

# CHAPTER - I

## INTRODUCTION

### 1.1 Background of the Study

Nepal is a landlocked country with agro-based economy. The kingdom of Nepal extends between latitude 26<sup>0</sup>22' to 30<sup>0</sup>27' north and longitudes of 80<sup>0</sup>4' to 88<sup>0</sup>12' east along the southern slopes of Himalayas. Nepal has a total area of 147181 sq. km and it is sandwiched between two most popular countries – China in North and India in the East, West and South. For administrative purpose, it is divided into five development regions, 14 zones and 75 districts. Similarly, with its geographical nature, it is divided into Mountains, Hills and Terai region. According to the CBS of Nepal, the decennial, (1991-2001), growth rate of the population of Nepal was 2.24 percent per annum. Now, the population of Nepal is 29.5 million in July 2008 with an annual growth rate of 2.17 percent. The Nepalese economy is based on agriculture, which accounts about 45% of the total GDP. About 76 percent of the total population is primarily engaged in agricultural sector. It still remains as one of the least developed countries with per capita GDP of US \$230 ([www.cbs.np](http://www.cbs.np), July, 2008).

An improved financial system fosters the efficient mobilization of domestic savings and allocates resources to their optimum use. The financial institutions help to mobilize savings by issuing instruments as desired by the savers. Financial deepening, in its narrow sense, is the creation of more instruments, institutions and markets.

In the common sense, an institution established by law that is involved in monetary transaction is called “Financial institution”. In other words we can define financial institution as the financial intermediary between the depositors and the entrepreneurs.

Financial institutions play important roles in financial markets and there has been an extraordinary growth of non-bank financial intermediaries (NBFI). The process of demand and supply of money through saving and loans can deliberate such institutions as tools of monetizing the economy. The financial institutions have both the demand and supply side and when financial institutions borrow for the purpose of making loans, the margin of profit emerges as the difference between lending and borrowing interest rates. In Nepal, finance companies are given more extensive role in making their own interest rate policies.

Financial institution play vital role in the economic development of nation and uplift the living standard of the people of the country. Financial institution motivates people to save their earnings and invest their savings in the productive sectors. Integrated and speedy development of the country is possible only when competitive banking service reaches in nook and corners of the country. Among them, financial companies occupies quite an important place in the framework of every economy because it provides capital for the development of industry, trade and business investing the saving collected as deposits. Besides that, these companies render a numerous services to their customer in view of facilitation their economic and social life. It is established with the objective of collecting the scattered capital in the country through non-banking activities. These companies are set up for the purchase of consumer's durables. They specialize in consumer lending to individuals and secured lending to business. They collect the funds in term of deposits and extends loan and advances to various sectors. The main sources of funds besides equities are saving and time deposit collection and issuance of debentures. The collected funds or sources are invested in those areas, which are generally ignored by the commercial banks.

In Nepal, the concept of Financial Institution was introduced when the first financial institution, Industrial Development Center was established in 1957. Later, it was

converted in Nepal Industrial Development Corporation (NIDC) in 1959 by special charter. Then after, three financial institutions are established in 1992 under the company act 1964. They are NIDC Capital Market Ltd., Nepal Finance and Saving Co. Ltd., and National Finance Co. Ltd. Subsequently, various financial institutions are established after then. And the people's participation in security investment and stock trading is increasing expectedly even though the investor does not have enough knowledge to invest in security. (Uprety, March 2000; 21)

Nepal Rastra Bank (NRB), i.e. the Central Bank of Nepal, regulates the finance companies. Finance companies are to be registered as per the policy of Nepal Rastra Bank. Actually, finance companies are the outcome of the monetary policy, whose works are as follows:

1. Finance companies are able to collect more assets in the form of deposit, which are uninstitutionally spread.
2. Finance companies can finance individuals, firms and industries by using their deposit in the form of loan.
3. They can provide long-term capital for the investors and entrepreneurs.
4. They can provide consortium loan by using the funds of many institution.

The dictionary of Modern Economics defines a finance company as a financial intermediary not a bank which may obtain fund from its own capital resources by accepting deposit (usually for fixed periods) or even by borrowing from other institutions which it then lends for variety of purpose, especially to finance hire purchase contracts but also leasing (Halter, 1999:18).

## **1.2 Significance of the Study**

The increasing number of domestic commercial banks, joint venture banks and financial institution has created a competitive environment in financial sector. The

investment opportunities of trade, industry, agriculture and other sectors have not comparatively been extended and on the other hand, Nepal Rastra Bank has declared that there must be Rs. 150 million, 50 million, 20 million and Rs. 1 million as paid up capital for leasing and finance company, only finance company based in Kathmandu, only finance company for outside the valley (Eastern, Central and Western development Region), finance company that operates on only one district (Western and Far Western Development Region) respectively. Thus, it is clear that finance companies have to face numerous difficulties to mobilize their deposit funds on the profit making investments so that they can achieve sufficient return from the investment and satisfy their shareholders by providing adequate return on their equity.

Financial development is one of the key indicators of economic development of any country. Financial institution provides regular energy for investments, which is needed for economic developments. In the financial sector, new institutions, instruments and financial innovations emerge in response to the need of national economy.

Nepal is an under developed country and there is need for additional capital investment to earn higher rate of economic growth. Domestic saving and foreign capital (grants and loans) are two principal sources of capital available for investment. Among them, domestic saving is the important and stable source of capital.

Development of financial institutions is essential for the rapid economic development of the country. Although, being an agricultural dependent country, the non-agricultural sectors should be given priority. This will help not only to solve the problems of employment but also in the economic development of the nation. Only the establishment of industry is not sufficient but successful operation is also

necessary. For successful operation, every industry and organization needs finance. The success and failure of business and industry widely depends on the crucial decisions made by the top management relating to the management of fund. Capital structure decision is one of the most crucial complex areas of financial decision relating to the management of fund and due to its interrelationship with other financial decision variables.

Finance companies deliver their economic services even to those sectors where commercial banks are not available, i.e. housing, hire purchase, leasing, share and securities. But finance companies cannot collect current accounts like commercial banks. Unmonetised economy is a unique feature of the Nepalese economy. Therefore, it is very difficult to get loans from the financial institutions. In the rural areas, most of the landlords and merchants give loans at a high interest rate. In this situation, finance companies can play vital roles in reducing interest rates by using their deposits. The interest rate is determined by the demand and supply process.

After 1990, Nepal Government has adopted the policy of economic liberalization. This policy has given more important role to the private sector. Financial liberalization policy is an important part of economic policy. Under this policy, the government has adopted liberal policy for the establishment, growth and development of new commercial banks and finance companies in a competitive basis. Because, of this, 85 finance companies have already registered at company Register Office and 79 had already started their operations (As of mid-October, 2008). Therefore this study is an attempt to overcome the discrepancy to some extent and has considerable significance. Specifically, the significance of this study can be summarized in the following points:

- a. This study helps to the management and the policy maker in setting and making a suitable investment policy.

- b. The investment policy of different financial sectors plays vital role for socio-economic development in the nation, that is why the study of investment policy of these financial sectors is needed so as possible.
- c. This study helps to raise public awareness about the relationship of investment policy between these financial companies in order to help them for rational decision for their investment.

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

Investment is the most important factor from the shareholders and a company's management point of view. Though, several financial companies have been established in the country within a short span of time, sufficient return could not have been achieved and strong, stable and appropriate investment policy has not been followed by these institutions. Due to tough competition of financial environment, these companies seem to be ready to grant much more loan, advances and other facilities against their client's insufficient deposit & without significant collateral. As a result, unsecured loan and investment may cause the liquidation of those financial companies. If the funds are wrongly invested without thinking any financial risk, business risk and other related factors, the company can not obtain profitable return and it may lose its principal. Investment policy may differ from one company to another but there is no optimum utilization of shareholders fund to have greater return in any financial companies. Nepal Rastra Bank has also played important role to make these companies to invest their funds in a good productive sector. For this purpose, Nepal Rastra Bank has imposed many rules and regulations so that they can have sufficient liquidity and security.

Though most of the financial companies have been successful to earn profit from fund mobilization, none of them seem to be capable to invest their entire fund in a more profitable sector. Besides these, unnecessarily more portion than the actual need on cash and bank balance is accumulated in their transactions as a idle fund.

Only fewer portions of them have been invested due to limit and narrow capital market and investment opportunities. Sometimes, they invest in highly risky sector and sometimes they don't take the risk to mobilize their idle fund. They invest in that sector which have lower risk and comparatively greater profit. Another problem is diversification in investment. It is found that some of the companies have diversified their investment in different fields like housing, hire purchase and institutional investments whereas some of them are not successful to invest their funds in different areas.

The following are the major problems those are being identified for the purpose of this study in terms of each sampled company in comparison to other companies:

1. The relationship of investment and loan and advance with total deposits, and net profit.
2. The effectiveness and efficiency of companies' fund mobilization and investment policies.
3. The effectiveness of the investment decision in the earning of the companies.
4. To examine if the investment strategy of these companies is successful to utilize its available fund or not.
5. To find out any stability in fund mobilizing policy.

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

The main objective of the study is to analyze and interpret the Investment policies of the Sampled Companies and compare the same with each other and how the fund is being mobilized as well as how they are functioning. Every Sampled Company has its own investment policy to invest its fund on different sectors. Thus, their investment decision criteria as well as policies may or may not be more efficient in comparison to other companies.

Therefore, the main objective of this study is to evaluate the investment policy of the finance companies of Nepal. However, its specific objective is given as follows:

1. To evaluate the liquidity, asset management efficiency and profitability positions in related to fund mobilization of above listed companies.
2. To examine fund mobilization & investment policy of these companies in respect to its balance sheet transactions.
3. To evaluate the growth ratios of loan & advances & total investment with respective growth rate of total deposits and net profit of the companies.
4. To determine the relationship between deposits and total investment, deposit and loans & advances, and net profit and outside assets of the listed companies.
5. To evaluate the trends of deposit utilization and project for next five years (2064/65- 2068/69).

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

This study will be limited by following factors:

1. This study is simply a partial requirement of MBS program. However there are some limitation, which narrowed the generalization e.g. inadequate coverage of industries, time periods taken, reliability of statistical tools used and other variations.
2. The whole study is based on secondary data collected from the sampled companies.
3. The study is concerned only a period of 5 years (2059/60–2063/2064). Hence the conclusion confines only to that years.
4. There are only four financial companies taken as population standard & the average of the same is taken as industry average to compare to the investment policy of each finance companies.

## **1.6 Scheme of the Study**

The study is divided into five chapters. Chapter one comprised of introductory parts of the study. It covers introduction of the subject matter, significance of study, statement of the problems, objectives, limitations & scheme of the study.

Chapter second composites the review of literature. The first section deals mainly with the theoretical & historical information related to finance companies, development of finance companies in developed countries, Asian countries & in Nepal. This section also covers the functions & services of finance companies & its role towards the national development, review of related book, thesis etc.

Chapter third deals with research methodology used to evaluate investment policies of finance companies in Nepal. It consists of research design, source of data, population & sample, statistical tools & method of analysis such as bar diagram, percentage, Karl Pearson's coefficient of correlation, simple regression as well as corresponding hypothesis are also adopted in this study.

Chapter four includes presentation & analysis of data through a definite course of research methodology. The main part of this chapter is to analyze different ratios related to investment & fund mobilization of sampled companies by using different statistical tools. It also contains the main findings of the study.

Chapter five discusses with the suggestions to the concern authority which is found by the study. This chapter includes summary, conclusion of the study and recommendation for the concerned authority. Besides these, bibliography & appendices are also included at the end of the study.

## **CHAPTER - II**

### **REVIEW OF LITERATURE**

Optimal investment decision has played a vital role in each and every organization. So, this subject is relevant for all parts that mobilize funds in view of return. This chapter tries to clarify the history and background of finance companies, concepts regarding the definitions of a finance company, investment etc. Similarly, the chapter highlights upon the literature that was concerned in this connection. Conceptual frameworks given by different authors in this area are reviewed from research work, different studies and thesis.

#### **2.1 Conceptual Framework**

##### **2.1.1 History of Finance Companies**

The world economy nowadays is dominated by the ups and downs of financial activities, which play the vital role for the development of the nation as well as for the world economy. The world economy activity trends are affected by open market policy and liberalization policies of the government. Economic liberalization policy has to create the environment for the establishment growth and development of Finance institutions in the world.

Initial step to organize financial services originated from the establishment of “The first Investment Bank began in Philadelphia, USA in 1764. The first commercial Bank, “The Bank of North America”, opened in the same city in 1781. Then the first investment Company, “The Massachusetts Hospital Life Insurance Company”, was founded in 1816 which is usually designated as the first saving Bank Insurance Company which is an old as the country itself.

