

**IMPACT OF NEPAL RASTRA BANK'S DIRECTIVES ON LOAN
POLICY AND INVESTMENT OF COMMERCIAL BANKS**

A comparative Study of Nepal Bank Limited & Himalayan Bank Limited.

A Thesis

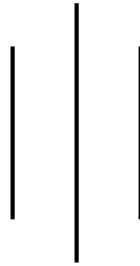
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RECOMMENDATION

This is to certify that the thesis

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*And found the thesis to be the original work of the student and written
according to the prescribed format. We recommend the thesis to be accepted as
partial fulfilment of the requirement for*

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DECLARATION

I hereby declare that the Thesis entitled “*Impact of Nepal Rastra Bank's Directives on Loan Policy and Investment of Commercial Banks: A comparative study of Nepal Bank Limited & Himalayan Bank Limited.*” submitted to Mechi Multiple Campus, Faculty of Management, Tribhuvan University is my independent research work, which is prepared as the partial fulfilment of the requirement for the Degree of Master of Business Studies (MBS) under the guidance and supervision of Dr. **Prithvi Bikram Rai** (Associate Professor), Mechi Multiple Campus, Bhadrapur, Jhapa , Nepal .

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TABLE OF CONTENTS

Page		
Recommendations		i
Viva Voce Sheet		ii
Declaration		iii
Acknowledgements		iv
Table of contents		v
List of Tables		viii
Lists of Figures		ix
List of Abbreviations		x
<i>Chapter-I</i>	Introduction	1-22
1.1	Background of the Study	1
1.1.1	Nepal Rastra bank-The Central Bank of Nepal	6
1.1.2	Development of Commercial Banks in Nepal	8
1.1.3	Function of Commercial Bank	11
1.1.4	Prohibition for Banks by NRB	16
1.2	Focus of the Study	17
1.3	Statement of the Problem	18
1.4	Objectives of the study	19
1.5	Significance of the Study	20
1.6	Limitations of the study	21
1.7	Organization of the Study	22
<i>Chapter-II</i>	<i>Review of Literature</i>	24-69
2.1	Conceptual/Theoretical Review	24
2.1.1	Bank-Evolution and Concept	24
2.1.2	Central Bank- Concept and Function	33

2.1.3 Commercial Bank-Concept and Functions	49
2.1.4 Factors Responsible for the Advent of Modern Banking	55
2.1.5 Concept of loan (credit) policy of Commercial Banks	58
2.2. Review of NRB Directive	59
2.3 Review of Articles	67
2.4 Thesis Review	67
2.5 Review of critical literature of NRB:"NRB Withdrawn Restriction in Commercial Banks"	69
<i>Chapter-III</i> Research Methodology	70-72
3.1 Introduction	70
3.2 Research Design	71
3.3 Sampling Method	71
3.4 Sources of Data	71
3.5 Tools and Techniques	72
<i>Chapter-IV</i> Presentation and Analysis of Data	74-99
4.1 Analysis of loan Disbursement to various sectors by Commercial Banks	74
4.1.1 Analysis of farming (primary) sector loan	74
4.1.2 Analysis of service sector loan	77
4.1.3 Analysis of Industrial sector loan	80
4.2 Impact of present C/D ratio on business and economic Development	83
4.3 Analysis of productive and passive or non-performing loan to various sectors	87
4.3.1 Analysis of productive loan to various sectors	87
4.3.2 Analysis of passive or non-performing loan	90

4.4 Impact on income employment generation by productive investment by Commercial Banks	96
4.5 Major finding	99
<i>Chapter- V Summary, Conclusion and Recommendations</i>	104-110
5.1 Summary	104
5.2 Conclusion	105
5.3 Recommendation	106
Bibliography	
Appendices	

LIST OF TABLES

Titles	Page
Table 1. Farming (primary) sector loan to total loan ratio of NBL & HBL	75
Table 2. Service sector loan loan to total loan ratio of NBL & HBL	63
Table 3. Industrial sector loan to total loan ratio of NBL & HBL	81
Table 4. Credit deposit (C/D) ratio for NBL & HBL	85
Table 5 Amount of productive loan and productive loan to total loan ratio of NBL & HBL	88
Table 6. Non-performing or passive loan to total loan ratio of NBL & HBL	95

LIST OF FIGURE

Titles	Page
Figure 1. Farming (primary) sector loan to total loan ratio of NBL & HBL	76
Figure 2. Service sector loan to total loan ratio of NBL & HBL	79
Figure 3. Industrial sector loan to total loan ratio of NBL & HBL	82
Figure 4. Credit deposit (C/D) ratio for NBL & HBL	85
Figure 5 Productive loans to total loan ratio Of NBL & HBL	89
Figure 6. Non-performing or passive loan to total loan ratio of NBL & HBL	95

ABBREVIATIONS

A/C	: Account.
A.D	: Anno Domini.
ATM	: Any Time Money.
BOD	: Board of Director
BoK	: Bank of Kathmandu
B.S	: Bikram Sambat.
CAR	: Capital Adequacy Ratio.
CG	: Counter Guarantee.
CRR	: Cash Reserve Ratio.
e.g.	: For example.
FDR	: Fixed Deposits Receipts.
F/Y	: Fiscal Year.
GAAP	: General Accepted Accounting Policy.
G'tee	: Guarantee
HBL	: Himalayan Bank Limited
i.e.	: That is.
Int'l	: International.
KBL	: Kumari Bank Limited.
Max	: Maximum

Min	: Minimum.
NG	: Nepal Government.
No	: Number.
NBL	: Nepal Bank Limited.
NRB	: Nepal Rastra Bank.
POS	: Point of Sale.
P/L	: Profit and Loss Account.
SLR	: Statuary Liquidity Ratio.
TRWA	: Total Risk Weighted Assets.
U.A.E.	: United Arab Emirates.
U.K.	: United Kingdom.
Viz.	: Namely.
Vol.	: Volume.
Wrt.	: With respect to.

CHAPTER- I

INTRODUCTION

1.1 Background of the Study

Nepal is a landlocked and least developed country in the world. Though the half century-long development practice of Nepal through its planned development endeavour takes overall socio-economic development as its overarching goal, Nepal's level of socio-economic development has been remained among the lowest in the world characterized by low per capita income, mass unemployment, low life expectancy, low literacy and condition that perpetuate poverty as a cyclical effect.

Nepalese economy is characterized by the subsistence agriculture. Over dependency of the population on the subsistence agriculture, which is traditional, non-mechanized and livelihood oriented sector, poverty has been emerged as one of the threatening challenge along with the increasing population. Over dependency of the population on the subsistence agriculture accompanied with slow industrial growth has resulted unemployment and disguised unemployment, which have further accelerated poverty. In the economies like Nepal where there is technological deprivation, lack of innovation and lack of alternative sources of employment, tremendous effort is required in order to improve the situation of the poverty stricken sections of the population.

Presently, Nepal is facing the most challenging issue of political conflict and instability for the last 18 years. It has been the most heart-felt problem for an

individual, an organization as well as for economic development of the country. It is generally accepted that political stability, peace and security on the one hand and good governance on the other are the pre-requisites for the socio-economic development of a country. But unfortunately, both of them are lacking in the present context of Nepal. Both the domestic and foreign investment in development sector of Nepal is decreasing and being diverted to other sector and other countries due to security situation of the country. It has raised the question mark on development assistance from foreign countries and organizations. Accordingly, human rights aspect has also been an issue for concerned persons, groups, and organizations. All these aspects have been deteriorated the socio-economic development of the nation. So, the time has come for Nepal to be serious for creating an environment for the investment and truehearted willing to provide development assistance to the country. Still the condition has not been so severe and donor countries and organizations have been responding to Nepalese request for her development by establishing and developing prioritised economic infrastructure, encompassing almost all sector indispensable for its socio-economic development. Likewise, it is also the concerned matter of development thinkers that most of the development partners have been saying to rethink about their development assistance to Nepal due to its security situation.

Banks are among the most important financial institutions in the economy and essential business in thousands of local towns and cities. In this context, there is much confusion about exactly what a bank is. Certainly, banks must be identified by the functions (service and roles) they perform in the economy. Banks are financial intermediaries, similarly to credit union,

savings and loan associations, and other institutions selling financial services. The term financial intermediary simply means a business that interacts with two types of individuals or institutions in the economy. Deficit spending individuals or institutions whose current expenditures for consumption and investment exceed their current receipts of income and who therefore need to raise funds externally by negotiating loans with and issuing securities to other units. On the other hand, surplus spending individuals or institutions, whose current receipts of income exceed their current expenditures on goods and services so they have surplus fund to save and invest. Therefore, there should be someone who can bridge these two individuals or institutions so that those who have surplus funds can be diverted to the deficit units. Hence, banks are that institution that performs this indispensable task to intermediating between two individuals and institutions in order to raise funds and then loaning those funds to deficit spending individuals or institutions.

A joint venture bank is formed of two forces between two or more enterprises for the purpose of carrying out a specific operation. Joint venture banks are the commercial banks formed by joining the two or more enterprises for the purpose of carrying out specific operation such as investment in trade, business and industry as well as in the form of negotiation between various group of industries or traders to advice mutual exchange of goods and services. Joint venture banks are the mode of trading to advice mutual exchange of goods and services for sharing competitive advantages by performing joint investment scheme between Nepalese investors, financial and non-financial institution as well as private investors and their parent banks each supplying fifth percent of the investment. The

parent banks, which have experiences in highly merchandised and efficient modern banking services in many parts of the world have come to Nepal with higher technology advance management skills. They are more efficient and effective monetary institution in modern banking fields than other old types of bank in Nepalese context. The primary objective of joint venture banks is always to earn profit by investing or granting the loan and advances to the people associates with trade, business, industry etc. that means they are required to mobilize their resources properly to acquire profit. How well a bank manages in investment has a great deal to do with the economic health of the country because the bank loans support the growth of economic activities of the country. Nowadays there is very much competition in banking market but less opportunity to make investment. In this condition, joint venture banks can take initiation in search of new opportunity, so that, they can survive in the competitive market and earn profit. But investment is very risky job. For a purposeful, safe, profitable investment bank must follow sound investment and loan policy.

There are several banks, which are of different types. In the study, we are only considering about the commercial banks and central bank. In context of Nepal, Nepal Rastra Bank is the central bank. The bank plays a vital role for the development of the country. It monitors the deposits, interest rates, other bank rates, and mandatory spread of finances to be maintained by the commercial banks, the proposition of the bank portfolio, establishment of branches and many more aspects of financial institutions. NRB acts as the bank of all other banks with a view to monitor and supervise the monetary situation. It lays down various rules and regulation for the banks and the banks have to obey such rules and regulations. At the same time, it protects

and maintains of national fund, foreign currencies and valuable goods. This bank acts as a lender of the last resort for commercial bank. On the other hand, this banks works or acts as clearing house control over credit etc.

At the time when the banks are concerned only with their financial viability, the role of central bank becomes crucial. The central bank plays an important role to develop banking, like developmental and promotional role, regulatory role and supervisory role. A central bank makes rules and regulations for the growth and to promote banking sector in the country. Nepal Rastra Bank has been playing an important role by creating suitable environment to establish commercial banks, developmental banks, finance companies and co-operatives. Up to now altogether there are thirty-two commercial banks, licensed by NRB for limited transaction as at mid march 2012. NRB makes rules regarding licensing operation, audit etc. Nepal Rastra Bank Act 1955 has given regulatory authority to it. Thus, Nepal Rastra Bank issues different guidelines/ policies/ directives to different financial institutions to operate such institutions effectively.

According to the Nepal Rastra Bank Act 2058, Section 23 (A), “The central bank has legal provision to regulate, to supervise and to direct. The tools that Nepal Rastra Bank used to control and monitor the financial institutions of the country are circular popularly known as Nepal Rastra Bank Directives”.

Commercial banks are established on the basis of only the Banks and Financial Institutions Act, 2063. These banks are such types of banks, which accept deposits from the public and re-lend these deposits to the people for

short periods. Most commercial banks are privately owned joint-venture banks.

The Nepalese economy has not become successful in creating an investment friendly environment. The private sector does not seem to be confident with the current economic political environment. In such a situation, there remain fewer possibilities to materialize the slogan of public-private partnership. Nepalese economy is experiencing increasing internal challenges. In this situation of ongoing socio-political anomaly, the economic development of the country is not just happened easily. The government needs huge resources to develop the country properly. To fulfil the objective of economics to development of the country, one of the most important sources is capital. This is generated by Bank and other financial institutions. Before going to in-depth of the study, it is better to give the introduction of Nepal Rastra Bank and development of commercial banks in Nepal.

1.1.1 Nepal Rastra Bank – The Central Bank of Nepal

The history of Nepal Rastra Bank is not longer in Nepal. It began with the independence of Nepal from Rana Regime in 1950. After the independence from Rana Regime, Planned effort of economic development was initiated and in almost all economic planning, Nepal Rastra Bank has played significant role, Nepal Rastra Bank has been playing crucial role towards fulfilling Nepal's development aspirations. It has instrumental in bringing about substantial improvements in the statue of socio- economic development in the country. Hardly, any sector of the economy exists which has been untouched by the guideline of Nepal Rastra Bank. The Nepal Rastra Bank is responsible of management and supervision of the monetary

and credit system of the country. This central bank has been given wide power under the various provisions of the following legislation, Nepal Rastra Bank Act 2058, Banks and Financial Institutions Act, 2063. The provisions of this Act are applicable to domestic as well as joint venture banking institutions.

