financial business faces. The best indicators of asset quality are hence nonperforming loan ratios. Various financial ratios are used by different academics to analyze the financial performance of finance organizations. Maintaining a low percentage of nonperforming loans is the top priority for all finance organizations. This is true as a large percentage of nonperforming loans has an impact on financial organizations' performance.

Therefore, a finance company's healthy portfolio is indicated by a low ratio of nonperforming loans to total loans. The better the firm does, the smaller the ratio.

Table 2

Structure and pattern of non-performing loan ratio of sample finance companies

(In percent)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	0.82	3.74	0.17	34.50	3.83
2013/14	1.76	4.37	0.12	19.63	2.33
2014/15	4.16	5.22	0.13	3.02	2.31
2015/16	2.04	3.71	0.09	1.64	1.71
2016/17	2.71	3.21	0.25	1.72	1.45
2017/18	2.75	2.24	0.17	1.92	1.13
2018/19	2.83	3.56	0.16	1.42	0.80
2019/20	1.16	3.37	0.68	3.41	1.00
2020/21	3.58	1.75	0.89	3.46	1.42
2021/22	2.30	1.58	0.61	2.78	1.36
Mean	2.41	3.27	0.33	7.35	1.73
SD	1.03	1.14	0.29	10.99	0.89
CV	42.54	34.85	88.08	149.57	51.51

Source: Appendix –I

Table 2 depicts that the non-performing loan ratio or credit risk of sample finance companies in Nepal. The average ratios of all finance companies are less than 5 percent. The highest non-performing loan ratio is 34.50 percent of PROFL in fiscal year 2012/113 and the lowest the ratio is 0.09 percent of PROFL in fiscal year 2015/16. The highest average ratio of PROFL is 7.35 percent. The lowest average non-performing loan ratio is 0.33 percent of SIFC. It is meant that SIFC performing best or maintaining their NPLs perfectly among them which shows SIFC has lowest credit risk among them. It can be concluded that SIFC has regular supervision and follow up for proper utilization of loan. The standard deviation of SIFC is lowest among them which mean SIFC has the lowest risk among the sample finance companies. By the coefficient of variation of the ratios, it can be concluded that MFIL has seen the most consistent in the ratios with the lowest CV of 34.85 percent among them.

4.1.1.3 Capital adequacy ratio

Capital ratios show how resilient financial organizations are to shocks. These ratios show which issues are now present. Problems with capital sufficiency and increased

risk exposure might result from negative developments in these ratios. The equity/total assets ratio, or CAR, was employed in this study to gauge capital adequacy. Put another way, this equity ratio represents the financial businesses' solvency or capital strength compared to their overall assets. A higher percentage indicates improved financial performance and increased stability and efficiency of the financing organization.

Table 3

Structure and pattern of capital adequacy ratio of sample finance companies

(In percent)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	13.12	19.05	13.26	30.19	16.64
2013/14	11.30	15.24	13.76	26.26	15.50
2014/15	11.22	11.40	15.14	23.16	17.67
2015/16	11.52	10.41	14.87	26.64	18.00
2016/17	13.36	17.18	15.71	28.19	16.73
2017/18	15.48	12.19	19.60	27.12	20.71
2018/19	13.73	10.42	23.00	42.72	15.69
2019/20	11.27	14.10	17.75	30.17	13.79
2020/21	13.33	12.81	16.19	22.05	12.48
2021/22	12.78	11.35	14.74	147.42	10.59
Mean	12.71	13.42	16.40	40.39	15.78
SD	1.39	2.94	2.97	38.03	2.91
CV	10.94	21.93	18.13	94.15	18.47

Source: Appendix –I

Table 3 represents that the capital adequacy ratio of sample finance companies in Nepal. The highest average capital adequacy ratio of PROFL is 40.39 percent. The lowest average capital adequacy ratio is 12.71 percent of GFCL. Higher the ratio, more stable and efficient the finance company is and good performance. That's why, PROFL has the highest the degree of protection money to depositors as well as efficiency and stability of a finance company performance. In terms of variability, the minimum standard deviation of 1.39 percent was realized for GFCL and the maximum standard deviation of 38.03 percent was realized by PROFL. It indicates that GFCL was considered as the least variation in terms of capital adequacy ratio and PROFL was considered as highest variation in terms of CAR. By the coefficient of variation of the ratios, it can be concluded that GFCL has seen the most consistent in the ratios with the lowest CV of 10.94 percent among them.