The more interesting development is US credit market in the 20<sup>th</sup> century, and then there has been the rapid growth in consumer credit. Installment credit was used for only a few items such as pianos, Encyclopedias and Sewing machines and total household expenditures. But the activities increase towards consumer's durable goods, such as automobiles, vehicles, boats and household appliance.

Finance Companies are the recent innovation in South Asia and they are established, growth and development from the mid 1950's. The first group of Finance Companies was established in Philippines and Singapore but they are suffering from so many difficulties. But the Companies have been established in Hong Kong, Thailand and Malaysia has developed efficiently to accomplish their objectives and goals.

Most Governments in South Asian countries have enacted legislation to protect both depositors and investor in this investment industry. Singapore and Malaysia have enacted protective legislation regulating all Finance Companies. The Hong Kong requires a Banking license or those Finance Companies that accept deposits. In Philippines, there also allow deposit of general public as a result of the passage in 1963 of a "truth-in lending act".

### **2.1.2 Establishment and Growth of Finance Company in Developed Countries**

The first investment bank began in Philadelphia in 1764. The first commercial bank "The Bank of North America" opened in the same city in 1781. The first Investment Company, the Massachusetts Hospital Life Insurance Company, was founded in 1816 in Boston. The Philadelphia saving bank insurance companies are as the country itself but mutual life insurance companies first began operations in the 1940's. The postal saving system, credit unions and funded system are all products of the 20<sup>th</sup> century.

There are different views about “Finance Company” by different countries. Most of the countries don’t have clear-cut directions to the Finance Company in terms of their function and area of coverage. However, Finance Act has mentioned certain areas of operations such as receiving time deposit of different maturity dates, providing loans for hire purchase; house construction, business and also undertaking merchant banking function such as share issue, management portfolio management mutual fund, project counseling merger etc.

“The more interesting development in US credit market in the 20<sup>th</sup> century, then there has been rapid growth consumer credit. Installment credit was used for only a few items such as pianos, encyclopedias, sewing machine and total household expenditures. But the activities increases towards consumers’ durable goods, such as automobile boats and house hold appliances” (Triffin, 1982; 33). Generally there are basically three types of financial activities by different shape and structure in finance companies which are given below and explained in the subsequent sections.

- Sales Finance Companies
- Consumer Finance Companies
- Credit Unions

#### **2.1.2.1 Sales Finance Companies**

Each and every kind of commercial banks is always focusing their activities towards the banking sectors. They are not able to serve different areas, so that the concepts to sale finance companies are come out which serve consumer’s back need and expectations.

Sales finance companies have always been oriented mainly towards the financing of automobiles, business equipment lease and loans against account receivable. A

typical transaction of a sales finance company might go something like this, “A dealer in some consumer durable goods (auto, house hold and appliance) sells an item on the installment plan. The dealer received will be made directly by the customer to the sales finance company.”(Ranlett, 1994; 209)

“Sales finance companies are different from other consumer credit institutions by virtue of their indirect extension of credit Sale finance companies typically purchase the installment contract the notes signed by purchases of consumer durable goods from the dealers involved. The other consumer credit sources deal directly with the borrower. Thus we can say that sales finance companies acted as go between obtaining credit from commercial bank channeling it into the purchase of consumption goods.” (Ranlett, 1994; 211)

#### **2.1.2.2 Consumer Finance Companies**

“The Consumers Finance Companies are much more specialized than commercial bank and sales finance companies. In the early 1960’s however some of the larger companies began to diversify their operation in USA. For example, Household Finance Corporation acquired a major interest in city Products Corporation, a large retail chain. Household earlier had acquired coast to coast store and Badger paint and hardware stores. The largest consumer Finance Companies obtained more of their funds from banks than do sales Finance Companies of similar size.” (Ranlett, 1994; 214)

#### **2.1.2.3 Credit Union**

After the Consumer Finance Companies, the last major financial institution in the installment credit market activities is the credit union. “The concept of credit union has been spectacular throughout the post-war period in USA. The credit union may operate under either federal or state charter. Credits unions are co-operative associations where members must be linked buy some common board

such as employment, church or labor union membership. Funds are derived almost entirely from member's share accounts, which typically are accumulated in small increments under payroll deduction schemes. They are used largely for installment cash loans to members, although credit unions also hold relatively small amounts of other financial assets such as cash, US Government securities and saving and loan shares." (Ranlett, 1994; 215)

### **2.1.3 Growth and Development of Finance Companies in Asian Countries**

The concept of finance companies is recent innovation in south Asia and its growth establishment and development was initiated from mid 1950's. The first group of finance companies was established in Philippines and Singapore but they are suffering from so many difficulties. But the companies, which were established growth and developed in Hong Kong and Malaysia, have been developed efficiently to accomplish their target goals and objectives.

Most governments in South Asia countries have been enacted legislation to protect both depositors and investors in the industry. Singapore and Malaysia have been enacted protective legislation regulating all finance companies. The Hong Kong required a banking license for those finance companies that accept deposit. In Philippines also general publics are allowed to deposit as a result of the passage in 1963 of truth in lending act. There are some special activities of finance companies for different countries which are as given below.

#### **2.1.3.1 Philippines**

Finance companies were first established in the Philippines in the wide 1950's. "The number grew rapidly and by 1962 there were over 250 companies. The Philippines congress also passed Truth-in-rapidly Act to correct some of the abuses evident in the posts. Currently there are three large companies and several

more than 100 small companies” (Triffin, 1982: 42). In recent year there have been three major finance companies, which are given below.

- a. International Finance Corporation
- b. Filipinos Investment and Finance Corporation
- c. Filipinos Mutual Finance Incorporated

The shares of these companies are traded on Manila Stock Exchange. These large Finance Companies operation is mainly consist of goods or services financing. Thus there are mainly three different units,

- i. Vehicle Finance
- ii. Applicable Finance
- iii. Air travel Finance

Beside those activities large finance companies engage in other activities too, which includes leasing, credit card operation etc.

#### **2.1.3.2 Thailand**

The finance companies in Thailand are still in the beginning stages. Two major companies are listed on the Bangkok Stock Exchange; one was established in 1961 and other in 1965. Both companies primarily finance on automobiles and the volume of their operations has been increasing rapidly. The name of these two companies is:

- a. Bangkok Investment Company Limited
- b. Commercial Credit Corporation Thailand Limited.

Finance companies are making a useful contribution on to Thailand’s general economic development particularly because medium term consumer credits were not previously available from other financial institution.

### **2.1.3.3 Hong Kong**

Finance companies were established in the Hong Kong at the end of 1967. There are about eight finance companies all sponsored by commercial banks.

“Way Foog Finance Company Limited was established in 1990. When finance companies first began to operate in Hong Kong the established of finance companies basically came from the automobile dealers who asked the financial community to provide hire purchase facility.

The main sources of funds for finance companies are their deposits funds provided by the parent bank and their own capital. Lending activities of the finance companies in Hong Kong are not limited to consumer durable. The activities towards the financing automobile, refrigerators, television sets and other consumer durable companies and also finances some heavy machinery for industry air conditioners and bulldozers.

### **2.1.4 Establishment, Growth and Development of Finance Companies in Nepal**

Nepal is an under developed country. There is a need for additional capital investment to get higher rate of economic growth. Domestic and foreign capital (grants and loans) are two principle sources of capital available for investment. Out of these two, domestic saving is the most important and stable source of capital.

Finance companies are currently viewed as catalyst in the process of economic growth of a country. A key factor in the development of an economy is the mobilization of domestic resources. As intermediaries, the Finance Companies help the process of resource mobilization. The government in turn is requirements of the country. Policies such as lending to the priority sectors, lending to the

educated unemployed people, creation of entrepreneurship in the society are certain examples, which the government in developing economics tries to implement with the help of financial institutions.

The growth and development of the financial institutions in an economy depends on very large extent on the quantum of funds they can command. With the rapid increase in the number of finance companies and the expansion of the financing business undertaken by them besides other financial institutions, a slow and steady competition for resources among the financial institutions is gaining ground. The institutions are making hard efforts to leave no stone unturned to mobilize maximum capital resources.

“The growth rate of saving is very low in Nepal. For example in 1990, gross domestic saving as percent of GDP remained 19.9%. This shows the growing resources gap in the economy. Nepal has obtained foreign capital to bridge this resource gap. Foreign capital only loan, is the long- term liability. Hence, the country can not depend on foreign loans forever. Therefore, financial development is indispensable to meet the growing demand for capital in the country” (Neupane, 1995: 112). After 1990, Nepal has adopted the policy of economic liberalization. The thrust of shift in policy boils down to added efficiency, which in turn is assumed by operation of market forces. This policy has given more important role to the private sector. Financial liberalization policy is an important part of economic liberalization policy. Under this policy, the government has adopted liberal policy for the establishment for new commercial banks and finance companies on a competitive basis.

Finance companies are new type of institutions in the Nepalese context. They can be registered only as public limited companies as per the finance Company Act 2042 B.S. and Public Limited Company Act 2053 B.S.

Nowadays there had been 80 finance companies of various sizes registered in Nepal Government Company Register Office. Out of them, 79 have already started operations and the remaining is waiting in the pipeline for the approval of NRB (As of Mid-October, 2008).

Although, the area of the study is confined to investment policies of selected finance companies of Nepal. Even then it is important to highlight on establishment of finance companies. Financial activities play vital role in the development of country. Financial activities are an integral part of National plan to accelerate the rate of economic development. The main objectives of finance company is the mobilization of small and large resources from urban as well as rural regions and their channels into prospective, structured and high priority areas to assist in the economy development of nation.

Finance companies have authorized capital that varies from Rs.10 millions to Rs. 240 million. In most cases, issued and paid up capital constitute 50 percent of the authorized capital. Among those, which have already started operational till Mid-July 2006, 44 finance companies are located within Kathmandu valley and 26 are outside Kathmandu valley.

Finance companies have to channel the funds by gradually shifting priorities from hire purchase and trading to industry to help in the capital formation within the country. The overall growth of the nature and extend of capital formation in the country. This in course of time, industrial financing should get higher priority in the lending strategy of finance companies in view of their future sustainability and full fledged growth.

Finance companies are the effective scientific instrument for mobilizing public, private and external financial resources and channel them into productive areas as short term loans and long term loan on different commercial business activities.

### **2.1.5 Government Policy Towards the Finance Companies**

Nepal is an under developed country, so financial activities play vital role in the development of the country. In another words, financial development is one of the key indicators of economic development for country. After 1990, Nepal has adopted the policy of economic liberalization and open market policy. The policy has given more important role to the private sector. Under this policy, the government has encouraged the established, growth and development of finance companies. In the 8<sup>th</sup> plan (1992-1997), it has been clearly started that, “the vacuum in the present national financial system needs to be filled by just institutionally developed capital market institution like investment companies, finance companies, leasing and housing finance in order to create a health competitive financial sector.” Under the policy, the government has adopted liberal policy for the establishment growth and development of finance companies.

### **2.1.6 Process of Registration of the Finance Companies**

Finance companies are registered only as public limited companies. As per Finance Company Act 1985, Finance Companies are registered with the register with “Company Register Office” which is under the Ministry of industry situated at Tripureshwor, Kathmandu. When they apply with memorandum paper and other necessary document with an application then there is one department for study about this organization. After the study of all these paper and document and if they found every documents and process correct, they give certificate for the opening of the finance Company.

### **2.1.7 Role of Nepal Rastra Bank towards the Finance Company**

Nepal Rastra bank is the Central Bank of the country and is to develop the financial system, which helps to mobilization of additional resources for investment to the economy. The main function of Nepal Rastra Bank is safeguarding the public interest so that the companies will not cheat them. After

registration of the Finance company in company registrar office, they will apply for license, with Nepal Rastra Bank. A high level technical committee has been constituted for more serious and detailed study and analysis of feasibility report submitted by finance company under the management and leadership of Nepal Rastra Bank Deputy Governor to accomplish the objectives of creating more competitive environment in the financial sector. Based on the recommendation of this high level committee, the policy and guideline will be published to help and direct the establishment of financial institutions. The committee will also help to determine basic eligibility criteria to be applied while issuing license to new finance companies and also in monitoring those already established and have started operations.

“Nepal Rastra Bank has recommended for the established of two finance companies namely “Nepal Housing Development and Finance Co. Ltd.” and “Nepal Finance and Saving Co. Ltd.” in the fiscal year (1991/92). This recommendation was in consistence with the provision of Finance Company Act 2042 B.S. which aims at expect to contribute to the transformation of the economy towards openness and market operations”(NRB, 1991/92: 22).

As finance companies collect deposit from the public and invest, Nepal Rastra Bank has fixed some of the regulation rules and NRB keeps it updating as per requirements. Some of the important rules are as follows ( NRB, 1985: 62).

- The minimum statutory liquidity requirement (SLR) is equivalent to 7% of total deposit liabilities.
- Of the total SLR, it can be invested in the government securities, NRB bonds, as balance with the NRB (1% of the total deposits) or commercial banks.