Prior to the establishment of Nepal Rastra Bank in 2013 B.S., Nepal Bank Limited, the first and only one commercial bank, had to perform some of the functions of the central bank. Before the establishment of Nepal Bank Ltd, There was *Tejarath Adda*, which was established with a view to extent credit to the public on the security of gold and silver. Up to 2013 B.S., the Nepal bank Ltd was one and only financial institution and taking charge of all the business transaction of government including currency exchange except commercial banking function. NRB later took a lead role as the central bank of the country and assumed the responsibility of ensuring proper management of the issuance of Nepalese currency notes; making proper arrangements for the circulation of Nepalese currency throughout the kingdom; stabilizing the exchange rates of the Nepalese currency; mobilizing capital for development; encouraging activities related to expansion of trade and industry; and developing banking.

Against the background, an urgent necessity was felt for the establishment of a central bank dedicated to the development of banking and finance to promote trade and industries, to manage circulation of national currency and to maintain exchange rate stability, Hence, the Nepal Rastra Bank Act 1955 was formulated.

Nepal Rastra Bank was established as a central bank on Baishakh, 2013 B.S (1956). The bank was empowered to Act to have direct control over banking institutions within the country. It also took over the treasury function of “*Mulukikhana Adda*” (Government Treasury) and started issuing currency in 1959 A.D.; and also thus relieved the various ‘*Mal Addas*’ (Revenue Office) of their work in the connection.

As central bank, Nepal Rastra Bank issues directives from time to time to commercial banks and other financial institutions regarding banking operations, currency and financial institutions to comply with such directives.

According to Nepal Rastra Bank Act, 2058, the bank has the following objectives:-

- a) Formation and management of monetary and foreign exchange policies for stability and balance of payment, which is essential for economic development.
- b) Promote essential liquidity for the stability of banking and financial sectors.
- c) Develop healthy, secured and strong system of payment.
- d) Regulation, supervision and monitoring of banking and financial system.
- e) Promote overall banking and financial system within the country to increase the public faith upon banks and financial institutions.

1.1.2 Development of Commercial Banks in Nepal:

The history of banking in Nepal may be described as component of the gradual and orderly evolution in the financial and economic sphere of the Nepalese life. Even now the financial system is still in the evolutionary phase. The existence of unorganised money market consisting of landlords, *shahukars* (rich merchants), shopkeepers and other indigenous individual money lenders has acted as barrier to institutionalised credit. These institutions although quite underdeveloped could still mobilize funds from a wide range of different sources. For many years, the indigenous individual wealthy agriculturists, landlords, merchants and traders conducted some banking activities along with their other business occupations. The activities were fragmented and mostly localized.

Nepal Bank limited was the first commercial bank of Nepal. It is taken as the milestone of modern banking of the country. It was established on 30th Kartik 1994 B.S, which was incorporated as a semi-government organization with an authorised capital of Rs. 10 million of which 51 percent share was owned by the government and rest by the private shareholders. It was started with collected amount of Rs. 170,200 from the sources of public deposit sources. From the beginning, it has rendered the following services to the customers:

- ◆ Accept deposits,
- ◆ Extend loans,
- ◆ Invest in government bond and securities,
- ◆ Perform agency functions,
- ◆ Render customer service (i.e., issue of bill of exchange)

Until mid-1940s, only metallic coins were used as medium of exchange. So the government needed separate institution or body to issue national currencies and promote financial organization in the country. To fulfil this need *Nepal Rastra Bank* was established as a central bank of Nepal in 2013 B.S under the Nepal Rastra Bank Act 2012 B.S.

With the establishment of Nepal Rastra Bank, the process of banking development started to gain momentum. *Rastriya Banijya Bank* was established, dated 10th Magh 2022 B.S., under the Nepal Rastra Banijya Bank Act, 2020 B.S, as a 2nd commercial bank of Nepal. It is the fully state owned and providing banking facilities with an authorised capital of Rs. 10 million. These two commercial banks, with 319 branches in the kingdom, are from the largest group of financial institutions.

Nepal is an agricultural country and agriculture is the basis occupation of major Nepalese people. The development of this sector plays the prime role in the economy. So the first separate institution in agriculture financing namely *Agriculture Development Bank* was established, dated 7th Magh 2024 B.S.

For more than two decades, no more banks were established in the country. After declaring free economy and privatisation policy, the government encouraged the foreign banks for joint venture in Nepal. As a result *Nepal Arab Bank Ltd (NABIL)* came into existence on 1984 A.D. under Commercial Bank Act-2031 B.S. as a joint venture bank. It has the authorised capital of Rs. 30 million, 50 percent share is held by Union Bank

of Middle East, Dubai, 20 percent by Nepal Industrial development Corporation, Nepal Insurance Corporation and Securities Marketing Centre and rest by the general public. This is the first modern bank with latest banking technology. Then a lot of commercial banks have been opened in the country.

Nepal Indosuez Bank was established on 1986 A.D. as a joint venture of Indosuez bank, France and public shareholder with an authorised capital of Rs 120 million.

Nepal Grindlays Bank, the Nepalese really saw modern banking when Nepal Grindlays Bank was established on 1987 A.D... This is also another joint venture between the Grindlays Bank of U.K., Nepal Bank Ltd and the general public. Today the name of this bank has been changed into Standard Chartered Bank Limited. In Nepal there are massive entrances of foreign banks as the country followed economic liberalization.

The *Himalayan Bank Ltd* is a joint venture with Habib Bank of Pakistan. It started its operation in 1993 A.D. with paid up capital of Rs. 60 millions.

Nepal SBI Bank Ltd is a joint venture between Employees Provident Fund and State Bank of India, established in 1993 A.D. with the initial paid up capital was 119.95 million, when Indian bank holds 50 percent of the equity.

Nepal Bangladesh Bank Ltd was established on 1994 A.D. in technology collaboration with IFFC Bank Ltd. of Bangladesh.

On 1994 A.D. *Nepal Everest Bank Ltd* was entered into joint venture commercial banking with Punjab National Bank of India (PNB). PNB holds 20 percent equity stake in the bank.

Bank of Kathmandu Ltd was established in a joint venture with Syan Bank of Thailand on 1995 A.D.

Similarly other joint venture banks in Nepal are *Bank of Cylon* as a joint venture with Srilanka Bank established on 1996 A.D., and today the name of this bank has been changed into *Nepal Credit and Commerce Bank Ltd.*

In the beginning, most of the bank came into exist as a joint venture bank but at present situation some of the bank has converted into fully stated owned, those banks are as follows,

Lumbini Bank was established on 1998 A.D. in Narayangadh. This is the first regional bank of Nepal.

Nepal Industrial and Commercial Bank was established on 1998 A.D.; it does not have any joint venture yet. But it has employed senior managers from India to handle its operation. *Machhapuchre Bank* started its operation on 2000 A.D., its head office is established in Pokhara.

Kumari Bank was established on 2001 A.D. and its head office is in Kathmandu. This bank has introduced internet banking which is a Hi-Tech banking system of the world.

Laxmi Bank was established on 2002 A.D. Its head office is situated in Kathmandu. Then rapidly *Siddhartha Bank, Agriculture development Bank, Global Bank, prime commercial Bank, Bank of Asia, Sunrise Bank, DCBL Bank, NMB Bank, Kist Bank, Janata Bank, Mega Bank, Commerz and Trust Bank, Civil Bank, Century Commercial Bank and Sanima Bank* was also established.

The banking industry is the lifeblood of economy. It is the bridge of nation's development. The entry of commercial banks functions led to rapid growth of banking system. The government's liberalization

Policy led to a dozen of commercial banks actively playing in the financial market of the counter. “Suggestion for the development of banking in the country on the basis of area approach is being made by the policy makers recently. The central idea behind this is that, depending on there area of operation and location, commercial banks could be assigned particular areas where they act as pace setter in providing integrated banking facilities. The establishments of commercial and Industrial Bank in Biratnagar, Lumbini Bank in Narayangadh, Machhapuchhre Bank in Pokhara are some of the example in the promotion of regional banking industries in the country. Similarly the introduction of Nepal Development Bank from the private sector exemplary in the history of banking in Nepal. Many of these banks have shown tremendous progress in term of deposits, lending or in customer base within a short period of time. In addition the government has also introduced five regional development banks, which have boosted up the income of poor in rural areas.”

Commercial banks are established under the Banks and Financial Institutions Act, 2063 (BAFIA). This Act sets out regulations for licensing, supervision and cancellation of license of commercial banks. Among all financial intermediaries, commercial bank is the dominant one. Commercial banks have to strictly follow the rules and regulations issued by Nepal Rastra Bank.

1.1.3 Function of Commercial Banks in Nepal

At present, the functions of commercial banks in Nepal have been widely developed and extended. Therefore we can not exactly enumerate all functions. However we can discuss its major functions under following heading.

(A) Accepting Deposits or Borrowings: Banks attract the idle savings of people in the form of deposits. These deposits may be current, saving and fixed accounts. Current account or demand deposits are repayable on demand without any notice. Usually no interest is paid on them because the bank cannot utilize short-term deposits, and must, therefore, keep cent percent reserve against them on the other hand, a little commission is charged for the services rendered by it.

Fixed or time deposits withdrawn only after the expiry of the period for which these deposits have been made. Higher rate of interest is paid in this account because bank can invest such amount safely for certain period. Time may range from three months to several years. The usual rate in Nepal today varies between 10% and 13% depending upon the time period for which deposits are made. Saving deposits stand midway between current and fixed deposits. Depositors cannot withdraw savings as soon as they need. Only limited amounts can be drawn at a time as allowed in a week. The rate of interest in such account is less than that on the fixed deposits.

(B) Giving Loans/ Lending: The bank earns profit by giving amounts deposited with it in the form of loans. Since the bank creates credit with its deposit, it is called manufacturer of credit. According to traditional concept commercial banks can grant only for short- term credit. But nowadays, it also provides long-term credit loan advanced by the bank. They hold a certain portion of cash reserve to meet obligations. The rest of the deposit amount is invested in loan financing which yields higher rates of interest as compared to those payable on deposits. Loan issued are not cash amounts.

Loans are deposited in current account in the name of borrowers. Borrowers draw as and when necessary. Commercial banks allocate a specific amount of cash for this necessity. The remaining portion goes for further loans that are again deposited in borrowers account. Thus loan creates deposit which again creates loans. This is credit creation. Money many times in excess of actual amount of deposits is created. Therefore banks are manufacturer of credit.

(C) Miscellaneous Functions: The functions other than main functions are called agency functions. The bank charges minimum fee for undertaking such agencies functions. This agency function and other functions can be explained as follows:

- ◆ **Remitting Funds:** Banks remit funds for their customers through bank draft to any place where they have branches or agencies. This is the economical and safe way of sending money.
- ◆ **Income Receiving and Payment:** The bank receives the dividend, interest on shares and debentures etc and makes payments of insurance premium, rent, income tax, electricity bills etc. periodically.
- ◆ **Purchase and Sale of Securities:** The commercial banks discount the securities of the businessmen and make them cash payments. Businessmen may not have to wait for the maturity date due to this facility. Banks also sale securities on the order of customers.

- ◆ **To Issue Letter of Credit:** A letter of credit acts as mediator between businessmen and banks. It has provided extensive facilities to businessman and industrialist around the world.
- ◆ **Trust and Attorney:** Commercial banks works as the administrator, trustee, executor and attorney in settlement of will and accounts of the customers.
- ◆ **Safe Custody:** Ornaments and valuable documents can be kept in safe deposit with a bank in its strong lockers, on payment of small charge. Thus the risk of theft is avoided.
- ◆ **References:** Bank provides references about the financial position of their customers when required. This is done when the customers want to establish business connections with some new firms within or outside the country.
- ◆ **Issue Credit Instruments:** The bank issues traveller's cheques, draft and Master Card to the customers.

The two essential functions of commercial banks may best be summarized as the borrowing and lending of money. They borrow money by taking all kinds of deposits- Deposits may be received on current account whereby the banker incurs the obligation of paying legal tender after the expiry of a fixed period or on deposit account whereby the bankers undertakes to pay the

customer an agreed rate of interest on it in return for the right to demand from him an agreed period of notice for withdrawals. Thus a commercial banker, whether it is through current account or fixed deposit account, mobilizes the savings of the society. Then he provides this money to those who are in need of it by granting overdrafts or fixed loans or by discounting bills of exchange or promissory notes. Thus, the primary function of a commercial banker is that of a broker and dealer in money. By discharging this function efficiently, a commercial banker renders very valuable service to the community by increasing the productivity capacity of the country and thereby accelerating the pace of economic development

1.1.4 Prohibition for Banks by NRB

Nepalese commercial banks are prohibited to do following activities:

- ❁ Purchase and sale of goods with transaction motive.
- ❁ Purchase of fixed assets not for own use.
- ❁ Extending credit facilities against the security of own share.
- ❁ Extending credit facilities to the director or the member of his undivided family.
- ❁ Extending credit facilities to the shareholder holding more than 1% share and to his undivided family.
- ❁ Extending business credit facilities to the employees and their undivided family.
- ❁ Extending credit to the company where the director or the members of his undivided family have 10% stake.
- ❁ Acting as the managing agent.

- ❁ Declaration/distribution of dividend to shareholders before complete amortization of preliminary expenses. Accumulated loss and before appropriation of fund for capital adequacy, reserves and provisions.⁵

1.2 Focus of the Study

According to the Nepal Rastra Bank Act 2058, Section 23 (A), “The central bank has legal provision to regulate, to supervise and to direct. The tools that Nepal Rastra Bank used to control and monitor the financial institutions of the country are circular popularly known as Nepal Rastra Bank Directives”.

The following loan related unified directives-2010 is mainly focused in this study:-

- ❖ **Directive no.2:** Provision of loan classification and loan loss provisioning on the credit.
- ❖ **Directive no.3:** Provision of limit on credit exposure and facilities to a single borrower, group of related borrowers and single sector of the economy.
- ❖ **Directive no.4:** Provision of accounting policies and format of the financial statements to be followed by commercial banks.
- ❖ **Directive no.13:** Provision of maintain cash reserve ratio on total deposit liabilities.