4.1.1.4 Size of the companies

Total assets divided by the natural logarithm of the company's size. Since firm size affects the performance of the financing company, it has been considered a specific internal independent variable in this study. Performance has a good or negative connection. If this is the case, managing a larger firm will be more challenging. On the other hand, because of the economies of scale that come with size, it has been determined that larger businesses may raise money more cheaply. For this reason, it is one of the crucial markers of the business's profitability.

Table 4

Structure and pattern of size of sample finance companies

(Rs. in million)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	2651885	1315068	1817486	338632	2516796
2013/14	3366345	1623639	1945000	373334	2920286
2014/15	3750700	2480614	1959477	400393	3398063
2015/16	4797665	3015233	2190458	735001	3804972
2016/17	5789969	4694277	4156983	775592	4603840
2017/18	7055546	7075727	4952714	1089891	5748148
2018/19	8724012	9848508	4875119	1976775	7757867
2019/20	10853623	9251053	6523430	2843506	8949002
2020/21	13294408	13711433	7901611	4088614	10864957
2021/22	15265893	15927769	9053451	6191428	13409025
Mean	7555004.60	6894332.10	4537572.90	1881316.60	6397295.60
SD	4367454.49	5171148.52	2632288.78	1954885.21	3711663.21
CV	57.81	75.01	58.01	103.91	58.02

Source: Appendix –I

Table 4 represents that the size of finance companies in Nepal. The highest size of companies is Rs.15927769 million of MFIL in fiscal year 2021/22 and the lowest the size of companies is Rs.338632 of PROFL in fiscal year 2012/13. The highest average size of companies of GFCL is Rs.7555004.60. The lowest average size of companies of PROFL is Rs.1881316.60. It reveals that the average size of companies of GFCL in Nepal during the study period is biggest. The finance company can reduce costs due to economies of scale that this entails; large finance companies can also raise capital at a lower cost. The standard deviation of PROFL is lowest among them which means PROFL has the lowest risk among the sample finance companies. By the coefficient of variation of the ratios, it can be concluded that GFCL has seen the most consistent in the ratios with the lowest CV of 57.81 percent among them.

4.1.1.5 Return on assets (ROA)

One key metric used to compare the financial performance of finance organizations was return on assets, or ROA. A financial measure called return on assets (ROA) indicates the percentage of profit (profit) that a finance firm generates in comparison to its total resources. The net income for the year divided by the total assets—typically the average value during the year—is the return on assets, or ROA. The return on assets (ROA) of a finance firm indicates how profitable its management is able to make use of the assets the company uses for its operations.

Table 5

Structure and pattern of return on assets of sample finance companies

(In percent)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	0.92	1.04	2.17	-8.52	0.64
2013/14	1.67	0.79	1.43	-1.12	2.22
2014/15	1.13	0.80	1.54	-1.33	4.60
2015/16	2.85	1.09	1.38	2.85	2.31
2016/17	1.67	1.09	3.14	1.68	1.92
2017/18	0.88	1.29	1.85	0.61	1.76
2018/19	1.69	0.74	2.67	1.43	1.32
2019/20	1.05	2.85	1.72	0.16	0.82
2020/21	1.46	3.63	1.45	1.01	1.08
2021/22	1.24	0.69	1.00	0.81	0.68
Mean	1.45	1.40	1.83	-0.24	1.74
SD	0.58	1.00	0.65	3.16	1.18
CV	39.85	71.63	35.50	-1303.27	68.12

Source: Appendix –I

Table 5 shows that the return on assets of sample finance companies in Nepal. The highest return on assets is 4.60 percent of PFL in fiscal year 2014/15 and the lowest the return on assets is -8.52 percent of PROFL in fiscal year 2012/13. The highest average return on assets of SIFC is 1.83 percent. The lowest average return on assets of PROFL is -0.24 percent. It indicates that, SIFC could manage their overall operations due to highest ratio among them. In other word, SIFC is able to make highest return to its assets by optimum utilization of the asset that contributes more to the combined mean of ROA. The standard deviation of GFCL is lowest among them which means GFCL has the lowest risk among the sample finance companies. By the coefficient of variation of the ratios, it can be concluded that SIFC

has seen the most consistent in the ratios with the lowest CV of 35.50 percent among them.