- For doubtful assets, there must be reserve fund maintained by each finance companies and the weighted of different assets are as given below.

<b><u>Name of Assets</u></b>	<b><u>Weighted%</u></b>
Cash & NRB balance	0
Govt. Bond & NRB bond	0
Cash balance at other finance companies	20
Cash balance at commercial banks	20
Investment on Share and Debentures	50
Investment on Govt. Organizations	100
Other investments	100
Fixed and other assets	100
Loan & advances and Leasing	100
Underwriting	50
Bank Guarantees	100

- In order to prevent these companies from over exposures to one single company or party the single borrower limit has been fixed at 25% of the core capital (Paid up capital + retain earnings + share premium + non redeemable preference share + General reserve) for fund-based investment and 50% for Non-fund based activities.
- Depending on the type of loan and their repayment, each company should maintain loan loss provision reserve fund according to following percentage.

<b><u>Types of loan</u></b>	<b><u>Percentage (%)</u></b>
Good loans (not matured)	1
Low quality loan (3-6 months matured)	25
Doubt loan (6-12 months matured)	50
Bad loan (more than 1 year matured)	100

- Flat interest rate system is removed completely.
- Finance companies are prohibited to lend to the directors as well as its family and circles.
- Finance companies can borrow or lend among themselves.
- Finance companies can't invest more than 60% of its total investment in one sector.
- The capital gearing ratio has been fixed at 10% which implies that finance company cannot collect deposits or extend loans exceeding 10 times of their core capital.
- Finance companies can collect fixed deposits, saving accounts recurring deposits and provident fund deposits of period varying from 3-72 months.
- To make aware of the status of finance companies for the entire public, they should publish their financial statement on newspaper half yearly following fiscal year.

To maintain above mentioned rules, all the finance companies has to send their weekly and monthly reports of their activities as per NRB format and NRB has authority to check the accounts of every finance company as and when needed by the bank.

#### **2.1.7.1 Financial Intermediaries are Generally Classified into Three Broad Groups**

One is commercial banking system, the other is non-bank financial institution (NBFIs) and the third one is other institution in financial activities. Apart from these, Nepal still has a large money market in the informal sector. These include indigenous moneylenders, merchants and traders.

Under the non-banking financial institution we can categories:

- Development banks.
- Finance companies.
- Cooperative societies.
- NGOs involved in lending activities.
- Postal saving banks.
- Credit Guarantee Corporation.
- Employees Provident fund.
- Citizen investment Trust.

The NBFIs are thus a mixed group of financial institutions other than commercial banks. The NBFIs include such institutions as life insurance companies, mutual savings banks, pension funds, building societies etc. but for the purpose of this study we have selected finance companies.

The increasing establishment and growth of the finance companies in the country is the result of economic liberalization policy of the government. In the eighth plan (1992-97), it has been clearly stated that “The vacuum in the present national financial system needs to be filled by institutionally developed capital market institutions like finance companies, investment companies and leasing and housing finances in order to create a healthy, competitive financial sector.” With this statement and the government policies, 80 finance companies have been registered. Out of them, 79 finance companies are in operation till date. As per government rules all the finance companies are public limited companies. That’s why it is very essential to monitor and analyze the performance of these companies for the regular benefit of both public as well as nation. This study tries to analyze the investment policies of finance companies as far as possible on the basis of available data.

#### **2.1.7.2 Major Activities Performed by Finance Companies are:**

### 1. Fund based activities

- a. Leasing and hire purchase
- b. Bill discounting
- c. Loans floating mutual funds
- d. Mutual funds

### 2. Non-funds based activities

Investment management, portfolio management, services for individuals and corporation, insurance management, underwriting, trust receipt, arranging trading market for buying and selling securities, private placement of shares and debentures, etc.

In practice, most of the finance companies are funds based. Finance companies are also important player in "Nepali capital market" investing over 10% of their funds in shares and government bonds.

Under the present regulatory regime, the NRB's non-banking operation unit supervises the finance companies in perspective of their activities as deposit taker and lender. The finance companies have to be registered with the security bond and Nepal Stock Exchange. They have to provide related financial information to central bank regularly.

The main activities of finance company are to approve deposit and invest same amount as loan. However, it has also been investing in the following activities.

1. Government securities
2. Share and debentures of company
3. Stock in trade.

#### **2.1.7.3 Objectives of Finance Company**

On the basis of "Bitta company Ain 2042", the objectives of finance company is to collect the scattered capital in the country and provide the same as investment in different fields for the financial or economical development of general public and raising the economical status of the country with active participation. In order to achieve the goals of finance companies in Nepal, it has performed the following functions:

1. Provision of installments or hire purchase loan for vehicle, machine, equipments, household goods or similar floating vehicle to individual, firm, company or institution.
2. To provide loan for purchase of residential house or warehouse or loan for building residential house or loan for purchase of land to build residential house or warehouse to the individuals, firms , company or institution.
3. Provision of loan for vehicles, machines, equipment or similar floating assets on lease (leading finance) to individuals, firms, companies or institutions.
4. Collection of deposits.
5. Issue of debentures or take loan and financial aid for the transaction in case capital is insufficient.
6. To examine whether the loan taken from the company is being used as per the stated objective or not.
7. To make contracts accordingly for security of the company while transacting or giving loan to individual, company, firm institutions, etc.
8. To acquire and use all kinds of required floating and fixed assets for operation of company.
9. To compensate all the expense incurred during the establishment of company.

#### **2.1.7.4 Finance Company Act 1985**

Under the Finance Company Act 1985, the finance company has to perform the following financial activities:

- To provide installments or hire purchase, credit loans for the purpose of vehicles, machinery tools and equipment, durable household goods or other similar movable property.
- To provide credit for the purchases or construction of residential houses or godowns or the land for the construction of the same.
- To provide lease-finance for vehicles, machinery, tools, equipment, durable household goods or similar other movable property.
- To provide term loans for operating any industrial, commercial or these enterprise which promote economic development.
- To sell and purchase loan bonds issued by Government of Nepal or Securities issued by other companies or institutions, underwrite them from syndicates for such purpose or participate in such syndicates and function as a broker according to the Securities Exchange Act 1983.
- To collect deposits.'
- To perform functions relating to Merchant Banking with the prior approval of the bank such as corporate counseling, loan syndication, issue management and underwriting, design and development of software package for finance companies and other activities like merger and acquisitions, financial engineering, capital structure, restructuring the debt equity ratio etc.
- To perform other functions which are necessary and relevant to the implementation of the objective of the Finance Company Act 1985.

Under the Finance Company Act 1985; a number of rules and regulation have been promulgated regarding the establishment and operation of finance companies in Nepal. Following are the important rules and regulations designed by the

Finance Company Rules 1992 regarding the establishment, operations, management, and share distribution, monitoring and control measures.

- Finance companies can be established to mobilize financial activities by distributing shares.
- The board should at least consist of five members who are elected by general meeting.
- The chair Person or the Board has to call the general meeting within one year of the company's established. After that, the general meetings are to be conducted once a year, within six months of completion of the company's fiscal year.
- The Company has to have at least Rs.2.5 million as the initial capital to establish the finance company. But NRB is given the right to fix this amount, looking at the size of the company and the number of branches of the finance company. (It has since been raised to Rs. 10 million.)
- The Company has to get approval from Nepal Rastra Bank to increase its authorized share capital.
- The finance company are required to offer at least 40 percent of the authorized capital to the general public. Whereas in case of finance companies established under the collaboration of foreign or International finance companies, the percent of share to the public can be at least 25 percent.
- If the fund is inadequate for various activities then the company has the provision to finance through debentures with the prior approval of NRB.
- NRB has the authority to monitor the accounting process and other financial activities of the company at any time of the year.
- At present finance companies are allowed to collect deposits equivalent to maximum amount of ten times the capital fund. Also they are required to manage their funds and match costs funding within interest rate margin or

spread of maximum 6 percent between deposits and loans. Moreover finance companies have to accept deposits varying from minimum three months to maximum of 6 years.

- They can not give loan without collateral.
- They are required to maintain 8 to 10 percent liquid funds of total minimum deposit liabilities. The liquidity ratio is liable to change according to the rules of the NRB.
- They have to maintain a reserve fund equivalent to 2 times of paid capital. Till the required amount in the fund is reached, they have to transfer at least 25 percent of their net profit to the reserve fund each year.

Therefore, these are the rules and regulation regarding the finance companies in Nepal. (Annual Publication, NRB, 1992.)

#### **2.1.7.5 New Umbrella Act 2060**

In order to limit and fixation of the functions of finance companies in Nepal, Nepal Rastra Bank has introduced the new act known as new umbrella act which determined the particular transaction of finance companies operated within the Nepal border.

Subject to the provision of this Act, Memorandum and Article of Association, a license holding entity of Class "C" category may conduct the following financial transaction.

- To Collect Deposit with or without interest or make payment of such deposit on the conditions prescribed by the Nepal Rastra Bank.
- To provide loan for hire purchase, leasing, housing and service orient business.
- To provide prescribed loan except hypothecated loan.
- Subject to by laws made by the committee, to underwrite the loan.

- To provide loan against the guarantee provide by bank or depository institution.
- To provide loan not exceeding the amount specified by the Rastra Bank to low-income families, families of lower economy class, families suffered from natural calamities and resident of some particular area or region of the country with the provision of individual or collective responsibilities.
- To issue, accept, redeem, endorse document, purchase or deal in letter of credit, bill of exchange, promissory note, cheque, drafts, traveler's cheque or any other financial instrument.
- To develop and operate the project in order to land development and to purchase land for construction of houses for residential, and to sell and manage such property.
- Subject to the directives of Nepal Rastra Bank, to carry on Merchant Banking transaction.
- To provide loan based on co-financing according to the agreement conclude among the license holding entity so as to divide the collateral accordingly.

#### **2.1.7.6 Problem Faced by Finance Company in Nepal**

Non-banking sector has been developing rapidly in recent years and are competing with the commercial banks by providing different services and facilities to the customers. But at present, most finance companies are facing financial problems and are not operating smoothly. Their performance is degrading day by day due to international and national economic depression and also due to lack of peace and security in nation.

Due to the lack of proper information about market status and situation and poor knowledge, market intermediaries exploit investors. Some times they think that investing in common stocks is intolerably hazardous. Due to this, many investors are afraid to invest into stocks. This is the main problem that does not allow

gearing up the capital market of the nation. The main problems for the individual investor are lack of proper information about market whereas the problem for financial sector to enhance the goodwill among the public is the frequent collapse of some finance companies being unable to utilize public funds properly. So, every policy and plan of financial institutions and government have to encourage them to invest on common stock.

Common stock holders of the company are its ultimate owners. Collectively, they own the company and ultimate risk is associated with ownership. So the common stock is known as risky security. Risk is defined as the variability of the return of a period. “Risk is the possibility or chance of meeting danger or suffering loss” (Hornby, 1996: 215). “The variability of returns from those that are expressed is defined a risk. The greater the variability, the riskier is the security”. (Van Horn, 1995; 91).

Investment is the employment of funds with the aim of achieving additional income growth in value. It involves the commitment of resources that have been saved or put away from current consumption in the hope that some benefits will produce in future. Investment involves long-term commitment and waiting for a reward. An investment involves the sacrifice of current rupees for future rupees. The sacrifice takes place in the present and certain but the reward comes later, which is uncertain. So the primary problem in investment is to identify the security, which has low risk and higher return. However return cannot increase substantially, risk can be reduced by diversification of funds in different stocks making portfolio of different stock. Well diversification can eliminate the systematic risks.

To eliminate the risk and enjoy and enjoy the return, the investor should follow the systematic investment process. “The investment process describes how an investor

makes decisions about what securities to invest in, how extensive these investment should be, and when they should be made. A five-step procedure for making the decision forms the basis of the investment process.”(Sharpe, Gordon & Jeffery, 1987: 177).

The first step of the investment process is to set the investment policy. It involves determining the investor’s objectives and the amount of his or her invest able wealth. Investor’s objectives should be stated in terms of both risk and return. The second step of the investment process is to perform security analysis. It involves examining a number of individual securities (or groups of securities) within the broad categories of financial assets. The purpose for conducting such examination is to identify those securities that currently appear to be misplaced. The third step of the investment process is construction of portfolio. Construction of portfolio involves identification of specific securities in which to invest, along with the proportion of investable wealth to be put into each security. The fourth step of the investment process is portfolio revision, which involves both realizing that the currently held portfolio is not optimal and specifying another portfolio to held with superior risk return characteristics. The investor must balance the cost of moving to the new portfolio against the benefit of the revision. And the fifth step is portfolio performance evaluation. It involves determination of the actual performance of a portfolio in terms of risk and return, and compares the performance with that of an appropriate “benchmark” portfolio.

The roles of finance companies have been instrumental in the overall economic development of the country. They help to pool and utilize resources, reduce costs and risks, expand and diversify opportunities, increase the allocative efficiency of resources, promote the productivity and economic growth. These are the main part of economy of the nation.