- ◆ **Directive no.17:** provision of landing restriction to the deprived sector of economy.

1.3 Statement of the Problem

In its 57 years of history various activities were undertaken by Nepal Rastra Bank. NRB Act 1955 gives the full authority to Nepal Rastra Bank. Banks should be established and operated under NRB's rules and regulations. There are almost thirty-two commercial banks: one of them is founded lately in Nepal, even though the banking today is not healthy and sound. In developing country like Nepal, the most of the people are not conscious about the banking system. So the main problem is the lack of banking knowledge itself.

Some banks may have very low capital adequacy ratio while some banks may have piled up non-performing assets (substandard, doubtful, bad loans). The people have been raising questions over the correctness of credit classification and provisioning of some banks. NRB issues directives from time to time to commercial banks. The banks must follow such directives.

The banks are categorizing the loans into four different categories according to new directives. Each category of the loan amount requires certain percentage of it to be provisioned for the probable loss. This amount is deducted by the profit of the bank. Similarly, other directives viz., capital adequacy ratio, single borrower limit, accounting policy, loan policy maintaining liquidity risk has also been changed. This may also affect in banking operation. Impact may be observed because of the changes made in directives, The directives, if not properly addressed, have potentials to wreck the financial system of the nation, as they are the only tools of the NRB to

supervise and monitors the financial institutions. The directives in themselves are not that important unless properly implemented.

However, due to lack of research works in this field there is a knowledge gap, especially in the two commercial banks namely Nepal bank ltd. and Himalayan bank Ltd. The major problem of this research work is to examine the impact of NRB directives in the commercial banks.

Therefore the study has been based on the following research questions:

1. What is the impact of directives of NRB on loan policies and investment of Nepal bank Ltd. and Himalayan bank Ltd.
2. How well are the directives being implemented in the banks under study?
3. How does NRB exercise supervision and monitoring of the banking performance of the commercial banks?

1.4 Objectives of the Study

Financial sector reform requires sound and good corporate governance for sustainable growth. It has extremely been essential to the protection of rights of the shareholders, clarity in duties and responsibilities of all stakeholders, disclosure and transparency and legal framework to sufficiently address good governance mechanism. It is envisaged that all these measures will ensure a healthy growth of financial sector. Enhancing the supervisory role of the central bank, strengthening accounting and auditing practices and finally increasing competition among the actors of financial sector are some of the measures initiated to develop an active and strong financial system in Nepal. Thus, NRB has undertaken various activities for the banking and financial development since its establishment. NRB has issued various regulations and directives to commercial banks to make the banking sector effective. The main objective of the study is to review loan related directives

of the NRB related to commercial banks. The study will be conducted with the broad objective of examining the state of NRB functions in the commercial banks in Nepal. The specific objectives of this study are given below.

1. To find out impact of the NRB directives on commercial banks under study.
2. To observe positive and negative impact of NRB directives during the research period.
3. To figure out whether NRB directives are actually being implemented on loan policy by Commercial banks or not.
4. To examine the effectiveness of supervision and monitoring functions of NRB.

1.5 Significance of the Study

Nepal Rastra Bank is the main figure of this research study. The directives of NRB are one which government authority controls the banks in the country. NRB issue directives to the commercial banks from time to time in order to maintain stability in the financial market. The directives are issued on the basis of monetary policies and the success of the monetary policies of the country depends on the directives of the central bank and its central role. So it is important to search on the directives. In the process of economy development, it has become necessary to develop NRB directives to meet commercial banks objectives. The commercial banks are supposed to follow the rules and regulations laid down by the NRB. This research though small has placed insight about the effects of the directives to the commercial banks and the implementation by them on loan policy. The directive of the central bank holds a central role in obtaining the success of the monetary policies.

This research will also provide useful and meaningful reference materials. Various suggestions will be presented to concerned two banks namely, Nepal Bank limited and Himalayan Bank limited at the end of this research. Nepal Rastra Bank official to act effectively for the implementation of the directives can use such suggestion.

A very good way of doing this would be by analysing the progress made in NRB's Directives. The study of this kind could contribute in filling knowledge gap and throw the light on NRB Directives practices in the country.

1.6 Limitations of the Study

Although there has existed thirty-two commercial banks in Nepal, only two commercial banks namely Nepal Bank limited and Himalayan Bank limited are taken to study. The sample, therefore, may not represent the entire population.

The new directives issued by Nepal Rastra Bank applicable to banks and financial institutions comprise twenty one directives, issued in 2068 B.S. Due to lack of materials and middle of the fiscal year, this thesis is mainly based on the previous directives. However the changes have been noted wherever possible. This new directives cover all the banks and non-bank financial institutions. So, it is also called unified directives. Previous directives contained twenty directives. There is no any difference between new and previous directives except directive no.4, which changed the format of financial statements of banks and financial institutions. The general directives are taken as guidelines. So, all the directives are not considered for the study due to the time limit and the data availability. In addition only

the directives issued in 2010 and new others directives have been considered for the study.

The commercial banks formulate their own loan policies after properly studying the directives of the central banks. They have close relationship between NRB Directives and commercial banks policies and always acting as a bridge between the NRB and commercial banks. Hence NRB issues directives from time to time and commercial banks are supposed to follow the rules and regulation and directives. In issuing of previous directives, there are eleven directives. But in the study, only five selective directives are highlighted among the directives.

The study consists only quantitative analysis because of non availability of data. The presentation and analysis have been made on the basis of comparative analysis of the data of Nepal Bank limited and Himalayan Bank limited.

For the study, only five years data from fiscal year 2007/08 to 2011/12 of Nepal Bank limited and Himalayan Bank limited have been collected. The period of five years is not sufficient for analysis but due to constraints of time and budget, is unable to obtain more than 5 years data.

1.7 Organization of the Study

The thesis outlook is divided into the following five chapters:

Chapter I: “Introduction Chapter”

This chapter includes background of the study, objectives of the study, focus of the study, statement of problem and research questions, significance of the study, limitations of the study, organization of the study.

Chapter II: This chapter is concerned with literature review. The reading materials of this chapter are conceptual review and review of related studies likes Directives, Articles and thesis books report , journals etc.

Chapter III: This chapter consists of research methodology, the way and use of techniques while studying, applied in research process; this includes research design, population and sample, sources of data, tools and technique, method of data analysis and interpretation.

Chapter IV: This chapter has covered the “Presentation and analysis of data”, with presenting charts, diagrams, figures and by using statistical tools, mathematical tools and financial tools and major findings.

Chapter V: This chapter is concerned with output of thesis as summary, conclusion and recommendation for improvement.

CHAPTER- II

REVIEW OF LITRATURE

This chapter deals with the conceptual, theoretical, review and reports, books, journals and articles.

2.1 Conceptual/ Theoretical Review

2.1.1 Bank- Evolution and concept:

Little is known about banking before the Middle-Ages. The Greeks and Mesopotamians had banks, as did the Romans. The civilizations regarded banking as ‘unnatural,’ but some banks were allowed to operate. There is no unanimity among the economists about the origin of the word ‘banking’ the term bank derives from the Latin ‘*bancus*’, which refers to the bench on which the bankers would keep its money and their records. Some persons trace its origin to the French word ‘*Banque*’ and the Italian word ‘*Banca*’

which means a bench for keeping, lending and exchanging of money or coins in the market place by money lenders and money changers.” thus there is difficult to say whether the term ‘bank’ has been derived from “*Bancus*”, “*Banca*” or “*Banque*” and German word ‘Bank’ means a joint stock company.

The height to which modern banking has developed is a contribution of slow and gradual process. Today’s Modern banks provide various facilities and services for the customer. It is the fastest, easiest and safest way of transacting money. We can find out that it had not been an easy revolutionary act. Banking has bit by bit developed through centuries and decades. It is necessary to know how the present banking system gradually developed. It has crossed various phases to come to the modern form. In ancient time goldsmith, businessman, and moneylenders used to perform the work of banking in every country. Traditional forms of banking were traced during civilization of Greek, Rome and Mesopotamia. Hence the following people are ancestor of modern banks. Merchants, Moneylender, Goldsmith

◆ **Merchants:** Merchants are the ancestors of the modern bank. Merchant had to remit money from one place to another place, which was not an easy task. They used to provide loan, exchange gold-silver and safety deposit the valuable ornaments. The merchants were trusted and they became popular easily. They issued letters similarly to today’s promissory notes to those who deposited valuable assets and those letters were used as modern money, which was accepted by all people. They used to make trading through actual coins on the periodic basis.

◆ **Moneylenders:** the next credit goes to the moneylenders. Moneylenders used to give loan to public and receive interest. People used to deposit money for safety. These deposits were not withdrawn on regular and similar basis. The moneylenders so utilized the amount deposited and earn return on them. So, seeing a good perspective they started collecting deposits providing small interest on it and then advancing loans charging a higher interest.

◆ **Goldsmiths:** Goldsmiths also play an important role in developing banks. They used to valuable properties like gold, silver, metals and coins too. They had sound credit standing in the society so they were very popular. Fear of theft and robbery led people to keep their valuables in the custody of the goldsmiths. Goldsmith used to charge commission for safekeeping and used to return the valuables on demand. The depositors had to visit goldsmiths for part and full withdrawal of gold, silver and coins. Gold and silver used to remain with the goldsmith for a relatively long period but coins had to be withdrawn from time to time. In order to remove the inconvenience, goldsmith used to give receipts which were known as goldsmith's note. It was made payable to bearer on demand and soon they enjoyed circulation. Thus, we can regard goldsmiths as the profounder of promissory notes.

“During the early periods, although the banking business was mostly done by private individuals, many countries established public banks either for the purpose of facilitating commerce or to serve the government. The Bank of

Venice established in 1157 A.D., is supposed to be the most ancient bank. Originally, it was not a bank in the modern sense, being simple and office for the transfer of the public debt.” In the world the word “Bank” mainly recognized after the establishment of “Riks Bank” of Sweden in 1656, In the middle of 17th century, before the establishment of this bank, there had established other banks like bank of Barcelona (1401 A.D.) and Bank of Genoa (1407 A.D.).These banks played an important role for the development and expansion of the modern banking system in Europe.

Thus, banking is as old as trade itself and its simplest form was money changing. But, banking in its modern form dated back to 1100 A.D. “The first banks were in the great centres of international trade in the Middle Ages, These centres were in Italy, on the western shores of the Mediterranean and in the coastal areas of northern and western Europe. General banking practice developed most rapidly in Italy. One of the earliest station banks was the vital of Venice, formed in 1157. It was formed as a result of forced loan made by merchants to the government of Venice, and it handled only government debt. The earliest deposit bank in Europe was the *Taula di Compi* in Barcelona, Spain, established 1401. Medieval banking developed most in Florence, Italy and was closely connected with the wool trade. The most famous Florentine banking families were the Abbati, Bardi, Frescobaldi, Mossi, Peruggi, Pulei and Scali. During the 1500s, families such as the Medicis of Italy and the Fuggers of Augsburg, Germany, succeeded the orders Florentine banking families as the lending bankers. The Fuggers were closely connected with the mining Industry. In 1587, the first public bank was established. It was the Bank of Venice, also known as the Banco di Rialto or Banco Della Piazza. The business of Bank of Venice was

entirely separate from merchant trading. Economists regard the Bank of Venice as having started the era of modern banking. The spread of modern banking through Europe was rapid from the late 1600s onwards. In 1609, the Bank of Amsterdam was founded in the Netherlands, in imitation of the Bank of Venice. It was the first bank of its kind north of the Alps. The Bank of Hamburg was founded in 1619, and the bank of Nuremberg in 1621. By 1700, there were many private banks in Europe, and more than 20 public banks. In England, most banks were private banks. But in 1694, the Bank of England was formed as a public company, with capital subscribed by the number of shareholders. The bank obtained a monopoly in joint-stock banking (banking carried on by public companies). This meant that for many years English banking developed in the form of small, privately owned local banks. Banking developed

late in the United States. The first successful bank was the bank of North American, which opened in Philadelphia in 1782.”

The history of bank in Nepal is not so old. Like other countries goldsmiths, merchants, and money lenders were the ancient bankers of Nepal. In the past, there was merchant namely, “*Sankhdhar*” who paid all the debts of people existing in the country at that time. Since then he introduced a new era called “*Nepal Sambat*”. This record proves the existing of money lending function at that time.

‘*Tejarath Adda*’ established during the tenure of the then Prime Minister Ranoddip Singh (B.S. 1933) was the first step towards the institutional development of banking in Nepal. *Tejarath Adda* did not collect deposits from the public but gave loans to the employees and public against the

bullion. Banking in modern sense started with the inception of Nepal Bank Limited on B.S. 1994-07-30. Nepal Bank Limited had a Herculean responsibility of attracting people toward banking sector from predominant money lenders' net and of expanding banking services. Being a commercial bank, it was natural that NBL paid more attention to profit generating business and preferred opening urban centres.

Integrated and speedy development of the country is possible only when competitive banking service reaches nooks and corners of the county. Keeping this in mind, government set up Rastriya Banijya Bank (RBB) in B.S. 2022.10.10 as fully government owned commercial bank. As the name suggests, Commercial bank are to carry out commercial transactions only. But commercial banks has to carry out the functions of all types of financial institutions Hence, Industrial Development Centre (IDC) was set up in 2013 for industrial development. In 2016, IDC was converted to Nepal Industrial Development Corporation (NIDC). Similarly, Agricultural Development Bank (ADB) was established in B.S. 2024.10.07.to provide finance for agricultural produces so that agricultural productivity could be enhanced by introducing modern agricultural techniques. Moreover Security Exchange Centre was established in 1976 to enhance capital markets activities. Securities Exchange Centre was renamed Nepal Stock Exchange (NEPSE) in 1993. NEPSE opened its trading floor on 13th Jan 1994. Thus the concept of bank was not developed at once. It is the result of gradual evolution for long period. Banks provide a wide range of services to the people so banks have become an essential in modern society.