4.1.1.6 Return on equity (ROE)

The other metric used to assess profitability success is return on equity. The most often used internal performance indicator of shareholder value is the ratio of return on equity, or ROE. The amount paid to shareholders on their equity is known as return on equity. Return on equity is a metric used to assess a business's profitability that shows how much money is made using the capital that shareholders have placed in the financial firm. The proportion of shareholders' equity that represents the net income returned.

Table 6

Structure and pattern of return on equity of sample finance companies

(In percent)

Year	GFCL	MFIL	SIFC	PROFL	PFL
2012/13	7.02	5.46	16.36	-28.23	3.82
2013/14	14.80	5.16	10.39	-4.27	14.34
2014/15	10.04	7.05	10.18	-5.74	26.03
2015/16	24.70	10.49	9.29	10.70	12.85
2016/17	12.52	6.35	19.99	5.96	11.49
2017/18	5.67	10.59	9.46	2.26	8.50
2018/19	12.34	7.12	11.59	3.34	8.41
2019/20	9.29	20.18	9.67	0.52	5.97
2020/21	10.92	28.30	8.95	4.56	8.67
2021/22	9.66	6.05	6.81	0.55	6.40
Mean	11.70	10.67	11.27	-1.03	10.65
SD	5.28	7.64	3.93	10.67	6.29
CV	45.18	71.54	34.89	-1031.70	59.08

Source: Appendix –I

Table 6 reveals that the return on equity of sample finance companies in Nepal. The highest return on equity is 28.30 percent of MFIL in fiscal year 2020/21 and the lowest the return on equity is -28.23 percent of PROFL in fiscal year 2012/13. The highest average return on equity of GFCL is 11.70 percent. The lowest average return on equity of PROFL is -1.03 percent. It is meant that the return on equity for the GFCL is the best or most effective management in earning profit among them. Moreover, it can be said that GFCL is generating more income and making progressive performance among them. The standard deviation of SIFC is lowest

among them which means SIFC has the lowest risk among the sample finance companies. By the coefficient of variation of the ratios, it can be concluded that SIFC has seen the most consistent in the ratios with the lowest CV of 34.89 percent among them.

4.1.2 Descriptive statistics of variables

Table 7 presents the descriptive statistics for the variables utilized in the investigation. The outcome demonstrates the lowest and highest performance metrics for the profitability indicators ROE and ROA, as well as other independent factors, for Nepali financial businesses.

Table 7

Descriptive statistics of variables of sample finance companies

Variables	N	Minimum	Maximum	Mean	Std. Deviation
CDR	50	63.33	107.51	82.5744	7.83237
NPLR	50	0.09	34.50	3.0194	5.33991
CAR	50	10.41	147.42	19.7400	19.53277
LSIZE	50	5.53	7.20	6.5806	0.41920
INF	50	3.60	9.93	6.5510	2.30315
ROA	50	-8.52	4.60	1.2370	1.73362
ROE	50	-28.23	28.30	8.6506	8.42259

Source: Appendix –II

Table 7 shows the descriptive statistics of dependent and independent variables used in the study. The first independent variables credit to deposit ratio shows that this ratio varies from a minimum of 63.33 percent to a maximum of 107.51 percent with an average of 82.5744 percent and standard deviation of 7.83237. The second independent variables non-performing loan ratio shows that this ratio varies from a minimum of 0.09 percent to a maximum of 34.50 percent with an average of 3.0194 percent and standard deviation of 5.33991. CAR ranged from 10.41 to 147.42 percent respectively. Then, the average CAR is 19.7400 percent with the standard deviation of 19.53277. On the control variable, the assets size has a range from 5.53 to 7.20 and mean of 6.5806 with the standard deviation of 0.41920. It reveals that the average assets size of finance companies in Nepal during the study period is bigger. The independent variable inflation rate (INF) has average of 6.5510 percent with the standard deviation of 2.30315 and the minimum and maximum range from 3.60 to 9.93 percent.

The summary of ROA shows that the average return on assets over the study period is 1.2370 percent and standard deviation of 1.73362, the maximum return on assets is 4.60 percent and the minimum of -8.52 percent. The return on assets shows how efficient the finance companies are using its assets to generate profit measured by profit before interest and tax divided by total assets. ROE mean is 8.6506 percent from the range to minimum -28.23 to maximum 28.30 percent, which is not satisfactory since it is not between ROE 15 to 25 or average. Then, standard deviation for ROE is 8.42259.