### **2.1.7.7 Failure of Finance Companies**

There are numerous examples of failure of finance companies. in the UK and the USA, many finance companies collapsed due to mismanagement or improper investment choice. This is true even in the case of Asian countries. In Malaysia, for example, most of the finance companies failed in the 1980's and went under liquidation. The principal reason for the failure of these companies can be listed as follows:

- a. Lower investment of the capital by the promoter.
- b. They were established as private companies and run by families.
- c. They had invested their capital to their own subsidiary companies.
- d. The rate of repayment of loans was not satisfactory because they had invested mainly for the consumption purpose.
- e. Capital out flow tendency.
- f. Lack of regulation and supervision by the central bank or Monetary Authority.

When finance companies went bankrupt, there was a big hue and cry by the depositors. They put pressure on the central bank through the government. In this situation there was also growing erosion of faith on the country's financial system. Therefore, the central bank was bound to take steps to overcome such situations.

### **2.1.7.8 Positive and Negative Effect of Finance Companies**

The positive impacts of finance companies are as followed:

They argue with a sense of confidence that the growth of finance companies has made it possible for clients to have easy access to fulfill individual credit needs which continue to be difficult in commercial banks as a result of too mainly unwanted and complicated procedures.

The depositors have now alternatives to choose a finance company where they can pour their funds with attractive return and incentives and favorable terms and conditions that they do not enjoy earlier. The only thing is that finance companies are gaining experience and have to restore full confidence of depositors.

Mobility of deposits by the old and newly emerging finance companies are coming up with positive signals of growth both in terms of volume and speed of deposits. Nevertheless, there is no denying the fact that finance companies have to gain the confidence of depositors further with better performance and funds utilization to generate adequate cash flows from investment and lending function to ensure timely repayment of obligations.

Data reveal that finance companies do not have any uniform standard in the maintenance of their liquid funds. However, the NRB has considered it important to monitor this aspect so to save finance companies from liquidity crunch. It is trying to develop appropriate guideline through the formation of a committee to study finance companies and thereby come out with concrete recommendations for this purpose.

In practical term, criticism on the growth of finance companies is an escapable reality. Such criticism is the direct outcome of events following experience and lessons learned from past mistakes. There are frequent hot news, public opinion debates and professional interactions shown in media about the ways followed and impacts predicted regarding the uncontrolled growth in number of finance companies within a short span of time, the mushroom growth of finance companies has raised reasonable doubts among the intelligentsia and professionals. The main focus of their version is that finance companies would be another kind of activities similar to Uphaar and Dhukuti programmes that would

rob the national wealth to a greater extent. Their arguments against finance companies are streamlined below:

The worldwide experience regarding the relationship between finance companies and economic development is found to be uncertain. For instance, the growth of finance companies in a number of countries, such as the U.K, Malaysia: U.S.A., India, etc., had to face loan repayment problems arising from growing credit defaults. There are also case where the deposits are neither paid interest nor the principal amount. The Savings and Loan Association in the USA had to experience liquidity crunch and cash flow problems. As such, the probability of failure of even single finance companies would bring a wider chain effect of pushing number of finance companies into a critical situation of closures and collapses.

The injection of too many finance companies in the financial system of the country is dangerous for the simple reason that they are relaying on consumer goods that are mostly imported without any relationship between national consumption pattern and domestic forces to operate freely in the national economy. Instead of discouraging the registration and permission of operating finance companies, the NRB should have concentrated much of its energy and effort to monitor them properly in the protection of broader national interests. The present attitude and official tendency directed to slow down the grant of license to those who have applied is in sharp contrast to undermine the very thrust of government's economic liberalization policy.

And to put on records of the fact that finance companies have made it possible for capital formation by creating demand for industrial goods and services. It would be the long- term strategy of finance companies to support more to industrial

financing to ensure overall growth of industries by having appropriate consumption-production relation from a funding process of finance companies.

But, the role and scope of finance companies in national; development contest are guided by what economists called it a development paradox. The paradox arises from the fact there are two equally appealing viewpoints relating to the impacts of finance companies on the national economy:

- a) Those supporting finance companies to have positive impacts on the national economy.
- b) Those opposing finance companies to have negative impacts on the national economy.

#### **2.1.7.9 Limitations on Finance Companies**

The coming of a finance company is a breakthrough from an informal to a formal credit financing within the regulation and control of the NRB. It is accepted facts that finance companies are playing actively in the manufacture of funds to meet the credit needs of the potential clients. In a situation when commercial banks are not able to meet the individual credit needs, it is timely that finance companies have grown to replace the unauthorized and illegal Uphaar and Dhukuti practices. The finance companies can do better and would do better to ensure favorable impact on the economy. Given this scenario, those who are waiting for NRB's approval hold the common viewpoint that there is no reason why the NRB is making unnecessary delays in providing license despite the open declaration of the government to allow competition and inject market the manufacture of credit in helping individuals to meet their credit needs by linking to production, trading and income reproducing effects of business and industry. The recycling of funds from individual to individual is done by finance company such as catering of the individual needs for timely credit financing.

So, the idea here is to make it possible for finance companies to borrow from commercial banks since:

- a) There is potential with finance companies to absorb credit by mobilizing to selective individuals, and
- b) While banks have potentials to collect deposits as they have gained public confidence to ensure adequate safety on deposits. The NRB should allow funds transfer process between banks and finance companies within given norms and standards of eligibility to make it possible for both to benefit at the same time in terms of deposits-investment matching.

Finance companies have to follow stay in business principle by diversifying financial product service delivery through promotion and establishment of companies, managing their share floatation, investment advice and information dissemination, underwriting, bridge financing, helping individuals to plan their investment portfolio depending upon preferences and need for liquidity, profitability, safety capital appreciation, etc. moreover, finance companies deal with individuals directly or through capital market to fulfill their individual credit needs and investment portfolio plans while commercial banks because of their bigger sizes in terms of resource deal more with institutional credit needs like development business and industry.

It should not be forgotten that finance companies have to generate income from fee-based activities rather than always depending upon fund-based activities. For this, finance companies have to specialize in merchant banking function such as new issues management, underwriting, investment counseling, portfolio management, market studies through research and development, etc.

### **2.1.8 Management and Organizational Structure of Finance Company**

Finance companies were established by various professionals of different fields and experienced, from which they easily accomplished their targeted goals and objectives.

They have many years of experienced in banking sector. Having experienced management it has been able to be one of the best Finance Company of the country. Because of the qualified management and staff, it makes possible to accomplish their targeted goals and objectives.

Only one promoted should be allowed to hold executive positions and all other should be recruited from outside to maintain a clear line demarcation between policy making board and executive staffs which carries the policy guides set by the board. The executive staff becomes accountable to board for all decisions undertaken by them and nature of punishments and rewards upon the merits of the case.

Under this shape of organization each and every kind of finance companies has different departments and each department reports to a man specially qualified for a particular function regarding financing, deposit collection and other activities. The specialists attain to one function in all the departments, but workman (departmental manager) has to worked under require number of assistant for achieving their goals and objective. The essence of this form of organization in the delegation of authority is from the top to downwards in accordance with the function to be performed and like workers have to receive orders from more than one person.

Each and every finance company has to be established, organized managed and operated with a professional team of mixing innovative with money and experience. Mostly, local national promoters establish finance companies whereas

some of the finance companies are on the joint venture with international organizations.

### **2.1.9 The Objectives and Services of the Finance Companies**

The main objectives of finance companies have to design for customer and also help them to execute the investment portfolio that is very suitable activities for the need and perfume. Another main function is to design for the investors business or venture the optimal capital structure and help them raise the capital that is “The adequate capital information for overall national development.” This is called “production consumption linking model of credit and investment.”

Developing the industry within the country is must and finance companies should redirect thinking in this line to finance the expansion and growth to both small and medium, scale industries, then by creating the market for industrial products within the country. Finance companies can help consumers to consume domestic products and at the same time creates market for their products.

#### **2.1.9.1 General Services Provided by the Finance Companies**

Finance companies can have many functions outlined by their management as per the market demands. However, there are certain specific functions of finance company, which are given below.

- a. Mobilization of small and large-scale deposits from rural and urban area and channeling of those deposits into productive structured and high priority areas to assist in the economic development of nation.
- b. Most important function of the finance company is to explore and innovate new business opportunities such as venture financing investment plans etc.

- c. Collecting and mobilizing fund for investment in the country. Their scope has increased both in volume and speed to meet the need of the client on easy terms and conditions.
- d. To prepare investment and credit strategy to the productive industrial sector which assist in the economic development of the nation.
- e. The finance companies are providing the various alternatives to depositors in enabling clients to deposit according to their need and preference.

Beside these functions, finance companies play effective role for the development of nation in indirect ways. They are as follows:

- a. The employment opportunities
- b. Income for exertion
- c. Saving recycle for future
- d. Avail the basic needs and expectation of customers.

#### **2.1.9.2 Special Services Offered by Finance Companies**

Nowadays the role of finance company has to be designated for customer and also help them to execute the investment portfolio that is very suitable activities for their need and perfume. Another main function is to design for the investors business or venture the optimal capital structure and help them raise the capital. There are some specific functions of finance company, which are given as follows

- A** i) Fund based activities
  - ii) Fee based activities
- B** i) Financial service
  - ii) Investment banking
  - iii) Merchant banking

The three services that are financial, investment and merchant banking can be described as under:

<b>Financial Services</b>	<b>Investment Banking</b>	<b>Merchant Banking</b>
Resource Mobilization	Stock Broking	Issue Management
Fixed Deposit Scheme	Trading & Market	Under Writing
Marketing		
Real State & Housing Financing	Fund Mgt. Scheme	Bridge Finance Issues
Asset Financing (H.P)	Equality Research	Equality Placements
Inter Company Deposits	Portfolio Management	Co-Operative-Advisory Service
Terms Loans	Structural Income Schemes	Project Counseling
Leasing		

There are some finance companies whose activities are only toward leasing. Lease is a popular and creative financing technique, which allow corporation and individual to secure and use equipment loan is lessee against, or user of the equipment is not owner of the equipment. The lesser is owner. In other words, lease the lessee against the rental income, the use of assets for specified period of time. This agreement help the lessee in overcoming the finance problem by having the facilities of using assets and also enabling the lessee to take the owner ship to fulfillment of certain condition of the lease agreement.

### **2.1.10 Contributing of Finance Companies toward National Economy**

Financial institution is the pillars of a nation's economy. Finance companies are recent feature in our country. For the continuous public trusts and confidence is imperative. Finance companies are potential institutional tools of collecting and mobilizing fund for investment in our country. The role of finance companies has to channel fund by gradually shifting priorities from hire purchase and trading to industry to help in the capital formation. The overall growth of national economy

is to be basically linked to the nature and extra of capital formation in the country. In another word we can say that the establishment, growth and development of finance companies is applicable as financial instrument to attract small saving. This will provide investment opportunities to the small and medium savers. The need to strength the institutionalization of finance companies is important to have meaningful relationship between finance company and national development through shift of credit to the productive industrial sector.

Finance activities play vital role in the development of country. Financial development is one of the key indicators of economic development of any country. Financial activities are the integral part of national plan to accelerate the rate of economic development. The main objective of finance company should follow to link credit to industries for production and consumer's function is important to make credit worthwhile to have a meaningful contribution to the development of national economy. As industry grows on the support and funding of finance companies, other economic development indicate follow such as creation of employment, income generation and saving to recycle for further collection of deposits by finance companies and then again extending credit to industries. The process should repeat to have significant relationship between growth of finance companies and overall economic on the other hand.

Finance company has to channel fund by gradually shifting priorities from hire purchase and trading to industry to help in the capital formation within the country. Thus in the course of time, industrial should get higher priority in the lending strategy of the finance companies. This will ensure their future sustainability for mobilizing public, private and external finance resource and channeling them into them into product areas as short-term loans and long term loans on different commercial business activities. Expansion and growth of both small and medium scale industries help the development of industrialization,

which create the market for industrial product within the country. Finance can help consumer to consume domestic product and at the same time helping industries both in financing of market for their products.

### **2.1.11 Different between Finance Company and Commercial Bank**

Financial institutions can be broadly categorized into banking and non-banking (i.e. finance companies). The former comprise of banking institutions with a primary aim to mobilize resources in various forms and to channel the same into the different sectors of an economy, which is more or less defined and controlled by the central bank of any country.

The non-banking categories of financial institutions are not allowed to do banking transactions such as issue of cheque, drafts, letters of credit and other negotiable instruments. They are also not allowed to accept current deposits from public. Whereas banking companies have to go in a mass under the guidelines specified for them, finance companies (non-banking) don't have any such requirement.