The lexis 'Banking' is a derivative of the terminology 'Bank'. Bank itself is an organization engaged in any or all of the various functions of banking viz. receiving, collecting, transferring, paying, lending, investing, dealing, exchanging and servicing (safe deposit, trusteeship, agency, custodianship) money and claims to money both domestically and internationally.

“The principal type of banking in modern industrial world is commercial banking and central banking. A commercial banking is a dealer in money and substitute for money, such as checks or bills of exchange. It also provides a variety of financial services. The basis of his business is burrowing from individuals, firms, and occasionally governments i.e., receiving “deposits” from them, with their recourses and also with its own capital. The banker makes loans or extends credit and also invests in securities”

Thus to maintain banking system a bank must have cash balances on hand in order to pay its depositors upon demand.

“Another type of banking is carried on by central banks. Central banks are banker to governments and “lender of last resort” to commercial banks and or financial institutions. They are often responsible for formulating and implementing their country’s monetary and credit policies, usually in co-operation with government.” There are other institutions, other than central banks, often called banks, such as Saving Banks, Development Banks, Investment Banks, Co-Operative Banks, Finance Companies, merchant bank, trust Companies and Building Societies, Export and Import Bank(EXIM), do not perform the banking functions but are best to know as financial intermediaries. But they take part in taking deposits and landing

money, and credit money. Three types of banks viz., commercial banks, saving banks and central banks are main banks.

“A *commercial banks* means the bank which deal in exchanging currency, accepting deposit, giving loans and doing commercial transactions.”(*Commercial Bank Act, 2031*)

Saving banks is such type of bank which accepts deposits on a longer-term basis than commercial banks. Such deposits are repayable only after short notice, not on demand. But, saving banks make loans for longer period in comparison to commercial bank.

There are different logics enhanced on the definition of *central banking*. V. Smith had said that the primary definition of central banking system in which a single bank has either complete or residuary monopoly in the note issue. But R.W. Hawtrey regarded that the central banking is basically related with lender of the last resort function. On the other hand, A.W. Shaw was more concerned with credit control function while defining the concept of central banking. The Bank of International Settlement (BIS) has urged that the central bank is the bank to which has been entrusted the duty of regulating the volume of currency and credit in the country. For a common understanding we can say that the central banking is that system which is empowered by the law is meant as a sole agent to issue and circulate notes and coins, to control the monetary and banking system and to maintain external as well as internal stability. In this regard what ever the definitions enhanced so far, basis crux is on the efficient regulations, monitoring and

supervision of the banking system by the central bank for the betterment of the country.

Although other remaining banks do not perform the banking functions so well but is best to know as financial intermediaries. They also play the vital role for the development of the Nation. “**Development Banks** are established for the development of certain sector. They collect fund from share capital, debentures, long term deposits and refining from central banks. They normally give long term loan and provide technical and other advice as well.”

Nepal Industrial Development Corporation and Agricultural Development Bank are development banks established for the development of industrial and agricultural sectors respectively.

“**Export and Import Banks** deal in foreign exchange and specialize in foreign trade. They open LCs and G’tees in foreign currencies. They make financing for export and import transactions, supplies information about foreign exchange; execute swap, forward contract, remittances, discounting bills etc.” Since there are no EXIM banks in Nepal, commercial banks discharge the function of EXIM banks.

Building Societies give loan for the construction of buildings. Nepal Awash Bikash Bitta Company (2049 B.S) is the first such a finance company in Nepal.

Co- operative banks underlying purpose of co-operative bank is a co-operation among member. They collect deposit among members and give loan mainly to members only. Navajeevan Cooperative Society Limited, Dhangadhi is the first co-operative bank of Nepal.

Merchant Bank deals with the acceptance of bill of exchange, the issue and placing of loans and securities, portfolio and unit trust management for dealing and some banking services. They also advise companies on acquisition, mergers and other financial matters. In Nepal Finance companies are involved in merchant banking activities. Merchant Banking and Finance Limited and NIDC Capital Market Limited have been found active in the merchant banking activities.

All types of banks are important to every country for the growth and development of the nation. Banks creates credit and also it expands business by developing a system of branches. “Banks with branches can use surplus deposits from one area to provide loans in areas where funds are inadequate to meet the needs of local borrowers.”

In most countries legislation related to commercial bank is similar although it is adapted to differing political system and economic situation. The government of most countries have right to back inspection

2.1.2 Central Bank –Concept and Functions

The concept of central banking is of recent origin. Prior to the commencement of twentieth century there had been no clearly defined

concept of central banking. But as the time changed, there is no country in the world which does not have a central bank. It is the bank that works as the leader of the money market. It is the chief of all banks operating in a country. It supervises, regulates and controls the functions of commercial banks and other financial institutions. The central bank also works as the baker to the government and advises the government on several matters. It is the only organization who monitors the whole economy of the country. Therefore, central bank is an important financial institution in every sovereign independent country in modern times. It is the apex of economy's banking system. Central bank is the central arch of the monetary and fiscal framework in every country of the world and its functions are indispensable for proper functioning of the economy and fiscal operations of the government.

The history of central bank is very old. In twentieth century, most of the banks in England, France, and Sweden etc were assuming more power that not considered them central banks. They were enjoying the right of note issue and were acting as the banker for the government and some times works as an agent for the government as well in the financial matters. However, they were not known as central banks but referred as the banks of note issue or national banks. The oldest central bank is Riks Bank of Sweden which was established in 1656. The bank of England came in 1694. The bank of England is the first bank to work as the position of the central bank and to develop all the fundamentals of central banking which are under operation. "The fundamentals, principles and tools and instruments developed by the bank of England were universally accepted by all the banks all over the country."

“The successful functioning of Bank of England forced other countries to think about the concept and principles of the central banks. As a result, The Bank of France was established in 1800 with the assistance of State Funds and private capital. Similarly, the bank of Russia was established in 1860 as a state bank. The objectives of the bank were to control monetary circulations, manage debt of the Russia and consolidate the whole of Russian Empire. In order to manage currency, Bank of Japan was established in 1882. These growing trends central banks made possible to almost European countries to have a central bank by the end of 19th century. Whereas the Federal Reserve System was established in 1914 to operate the functions of central bank. The international financial conference held in Brussels in 1920 encouraged all the European countries to establish a central bank in their respective countries. A resolution was passed in this conference - those countries which had not yet established a central bank should proceed to do so as soon as possible, not only with a view to facilitating the restoration and maintenance of stability in their monetary and banking system. But in the interest of the world co-operation.” The bank of Netherlands was founded in 1814 on the ruins of old bank of Amsterdam. The national bank of Austria, is the result of the reorganization of bank of Austria-Hungary in 1877, was established in 1817 to manage deteriorated situation of over issue paper currency. In nineteenth century, the bank of Norway, The National Bank of Copenhagen renamed The National Bank of Denmark; the Bank of Spain was also established in 1817, 1818 and 1856 respectively. Today the number of central bank stands over 150. The above resolution has encouraged lot of countries to establish central banks in different part of the world. The establishment of international monetary fund, which is the highest body in the world to control monetary systems, in

1944, facilitated the starting of central banks in Asia and Africa. Today, central bank is a common organization for managing economic system in any country in the world. Central banks have become an important organization of the government. Previously, central banks were privately owned and in the form of joint stock bank. In other words they were managed by the shareholders of the organization. It is because the objective of the bank was to finance to government from the private sector”.

By seeing the development of central banking, it can be defined as an institution taking a responsibility of issuing currency or managing the expansion and contraction of the volume of money and also act as banks of government and for other banks. Central bank is the bank who acts in accordance with government policy as guardians and controllers of a country's monetary system, issuing notes and coins to the public, and providing the chief financial link between a country's financial system and the rest of the world. The guiding principle for a central bank whatever functions or group of functions it performs at any moment is that it should act only in the public interest and without regard to profit as a primary consideration.

The meaning of central bank has been defined in different ways according to situation and needs. Different authors have given different definitions for central bank. Therefore, it is very difficult to give a precise definition of central bank. The momentum took place when it started to work as the bankers bank much later not as the privately owned bank as discussed. That is why, the meaning of central bank varied according to time and situation. In this context DeKock observes, “central bank have developed their own code of rules and practices, which can be described as the art of central

banking but which, in a changing world, is still in process of evolution and subject of periodical readjustment.” In the past, there was no much difference in the meaning and definition between and ordinary bank with the central bank except in some areas.

According to M.H. DeKock, “A central bank is a bank which constitutes the apex of monetary and banking structure of its country and which performs, as best as it can in the national economic interest”, which are as follows:

- ✚ The regulation of currency in accordance with the requirements of the business and the general public for which purpose it is granted either the sole right of note issue or at least as partial monopoly thereof.
- ✚ The performance of general banking and an agency services for the country.
- ✚ The custody of cash reserves of the commercial banks
- ✚ The custody and management of the nation’s reserves of the international currency.
- ✚ The granting of accommodation, in the form of discounts of collateral advances , to commercial banks, bill brokers and dealers, or other financial institutions and general acceptance of the responsibility of lender of the last resort.
- ✚ The settlement of the clearance balance between the banks; and
- ✚ The control of credit in accordance with the needs of business with a view to carrying out the broad monetary policy adopted by the country.

DeKock further elaborated the definition of central banks by, “A further requisite of real central bank is that should not, to any great extent, perform such banking transactions as accepting deposits from the general public and accommodation regular commercial customer with discounts and advances. It is now almost generally accepted that a central bank should conduct direct dealing with the public only in such forms and to such extent as, in the circumstance of the particular country, it considers absolutely necessary for the purpose of carrying out its monetary and banking policy.”

Kisch and Elkin define central banking as, “the maintenance of stability of monetary standard which involves the control of monetary circulations.”

The International Bank for the settlements defines a central bank as, “the bank in any country which has been entrusted the duty of regulating the volume of currency and credit I the country.”

According to Hawtrey, “the central bank is to act as the lender of the last resort.”

Vera smith defines it as, “the primary definition of central banking is a banking system in which a single bank has complete or a residuary monopoly in the note issue.”

“The central banking is entirely different from commercial or other branches of banking and that its main aim is to serve in the public interest and not to secure to profits. The functions of central bank and the obligations resting upon it are of a very special character calling for skill, experience and judgement of a kind different from those, which must be possessed by

commercial banks. No banker can neglected the rules of prudence and safety, but the object of commercial banker is to make a profit. The situation of a central bank is such that it must often undertake operations which are not only profitable, but result in losses, its aims must be the economic welfare of the country.”

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

“In appearance the main distinction between a central bank and a commercial bank is that nowadays, the central bank does not involve much in banking, but the more fundamental different is one of aim. The commercial bank thinks primarily of making a profit, whereas the central bank thinks the effect of its operations on the working of the economic system. A commercial bank has its shareholder and is expected to do the best it can for them. But the government by contrast, usually owns the central bank. The commercial bank may be few or many and they are to the found doing business with the general public all over the country. There is only one central bank in each country. It has few officers and it does little, if any business for the general public. Its market operation are mainly

impersonal and confined to what is necessary for influencing the country's financial business in the directed by economic policy.”

The central bank is referred in different names particularly reserve banks in most countries. The logic behind the name has also equal significance as it has full right for bank reserves which is one of the peculiar functions of the central bank. According to the above definitions, we can summarize it as an organization that is authorized to manage the whole economic system in a country, maintains the cash reserves of the commercial banks, issue notes and work as a lender of the last resort to all commercial banks. It also works as the banker to the government and to commercial banks. It is the only organization who has full authority of note issue and manages the currency. The central bank is the non profit organization although it generates profit in the course of its function. In short, the objective is to serve the board national interest in monetary matters and to support the economic policies of the government.

The basic objective of most of the central bank is to act as a promoter of monetary stability and a catalyst of a sound financial structure. Issuing currency and working as a government's banker and financial advisor is also considered as the primary objective. It is said that in order to meet the set objective, central banks have their own guiding principals in promoting the economic and financial interest of the economy without regard to macroeconomic stability as a basic consideration. Any central bank, therefore, carries out its primary functions within the context of broader goals of promoting sound, healthy and efficient economic and financial sector, maintaining price stability and ensuring a sound balance of payment

system and situation in the country. Besides this some central banks, mostly in developing countries, focus on attaining a high level of employment, reducing poverty and restructuring financial system in their quest for the primary goal and accordingly frame their core functions to attain these overall goals. Whatever the objectives or goals set by the central bank, the overall interest of the central bank is to ensure the availability of money and credit in the economy at the desired cost and volume. In this context any central bank would perform various functions as the banker for currency issue, custodian of international reserve, safeguarding the value of the currency and banker and financial advisor to the respective government. These objectives and functions are well addressed through formulation and implementation of monetary policy and overall management of financial system. In a simple language, the general price level which is also known as the average exchange rate for money against all goods and services, and its changes over time, plays a significantly important role in any society simply because it influences the nature, scope and fundamental characteristics of any country's economic and social relationship over the period of time. It is, thus no wonder that the central bank of the country becomes unlimited guardians of the purchasing power of money. Whatever the decorative phrases we do use to portray the role, rationale and relevance of the central bank, the unlimited responsibility is the management of money. "For, at root, money – serving as a store of value and medium of exchange- is the lubricant that enables the society to organize itself to achieve economic growth.