4.1.3 Correlation analysis

A table displaying correlation coefficients between variables is called a correlation matrix. The correlation between two matching variables is displayed in each cell of the table. Data may be summarized using a correlation matrix. This gives us a quick overview of the variables that correlate at different strengths and levels of significance. A correlation value of 0 signifies the absence of a linear relationship between the two variables. The correlation coefficient between two variables goes from +1, which represents a perfect positive link, to -1, which represents a perfect negative relationship. In Table 8, the correlation matrix is displayed as follows.

Table 8

Pearson correlation coefficients of study variables

	CDR	NPLR	CAR	LSIZE	INF	ROA	ROE
CDR	1						
NPLR	-.221	1					
CAR	.069	.103	1				
LSIZE	-.023	-.490**	-.130	1			
INF	-.129	.270	-.035	-.521**	1		
ROA	.223	-.829**	-.134	.436**	-.199	1	
ROE	.048	-.683**	-.292*	.496**	-.118	.924**	1

**. Correlation is significant at the 0.01 level (2-tailed).

*. Correlation is significant at the 0.05 level (2-tailed).

Source: Appendix-III

Table 8 reveals the correlation test between both dependent and independent variables using correlation coefficient matrix. The correlation test shows that credit to deposit ratio (CDR) has insignificant relation with ROA in 5 percent level of significance with correlation coefficients 0.223 which means that there is positive correlation between CDR and ROA. At the same time, credit to deposit ratio has also

insignificant positive relation with ROE. Then, there is significant negative correlation of non-performing loan ratio with ROA and ROE. This analysis also shows that capital adequacy ratio has insignificant negative relationship with ROA and significant negative relationship with ROE of the finance companies. At the same time, size of companies (LSIZE) has significant positive relationship with ROA and ROE. Moreover, inflation rate has insignificant negative relationship with profitability (ROA and ROE) of the finance companies.

4.1.4 Regression analysis

When the emphasis is on the link between dependent variables (ROA and ROE) and independent factors (credit to deposit ratio, non-performing loan ratio, capital adequacy ratio, size of enterprises, and inflation rate), it encompasses a variety of modeling and analysis methodologies. One of the main analytical tools for panel data analysis is ordinary least square regression (OLS).

Table 9

Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.834[a]	.695	.661	1.00955

a. Predictors: (Constant), INF, CAR, CDR, NPLR, LSIZE
b. Dependent Variable: ROA

Source: Appendix-IV

R^2 value is 0.695 means the model fits (accounts) for 69.50 percent of the variance in the dependent variable, ROA. The strength of variables relationship (multiple correlation coefficients) is based on the value of R statistic which is 0.834, indicated that there is a high degree of relationship between study variables. This implies that the ROA was highly influenced by its independent variables. Standard error of estimate is flawlessly associated with regression analysis.

Table 10

Analysis of variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	102.423	5	20.485	20.099	.000[b]
	Residual	44.844	44	1.019		
	Total	147.267	49			

a. Dependent Variable: ROA
b. Predictors: (Constant), INF, CAR, CDR, NPLR, LSIZE
Source: Appendix-IV

An examination with ANOVA (F–value) indicates that explains the most possible combination of predictor variables that could contribute to the impact of dependent variables. Results show significant impact of ROA indicator. On the F-values of 20.099 ($p = 0.000 < 0.05$) for INF, CAR, CDR, NPLR, LSIZE as ROA proxy, it clearly shows that there is a significant relationship between the dependent variable (ROA) and the independent variables.

Table 11

Regression coefficient of independent variables with ROA

Variables	Coefficients	t-statistics	p-value	Collinearity Statistics	
				Tolerance	VIF
(Constant)	-1.393	-.347	.730		
CDR	.014	.701	.487	.899	1.112
NPLR	-.256	-7.958	.000	.703	1.423
CAR	-.004	-.531	.598	.962	1.039
LSIZE	.314	.683	.008	.561	1.782
INF	.045	.601	.551	.700	1.429

Source: Appendix-IV

Table 11 presents the regression coefficient of independent variables credit to deposit ratio, non-performing loan ratio, capital adequacy ratio, size of companies and inflation rate and the intercept value of dependent variable ROA. P-value indicates at what percentage or precession level of each variable is significant. Tolerance indicates the percent of variance in the independent variable that cannot be accounted for by the other independent variable while variance inflation factor (VIF) is the inverse of tolerance. It shows that tolerance values were above 0.1 and VIF below 10. That's why, there is no multicollinearity in the model.