A non-banking financial institution is also known as a Finance Company. They basically deal in finance i.e. money. Thus, one of their basic roles is to act as an intermediary in finance transaction. On the basis of activities and service area there is difference between commercial bank and Finance company which are given below:

- a) Finance company is able to provide higher interest rate and various alternatives for deposits as compared to commercial bank.
- b) Finance companies provide long term and short term loans while commercial banks deal mostly with long term loans.
- c) Finance companies can extend financial services and provide loans in those areas where commercial bank are not reached.

- d) The commercial banks focus their activities only in banking area. But finance companies are focusing their activities and services oriented towards the consumer.
- e) The recycling of funds from individual to individual is done by finance company while commercial bank cannot be able to do it.
- f) Finance companies deal with individuals directly or through capital market to fulfill their individual credit needs and investment portfolio plans while commercial banks deal more with institutional credit needs like developing business and industry.

#### **2.1.12 Source of Funds of Finance Companies:**

A finance company will have access to a number of funding sources, broadly classified into capital (own funds) and debt (borrowed funds). The capital may be in the form of equity shares, preference shares, and convertible debentures etc. Besides these, a company may retain a part of its profits and plough it in the business. The sources of borrowed funds of finance companies are generally as follows:

- i) Commercial Bank
- ii) Institution sources (depositors and lenders) such as insurance companies, public and financial institutions, pension funds, employees' provident fund, welfare funds, corporate etc.
- iii) General public by means of Fixed Deposits
- iv) Capital market by the way of debentures and other tradable instrument issue.
- v) Money Market
- vi) Inter-finance Company deposits

Of the above, most of the sources mentioned in point ii, debentures, tradable instruments issue and money market sources are largely untapped in Nepal can

carry immense potential as sources of funds. What are the needs in our context is the ability to identify and foray into new and unexplored avenues with instruments that suits the requirements of that particular avenue/segment.

Worldwide, commercial banks are the chief source of finance for finance companies, especially leasing companies. In India, finance companies have relied upon bank funds to a very large extent, which is the reason that has promoted banks to float their own subsidiaries finance. Because of the nature of their own funds, which mostly flow from demand and term deposits, banks lend for short terms. These short terms loans are usually for not longer than 3 to 5 years and serve as marching finance or back up finance for leasing and other transaction. This is the general fashion followed by commercial banks.

For effective mobilization of fixed deposits, it is necessary to identify a target group and then make persistent innovative efforts to capture it. Depositors today need a wide choice. With a little imagination, novel schemes can be formulated within NRB rules: to replace the present stereo typed cumulative or periodic return schemes.

There are various numbers of finance companies, which are already in operations but have not yet floated shares to the investing public. These finance companies that vary in sizes, capital contributions and scope of operations and even their management differs from each other with different backgrounds and experience.

### **2.1.13 Resources Mobilization of Finance Companies**

The growth and development of the financial institutions in an economy depends to a very large extent on the quantum of funds they can command. With the rapid increase in number of finance companies and the expansion of the financing business undertaken by them besides other financial institutions is gaining ground.

These institutions are making hard efforts to leave no stone unturned to mobilize maximum capital resources.

In this context, Nepal Rastra Bank' permissions to finance companies to raise funds equal to ten times of their net worth have come in handy. The other important factor that has stimulated the growth of finance companies and the steady increase in deposits is that, unlike in most other countries, finance companies have been allowed to mobilize deposits rights from the day they start their business operations and there are no other entry norms prescribed. Another notable feature of the Nepal Rastra Bank directives governing deposits interest rates and the lending interest rates and no floor or ceiling rates has been fixed.

After the enactment of the Nepal finance company act 1985 (2042 B.S.), altogether, about 193 financial institutions including 79 Finance companies, 28 Development banks, 11 Micro-finance development banks, 18 Commercial bank, 19 Saving & Credit Co- operatives and 47 NGOs have already come into the market.(As of mid-October, 2008). Apart from them, there are hundreds of other such institutions those are operating without NRB license.

Finance companies are a comparatively new scenario in the country, and they have to compete with other very well accepted financial institutions, including commercial bank, and are practically made to fight against the prevailing public psychology that works against finance companies. The sources of funds for financial institutions are not being widened, and the annual increment rate is very low. Accordingly, competition for funds, both inter-financials and inter-finance companies has really augmented.

In Nepal, finance companies have been able to mobilize funds totaling to over Rs. 19812.2 million as on mid July 2008. This is an increase of about 21% over the

corresponding period of the previous year when the total funds at finance companies amounted to Rs. 13058.5 millions. If we compare further back there was an increase of about 23% in the year 1999. This increase can be considered to be enthusiastic keeping in mind that the finance companies are in the initial stage of their development. This indicates the huge potential that the finance companies carry and the contribution they can make to the national economy with a little more encouragement.

“Finance companies are basically risk institutions with institutional and retail funds and undertake term lending functions. The structure of resources of finance companies in developed and developing economies depends on institutional sources and retail comprises only a small portion of the total resources mobilized by them (Sharma, 2002: 57).

Finance companies have a completely different perspective of the whole amount of resources and credit management. This difference in the perspective has resulted in wide dissimilarities between banks and finance companies and difference becomes more and more visible with the development of finance companies. Commercial banks function center on sourcing of institutional fund and their channel into trade, commerce and industries as short to medium term advance. Whereas as finance companies concentrate on raising retail funds and scheme/use specific loans and their channel as medium to long term loans into various sectors of the economy.

This difference in the basic structure between a banking institution and a finance company needs to be understood well as there are wide feeling that are competing for the same sources of funds. Such feelings hold true on the case where finance companies are a new scenario and only traditional sources of fund exist for both finance companies as well as commercial banks and new sources are yet to be

developed. But as mentioned above experience of other economies have proved it otherwise. Four basic practical steps are involves in resources mobilization of finance companies, which are as follows:

- Awareness about various avenues for resources mobilization, i.e. sources of funds.
- Selecting a particular sources or sources mobilization.
- Selecting out strategies for resources mobilization (such strategies will naturally be company-specific).
- Implementation of the resources mobilization strategy.
- Conducting periodic reviews.

The existing finance companies that have started gaining experience are some or the other seems to have a lot of variations in their investment portfolio strategy. Some have concentrated their investment heavily in government securities while other in risky assets portfolio such as investment in shares. None of the finance companies have invested in government bonds yet.

#### **2.1.14 Features of Sound Lending and Investment Policy**

The income and profit of a finance company largely depends upon its lending procedures, policies and investment of its funds in different securities. There is always a positive relation between the credit and the profitability of the bank. The greater the credit created, the higher will be its profitability. A sound lending and investment policy is not only the pre-requisite for finance companies profitability, but also crucial for the promotion of commercial savings of a backward country like ours. Some of the main characteristics for sound lending and investment policies that must be considered by finance companies are:

## **A. Safety and Security**

A finance company should always be cautious about the safety and security of its investments. It should never invest its funds in those securities which are too volatile i.e., which are subject to too much depreciation and fluctuation because a little difference may cause a great loss. Similarly, it should not invest its funds into speculative businessperson who may earn millions or be bankrupt in a split of seconds. It should always have a proper security that has been pledged for making investments. Securities means adequate collateral having good value, which can easily be sold off, if required at any point of time, the bank should accept those securities that are commercial, durable and marketable having a fair market value. For this purpose, the bank should apply "MAST" in order to reach to a proper investment decision, where MAST stands for

M= Marketability

A = Ascertain ability

S = Stability

T = Transferability

The capital structure of finance company consists of money borrowed from customers on various accounts. Therefore, it must take immense care while providing loans to borrowers. For this, risk and return must be properly analyzed, so that depositor's money is advanced safely. Hence, the finance company should consider the 3c's in arriving to the decision regarding the advances of funds. The 3c's are Character, Capacity and Capital.

## **B. Liquidity**

Liquidity is the ability of a firm to satisfy its short- term obligations when they become due for payment. People deposit money in finance company on different accounts with the confidence that it will be able to repay their money when they need. In order to maintain this confidence and loyalty of the depositors, the

company must keep this point in mind while investing its excess funds in different securities, so that it can meet current or short-term obligations when they become due for payment.

### **C. Profitability**

Profit is an income from an investment or transaction. It is the excess of income over expenditure during a period of time. Finance companies can maximize its volume of wealth through maximization of return on their investments and lending. They must invest their funds rationally to those areas, which will maximize their profits. The profit of Finance companies depends upon the interest rates, volume of loans, its time period and nature of investment in different securities. Thus, the greater the ability of a bank to create credit, the higher will be its profitability.

### **D. Diversification**

A finance company should always bear in mind not to invest only in a particular sector. In fact, it should diversify its investments. Diversification helps to minimize risks and uncertainties. It is based on a popular saying, "Do not put all the eggs in the same basket", this is because diversification of loans helps to sustain loss according to the law of average. If securities of a company are deprived, there may be appreciation in the securities of other companies, which will minimize and recover the loss from the former. Hence, a good diversification theory advocates investment in various portfolios.

### **E. Legality**

Finance company should invest only in legal activities of a business. It should not invest in any kinds of illegal activities that may hamper its reputation as well as, if loss occurs, will solely be responsible for the loss of its investment. Illegal securities will bring out lots of problems for the investor. Therefore, a finance

company must abide by the rules and regulations along with different sorts of directives issued by the central bank ( Nepal Rastra Bank ), Ministry of Finance, Ministry of Law and other relevant authorities while mobilizing its funds for its own interest.

#### **F. Purpose of Loan**

Loans are taken for various purposes hence, it is very important for the finance company to know why this is taken or for what purpose for security reasons. If a borrower mis-uses the loan granted by the company, the company may suffer heavy loss. Therefore, in order to avoid such circumstances, it is essential that a company examine all the essential documents and information about the scheme of the project and credit worthiness of the borrower before approving the loan. So, the purpose of the loan must be clearly stated in order to determine whether it is taken for a proper cause or whether the borrower will be able to repay it.

#### **G. Tangibility**

However, it may be considered that tangible property does not yield any income apart from direct satisfaction of possession of property, many a times; intangible securities have lost their value due to price level inflation. A finance company should prefer tangible security to intangible ones.

#### **H. National Interest**

Every organization is driven with a selfish motive of its own profit maximization, which of course is not illicit, but at the same time, they should consider the national interest. Finance companies, though may not get maximum return from such investments, and should carry out its obligation towards the society and the country. They are required to invest on such sectors as per the Government and Nepal Rastra Bank's instructions. Thus, they are encouraged to invest in those sectors that will help to increase the national interest. Some examples of

investment in national interest are investment in government bonds, priority and deprived sector lending etc.

### **2.1.15 Meaning of Some Important Terms**

Since the study is based on financial and managerial accounting subjects, efforts have been made to clarify the meaning of some important terms, which are frequently used in this study.

#### **2.1.15.1 Banking Terms**

##### **a) Loans and Advances**

Loans and advances is the main source of income for a financial institution. The deposits can be crossed beyond a desired level but the level of loans, advances and overdrafts will never cross it. The facility of granting loan and advances is one of the main services, which customers of the finance company can enjoy.

Funds borrowed from financial institutions are much cheaper than those borrowed from unorganized moneylenders. The demand for loan has excessively increased due to cheaper interest rate. Further, an increase in economic and business activities always increase the demand for funds. Due to limited resources and increasing demands for loans, there is some fear that financial institutions and other commercial banks too may take more preferential, collateral while granting loans causing unnecessary botheration to the general customers. Such loans from these institutions would be available on special request only and there is a chance of utilization of resources in economically less productive fields. These are undesirable effects of too low interest rate.

##### **b) Investment on Govt. Securities, Shares and Debentures**

Though a finance company can earn some interest and dividend from the investment on government securities, shares and debentures, which it is not the major portion of income but it is treated as a secondary source of banking business. A financial institution may extend credit by purchasing govt. securities, bond and shares for several reasons.

- i) It may want to space it's maturing so that the inflows of cash coincide with expected withdrawals by deposits of large loan demands of its customers.
- ii) It may wish to have high-grade marketable securities to liquidate if its primary reserves become inadequate.
- iii) It may also be forced to invest because the demands for loans has decreased or is not sufficient to absorb its excess reserves.

However, investment portfolio of finance company is established and maintained primarily with a view to nature of financial company's liabilities. That is since depositors demand funds in great volume without previous notice; the investment must be of a type that can be marketed quickly with little or no shrinkage in value.

#### **c) Investment on Other Company's Shares and Debenture**

Due to excess funds but least opportunity to invest those funds in much more profitable sector and to meet the requirement of Nepal Rastra Bank's directives, many financial companies have to utilize their funds to purchase shares and debentures of many other financial and non-financial companies.

#### **d) Off-Balance Sheet (OBS) Activities**

Off-balance sheet activities involve contracts for future purchase or sale of assets and all these activities are contingent obligations. These are not recognized as assets or liabilities on balance sheet. Some good examples of these items are letter of credit, letter of guarantee, bills for collection etc. nowadays, such activities are

stressfully highlighted by some economists and finance specialists to expand the modern transactions of these companies.