"The first concern of a central bank is the maintenance of a soundly based commercial banking structure. While this concern has grown to comprehend

the operations of all financial institutions, including the several groups of non-bank financial intermediaries, the commercial banks remain the core of the banking system. A central bank must also co-operate closely with the national government. Indeed, most governments and central banks have become intimately associated in the formulation of policy.” thus, it is difficult to lay-down any hard and fast regarding the function of the central bank. The powers and the range of development functions may be vary in different countries as depend upon country’s need and economic condition. Mostly some development functions are to found importance.

◆ **Monopoly of note issue:** “Generally central bank enjoys the monopoly of note issue of various denominations and supplies to the market as per requirement. There are various systems regarding note issue. The system of a central bank differs from others. In Nepal, Nepal Rastra Bank issues notes based on proportional reserve system. This power of central bank enables them to regulate and control money supply in the country One of the most important functions of a central bank is the issue of legal tender currency, the main reasons for the concentration of note-issue in a central bank may be found in the necessity of bringing about uniformity in the note circulation of a country and of avoiding the anomaly of over-issue by many banks established with the primary motive of securing profits. Further, the monopoly enjoyed by a bank, which has close connections with the state, confers on the notes a distinctive prestige. These notes are capable of commanding public confidence. Above all, the vary basis of monetary management is closely correlated with the

capacity of a central bank to vary the total amount of legal tender currency according to the requirements of trade and industry. Thus, it invariably follows that a central bank, which is endowed with the necessary powers of monetary management, must be equipped with the monopoly of note issue.” thus, no other bank than the central bank

is authorized to print currency notes. In this regard, DeKock explains, “The privilege of note issue was almost everywhere associated with the origin and development of central banks. In fact, until the beginning of twentieth century, they were generally known as banks of issue.” Thus we can say that a central bank is the producer of currency in a country.

◆ **Custodian of cash reserves of commercial banks:** “The centralization of cash reserves in the central bank is a source of great strength to the banking system of any country. Centralized cash reserves can at least serve as the basis of a larger and more elastic credit structure than if the same amount were scattered among the individual banks. The centralization of cash reserves is conducive to economy in their use and to increased elasticity and liquidity of the banking system and of the credit structure as a whole but only in an indirect manner. It is, in fact, the central bank's function of rediscount and lender of last resort, which directly serves to promote such economy, elasticity and liquidity”¹⁷

◆ This central bank is the bank, which is the custodian of the commercial bank's cash reserve. These functions of central bank

associated with the function of bank of issue and Government's banker.

◆ **Government's bank:** central bank discharges following tasks for the government:-

- Advice to the government on various aspects of the economy.
- Maintenance of accounts of government bodies.
 - Fund Transfer, LC and Guarantee transaction for government bodies.
- Rising of public debt.
- Overdraft facility to government.

◆ **An advisor & banker to the government:** Another most important function of a central bank is an advisor & bankers of government. "In every country, the government receives and spends huge amount through taxation. The government receives taxes and borrows large sums from the money market. Such multiple financial operations of the government are likely to have a disturbing influence on the money market. The central bank gives appropriate advice to the government in operating its financial matters. Another banking service rendered by the central bank to the government in the provision of the necessary foreign exchange required to discharge the obligations of the government in connection with the foreign trade of the country. Another function of central bank is to arrange short term loans and advances to the government in anticipation of collection of taxes." Hence, central bank discharges tasks for the government

such like advice to the government on various aspects of the economy, fund transfer, letter of credit and guarantee transaction for government bodies, maintenance of accounts of government bodies, rising of public debt etc.

- ◆ **Credit Control:** Commercial banks create credit by giving loans. Creation of credit means creation of money. Creation of credit is good for economy to a certain level only. However, excess credit creation can have serious repercussion on the stability of price and foreign exchange. Depending upon the need of economy, central banks contract/expand commercial bank's capacity to create credit through bank rate, Statutory Liquidity Ratio and open market operation.

- ◆ **Lender of the last resort:** When banks in the country need fund and they cannot collect from other sources, they knock the door of the central bank .Central bank as the lender of the last resort gives loans to banks with or without securities. Though central banks try to rescue failing banks in a number of ways, it will not be prudent for every bank to expect all types of support from central banks. Central banks normally rescue those banks which are 'too big to fail' and the banks which can be revived. The rate central bank applies while lending money is known as the 'bank rate' or 'refinance rate.

- ◆ **Management of foreign exchange:** "A central bank is entrusted with the responsibility of managing foreign exchange (forex) of the country. Since forex has a direct link with country's

international trade, remittance and movement of capital, caution should be exercised while making any rules. In economically advanced countries, we see an uninterrupted movement of capital. Central banks in such countries let the market determine exchange rate but do not hesitate to intervene in the market if it deems the prevailing exchange rate is inconsistent with economic fundamentals. Country to this, central bank in the developing countries exercise control in all the aspects of foreign exchange but the wave of liberalization has forced them to develop their power. Nevertheless, it should act like a watch dog to ensure that the country does not face balance of payment (BOP) problem”

◆ **Bank of central clearance, settlement and transfer:** “In the absence of a central agency for clearance and settlement each bank has to enter into a separate clearance and settlement transaction with other banks individually which is very inconvenient to all banks”²⁰ Hence, central bank plays a role as the clearinghouse for settlement. It operates as the clearinghouse for all its related banks as a matter of mechanism or of bookkeeping.

About the middle of the nineteenth century bank of England developed the function of central clearance and settlement. There after the other banks gradually took it up. Although not usually regarded as an important factor, central clearance and settlement has generally been accepted as a necessary function of central bank.

- ◆ **Regulation, supervision and control:** A central bank is the supervisor of the financial sector. It makes regulations for operation of financial institutions. It gives license to them for operation, makes regulation regarding Statutory Liquidity Ratio (SLR), Cash Reserve Ratio (CRR), capital adequacy, interest structure, foreign exchange, credit portfolio, loan classification and provisioning, income recognition, to name a few, in the same direction. It regularly monitors to ensure proper implementation of its rules. In case of violation, it takes different types of actions. A central bank is empowered even to snatch the license of operation.
- ◆ **Other miscellaneous function:** Central banks collect periodic data to know the fiscal and monetary condition of country. They publish periodic data with regard to balance of payment, international trade, money supply etc, and also they organize training for the employees of various financial institutions for the development of sound banking system. The Reserve Bank of India had established 'Banker's Training College' in 1954. Similarly Nepal Rastra Bank had also established 'Banker's Training Centre' in 1978. Apart from it central banks makes available reports, information to the commercial banks and other financial institutions by arranging seminar, carrying various surveys etc.

Above all developing functions are very much important for the development of sound banking system and corporate governance. Both of

developing and un-developing countries financial institutions play the vital role for the economic growth of nation and a central bank is a guardian of financial institutions. There are some principles of central bank. According to the Encyclopaedia Britannica, the principles of central banking grew up in response to the recurrent British financial crises of 19th century. The cause of the fluctuations in output and employment make the banks cautious enough in maintaining its liquidity position. This raises the need for a disinterested outside authority able to view economic and financial developments objectively and to exert some measure of control over the activities of the banks. A central bank must also cooperate closely with the national government. Indeed, most central banks and governments have become intimately associated in the formulation of policy.

◆ **Open market operations:** Deliberate buying and selling of government and other approved securities in the money market by the central bank, on its own initiative is called open market operations. Broadly, open market operations include purchase and sale by the central bank in the market of government securities, other securities, banker's acceptances and foreign exchanges. It is very simple to understand this principle. "During boom, a period of dangerous for economy stability, the central bank sells the government and other approved securities from its securities portfolio in the market to reduce the aggregate supply of money in the economy. Buyers of these securities pay the central bank by drawing on their cash deposits in the banks. It means the reduction of size of bank's deposit held with central bank. Reduction in their cash reserves forces the banks to reduce

their advances and refuse future loans. On the other hand, in slump economy, the central bank buys the government and other securities by paying cash. As a result, it increases the cash reserves of commercial banks which are used to support additional loans.”

◆ **The central bank and national economy:** “Since no modern economy is self-contained, central bank must give considerable attention to trading and financial relationships with other countries. If goods are brought abroad, there is a demand for foreign currency to pay for them. Alternatively, if goods are sold abroad, foreign currency is acquired that the seller ordinarily wishes to convert into his own currency. These two sets of transactions usually passed through the banking system.”²² The objective may be achieved more directly by re- evaluating a country’s exchange rate.

◆ **Relationships with commercial banks:** “The willingness of a central bank to offer support to the commercial banks and to other financial institutions in time of crises was greatly encouraged by the gradual disappearance of weaker institutions and a general improvement in bank management.”
(*Encyclopaedia Britannica, 1981: 700*)

◆ **Responsibility to the government:** Over the years central banks have acquired the number of well defined responsibilities to their respective governments. It has become the matter to accept

responsibility for the financial affairs of the government. “As banker to the government, furthermore, the central bank has an obvious responsibility to provide routine banking services, such as arranging loan flotation and supervising their service. Renewal and redemption.”

◆ **Direct actions:** “Direct action refers to coercive measure taken by the central bank against an offending commercial bank or financial institution. In other words, it is a refusal to rediscount or grant further rediscount facilities to the defaulting banks. It also includes directives to banks generally concerning their lending and investing operations. More precisely, direct action refers to all forms of controls and direction which the central bank may enforce upon the entire banking system or upon a particular bank or banks concerning lending and investment. Direct action also takes the form of charging a penal rate of interest for money borrowed beyond the prescribed amount of refusing to grant further rediscounting facilities to the offending banks.”

2.1.3 Commercial Bank – Concept and Functions

The banks which perform all kinds of banking business are known as commercial banks. Generally commercial banks deal with finance, trade and commerce. Since their deposits are for a short period, these banks normally advance short- term loans to the businessmen and traders. They specially avoid long- term lending. Majority of the commercial banks are in the public sector. They are established with the capital collected by issuance of share in public. Hence the commercial banks are also called joint stock banks. A commercial bank is a business bank or profit earning institution. Banks are

intermediaries in following funds from those who have surplus money to those who need it. This bank collects (saving) money scattered in a country and provides short-term loan to the entrepreneurs and individuals

“Commercial banks are the organized on a joint stock company system, preliminarily for the purpose of earning of profit. They can be either of branch banking type with a large network of branches or of the unit banking type. Although the commercial banks attract deposits of all kinds’ current, savings and fixed their resources are chiefly drawn from current deposits, which are repayable on demand. So they attach much importance to the liquidity of their investments and such they specialize in satisfying the short term credit needs of business rather than the long term.”

The commercial banks invest in securities of many classes of issue. Some of the larger ones buy and sell government securities in capacities as dealers, and almost all are willing to act as agents for their customers in executing orders to buy and sell securities of all kinds. The larger commercial banks, too, maintain the great bulk of foreign exchange facilities, and many smaller ones have corresponded relationships with these banks to enable them also to buy and sell foreign currencies. The bulk of the deposits commercial banks accept from the public are of short- term maturity. Therefore, most of their lending is confined to short-term purpose. Their lending activities are concentrated heavily on low risk, high profit commercial activities. However the lending operations of commercial banks have undergone considerable changes over time. These banks now provide finance for production purposes in agriculture and industry. They also take part in medium and long-term

project lending, usually sharing the risk with other agencies through syndicate or consortiums.

“Although commercial banks are privately owned business enterprises they have been given the extraordinary power to create money in the form of demand deposits, all well as to extinguish money so create” (*Kent, 1972:323*).

“Commercial banks are ‘ financial intermediaries’ for they also borrow from those who are not immediately spending all their current receipts and they lend to those who have intentions of immediate spending on goods beyond the range of their own current receipts.” (*Sayers, 1967:17*)

Among all commercial bank is the perfect example of financial intermediary. Commercial banks are not only to carry out commercial transaction but also had to carry out the functions of all type of financial institutions Thus the commercial banks are the heart of financial institutions which hold the deposits of public & governments and make funds available to borrowers such like governments, individuals etc. They affect the monetary policy of country because they are media which provide our medium of exchange. Hence, the most important type of financial institution in every country is commercial banks in term of aggregate assets. The typical commercial banks have a very large number of branches scattered all over the countries.

At present, the function of commercial bank in have been widely developed and extended. Therefore we can not exactly say all functions. However we can discuss its major functions under following heading.

A) Accepting Deposits or Borrowings: Banks attract the idle savings of people in the form of deposits. These deposits may be current, saving and fixed accounts. Current account or demand deposits are repayable on demand without any notice. Usually no interest is paid on them because the bank cannot utilize short-term deposits, and must, therefore, keep cent percent reserve against them on the other hand, a little commission is charged for the services rendered by it. Fixed or time deposits can be withdrawn only after the expiry of the period for which these deposits have been made. Higher rate of interest is paid in this account because bank can invest such amount safely for certain period. Time may range from three months to several years. The usual rate in Nepal today varies between 10% and 13% depending upon the time period for which deposits are made. Saving deposits stand midway between current and fixed deposits. Depositors cannot be withdrawn savings as soon as they need. Only limited amounts can be drawn at a time as allowed in a week. The rate of interest in such account is less then that on the fixed deposits.

B) Giving Loans/ Lending: The bank earns profit by giving amounts deposited with it in the form of loans. Since the bank creates credit with its deposit, it is called manufacturer of credit. According to traditional concept commercial banks can grant only for short- term credit. But nowadays, it also provides long-term credit loan advanced by the bank. They hold a certain portion of cash reserve to meet obligations.

The rest of the deposit amount is invested in loan financing which yield high rates of interest as compared to those payable on deposits. Loans issued are not cash amounts. Loans are deposited in current account in the name of borrowers. Deposits amount with loan. Borrowers draw as when necessary. Commercial banks allocate a specific amount of cash for this necessary. The remaining portion goes for further loans that are again deposited in borrowers account. Thus loan creates deposit which again creates loans. This is credit creation. Money many times in excess of actual amount of deposits is created. Therefore banks are manufacturer of credit.