The results of regression model indicated that the relationship between credit to deposit ratio (CDR) has a positive relationship with ROA by a coefficient estimate of 0.014. This means that holding other independent variables constant and when one percent increases in credit to deposit ratio (CDR), as a result it increases ROA of the finance companies by 0.014 percent and the p value of credit to deposit ratio (CDR) is 0.487 discloses that it is statistically insignificant at 5 percent level of significance.

The results of regression shows that the relationship between non-performing loan ratio (NPLR) has a negative relationship with ROA by a coefficient estimate of -0.256. This means that holding other independent variables constant and when one percent increases in non-performing loan ratio (NPLR), as a result it decreases ROA of the finance companies by 0.256 percent and the p value of non-performing loan ratio (NPLR) is 0.000 discloses that it is statistically significant at 5 percent level of significance. This means NPLR has significant impact on ROA of finance companies.

According to the regression result of capital adequacy ratio (CAR) has a negative relationship with ROA by a coefficient estimate of -0.004. This means that holding other independent variables constant and when one percent increases in capital adequacy ratio (CAR), consequently it decreases ROA of the finance companies by 0.004 percent and the p value of capital adequacy ratio (CAR) is 0.598 reveals that it is statistically insignificant at 5 percent level of significance. Accordingly, the result supports the working hypothesis that capital adequacy ratio (CAR) have negative and statistically insignificant effect on ROA of finance companies.

The results of regression model indicated that the relationship between size of finance companies (LSIZE) has a positive relationship with ROA by a coefficient estimate of 0.314. This means that holding other independent variables constant and when one percent increases in size of finance companies (LSIZE), as a result it increases ROA of the finance companies by 0.314 percent and the p value of size of finance companies (LSIZE) is 0.008 discloses that it is statistically significant at 5 percent level of significance. Hence, this is significant negative relationship between size of finance companies (LSIZE) and ROA.

According to the regression result of inflation rate (INF) has a positive relationship with ROA by a coefficient estimate of 0.045. This means that holding other independent variables constant and when one percent increases in inflation rate (INF), as a result it increases ROA of the finance companies by 0.045 percent and p value of inflation rate (INF) is 0.551 reveals that it is statistically insignificant at 5 percent level of significance. Accordingly, the result supports the working hypothesis that inflation rate (INF) have statistically insignificant positive effect on ROA of finance companies.

Table 12

Model summary

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.754[a]	.568	.519	5.84222

a. Predictors: (Constant), INF, CAR, CDR, NPLR, LSIZE
b. Dependent Variable: ROE

Source: Appendix-V

R^2 is a summary measure that tells how well the sample regression line fits the data. In this case, the model fits (accounts) for 56.80 percent of the variance in the dependent variable, ROE. In this study, the R statistic is 0.754, indicated that there is a strong relationship between study variables. This implies that the ROE was highly influenced by its independent variables. Standard error of estimate is flawlessly associated with regression analysis.

Table 13

Analysis of variance (ANOVA)

Model		Sum of Squares	df	Mean Square	F	Sig.
1	Regression	1974.269	5	394.854	11.569	.000[b]
	Residual	1501.789	44	34.132		
	Total	3476.058	49			

a. Dependent Variable: ROE
b. Predictors: (Constant), INF, CAR, CDR, NPLR, LSIZE

Source: Appendix-V

An examination with ANOVA (F–value) indicates that explains the most possible combination of predictor variables that could contribute to the impact of dependent variables. Results show significant impact of ROE indicator. On the F-

values of 11.569 (p = 0.000 < 0.05) for INF, CAR, CDR, NPLR, LSIZE as ROE proxy, it clearly shows that there is a significant relationship between the dependent variable (ROE) and the independent variables.

Table 14

Regression coefficient of independent variables with ROE

Variables	Coefficients	t-statistics	p-value	Collinearity Statistics	
				Tolerance	VIF
(Constant)	-23.457	-1.010	.318		
CDR	.043	-.385	.702	.899	1.112
NPLR	-.923	-4.952	.000	.703	1.423
CAR	-.081	-1.860	.070	.962	1.039
LSIZE	5.470	2.058	.046	.561	1.782
INF	.621	1.433	.159	.700	1.429

Source: Appendix-V

Table 14 presents the regression coefficient of independent variables credit to deposit ratio, non-performing loan ratio, capital adequacy ratio, size of companies and inflation rate. It shows that all tolerance values were above 0.1 and VIF below 10. That's why, there is no multicollinearity in the model.