### **e) Deposits**

For a financial institution, deposit is the most important source of the liquidity. For its financial strength, it is treated as a barometer. Though they constitute the great bulk of liabilities, the success of a finance company greatly depends upon the extent to which it may attract more and more deposits.

## **2.2 Introduction of Sampled Companies**

### **2.2.1 Goodwill Finance Co. Ltd.**

Goodwill finance Co. Ltd. is established with the aim of achieving the national economic goal by mobilizing the small level of saving of the local people. The company was registered in the year of 2051 B.S. while it has got the license from Nepal Rastra Bank only in the year 2052 B.S. The company started its operation from the year 2052 B.S. with the authorized capital of Rs. 50 millions issued capital Rs. 25millions and paid Rs. 7.5 millions. However it started to flow its shares to the general public in the year 2055 B.S. It proved to be a successful within a very short span of time. In the same year the company was listed into the stock exchange.

Situated at the middle of the capital city (Dillibazaar, Kathmandu), the company has maintained the average growth since the establishment. This is justified by the mobilization of funds statement to till date (refer to the balance sheet and profit and loss statement to till date at appendix).

The company provides the following services at present:

1. Fixed deposits
2. Periodic saving scheme
3. Loans to general public

4. Market producer
5. Investment services
6. Company promotional activities
7. Financial guarantees

### **2.2.2 National Finance Co. Ltd.**

National Finance Co. Ltd. is established in the year 2049 B.S. The company was registered with company registrar's office in the same year. While it has started its operation in the year 2050 B.S. and got the license from Nepal Rastra Bank in the same year.

The company was started its operation with authorized capital Rs.60 millions and issued capital Rs. 30 millions. At the establishment it was in Basantapur, in front of Kathmandu Durbar Square. Later on, it has shifted into its own building at Pako, New Road in the year 2057 B.S. The company was established with the aim of achieving the national economic goal by mobilizing the small level of saving of the local people.

However, it started to flow its shares to the general public in the year 2055 B.S.. It proved to be a successful company within a very short span of time. In the same year, the company was listed in the stock exchange.

National Finance Company provides the following services:

- i. Fixed deposits
- ii. Periodic saving scheme
- iii. Loans to general public
- iv. Market producer
- v. Investment services
- vi. Company promotional activities

- vii. Financial guarantees
- viii. Hire purchase, leasing trade and other kinds of business.

### **2.2.3 Universal Finance Co. Ltd.**

Universal Finance co. Ltd was established in the year 2052 B.S. in the same year, it has registered with company registrar's office. In the year 2053 B.S, it has got the license from Nepal Rastra Bank and started its operation.

At the establishment, the company started its operation with capital of Rs.39.56 millions. Up to till date; it has owned Rs.75 millions and Rs.50 millions as an authorized and issued & paid-up capital respectively.

The company office is situated in Kantipath, Jamal, Kathmandu. The company was established with the aim of mobilizing the small levels of depositors of general public into the business and industry. While briefly studying the position of this company, it seems to be successful to list its name in the contribution of national economic growth.

The services provided by this company are as follows:

- a. To accept deposits in saving and fixed accounts by providing standard rate of interest.
- b. To provide loan by accepting the security of debtor.
- c. To encourage lower income customers, it provides periodic saving scheme.
- d. To play as a mediator for issuing public share, share certificates, debentures, government securities and other services.
- e. It provides locker facilities to their customer to keep valuables goods, documents, acts etc.
- f. To give services like hire purchase, leasing, trading of stock etc.

### **2.2.4 Standard Finance Co Limited**

Standard Finance Co. Ltd. was registered with company registrar's office in the beginning of 2052 B.S. Later on, it started its operation with the license from Nepal Rastra Bank in the same year. The company has started its operation with Rs.20 millions, Rs.10 millions and Rs.10 millions as an authorized, issued and paid up capitals respectively.

During the endings of year 2052 B.S, it has floated its shares to general public and in the same year, it was listed in the stock exchange. The company was established with the following objectives;

- i) Development of share market, trading of stock and mediation in Nepal.
- ii) Trading of all kind of stocks with the policy of open trading.
- iii) Introducing new schemes of business opportunities and services for general public.
- iv) The services after the issuance of public shares such as issuing share certificates, debenture, bonds and other services.
- v) The hire purchase, leasing and other kinds of services for industry, trade and other kinds of business.

This company is situated at Kamalpokhari, the heart of the Kathmandu valley. Up till now it has owned Rs.240 millions, Rs.120 millions, Rs.60 millions as an authorized, issued and paid up capital respectively.

Since the establishment, the company has also proved to be a leading company in the circles of financial institutions in Nepal. This can be justified with the financial statement issue yearly till date.

### **2.3 Review of Books and Articles**

Finance companies are such types of institutions, which deal in money and substitute for money. They deal with credit and credit instruments. Good circulation of credit is very much important of these institutions. Unsteady and unevenly flow of credit negatively affects the economy as well as the companies. Thus, to collect fund and utilize it in a good investment cannot be a lighter job for such organizations. They should properly utilize its funds in various investment avenues with a view to sustain and earn profit. Hence, an investment of fund may be the question of life and death for a finance company.

**James B. Baxley** is of the view that, "Investment policy fixes responsibilities for the investment disposition of the banks' assets in terms of allocating funds for investment and loan and establishing responsibility for day to day to management of those assets"(Baxley, 1987: 112).

Emphasizing the importance of investment policy, **H.D. Crosse** puts his view in this way, "Lending is the essence of financial institutions, and consequently the formulation and implementation of sound policies are among the most important responsibilities of directors and management. Well conceived lending policies and careful lending practices are essential to perform their credit function effectively and minimize the risk inherent in any extension of credit"(Crosse, 1963: 235).

It is said that a finance company must strike a right balance between liquidity, profitability and safety. "The secret of successful finance company is to distribute resources between the various forms of assets in such a way as to get a sound balance between liquidity and profitability so that there is cash (in hand quickly releasable) to meet every claim and at the same time, enough income for the company to pay its way and earn profits for its shareholders"(Radhaswami & Vasudevan, 1979: 321).

According to **L.V. Chandler**, "A Financial Institutional seeks optimum combination of earning, liquidity and safety while formulating investment policy"(Chandler, 1973: 162).

In the words of **Gitman and Jochnk**, "Investment is any vehicle into which funds can be placed with the expectations that will preserve or increase in value and generate positive returns"(Gitman & Jochnk, 1990: 56).

**S.P. Singh and S. Singh** holds that, "The investment (credit) policies of finance companies are conditional, to great extent, by the national policy framework; every company has to apply his own judgment for arriving at a credit decision, keeping of course, his company's credit policy also in mind"(Singh,1983:165).

**Charles P. Jhones** defined investment as, "The commitment of funds to one or more assets that will be held over some future time period"(Jhones, 1988: 45). Investment is the study of the investment process and is concerned with the management of an investor's wealth.

"Default risk arises because firms may eventually be bankrupt. Some default risk is undiversifiable because it is systematically related to the business cycle, which affects almost all investments. However, some default risk may be diversified away in a portfolio of independent investments" (Francis, 1983: 315).

Investments policies include credit analysis and its principle purpose is to determine the ability and willingness of a borrower to repay a requested loan in accordance with the terms of the loan contract. Factors considered in credit analysis are capacity to borrow, characters (honestly, integrity, industry, ability to create income, morality, ownership of assets, economic condition etc). Loans are the most important assets held by finance companies and their lending provides the bulk of income (Cotter Reed, 1976: 203).

**Cotter, Reed** (1976) has stated that, "More and more financial institutions have developed formal, written lending policies in recent years. They provide guidance for lending officers and thereby establish a greater degree of uniformity in lending practices. Since, lending is important both to the financial institutions and their community, loan policies must be worked out carefully after considering various factors like

- a. Risk and profitability of various types of loans
- b. Economic condition
- c. Stability of deposits
- d. Influence of monetary and fiscal policy
- e. Capital portion
- f. Ability and experience of company personnel
- g. Credit need of the areas served

**Prof. M. K. Shrestha** (1995) has stated in his book "Finance Companies in Nepal" that finance companies have to be established, organized, managed and operated with a professional team of mixing innovative ideas with money and experience .

"Economic liberalization policy of the government has encouraged the establishment and growth of finance companies in the country within a short span of time. In a situation when the existing financial institutions, especially commercial banks are unable to supply credit timely and carry capital market activities, finance companies have come timely to meet the individual credit needs, undertaken merchant banking functions and also curtail the operation of Upahar and Dhukuti programs".

There are clear explanations about the function of finance companies in his book "One of important think to be considered by finance companies are they have to

generate income from fee based activities rather than always depending upon fund based activities. These include a board range of merchant banking functions such as project planning, corporate counseling, loan syndication through underwriting and bridge financing issue management, individual investment, portfolio management, mutual fund, venture financing, leasing, mergers and acquisitions, brokerage and management consultancy services etc. this provides a simple answer to have a clear line of distinctions between finance company and commercial bank. Finance company deal with individuals directly or through capital market to fulfill the individual credit needs while commercial banks because of there bigger size in terms of resources deal more with institutional credit needs like developing business. The recycling of funds from individual to individual is done by finance company such as catering of the individual needs for timely credit financing.

He further explains about the role and function of Nepal Rastra Bank towards the finance company as follows. After the finance company is registered and applied for license with NRB, a high level technical committee does more serious and detail study and analysis of feasibility report submitted by finance companies under the management and leadership of NRB's deputy governor. Based on the recommendations of this high level committee, policy, framework and guide line will be published to help and direct the establishment and regulation of finance companies in the country. The recommendations of this committee will also help to determine basic eligibility criteria to be applied while issuing license to new finance companies and also in monitoring to those already establish and have started operations.

In the words of **Sharpe and Alexander**, "Investment, in its broadest sense, means the sacrifice of certain present value for (possibly uncertain) future value". ("Sharpe & Alexander 1999: 124).

**Frank K Reilly** has defined investment in this way, " An investment may be defined as the current commitment of funds for a period of time to derive a future flow of funds that will compensate the investing unit for the time the funds are committed, for the expected rate of inflation and also for the uncertainty involved in the future flow of the funds" (Frank, 2002: 64).

**Dr. Preeti Singh** has defined investment, "Investment is the employment of funds with the aim of achieving additional income of growth in value" (Singh, 1993:15).

From the above definitions, it is clear that an investment means to trade a known rupee amount today for some expected future stream of payments or benefits that will exceed the current outlay by an amount that will compensate the investor for the time the funds are committed, for the expected changes in prices during the period and for the uncertainty in expected future cash flows.

A financial institution must mobilize its deposits and other funds to profitable, secured and marketable sector so that it can achieve a handsome profit, should be secured as well as can be converted into cash whenever needed. Obviously, a firm that is being considered for commercial loans must be analyzed to find out why the firm needs money, how much money the firm needs and when and how it will be able to repay the loan.

#### **2.4 Review of Relevant Studies**

The effort has been made in this heading to highlight some related articles published in different economic journals, magazines, newspapers and other related sources. However, there is not much articles published related to investment management in Nepal.

In the article published by **Schultz Collins Lawson** Chambers Inc. in 1999 explained that "Selecting investment options for a defined contribution plan can be an extremely difficult task. Many plan sponsors find that they are faced with an endless supply of opinions regarding how the problem should be addressed. Further, they lack a rational framework for coherently addressing the selection process. An investment policy statement can be an invaluable tool for streamlining investment selection and documenting the prudence of the sponsor's selection process. The effort implicit in drafting a high quality investment policy statement will be well rewarded."

**Thomas K. Philips** (2003) has stated in his article "An Opportunistic Approach to Alternative Investing"([www.investmentpolicy.com](http://www.investmentpolicy.com)) that capital should be committed to alternative investments based on both their expected returns and the nature of the current opportunity set. An investor seeking the best return from alternative investments would, as a result, direct most new commitments at a given time to a few asset categories and invest in the remaining categories only on a very selective basis. Over time, such an investor would build a diversified portfolio of private partnerships with outstanding management that have had the foresight to launch their partnerships when good properties or deals were available at fair prices in their market segment.

The research-oriented articles prepared by **Ajay Ghimire** (1997) "Process involved in financing a corporation: A Nepalese context." In this article he puts stress on the establishment of finance companies as "Financing and investment are two sides of the same coin. A firm 'F' taking money from firm G (G could be any legal entity including a financial institution) to finance activities of firm F can be interpreted as firm G investing in firm 'F'. Such investments do not necessarily have to be in the form of equity or common stock (Residual claim). Further, firm G's financing of firm F does not necessarily have to be in the form of debt or loan

(Fixed claim). Between common stock and plain vanilla debt, a firm could design and sell many claims in order to finance its assets.