C) Miscellaneous Functions: The functions other than main functions are called agency functions. The bank charges minimum fee for undertaking such agencies. This agency function and other functions can be explained as follows:

- ◆ **Remitting Funds:** Banks remit funds for their customers through bank draft to any place where they have branches or agencies. This is the economical and safe way of sending money.
- ◆ **Income Receiving and Payment:** The bank receives the dividend, interest on shares and debentures etc and makes payments of insurance premium, rent, income tax, electricity bills etc. periodically.
- ◆ **Purchase and sale of securities:** The commercial banks discount the securities of the businessmen and make them cash payments.

Businessmen may not have to wait for the maturity date due to this facility. Banks also sale securities on the order of customers.

- ◆ **To Issue Letter of Credit:** A letter of credit acts as mediator between businessmen and banks. It has provided extensive facilities to businessman and industrialist around the world.
- ◆ **Trust and Attorney:** Commercial banks works as the administrator, trustee, executor and attorney in settlement of will and accounts of the customers.
- ◆ **Safe Custody:** Ornaments and valuable documents can be kept in safe deposit with a bank in its strong lockers, on payment of small charge. Thus the risk of theft is avoided.
- ◆ **References:** Bank provides references about the financial position of their customers when required. This is done when the customers want to establish business connections with some new firms within or outside the country.
- ◆ **Issue Credit Instruments:** The bank issues traveller's cheques, draft and Master Card to the customers.

The two essential functions of commercial banks may best be summarized as the borrowing and lending of money. They borrow money by taking all kinds of deposits- Deposits may be received on current account whereby the

banker incurs the obligation of paying legal tender after the expiry of a fixed period or on deposit account whereby the bankers undertakes to pay the customer an agreed rate of interest on it in return for the right to demand from him an agreed period of notice for withdrawals. Thus a commercial banker, whether it is through current account or fixed deposit account, mobilizes the savings of the society. Then he provides this money to those who are in need of it by granting overdrafts or fixed loans or by discounting bills of exchange or promissory notes. Thus, the primary function of a commercial banker is that of a broker and dealer in money. By discharging this function efficiently, a commercial banker renders very valuable service to the community by increasing the productivity capacity of the country and thereby accelerating the pace of economic development. He gathers the small saving of the people, thus reducing to the lowest limits idle money. Then he combines these small holdings in amounts large enough to be profitably employed in those enterprises where they are most called for and most needed. Here, he makes capital effective and gives industry the benefits of capital, both of which otherwise would have remained idle. Take for instance, the practice of discounting bills. By converting future claims into present money, the commercial banker bridges the time element between the sale and actual payment of money. This enables the seller to carry on his business without any hindrance and the buyer will get enough time to realize the money. Thus we have seen that a banker receives deposits, which he has to repay according to his promise, and makes them available to those people who are really in need of them. He is actually distributing his deposits between the borrower and his own vaults. Herein lies the most delicate of the functions of the commercial banker.

2.1.4 Factors Responsible for the Advent of Modern Banking

It is little bit cumbersome to distinguish the exact meaning of modern banking and traditional banking. It is a subjective issue so far. As the technology changes and new financial tools emerge I the economy, the ‘so-called modern banking’ existing today would be termed as traditional and obsolete one tomorrow. However, operation of the banking service with contemporary tools, efficient human resources and new technology en-mass can be termed as a modern banking or vice versa.

Several arguments can be extended in support of the advent of the modern banking. However, principal phenomenon discussed in the text follows have made environment conducive for the inception of ‘modern banking system’

) **Organizational change:** The numbers of banks and bank branches have been established as ‘mushroom growth’ style over the world. Especially, after the financial globalization and liberalization, this trend is in ‘acceleration’. This up-shooting expansion in banking business has brought a realization of modernized and dynamic concept of banking in providing the services efficiently and swiftly. In this connection, banks are willingness or unwillingly compelled to reform, renovate and expand their organizational structure and layout.

) **Change in Nature of Loan Demand:** Previously, there was a small volume of credit for small types of business and industrial activities. But, after the evolution of ‘the theory of division of labour’ and ‘specialization’, there has been a spectacular change in economic activities, and the industrial revolution also took place.

Thus, the nature and tendency of lending changed from individual borrowing to corporate borrowing. For this, simple types of appraisals were not sufficient to maintain an appropriate portfolio. For this project/ industry/business appraisal, advanced types of programming, different types of financial ratio analyses, credit risk evaluations etc were needed and these factors led the banking system towards modernization.

) **Competition and Protection of Public Interest:** This is an age of ‘cut-throat-competition’ than before. There are so many banks commencements, mergers and/or liquidations over the world. This is quite natural in the competitive environment. In contrast, the banking system ought to consider in protecting the interest of the depositors. So, to survive in the competitive market on reasonable mark-up with protection of the depositors interest is a main challenge to the banking system. And, this condition virtually invited modernization in the banking system.

) **Responsibility to Reduce Regional Imbalances:** Especially after the incarnation of the ‘State Intervention Policy’ with so-called collapse of ‘classical Theory’, the banks were liable to participate in the government’s programs of reducing sector-wide disparities. Either on the basis of poverty line or the prioritized sub-sectors, banks is to shake hands with poor through finance. Government has had identified diverse mandatory areas to embark upon. In this course, banks are compelled to implement their strategies of credit planning, bank marketing and customer service in such a way that enables them in making trade off between social obligation and

business motive. Advent of this type of condition motivated the banking system in the direction of modern outlook.

) **New Innovations Reduce regional Imbalances:** The most responsible factor for modernization the banking system is significant improvements in the technology. Technology has affected all the corners of economic and social system. Previously, there were traditional activities on lending and deposit, but now the nature of those transactions has changed, for example, there were foreign exchange transactions in a controlled terms viz. direct quotation and exchange, but now there are so many types of forward and future transaction (derivative product) with managed floating system. Even in the lending side also, transaction trends has been diverted from individual to syndicate loans and consortium financing. In the part of customer service, there are computerized banking services with Automated Tailor Machine (ATM), Electronic Fund Transfer, Electronic Clearing-House, implementation of the concept of 'Step-at-Door Service' for deposit collection and loan disbursement. Nature of the transactions is also changed. For example, collateral based lending practices based on goodwill, faith, track record, personal guarantee, and project financing. Most of the business transactions are inclined to 'off balance-sheet' (non-fund based) nature like guarantee, letter of credit etc.

2.1.5 Concept of loan (credit) policy of commercial Banks:

Loan policy of commercial banks is also known as the credit policy. The extension of credit is one of the major functions of a banking institutions credit usually represent the bulk of the institutions assets, while interest on the credit represents the major source of it's income. Credit operations should be reviewed by banking at the institution's credit appraisal, credit approval, documentation and security, credit supervision and credit recovery or restructuring. Proper credit appraisal involves the assessment of three main aspects: THE APPLICANT, THE PURPOSE AND THE SECURITY. Approval for credit facilities should be made only by bank non-bank authorized officers within their authorized limits; standard term and conditions should govern credit approval. Loan and security documentation refers to the possession and possible use of legal documents to validate the claim of the bank against borrower. To ensure that the borrower is fully aware of his/her duties and obligations, the major terms and conditions should be stated in the loan agreement. Constant monitoring of the operations of the borrowers account is essential, because borrowers may suffer an inability to adhere to repayment schedule.

A credit policy of a commercial bank is a set of formal guidelines designed to ensure consistency in credit operations. The policy should be formulated and approved at the highest management level and then disseminated within the bank and financial institutions. The policy should be reviewed periodically and revised to adapt to changing conditions. A concentration of credit to an economic sector refers to loans and advance which pertain to the same economic sector. For example borrowers from the iron and steel industry, borrowers from the cement industry and considered to belong the same economy sector; housing and construction. A depression in that sector would adversely affect the prospects of the various industries within that

economic sector and would ultimately affect the banks most exposed to borrowers from that economic sector. Connections between borrowers are sometime difficult to establish some borrowers find it advantageous to deliberately conceal any connections with other borrowers. Also, some banks may allow their borrowers to disguise credit concentration in order to circumvent a single borrower lending limit imposed by the central bank. NRB regulations with respect to bank and financial intuitions allows them to extend funded exposure up to 25% of their core capital and non funded exposure up to 50% of their core capital to a single borrower or group of related borrowers. Furth more, the regulations specially the various sector of lending but doesn't restrict for single sector lending and it provides authority to monitor and supervise to BOD of concerned bank and financial intuitions Bank should ensure that a reliable information system is established so that the risk of their existing credit portfolios can be continually and properly assessed. Before new credit recommended for approval, concentration to credit policy should be analyzed.

2.2 Review of NRB Directives

Nepal Rastra Bank has recently issued twenty-one directives on the code of conduct for board director and employees of banks and non-banks financial institutions (Unified Directives). These directives are issued as authorised by Section 22 of the NRB Act. The section 22 of NRB Act read as “The bank may issue directives from time to time to commercial banks and financial institutions regarding banking operations, currency & credits. It shall be the duty of commercial bank and financial institutions to comply with such directives.” These kinds of directives as such are new from the regulator

side. Ethical standard in any financial institution is normally set at the time of establishment of the entity. Such regulation may be governed by the personnel rule in the case of employee and law or by oath to the directors.

The new directives issued by Nepal Rastra Bank applicable to banks and financial institutions comprise twenty one directives, issued in 2068 B.S. Due to lack of materials and middle of the fiscal year, this thesis is mainly based on the previous directives. However the changes have been noted wherever possible. Previous issued directives focused only on commercial banks but new directives must be followed by banks and all other financial institutions from the beginning of 068/69. This new directives cover all the banks and non-bank financial institutions. So, it is also called unified directives. Previous directives contained eleven directives. There is no any difference between new and previous directives directive no.4, which changed the format of financial statements of banks and financial institutions. So, the unified directives are as follows:

Directive no.1: Regulation relating to maintenance of minimum capital fund by the banks and financial institutions.

Directive no. 2: Regulation relating to loan classification and loan loss provisioning.

Directive no. 3: Regulation relating to limit on credit exposure and facilities to a single borrower, group of related borrowers and single sector of the economy.

Directive no. 4: Regulation relating to accounting policies and format of the financial statements to be followed by bank and non-bank financial institutions.

Directive no. 5: Regulation relating to minimization of risk inherent in the activities of bank and non-bank financial institutions.

Directive no. 6: Regulation relating to good corporate governance of bank and non-bank financial institutions.

Directive no. 7: Regulation relating to timeframe for implementation of regulatory directives issued in connection with inspection and supervision of the banks.

Directive no. 8: Regulation relating to investment in shares, debentures and securities by bank and non-bank financial institutions.

Directive no. 9: Regulation relating to submission of statistical data to Nepal Rastra Bank, Banking Management Division and Inspection and Supervision Division by bank and non-bank financial institutions.

Directive no.10: Regulation relating to sale and re-registration of foundation shares of bank and non-bank financial institutions.

Directive no.11: Regulation relating to consortium financing by bank and non-bank financial institutions.

Directive no.12: Regulation relating to loan and wilful defaulter or blacklisted information should be given to Nepal Rastra Bank by bank and non-bank financial institutions.

Directive no. 13: Regulation relating to Compulsory Balance.

Directive no. 14: Regulation relating to branch/office

Directive no. 15: Regulation relating to interest rate

Directive no. 16: Regulation relating to collection of financial resources.

Directive no. 17: Regulation relating to lending to deprived sector.

Directive no. 18: Regulation relating to amalgamation, merger and upgrading.

Directive no. 19: Regulation relating to know your customers.

Directive no. 20: Regulation relating to subsidiary companies.

Out of twenty directives, this research work is limited to the following five directives.

Directive no. 2: Regulation relating to Provision of loan classification and loan loss provisioning:

With an objectives to minimize the possible loss of credits extended by commercial banks, as provided under Section 23 (1) of Nepal Rastra Bank Act 2012 (with amendment) relating to development and regulation of banking system, this directives in respect of loan classification and provisioning has been issued in exercise of authority under Banks and Financial Institutions Act, 2063. (BAFIA)

- i) A bank is required to classify their loans and advances on the basis of ageing of the principle.
- ii) All loans and advances need to be classified into the following four types.

◆ **Pass:** Loans and advances whose principle amounts are not past due and past due for a period up to 3 month shall be included in this category. These are classified and defined as Performing Loans.

◆ **Sub-standard:** All loans and advances that are past due for a period of 3 month to 6 months shall be included in this category.

◆ **Doubtful:** All loans and advances which are past due for a period of 6 month to 1 year shall be included in this category.

◆ **Loss:** All loans and advances which are past due for a period of more than 1 year as well as advances which have least possibility of recovery or considered unrecoverable and those having thin possibility of even partial recovery in future shall be included in this category.

Loan and Advances falling in this category of Sub-Standard, Doubtful and loss are classified and defined as Non-Performing Loan.

Directive no. 3: Regulation relating to limit on credit exposure and facilities to a single borrower, group of related borrowers and single sector of the economy:

With the objective to minimize the concentration risk resulting from of the credit extended by the commercial banks to a single borrower or group of related borrowers as well as to the single sector of the economy, as provided under Section 23 (1) of Nepal Rastra Bank Act 2012 (with amendment) relating to development and regulation of banking system, this directives has been issued in exercise of authority under Section 22 of the same Act.

i) As per NRB Directives, banks should classify into fund-based loan (trust receipt, overdraft, term loan etc) and non-fund based loan (guarantees, letter of credit, commitments etc.). The NRB has brought following limit:

Loans and advance	From FY 2002/2003
Fund based	25% of core capital
Non-fund based	50% of core capital

ii) Banks should not maintain above limit, when loan provided under guarantees of fixed receipts, banks deposits, government securities, NRB debentures and rated national and international banks.