The results of regression model indicated that the relationship between credit to deposit ratio (CDR) has a positive relationship with ROE by a coefficient estimate of 0.043. This means that holding other independent variables constant and when one percent increases in credit to deposit ratio (CDR), as a result it increases ROE of the finance companies by 0.043 percent and the p value of credit to deposit ratio (CDR) is 0.702 discloses that it is statistically insignificant at 5 percent level of significance.

The results of regression model indicated that the relationship between non-performing loan ratio (NPLR) has a negative relationship with ROE by a coefficient estimate of -0.923. This means that holding other independent variables constant and when one percent increases in non-performing loan ratio (NPLR), as a result it decreases ROE of the finance companies by -0.923 percent and the p value of non-performing loan ratio (NPLR) is 0.000 discloses that it is statistically significant at 5 percent level of significance.

According to the regression result of capital adequacy ratio (CAR) has a negative relationship with ROE by a coefficient estimate of -0.081. This means that holding other independent variables constant and when one percent increases in capital adequacy ratio (CAR), consequently it decreases ROE of the finance companies by 0.081 percent and the p value of capital adequacy ratio (CAR) is 0.070 reveals that it is statistically insignificant at 5 percent level of significance. Accordingly, the result supports the working hypothesis that capital adequacy ratio (CAR) has negative and statistically insignificant effect on ROE of finance companies.

The results of regression model indicated that the relationship between size of finance companies (LSIZE) has a positive relationship with ROE by a coefficient estimate of 5.470. This means that holding other independent variables constant and when one unit increases in size of finance companies (LSIZE), as a result it increases ROE of the finance companies by 5.470 percent and the p value of size of finance companies (LSIZE) is 0.046 discloses that it is statistically significant at 5 percent level of significance.

According to the regression result of inflation rate (INF) has a positive relationship with ROA by a coefficient estimate of 0.621. This means that holding other independent variables constant and when one percent increases in inflation rate (INF), as a result it increases ROA of the finance companies by 0.621 percent and p value of inflation rate (INF) is 0.159 reveals that it is statistically insignificant at 5 percent level of significance. Accordingly, the result supports the working hypothesis that inflation rate (INF) have statistically insignificant positive effect on ROA of finance companies.

4.2 Discussion

The main objective of this study is to examine the impact of non-performing loan on profitability of finance companies in Nepal. Non-performing loan has a direct impact on return on assets and returns on equity, the two main parameters for measuring profitability of the finance companies in Nepal. This study showed that the non-performing loan ratio of SIFC performing best or maintaining their NPLs perfectly among them which shows SIFC has the best lending policy among them. Profitability position in terms of ROA, SIFC could manage their overall operations

due to highest ratio among them. However, GFCL the best or most effective management in earning profit among them.

The correlation analysis revealed that there is significant negative correlation between credit to deposit ratio and ROA. This is consistent with Gnawali (2018) conclusion. This is also consistent with Pokharel and Pokharel (2020) which observed that credit to deposit ratio has positive relationship with ROA. However, it contradicts with the findings of Kingu et al. (2018); Panta (2018) which observed that a negative association between credit to deposit ratio and ROA. However, credit to deposit ratio has insignificant positive relationship with ROE. This is not consistent with Bhattarai (2020) which observed that there is negative relationship between credit to deposit ratio and ROE. Then, non-performing loan ratio (NPLR) has significant negative relation with ROA, supporting the findings of Nyarko-Baasi (2018) but opposite to the finding of Pokharel and Pokharel (2020); Panta (2018); Gnawali (2018); Bhattarai (2020). The correlation coefficient between bank profitability measured by ROE and non-performing loan ratio is positive and the relationship is also strong. The correlation between capital adequacy ratio and ROA is insignificant negative and there is significant negative correlation between capital adequacy ratio and ROE which is similar to the findings of Bhattarai (2020). The correlation between size of finance companies and ROA is significant positive correlations which in similar with the findings of Panta (2018) and there is positive and significant correlation between size of finance companies and ROE and this is similar to the findings of Bhattarai (2020). Finally, this analysis also shows that inflation rate (INF) has insignificant negative relationship with ROA and it has also insignificant negative relation with ROE which is not consistent with the findings of Panta (2018); Nyarko-Baasi (2018).