**Dr. Radhe S. Pradhan** (1994) "Financial Management and Practices in Nepal" in 1992, dealt mainly with financial function, sources and types of financing, financing decision involving debt effect of change in taxes on capital structure, financial distress, dealing with banks and dividend policy. The main findings of the study connected with financial management are as follows:

- The enterprises have a definite performance for bank loans at a lower level of debts.
- Generally, there is no definite time to borrow the issue stocks. That is majorities of respondents are unable to predict when interest rate will lower or go up or are unable to predict when the stock will increase or decrease.
- Most enterprise does not borrow from one bank only and they do switch between banks whichever offer best interest rates.
- Most enterprises find that banks are flexible in interest rates and convenient.

Thus, to sum up it can be said that out of numerous studies in the capital market of Nepal, this study has established itself as a milestone.

In a hypothetical world where person managing a corporation (firm) acts with the sole objective of maximizing value of the firm, the firm seeking finance will chose the financier and mode of financing that maximizes the value of the firm. Similarly a hypothetical financial institution whose managers act with the sole consideration of maximizing value of the institution, will invest in firms and business in such a way that maximizes value of the institution.

At conclusion, he states that "Financing and investment decision, or for that matter any decision, of a firm is an outcome of a complex equilibrium process. Multitude of complex relationship is between the firm and owners of various resources (material, skill, capital etc) and among various resource owners. Even the relationship of the consumer of output with various resource owners within and outside the firm affects the outcome. Therefore, there is no "One best investment policy" of all organizations. The organizations interested in optimizing its investment decision should formulate its investment policy taking into consideration the skilled, taste and preference of managers involved in the decision making process".

## **2.5 Review of Previous Thesis**

During the study, the previous students have carried out several thesis works. Among them some, study papers are found to be relevant for this study. They are presented as following:

**Ruru Kusom Gautam** (2000) in her thesis paper, "Investment Analysis of the Finance Companies in Context of Nepal" has pullout the following objectives:

- a) To evaluate the lending and investments policy of the Finance Company.
- b) To find out the relationship between deposits and total investment, deposit and loans and advances and net profit.
- c) To analyzes the adaptation of repayment mechanism of loans and advances maintained by the finance company.
- d) To examine the relationship between Finance company and other financial institutions in the field of capital markets.
- e) To suggest and recommend some measures on the banks of comparative fund mobilization and investment policy of these companies for the improvement of financial performance in future.

She pointed out the following conclusions from her research study:

Economic liberalization policy of the government has encouraged the established and growth of finance companies in the country within a short span of time. In a situation when the existing financial institutions, especially commercial banks were unable to supply credit timely and carry capital market activities, finance companies have contributed a lot.

She found the overall performance of finance companies is satisfactory and Nepal Rastra Bank has to play more active role to enhance the operation. The analysis of lending and investment activities shows that only very few finance companies have aggressive investment strategy as compared to most of the others following conservative strategy. Initially the major part of their lending was on consumer durable through hire purchase and housing financing. However, the trend is changing towards term loan. As term loan mainly consists of business and industrial loan, this is the indication of investment on productive sector.

Putting upper and lower selling rather than present spread rate system should control the unhealthy competition on interest rate. This will not only reduce the confusion of the customer, it will ensure the proper functioning of the company. Another important thing is strong repayment mechanism and its implementation. As the number of defaults is increasing, this should be in first preference.

Strengthening and the institutionalization of the finance companies is very important to have a meaning relationship between finance companies and national development through the shift of credit to the productive industrial sectors. At the same time, series of reforms such as consolidation of finance companies, good relationship between finance companies and commercial bank, directing attention to venture capital financing, appropriate risk return trade off by linking credit to timely repayment schedules, avoiding imperfections, allowing flexibility in

lending, one window service from NRB, need of a strong supervision and monitoring from NRB, diversify scope of activities to fee based services, allow funds transfer, refinancing facilities for finance companies, professional culture within finance companies etc. All these are necessary to ensure better future performance of finance companies as they have already been established and growing in Nepal.

Finally she has stressed on the part that finance companies have to prove that they can really contribute to the national economy, are efficient and viable agencies for mobilization of saving and its channel into productive sectors are professional managed and competent enough to ensure adequate rate of return on investment and are strategically well planned to be competitive with banks and other agencies and are trust worthy.

**Netra Kumar Katri** (1994) in his thesis paper, "A Study on Investment Policy of Nepal industrial Development Corporation" has found the highest percentage of loan has been invested as direct loan and the least percentage as guarantee loan. He had further discovered that NIDC has given high priority in central development region and the least to Far Western development region. During this study period, NIDC has allocated highest percentage of financial assistance to hotels; lodge as well as tourism based industrial sector and the other industrial sectors. Therefore, he has stressed the need of financing in all region and all sectors providing equal preference to minimize industrial imbalance in the different regions.

**Shova Palikhey** (2000), in her thesis paper, "Performance evaluation of finance companies (A Case Study of Annapurna Finance Company Ltd. Pokhara), has found the liquidity and profitability position of the company is satisfactory. It has sufficient amount of cash available for meeting immediate payment. During her

study period, total deposit of the company increased by 35.54 times. In the same way, loan and advances also increased by 31.43 times. There is high degree of positive correlation between investment portfolio and return of the company. The main objection of her study was to examine the role of Annapurna Finance Company Ltd. in the process or economic development in Pokhara.

**Shree Ram Ghimire** (2000), in his thesis, "A Study on Financial Performance of Finance Companies in the Context of Nepal", has found the liquidity position of AFCO is comparatively better than that of other Finance companies. Highly fluctuating liquidity positions show that the company has not formulated and stable policy. Profitability position of Nepal Share Market & Finance company Ltd. is comparatively not better than that of the selected finance companies. His main objective of his study was to find out the empirical relationship between various important variables i.e., deposits loan and advances, investments, net profit etc and compare between the selected finance companies.

**Resham Raj Pathak** (2001), in his Thesis "A Comparative Study on Financial Performance between Standard Chartered Bank Limited & Himalayan Bank Limited", has found Standard Chartered Bank Ltd. is seemed relatively better than that of Himalayan Bank Ltd. although both the banks liquidity position is not satisfactory. Both the banks have been efficient in utilizing most part of their total assets in profit generating purpose but comparing both banks, Standard Chartered Bank Ltd. has better performance than Himalayan Bank Ltd. for utilizing assets. Return on investment comparatively decided that Himalayan Bank Ltd. has idle deposit, due to the lower return as compared with Standard Chartered Bank Ltd. During his study period comparatively operating and non-operating income of Standard Chartered Bank Ltd. has higher percentage than Himalayan Bank Ltd. and also it gave the higher dividend to its shareholders. The main objectives of his

study was to analyze the financial strength and weaknesses of these two joint venture, banks Standard Chartered Bank Ltd. and Himalayan Bank Ltd.

**Min Bahadur Rana Bhat** (1997), in his thesis, "An Analysis of Financial Performance of Finance Companies in the context of Nepal" has stated that:

There are various services provided by finance companies for the customers. Among them the uses of funds towards Hire Purchase and Housing financing must be shifted towards the business financing. These activities must be taken by finance companies because for achieving the long term objectives of finance companies to shift investment and credit strategy to the productive industrial and business sectors of the economy so as to have adequate capital formation for overall national development.

The unhealthy competition of interest rate towards finance companies for collection of deposit fund and uses of that fund should not be there. There must be certain demarcation line between the various finance companies, which already started their functions.

That is very important to have frequent sharing of experience by conducting a seminar or workshop at least once or twice a year. The key participants will be top executives from Finance companies and concerned regulating authorities to identify where the problems lie in their efficient operations and then based on the feedback information undertake policy measures for future follow-up actions. Nepal Rastra Bank should also encourage training to new entrants to provide orientations on the conceptual dimensions and practical aspects of operating Finance Companies through the development of capital market training institute.

Finance company is playing with public money that consists of both depositors and investors. As such, Nepal Rastra Bank has to keep a strict watch over their

activities to protect the interest of public. For these, regular follow-up and information must be made mandatory to Nepal Rastra Bank to have correct evaluation and monitoring of their performance and minimize any irregularities dictated in the course of investigation. Progress reporting should be a continuous process and finance companies should make their performance transparent to the investing public. In this regard, Nepal Rastra Bank's monitoring and supervision department and also credit information bureau must be further strengthened and institutionalized. This is important to control on both credit flows and unhealthy credit practice by identifying the main credit defaulters and also preparing a black list of the credit defaulters. Professionals with adequate logistic support should manage the monitoring and supervision department and staff to enable it to make independent evaluation finance companies based on well-defined monitoring and supervision criteria. Moreover, there should also be professional representation in the credit information bureau instead of having only member to it. It should conduct studies from time to time by contracting with private consulting firms to produce and independent report on the credit performance status of finance companies.

The finance companies must be allowed to mobilize deposits from border and neighboring areas from Indian citizen's deposits public outer against the government for not stopping flight of capital from the country.

There is an urgent need to have a gradual shift of focus from traditional financing business to the dynamic and innovative areas such as, merchant banking consortium financing and venture capital, project financing etc. also there is a need to offer innovative schemes and instruments in resources mobilization.

**Dhurba, K.C.** (2007), in his study paper, "A Study on the Investment Policy of Pashchimanchal Finance Company Limited" PAFICOL has collected inactive

capital and it has also provided financial assistance to the investors. It has provided attractive interest rate for the deposit to collect the money and also enhance to mobilizing those kinds of resources. Company has make financial resources through the collecting deposit and acquiring the share from new and existing shares. It was increased the number of share through the existing shareholders. During the study period, we found that each sectors of investment of loan and advance is going to positive changes and other major findings of the study.

**Dharma Raj Khanal** (1987), in his thesis entitled, “Investment in priority sector by commercial banks (a study of commercial banks of Kathmandu valley)” has put forward following objectives:

- a) To analyze the trend of investment in priority sector.
- b) To find out the extent of profitability affected in this sector.
- c) To measure the efficiency of the program in the rural and urban sectors.
- d) To evaluate the banking procedures and services in disbursing loans.
- e) To explore the reasons for low investment.

The main findings of the research were as follows:

- i. The investment in priority sector has an increasing trend.
- ii. Banks are giving due consideration to increase investment in the priority sector.
- iii. Due to low interest rate, overhead cost increased in administration and showed low profitability.
- iv. The regression analysis had shown a negative relationship between profit and investment.
- v. The chi-square test has shown that the investment program in rural and semi-urban areas is more effective than in urban areas.

- vi. Banking procedure regarding loan disbursement in priority sector is much more complicated.
- vii. There is wide gap between demand and supply of loan.
- viii. Due to security and lack of proper legal documents most loan requesters have been rejected and even cancelled some of the projects in different sectors.

## **2.6 Research Gap**

Research, the word denotes searching again and again for the same thing to make it clearer and clearer. It incorporates all the search works that are carried either to strengthen the previous findings or to create something new in the world.

This research as is done in the similar topic previously done by some other researchers and by using similar research tools, intends either to strengthen the findings identified by these researcher or to keep its own findings against those previous finding with its own logic. Side by side it also expects some new findings during the course of research.

The research work done cannot be posted as the unique one and said that this type of work is done first time in this field. However, utmost effort has been put upon to save it from allegations of begin copy of previous research works done in the same topic.

Most of the previous researches in the topic have been carried out with five-year data. Similarly, the number of sample firms taken in account by the previous researches is five. Here, in this research five year's data has been taken into account. This research has been conducted with reference to the four sample firms.

Among the previous research works done in this topic, the samples were either mixture of banks and finance companies or that of insurance companies and manufacturing units. Here, the research work has been done with special reference to the Finance Companies.

## **CHAPTER - III**

### **RESEARCH METHODOLOGY**

#### **3.1 Introduction**

The last two chapters covered the introduction where backgrounds of the financial companies have been streamlined. There after, the review of literature with subsequent reviews of relevant ideas, theories and research findings have also been discussed. Therefore it made me to come upon the choice of research methodology. While research methodology refers to various sequential steps being adopted by a research in studying a problem with certain objectives in view. In other words, research methodology describes the methods and process applied in the entire aspect of the study.

The basic objective of this study is to evaluate the investment policy of Finance companies comparing with each other and recommend the useful and meaning points so that all concerned can have the relevant knowledge from this study. To accomplish this job, the study follows the research methodology described in this chapter.

#### **3.2 Research Objectives**

To meet the objectives of the study, the different methods tools are being used. The following question will be solved with the methods being undertaken.

- To examine the liquidity assets management and profitability ratios in the comfortable marks in all the finance companies.
- To analyze the affect of growth on loan and advances and total investment with respect to the growth on deposits and net profit.
- To investigate the mobilization of funds of finance companies in satisfactory manner.

- To find out the trend of deposit utilization of these companies.
- To highlight the relationships between deposits and total investment, deposit and loans and advances and net profit and outside assets.

### **3.3 Research Design**

“A research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure.” It is the plan, structure and strategy on investigations conceived for obtaining answers to research questions and to control variances. To achieve the objective of this study, descriptive and analytical research designs have been used.