Directive no. 4: Regulation relating to provision of accounting policies and format of the financial statements to be followed by bank and non-bank financial institutions:

i) The period of Shrawan to Ashad shall be the fiscal year of all Commercial banks. Banks need to take Shrawan- Ashad (mid July/mid August-mid June/mid July) as a fiscal year.

ii) Banks need to publish balance sheet, profit and loss account and cash flow statement in annual report after auditing according to the statutory form issued by NRB.

iii) Banks need to publish financial statement including following subject:

- ◆ No changes to be made in the prescribed format and accounting heads.
- ◆ Annually distributed, recorded and written-off of principle and interest of loans and advances.
- ◆ Reconcile account according to past due.
- ◆ Weighted Average Interest Rate Spread of deposits and loans.
- ◆ Transaction related to on-balance sheet and off-balance sheet.
- ◆ Classification of assets and liabilities as per NRB Directives relating reducing liquidity risk on the basis of maturity period.
- ◆ Collateral for borrowing loans.

- ◆ Other necessary documents to inform and understand balance sheet and P/L account.

Directive no. 13: Regulation relating to compulsory reserve/statutory liquidity:

Following directives have been issued with regard to compulsory reserve and liquid assets to be maintained by a licensed institution based on its deposit and borrowing liabilities having exercised the powers. Conferred by section 79 of the NRB act 2002.

It shall be mandatory for class "A" institutions licensed by this bank and for the "B" and "C" classes institutions licensed by this bank and accepting the current/call accounts to maintain a deposit of 5.5% of the total deposit liabilities at this bank.

Directive no. 17: Regulation relating to lending to deprived sector:

The following directives have been issued having exercised the power conferred by section 79 of the Nepal Rastra Bank act 2002, with regard to the deprived sector lending to be extended by the institutions of class 'A', 'B' and 'C' licensed by this bank:

- 1) The 'A' class licensed institutions (commercial Banks) are required to lend at least 3% of their outstanding loan and advance (including bills purchased and discounted).
- 2) For the purpose of these directives, "deprived" means law income and especially socially backward women, tribal people, Dalit, blind, hearing impaired and physically incapacitated persons, marginalized and small farmers, craft-men, labour and landless squatters family. All micro-credits to be extended for

the operation. Of self-employment oriented micro-enterprises for the uplift meant of economic and social status of deprived sector up to the limit specified by this Bank is termed as 'deprived sector lending'.

All above these types of directives are issued only by the NRB and the commercial banks have to follow such directives with commercial banks' own policies.

2.3 Review of Articles

Tamrakar in his article entitled "NRB takes charges of Lumbini Bank" and Machhapuchre Bank published in Banking News Letter, May/July-(2010) has stated that NRB took action against two commercial banks operating in the capital city, Kathmandu. The central bank took action against these to banks for their failure to abide by the provision of flowing loan to the disadvantaged group of the society. As per the agreement, 3% of total loans should be flown to the disadvantaged class.

The NRB fined Rs. 2, 26000 to Machapuchree Bank & Rs. 8, 80000 to Lumbini Bank. Both of the banks were found for their inability to flow loan as per the provision for the financial year of 2007/08.

2.4 Thesis Review

In the context of Nepal, Nepal Rastra Bank is the central bank of Nepal. There are many studies related to central bank. But, some studies have been conducted regarding the role of NRB in economic development of Nepal and few studies are conducted on the NRB role for banking development.

According to Members of Chartered Accountants of Nepal in this report, 2010 (an unpublished report) which was related to the guidelines of NRB have shown the effectiveness of guidelines to commercial banks and also presented rules and regulation which must be followed by commercial banks. Sontosh Pandey, in his thesis entitled NRB Directives, their implementation and impact on the commercial banks submitted to faculty of management, TU, for Master Degree of Business Studies concluded that the changes in NRB Directives have made the impacts on the commercial banks. Because of previous directives, banks have to increase the operational cost and dividends to shareholders and bonus to the employees are scaled down due to decrease in profits of banks. He has also observed about the protection of deposits of public because of reduction in the loan exposure. He further states that due to previous directives, its foresight results lead to bank financially healthy and stronger in future. Finally, he laid down about the changes in directives will bring prosperity to the shareholders, depositors, employees and the economy to the country as a whole. He suggested, in this thesis, to NRB that the NRB should issue directives after doing proper homework. NRB must strengthen the functioning of its Credit Information Bureau. NRB should be practical and should issue directives to be applicable in context of Nepal, not only to meet the international standards, otherwise complaints from commercial banks may arise. However, in the present context, the commercial banks must be comply with such directives and maintain its policies. And, NRB has directed commercial banks to obey such rules and regulations; otherwise NRB will take action as per NRB Act, 1955.

Above study is based on the impact of directives to commercial banks and the study consists only three directives. Presently, NRB has issued unified directives 2011 relating to banks and financial institutions regulation and prudential comprises twenty one directives. The findings of above study may indicate the certain impact of the new directives to the commercial banks. The present study focuses on the five directives of NRB and studies on rules maintaining by Nepal Bank Limited and Himalayan Bank Limited. The previous directives already had been changed. Thus, the present study is more relevant than the above. This study will also carry out to fill the gap, which was lack in the previous study.

2.5 Review of critical literature of NRB:

"NRB Withdrawn Restriction in Commercial Banks" Focuses about the further establishment of commercial banks in Nepal, where NRB has withdrawn the seven-year restriction. Under new directives, commercial banks must maintain paid –up capital equivalent to Rs 1 billion and Rs 25 million at the national and regional levels respectively. This provision stipulates one compulsory requires the joint investment of foreign banks or financial institutions and a Nepali firm, company etc. for the operation of such commercial banks. These new NRB banking policy has affected the Nepal Army’s longstanding plan to establish a separate commercial bank under its management ownership. Also, there may be negative effect on foreign investment because of no registration of new banks starting from the year 1995 due to excess of competition aroused by massive investment following the adoption of liberal policy.(New Business Age, Sept. 2011:10)

CHAPTER III

RESEARCH METHODOLOGY

3.1 Introduction

Research methodology refers to the various sequential steps (along with a rationale of each step) to be adopted by a researcher in studying a problem with certain objectives in a view.

Research is the investigating by planning, structuring with strategy to find out the problems and to control the variance. Research refers to a search of

knowledge, which may be scientific research or systematic research for pertinent information on a specific topic. Research has significance to solve various operational and planning problems of business and industry. The purpose of research is to discover answers to questions through the application of scientific procedures. The main aim of research is to find out the truth which is hidden which has not been discovered at yet.

The research methodology gives the student the necessary training in gathering materials and arranging or card indexing them, participation in field work when required and also training in techniques for the collection of data appropriate to particular problems, in the use of statistics, questionnaires and controlled experimentation and in recording evidence, sorting it out and interpreting it.

The basic objective of this study is to ‘Impact of Nepal Rastra Bank (NRB)’s Directives on loan policy and investment of commercial Bank a comparative study of Nepal Bank Ltd and Himalayan Bank Ltd. An attempt is made to carryout the following activities in this study:-

- ➡ Review the changes NRB's Directives and define.
- ➡ Conduct structure reviews regarding benefits and weaknesses of the Nepal Rastra Bank’s Directives
- ➡ Conduct study of previous unpublished research works.

3.2 Research Design

This study is based on certain research design keeping as the objectives of the study in mind. Generally research design means definite procedures and techniques, guideline propound ways for research, ability. This study evaluates the impact of NRB's directives with the help of maintained research design. For this purpose the research design of this study is used for analytical as well as descriptive methods of collected data. The selection of this type of research has become necessary keeping in view the quantity and quality of information that is available

3.3 Sampling method:

There are thirty-two commercial banks, seventy five development banks and five rural development banks are operating in Nepal. Among all, this study comprises two commercial banks namely; Nepal Bank Ltd and Himalayan Bank Ltd have been selected as sample for this study from entire population.

3.4 Sources of Data

The research outlook is basically guided by primary as well as secondary data. The current research study is primarily dependent on secondary data collected from reliable sources.

- A) Directives of NRB.
- B) Previous related studies.
- C) Published article of different authors.
- D) Journals and other published and unpublished related documents and reports from Tribhuvan University Library, Nepal Rastra Bank Library, Mechi Multiple Campus Library.

The study is related to NRB and other commercial banks so the main source of data is obtained from secondary source. The use of primary source is very negligible. The secondary data were directly collected from surfing internet and other relevant data are gathered from published articles, journals, reports of NRB, Nepal Bank Ltd and Himalayan Bank Ltd. etc.

3.5 Tools and techniques

In this research two types of tools are used for analysis to make the study specific and reliable.

- I) Financial tools
- II) Statistical tools

I) Financial Tools - Various financial tools are used for analysis. The basis tools used are as follows:

1. Loan Classification and Provisioning- The amount of loans in the various categories has been calculated by using the models of NRB. Apart from, for each category, the actual provisioning amounts have been calculated according to the directions laid down by NRB.

2. Single Borrower's Limit - Single borrower's limit refers to the maximum credit limits that can be extended to a customer, firm, company or companies of the same group. The formula and figure that lay down by NRB have been used to calculate the single borrower limit.

3. Accounting Policy and structure of financial structure- To calculate the accounting policy and structure of financial structure, the models and chart have been used.

4. Risk reducing on activities of commercial banks- In order to compute the risk reducing on activities of commercial banks, the models and formula as laid down by NRB has been used.

5. CD ratio- This ratio is derived by dividing total loan and advance by total deposit of the bank.

6. NPL Ratio- Non- performing loan ratio is calculated by dividing non-performing loan by total loan of the bank.

II) Statistical tools – many statistical tools are often employed in the analysis and presentation of data as an aid to management and managerial decision. Following statistical tools are used more systematically in this chapter.

Trend analysis of deposit, loan and advance and the multiple bar diagrams are presented as statistical tools where it is necessary to compare between one another banks.

CHAPTER IV

PRESENTATION AND ANALYSIS OF DATA

The main objective of this chapter is to analysis and present the data collected from Nepal Bank Ltd. and Himalayan Bank Ltd. According to the objective of the study, this chapter is confined into the following four sub topics:

4.1. Analysis of loan disbursement to various sectors by commercial banks:

Commercial banks are the principal sources of loan able funds. They support individual, institutions and government for their credit needs. In general, a bank is an organization whose principal operations are concerned with the accumulation of the temporary idle\scattered money of the general public for the purpose of advancing to others for productive use or expenditures. Here for purpose of study, these loans of commercial banks have been divided in the following three sectors of economy:

4.1.1 Analysis of farming (primary) sector loan:

Farming sector loan of commercial banks is that amount of loan which is provided to produce and promote agro-based products, transportation expenses etc. as per needs of clients. In Nepalese context, maximum amount of farming loan is provided for the product like tea, paddy, maize, animal keeping etc. Commercial Bank and financial institution has not any restriction for farming sector lending issued by NRB. So, commercial bank has own loan policy to make decision in provide loan in different sectors of

economy. A commercial bank may mobilize its bank deposit in various sectors as loan, which plays a vital role for economy growth and income employment generation. Economic growth of country depends on sector wise loan provided by financial intermediaries like bank, financial institutions.

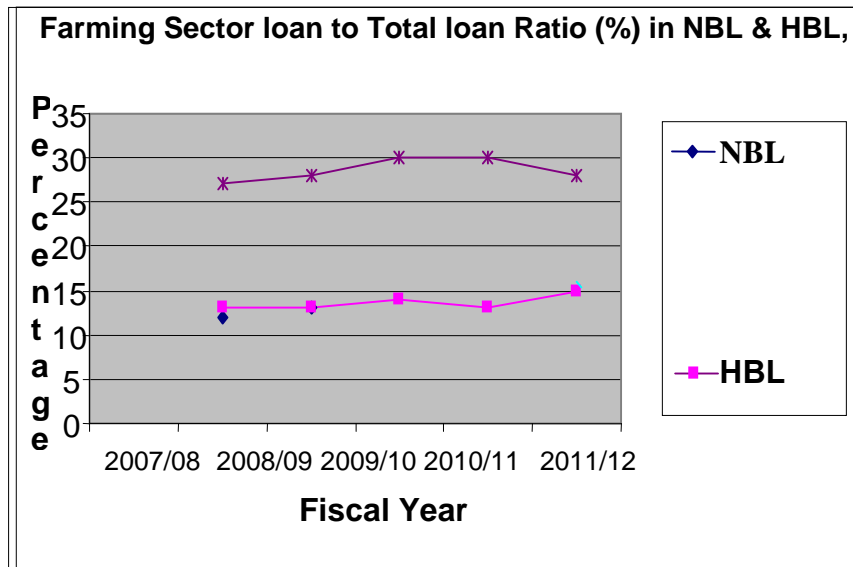
Agriculture sector loan may be informed of long term loan, working capital loan or overdraft loan. Here, we consider only the total farming sector loan as the sum of different from of loans. A high ratio of farming sector loan is the indicator of highly flow of funds in farming sector by commercial banks. The farming loan to the total loan ratio is calculated by dividing total farming sector loan by total loan of same bank during the period.