The multiple regression analysis found that credit to deposit ratio has insignificant positive impact on ROA of finance companies in Nepal which is consistent with the findings of prior empirical studies of Pokharel and Pokharel (2020). However, it contradicts with the findings of Bhattarai (2020). Further, non-performing loan (NPLR) has negative and statistically significant impact on ROA, supporting the findings of studies supporting the findings of studies of Gabriel, Victor and Innocent (2019) but contradicts with the results of Pokharel and Pokharel (2020). Likewise, CAR has negative and statistically insignificant effect on ROA at 5 percent level. The

result is consistent with the finding of Gnawali (2018) which observed that CAR has insignificant positive impact on ROA of the finance companies. However, the result is contrary to Bhattarai (2020); Amin, Rahman and Hossain (2021), Martiningtiyas and Nitinegeri (2020) who have claimed that CAR tends to be associated with less profitability of finance companies. At the same time, LSIZE has positive and statistically significant effect at 5 percent level. The result is similar to the Bhattarai (2017) who have found that larger size of companies contributes to higher profitability. However, the result is contrary to Gnawali (2004), who have claimed that big size tends to be associated with less profitability of finance companies. Additionally, inflation rate has insignificant positive effect on ROA and it is consistent with the findings of Bhattarai (2020); Amin et al. (2021). However, it contradicts with Gabriel et al. (2019) which concluded that there is negative effect of inflation rate on ROA of the finance companies.

As regards regression in ROE, credit to deposit ratio (CDR) has insignificant positive impact on ROE at 5 percent level which is consistent with the findings of prior empirical studies of Gnawali (2018) but opposite to the findings of Bhattarai (2020). Further, non-performing loan ratio (NPLR) has negative and statistically significant impact on ROE which is consistent with the finding of Bhattarai (2017) which concluded that there is negative effect of NPLR on ROE of the finance companies. CAR has negative and statistically insignificant effect on ROE at 5 percent level, supporting the findings of Bhattarai (2020). However, the result is inconsistent with Gnawali (2018) which observed that CAR has positive impact on ROE of the finance companies. LSIZE has positive and statistically significant effect on ROE at 5 percent level, supporting the findings of Bhattarai (2017) and Gnawali (2018) which observed that size of companies has positive impact on ROE of the finance companies. However, it contradicts with the finding of Do et al. (2020) which observed that size of companies has negative and insignificant impact on profitability of the finance companies. Additionally, inflation rate has positive and insignificant effect on ROE. This result is similar to the results of Bhattarai (2020) but opposite to the result of Bhattarai (2017).

CHAPTER – V
SUMMARY AND CONCLUSION

This last chapter includes a summary, findings, and some recommended implications for the benefit of the chosen financial organizations. It also highlights the study's conclusions in order to help the nation navigate the current economic downturn.

5.1 Summary

For finance organizations, non-performing loans serve as a crucial gauge of their financial soundness. The way that finance businesses manage credit risk is crucial because it impacts their capacity to act as financial intermediaries, which is how they generate most of their revenue, and in the end, it influences the financial stability of an economy. In this sense, NPL has once again caught the attention of regulators and upper management in the banking industry. Every crisis is followed by painfully gradual measures aimed at attaining financial stability. All areas of an economy are impacted by the problem of non-performing loans, but the financial institutions, such as finance companies with substantial loan portfolios, are the most severely affected. High non-performing loan (NPL) rates in the BFI sector might impede the advancement of economic growth.

The main objective of this study is to analyze the effect of non-performing loan on profitability of finance companies in Nepal. The other specific objectives are to analyze the pattern of non-performing loan and profitability of finance companies in Nepal, to examine the relationship between non-performing loan and profitability of the finance companies and to analyze the impact of non-performing loan ratio, credit to deposit ratio, capital adequacy ratio, size of the finance company and inflation rate on profitability of sample finance companies. The research design undertaken in the study consists of descriptive and causal research design. Descriptive research design is adopted for descriptive statistics contains mean, standard deviation, minimum and maximum values of variables and explain the characteristics of sample companies. Causal comparative research design is followed for regression analysis and correlation analysis and to measure the direction and magnitude of relationship between dependent and independent variables. There are 17 finance companies in Nepal. They

constitute the population. Out of them only five finance companies are selected namely; Pokhara Finance Limited (PFL), Progressive Finance Limited (PROFL), Goodwill Finance Company Limited (GFCL), Shree Investment & Finance Company Limited (SIFC) and Manjushree Financial Institution Limited (MFIL) are selected as sample for the study. This study is mainly depends on the use of secondary data that consists of annual reports of the respective finance companies. Besides the annual reports various other sources of data have also been used for the purpose of the study plan documents, newspaper, magazine, economic journals, NRB reports etc. The study covered the period between 2012/13 and 2021/22. This study used descriptive analysis, correlation analysis and multiple regression analysis to achieve the objectives.