Some statistical and accounting tools have also been applied to examine facts and descriptive techniques have been adopted to evaluate investment performance of the finance companies.

### **3.4 Source of Data**

This study is conducted on the basis of secondary data. The data relating to the investment, deposit, loan and advances and profit are directly obtained from the balance sheet and profit and loss account of the concerned finance company's annual reports. Supplementary data and information are collected from number of institutions and regulating authorities like Nepal Rastra Bank etc.

According to the need and objectives, all the secondary data are compiled, processed and tabulated in times series. In order to judge the reliability of data provided, the banks and other sources are compiled with the annual reports of auditor. Formal and informal talks to the concerned head of the departments of the finance companies were also helpful to obtain the additional information of the related problem. Similarly, various data and information are collected from the

periodicals, economic journals, managerial magazines and other published and unpublished reports and documents from various sources.

### **3.5 Population and Sample**

It is not possible to study all the data related with all finance companies of Nepal. There are 79 finance companies in the country and their stocks are traded actively in stock market. So, the investment policies of listed four companies are being compared with that average of the same which are selected from population. The above mentioned 79 finance companies are considered as population.

To calculate industry average, the selected samples are as follows:

- a. Universal Finance Co. Ltd.
- b. National Finance Co. Ltd.
- c. Standard Finance Co. Ltd
- d. Goodwill Finance Co. Ltd

### **3.6 Data Collection Process**

As explained in previous chapters, the main sources of secondary data are the yearly reports of the finance companies published in their respective annual general meetings. In addition to that, some of the relevant data are also collected from the non-bank financial statistics published by the non-bank regulation department of Nepal Rastra Bank.

### **3.7 Methods of Analysis**

To achieve the objectives of the study, various financial, statistical and accounting tools have been uses in this study. The analysis of data will be done according to pattern of data available. With the available tools and resources, analytical statistical tools such as bar diagram, percentage, Karl Pearson's coefficient of correlation, simple regression as well as corresponding hypothesis are adopted in

this study. Similarly, some strong accounting tools such as ratio analysis and trend analysis have also been used for financial analysis.

The various calculated results obtained through financial, accounting and statistic tools are tabulated under different headings. Then they are compared with each other to interpret the results.

### **3.7.1 Ratio Analysis**

The relationship between two accounting figures expressed mathematically is known as a financial ratio. "Ratio analysis is used to compare a firm's financial performance and status to that of other firms or to itself over time." From the help of ratio analysis, the qualitative judgment can be done regarding financial performance of a firm.

In this study, following ratios are calculated and analyzed:

#### **3.7.1.1 Liquidity Ratios**

Liquidity is measured by the speed with which a bank's assets can be converted into cash to meet deposit withdrawals and other current obligations.

##### **i).Current Ratio**

This shows the relationship between current assets and current liabilities. Current assets included cash and bank balance, money at call or short notice, loans and advances, investments in govt. securities and other interest receivable and miscellaneous current assets. Similarly, current liabilities include deposits and other account's short-term loan, bills payable, tax provision, staff bonus, dividend payables and miscellaneous current liabilities.

Current ratio is calculated as:

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

The widely accepted standard of current ratio is 2:1 but accurate standard depends on circumstances in case of seasonal business ratio.

**ii. Cash and Bank Balance to Total Deposit Ratio:**

This ratio is computed by dividing cash and bank balance by total deposit. This can state it as:

$$\frac{\text{Cash and Bank Balance}}{\text{Total Deposit}}$$

Cash and bank balance includes cash on hand, foreign cash on hand, cheques and other cash items, balance with domestic bank and balance held abroad. The total deposit consists of current deposits, saving deposits, fixed deposits, money at call and short notice and other deposits.

**iii. Cash and Bank Balance to Current Assets Ratio:**

This ratio is computed by dividing cash and bank balance by current assets. We can state it as:

$$\frac{\text{Cash and Bank Balance}}{\text{Current Assets}}$$

**iv. Investment on Government Securities to Current Assets Ratio**

Investment on government securities includes treasury bills and development bonds etc. This ratio can be computed by dividing investment on government securities by current assets. This can be mention as:

$$\frac{\text{Investment on Govt. Securities}}{\text{Current Assets}}$$

**v. Loan and Advances to Current Assets Ratio:**

This ratio can be computed by dividing loans and advances by current assets. This can be stated as:

$$\frac{\text{Loans and Advances}}{\text{Current Assets}}$$

The numerator consists of loans, advances, cash credit, local and foreign bills purchased and discounted.

**3.7.1.2 Assets Management Ratios (Activity Ratios)**

Assets management ratio measures how efficiently the bank manages the resources as it commands. The following ratios are used under this asset management ratio:

**i. Loan and Advances to Total Deposit Ratio**

This ratio can be calculated by dividing loan and advances by total deposits. This ratio can be stated as:

$$\frac{\text{Loans and Advances}}{\text{Total Deposits}}$$

**ii. Total Investment to Total Deposit Ratio**

This ratio can be calculated by dividing total investment by total deposits.

This can be mentioned as:

$$\frac{\text{Total Investments}}{\text{Total Deposits}}$$

The numerator consists of investment on government securities, investment on debentures and bonds, shares in subsidiary companies, shares in other companies and other investment.

### **iii. Loans and Advances to Total Assets Ratio**

This ratio is calculated by dividing loans and advances by total assets. This can be stated as:

$$\frac{\text{Loans and Advances}}{\text{Total Assets}}$$

The denominator includes all assets of on–balance sheet items. In other words, this includes current assets, net fixed assets, loan for development banks and other miscellaneous assets but excludes off-balance sheet item like letter of credit, letter of guarantee etc.

### **iv. Investment on Govt. Securities to Total Assets Ratio**

This ratio is calculated by dividing investment on government securities by total assets. This can be stated as:

$$\frac{\text{Investment on Govt. Securities}}{\text{Total Assets}}$$

### **v. Investment on Shares and Debentures to Total Assets Ratio:**

This ratio can be computed by dividing investment on shares and debentures by total assets. This can be stated as:

$$\frac{\text{Investment on Debentures and Shares}}{\text{Total Assets}}$$

The numerator includes investment on debentures, bonds and shares of other companies.

### **vi. Total OBS Operation to Loan and Advances Ratio**

This ratio is calculated by dividing total OBS operation by loan and advances.

This can be stated as:

$$\frac{\text{Total OBS Operation}}{\text{Loans and Advances}}$$

The numerator gives the indication that these transactions/operations are not included or not part of balance sheet items assets or liabilities. It includes letter of credit, letter of guarantees, documents negotiated under reserve (DNUR), capital commitments, commitments on foreign currency purchase contracts, claimed at bank but not accepted and other such transactions.

### **3.7.1.3 Profitability Ratio**

Profitability ratios are very helpful to measure the overall efficiency of operations of a firm. It is a true indicator of the financial performance of any institution. It is notable that higher the profitability ratio betters the financial performance and vice versa. Profitability positions can be viewed in different ways:

#### **i. Return on Total Assets Ratio**

This ratio is calculated by dividing net profit by total assets. This can be stated as:

$$\frac{\text{Net Profit}}{\text{Total Assets}}$$

The numerator indicates portion of incomes left to the internal equities after all costs, charges, expense have been deducted.

#### **ii. Return on Loan and Advances Ratio**

This ratio is calculated by dividing net profit by loan and advances. This can be stated as:

$$\frac{\text{Net Profit}}{\text{Loan and Advances}}$$

**iii. Total Interest Earned to Total Outside Assets Ratio:**

This ratio is calculated by dividing total interest earned by total outside assets and can be stated as:

$$\frac{\text{Total Interest Earned}}{\text{Total Outside Assets}}$$

The denominator includes loan and advances and all types of investment. The numerator comprises total interest income from loans, advances, cash credit and overdraft government securities, inter-bank and other investments.

**iv. Total Interest Earned to Total Assets Ratio**

This ratio is calculated by dividing total interest earned by total assets. This can be stated as:

$$\frac{\text{Total Interest Earned}}{\text{Total Assets}}$$

**v. Total Interest Paid to Total Assets Ratio**

This ratio is calculated by dividing total interest paid by total assets. This can be stated as:

$$\frac{\text{Total Interest Paid}}{\text{Total Assets}}$$

The numerator consists of total interest expenses on deposit liabilities, loan and advances (borrowing) & other deposit.

**3.7.1.4 Hire Purchase Loan to Total Loan and Advance Ratio**

Hire purchase loan to total loan and advance presents the ratio of hire purchase loan in total loan and advance for the specific period. This ratio can be calculated by dividing hire purchase loan by total loan and advance. This ratio can be stated as:

$$\frac{\text{Hire Purchase Loan}}{\text{Total Loan \& Advances}}$$

### **3.7.1.5 Housing Loan to Total Loan and Advance Ratio:**

Housing loan to total loan and advance presents the ratio of housing loan in total loan and advance for the specific period. This ratio can be calculated by dividing housing loan by total loan and advance. This ratio can be stated as:

$$\frac{\text{Housing Loan}}{\text{Total Loan \& Advances}}$$

### **3.7.1.6 Term Loan to Total Loan and Advance Ratio**

Term loan to total loan and advance present the ratio of term loan in total loan and advance for the specific period. This ratio can be calculated by dividing term loan by total loan and advance. This ratio can be stated as:

$$\frac{\text{Term Loan}}{\text{Total Loan \& Advances}}$$

### **3.7.1.7 Growth Ratios**

To examine and analyze, following growth ratios are calculated in this study:

- Growth ratio of total deposits
- Growth ratio of loan and advance
- Growth ratio of total investment
- Growth ratio of net profit

### **3.7.1.8 Statistical Tools Used**

#### **a. Coefficient of Correlation Analysis (r)**

Correlation is the statistical tool that we can use to describe the degree to which one variable is linearly related to another. The coefficient of correlation measures the degree of relationship between two sets of figures. Among the various methods of finding out coefficient of correlation, Karl Pearson's method is applied in the

study. The result of coefficient of correlation is always between +1 and -1. When  $R = +1$ , it means, there is perfect relationship between two variables and vice-versa. When  $r = 0$ , it means there is no relationship between two variables. The Pearson's formula is:

$$r = \frac{N \sum dx dy - \sum dx \times \sum dy}{\sqrt{N \sum dx^2 - (\sum dx)^2} \sqrt{N \sum dy^2 - (\sum dy)^2}}$$

Where,

$r$  = coefficient of correlation

$x$  = independent variable

$y$  = dependent variable

$N$  = no. of periods

Probable error of correlation is calculated by the following formula:

$$P.E.r = 0.6745 \frac{1 - r^2}{\sqrt{N}}$$

### **b. Least Square Linear Trend.(Trend Analysis)**

Among the various method of determining trend of time series, the most popular and mathematical method is the least square method. Using this method of least square in the study, it has tried to estimate the future trend of loan and advances and deposit and investment. For estimation, straight line method is:

$$Y = a + bx$$

Where,

$Y$  = dependent variable

$x$  = independent variable

$a$  = y intercept

b = slope of trend line

**c. t – Statistic**

To test the validity of our assumption, if sample size is less than 30, ‘t’ – test is used. For applying ‘t’ – test in the context of small sample, the ‘t’ value is calculated first and compared with the table value of ‘t’ at a certain level of significance. If the value of ‘t’ exceeds the table value (say 0.05), we infer that the difference is significant at 5% level. But if ‘t’ is less than the concerning table values of the ‘t’, the difference is not treated as significant.

**d. Standard Deviation (S.D)**

The measurement of the scatterness of the mass of figures in a series about an average is known as dispersion. The standard deviation measures the absolute dispersion. The greater the amount of dispersion, greater the standard deviation. A small standard deviation means the high degree of uniformity of the observations as well as homogeneity of series and large standard deviation means just the opposite. In this study, standard deviation of difference ratios are calculated.

$$\text{S.D.} = \sqrt{\frac{\sum x^2}{N} - \left(\frac{\sum x}{N}\right)^2}$$

Where,

X = variable

N = no. of period

**e. Co-efficient of Variance (C.V.)**

The co-efficient of variance is the relative measure of dispersion, comparable across distribution which is defined as the ratio of the standard deviation to the mean expressed in percent. It is calculated as:

$$\text{C.V.} = \frac{\text{S.D.}}{\text{Mean}} \times 100\%$$

#### **f. Simple Regression Analysis**

Sometimes the correlation between the two variables may be insufficient to determine a reliable estimation equation. Yet, if we add the data from more independent variables, we may be able to determine an estimating equation that describes the relationship with greater accuracy. In regression analysis, we use independent variables utilizing more of the information available to us to estimate the dependent variable.

In this study, net profit (y) is dependent variable and saving from interest\* (x) is taken as independent variable.

\*Saving from interest = Income from interest – Expenses on interest

$$Y = a + bx$$

Where,

$$Y = \text{Net Profit}$$

$$X = \text{Saving from Interest}$$