This study shows that the non-performing loan ratio of SIFC performing best or maintaining their NPLs perfectly among them which shows SIFC has the best lending policy among them. Profitability position in terms of ROA, SIFC could manage their overall operations due to highest ratio among them. However, GFCL the best or most effective management in earning profit among them. The correlation analysis reveals that The correlation analysis shows that credit to deposit ratio has insignificant negative relation with profitability (ROA and ROE) of the finance companies. However, non-performing loan has significant negative relationship with profitability. Then, capital adequacy ratio and inflation rate have negative relationship with profitability of the finance companies. Moreover, size of companies has strong positive relationship with ROA and ROE of the finance companies. The regression analysis reveals that credit to deposit ratio and inflation rate have insignificant positive impact on profitability (ROA and ROE) of the finance companies in Nepal. However, non-performing loan ratio has significant negative impact on profitability (ROA and ROE) of the companies. Moreover, capital adequacy ratio has insignificant negative impact on profitability whereas, size of companies has significant positive influence on profitability (ROA and ROE) in Nepalese finance companies. Hence, it can be concluded that non-performing loan has strong impact on profitability of the finance companies in Nepal.

5.2 Conclusion

This study aimed to analyze the non-performing loans and its impact on profitability of finance companies in Nepal. This study concluded that liquidity ratio of PFL shows that the bank is the most successful among them to mobilize its total deposit as loan and advances and acquiring high profit. The non-performing loan ratio of SIFC performing best or maintaining their NPLs perfectly among them which shows SIFC has lowest credit risk among them. Profitability position in terms of ROA, SIFC could manage their overall operations due to highest ratio among them. In other word, SIFC is able to make highest return to its assets by optimum utilization of the asset. However, GFCL the best or most effective management in earning profit among them. Moreover, it can be said that GFCL is generating more income and making progressive performance among them due to the highest ROE.

The correlation analysis concluded that credit to deposit ratio ratio has insignificant negative relation with profitability (ROA and ROE) of the finance companies. However, non-performing loan has significant negative relationship with profitability. Then, capital adequacy ratio and inflation rate have negative relationship with profitability of the finance companies. Moreover, size of companies has strong positive relationship with ROA and ROE of the finance companies.

The regression analysis also concluded that credit to deposit ratio and inflation rate have insignificant positive impact on profitability (ROA and ROE) of the finance companies in Nepal. However, non-performing loan ratio has significant negative impact on profitability (ROA and ROE) of the companies. Moreover, capital adequacy ratio has insignificant negative impact on profitability whereas, size of companies has significant positive influence on profitability (ROA and ROE) in Nepalese finance companies. Therefore, it can be concluded that non-performing loan has strong impact on profitability of the finance companies in Nepal.

5.3 Implications

On the basis of above summary and conclusion, following implications are made;

- • This study discovered that while credit to deposit ratio, capital adequacy ratio, and inflation rate have little effects on profitability, non-performing loan ratio and company size had a substantial influence. Therefore, these data and

findings signal policy makers, regulators, and finance company management to take appropriate measures to handle non-performing loans in every manner feasible.

- According to the study, an effective management of non-performing loans would benefit not only finance companies but also individuals, businesses, and the overall economy by taking into account the various variables of non-performing loans and how they impact finance companies' profitability. Consequently, this enhances the prosperity of the financial industry and the community at large.
- The research also forces finance company management to evaluate their own previous performance and provides guidance for their next goals and initiatives. This study can provide some of the most recent information, statistics, and challenges related to credit risk. Therefore, bankers, stockholders, depositors, as well as future scholars and students, will find this study to be relevant.
- This study offers a lucid conceptual understanding and information on non-performing loans. Therefore, this paper can be used as a source by future researchers.

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Abstract This study investigates the influence of non-performing loans on profitability in Nepalese financial institutions. Secondary data was acquired from Nepalese financing businesses during 10 years (2012/13 to 2021/22). This study employed multiple regression analysis. This analysis demonstrates that SIFC's

non-performing loan ratio is the best or maintains their NPLs precisely among them , indicating that SIFC has

the finest lending policy. SIFC could manage their whole operations since they had the greatest ROA ratio. However, GFCL

the best or most effective management in earning profit among them . The correlation analysis

reveals that The correlation analysis shows that credit to deposit