Table 1: Farming (primary) sector loan to total loan Ratio (%) NBL and HBL

Name of Banks		F/Y		2011/12	2010/11	2009/10	2008/09	2007/08	Average
NBL	Amount in million RS			6502	4605	2965	2016	1626	
	Percent of Total Loan			24.34	19.55	16.83	13.61	12.03	17.27
HBL	Amount in million RS			4966	3851	3708	2708	2409	
	Percent of Total Loan			15.06	13.22	14.53	13.42	13.54	13.95

The farming sector loan ratio of NBL & HBL is also presented in a figure for a visible indication of change in the ratios

Figure 1: Farming (primary) sector loan to total loan Ratio of NBL & HBL



Above table and figure no 3 exhibit shows the farming loan to total loan ratio and amount of farming loan during the research period of five fiscal year for NBL and HBL and in-depth analysis of this ratio is done below:

The farming loan to total loan ratio of NBL is in increasing trend with increasing rate. It indicates that the present strategy of bank is to leave the other risky investment sector like industry, service etc. and shift funds from risky sector to non-risky productive sector like farming sector. The highest

farming loan ratio for NBL is 24.34% in fiscal year 2011/12 and minimum farming loan ratio is 12.03% in fiscal year 2007/08. The loan is increased by 1.58%, 3.22%, 2.72% and 4.79% in fiscal years 2008/09, 2009/10, 2010/11 and 2011/12 respectively than its respective previous fiscal year. The NBL has 17.27% farming loan to total loan ratio on average during the five years study period.

The farming loan to total loan ratio of HBL is slightly in increasing trend. It indicates that the bank has a policy of lending in farming sector at nearly 14% of total lending of bank. The maximum farming loan to total loan ratio for HBL is 15.6% in last fiscal year 2011/12 and the minimum ratio was 13.22% in fiscal year 2010/11. The ratio of farming loan is decrease by 0.12% and 1.31% in fiscal years 2008/09 and 2009/10 respectively and increase by 1.11% and 1.84% in fiscal years 2009/10 and 2010/11 respectively than its respective previous fiscal year. The average farming sector loan to total loan for HBL is 13.95% for the last five fiscal years.

4.1.2 Analysis of service sector loan:

Service sector loan is that amount of loan provide by commercial banks to service product producers or service organization are that types of organization that provide service to customers. Service is characterized by intangible output like hair cutting, teaching, guest house, legal services, health care, and communication service etc. Service are used immediately and cannot be stocked like product thus cover the small areas. Service uses more labour and less equipment compared to manufacturing operation. So, service sector can create maximum employment opportunity in economy, however some service is equipment based like computer programming

service, railway service, telephone service, etc. It has direct consumer content and frequent customer participation on conversion process. Simple methodologies could be used for measuring conversion activities, resources consumption and consumer satisfaction. Service sector would not need more capital than manufacturing organization but service use their maximum fund for promotion expenses to develop service sector, government should make sound intellectual property rights like patent, copy right, trade secrets etc.

A high ratio of service sector loan to total loan indicates that the banks are lending funds at higher proportion of total loan for the development of service sector and vice versa. Service sector is a very productive sector of economy because it contributes 36% in GDP as well as income employment generation on Nepalese economy. This ratio is calculated by dividing service sector loan by total loan of banks during fiscal year.

Table 2: Service sector loan to total loan Ratio (%) of NBL & HBL

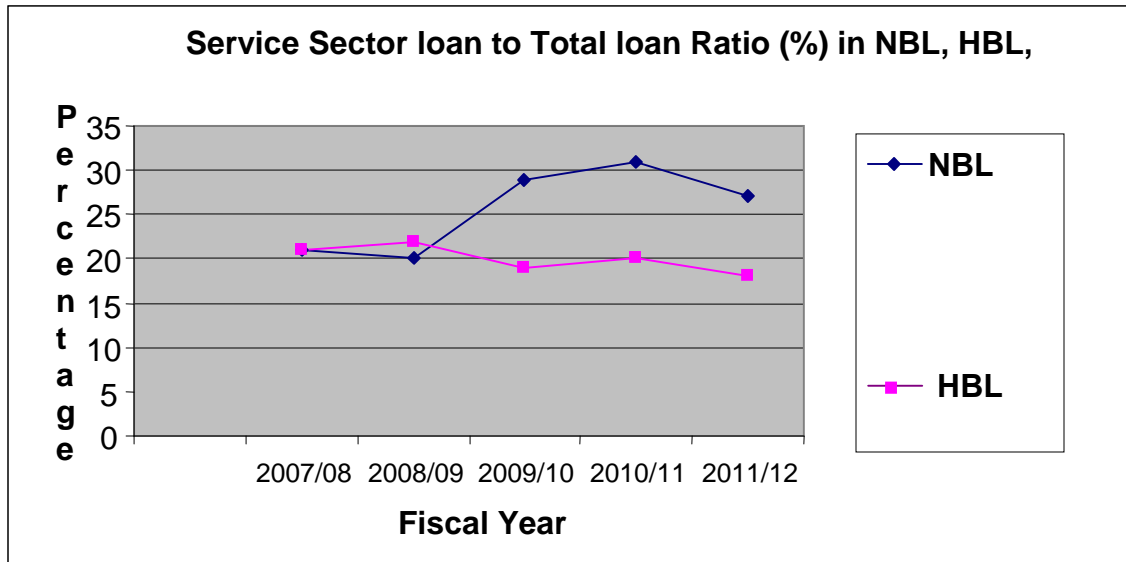
Name of Banks		F/Y	2011/12	2010/11	2009/10	2008/09	2007/08	Avera
		NBL	Amount in million RS	7212	7331	5109	309	2846
	Percent of Total Loan	27.00	31.12	29.01	20.89	21.05	25.81	
HBL	Amount in million RS	6118	5992	5013	4490	3783		

	Percent of Total Loan	18.56	20.58	19.64	22.25	21.26	20.46
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Sources: Banking and financial statistics, NRB 2012

Service sector loan total loan ration of NBL & HBL is also presented in a figure for a visible indication of change in the rations:

Figure 2: Service sector loan ratio of NBL & HBL



Sources: Banking and financial statistics, NRB 2012

Above table and figure shows the amount of amount of service loan and service loan to total loan ratio during the study period. For NBL and HBL. The ratio is calculated by dividing service loan by total loan of the bank. An in-depth analysis of these ratios is done below:

The service loan to total loan of NBL is in increasing trend on average. It indicates that the present policy of NBL is to increase lending in service sector to promote service organization for the healthy growth of economy. The maximum service loan to total loan ratio is 31.12% in fiscal year 2010/11 and the minimum ratio is 20.89% in fiscal year of 2007\08. The service loan to total loan ratio is decreased by 0,16% in fiscal year 2008/09, increase by 8.12% in fiscal year increase by 2.11% in fiscal year 2010/11 and decrease by 4.12% in last fiscal year 2011/112 than its respective previous fiscal year . NBL last 25.81% service loan to total loan ratio on average for last five fiscal years.

The service loan to total loan of HBL is fluctuating in study period. It indicates that the bank may not have constant policy for service sector lending. The maximum service loan to total loan ratio is 22.25% in fiscal year 2008\09 and the minimum ratio is 18.56% in fiscal year 2011/12. The ratio increase by 0.99% in fiscal year 2008/09; decrease by 2.61% in fiscal year 2009/10; increase by 0.94% and again decrease by 2,02% in last fiscal year 2011/12than respective previous fiscal year. HBL has 20.46% service loan to total loan on average during the study period of five fiscal years.

4.1.3. Analysis of industrial sector loan:

Industrial sector is the one of the most important sector for the developed economy because the growth of industrial sector helps to increase GDP of the nation. Industrial sector also play a vital role in trade balance as well as balance of payment by increase export of goods and services. Underdeveloped and developed country like Nepal should give priority to industrial sector for the development of economy by promoting import substitutes industry like cement, fibbers, medicine, clothes, coal, tire-tube, industry etc. and export promotion industry etc. to develop these industry entrepreneur should have sufficient capital which may supply by commercial banks. Therefore the development of industrial sector depends on lending of commercial banks. It should regulate by central bank. For the flow of funds to industrial sector. Growth of industrial only does not depends on capital, it is highly affected by the political situation of nation-un favourable political situation is harmful for industrialization the economy continues to suffer from political uncertainties real GDP grew by 3.5% in fiscal year 2011

below the 5% on average during fiscal year 2007-2010 but slightly above the 3.1 % average of intense conflict period (fiscal year 2007-2012). The fiscal year 2012 growth rate is likely to remain below 4% of performance of the non agriculture sector (industry and service) is projected to remain poor. These sectors are being adversely affected by political uncertainties, poor law and order situation, militant labour problems and other governance issues.

The high ratio of industrial loan to total loan ration indicates that the industrial sector is growing highly in this nation and it is able to promote industrial development. This ration is calculated by dividing industrial sector loan by total loan of the same bank during a time period.

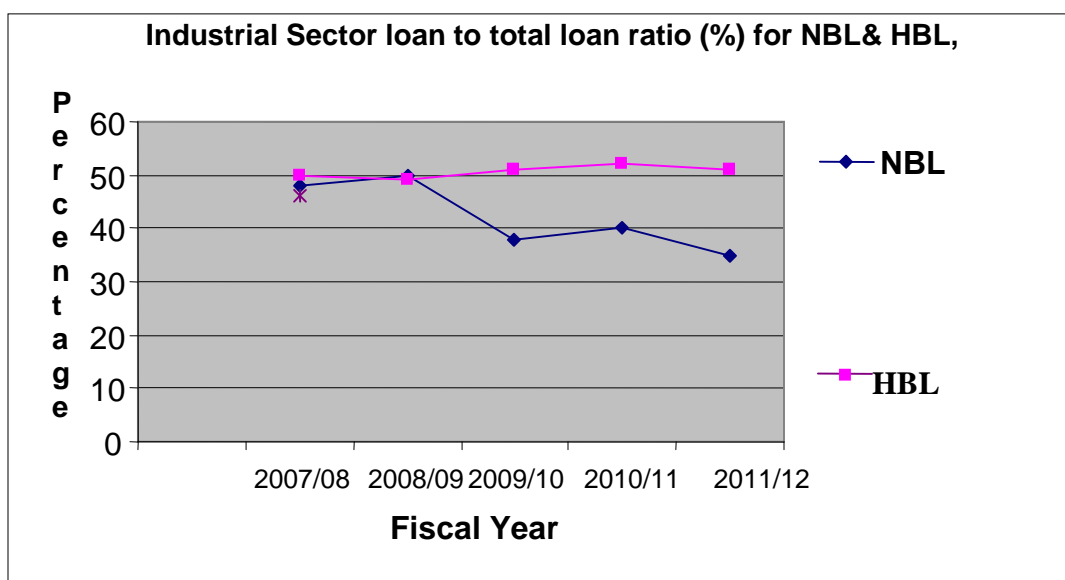
Table 3: industrial loan to total loan ratio (%) of NBL& HBL

Name of Banks		F/Y		2011/012	2010/11	2009/10	2008/09	2007/08	Average
		Amount in Million RS	Percent of Total Loan						
NBL	Amount in Million RS			9575	9461	6816	7456	6564	
	Percent of Total Loan			35.85	40.16	38.70	50.33	48.56	42.72
HBL	Amount in Million RS			17089	15359	13125	9980	8968	
	Percent of Total Loan			51.84	52.74	51.43	49.46	50.40	51.17

Sources: Banking and financial statistics, NRB 2012

The industrial loan ration is also presented in a figure for a visible indication of change in the ratio

Figure 3: industrial loan of NBL& HBL



From above table and figure are look the position of industrial sector loan during last five fiscal years lending by Nepalese commercial banks, NBL & HBL an in depth analysis of these ratio is done below:

The industrial loan to total loan ratio of NBL is in decreasing trade on an average which indicates that the industrial sector is more risky sector for lending at present time because of political instability so bank wants to reduce its industrial sector loan. The maximum industrial loan to total loan ratio is 50.33% in fiscal year 2008/09 and the minimum ratio is 35.85% in

last fiscal year 2011/12 here the industrial loan to total loan ration was increased by 1.77% in fiscal year 2008/09, decreased by 11.63% in fiscal year 2009/10, increased by 1.46% in fiscal year 2010/11 and decreased by 4.31% during the last fiscal year 2011/11 than their respective previous fiscal years. NBL has 42.72% industrial loan to total loan ratio on average during the study period.

The industrial loan to total loan ratio of HBL is in constant trend at nearly 51% which indicates that HBL have a constant lending policy for industrial sector which will more helpful to increase industrialization of nation . The industrial loan to total loan of HBL is maximum that is 52.74% in fiscal year 2010/11 and minimum ratio us 49.46% in fiscal year 2008/09 here the deviation between maximum and minimum ratio is only 3.28% which shows the consistency of lending of HBL. The industrial loan ratio was decreased by 0.94% in fiscal year 2008/09, increased by 1.97% in fiscal year 2009/10, increased by 1.31% in last fiscal year 2011/12 than its previous fiscal year. HBL has 51.17% industrial loan on total loan ratio on average for last five fiscal years.

4.2 Impact of present C/D Ratio on Business and Economic Development:

Credit deposit ratio is widely used banking indicator which shows how much of the resources deposited in banks are converted into loans and contributes to the economic growth. A poor C/D ratio becomes a matter of serious concern for the people and shows a negative attitude of the banks in lending resources.

C/D ratio also depends on growth in mobilization of deposits, development of credit, institutional infra structure etc. In recent times there has been a considerable amount of discussion on the Usefulness of C/D ratio as a measure of allocation of funds by banks, and that a few other indicators of credit deployment have been recognized.

A bank cannot lend everything that has been deposited by its clients. It needs to keep a minimum percentage of deposit in Nepal Rastra Bank (NRB), which is referred to as cash reserve ratio (CRR). CRR is presently reduced from 5.5 % to 5 %. As a result inter bank rates among commercial banks declined to the low single digit levels, much below than Indian rates. However smaller financial institutions continue to suffer from tight liquidity position and pay higher inter bank rates.

Apart from CRR, banks need to maintain certain amount of cash in the vault in order to meet their cash needs arising from withdrawal of deposits, maturity, liabilities and disbursement of loans. The relation of cash in vault to deposit in the bank on mid march 2012 was close to 1%.

The financial sector has come under stress since late 2009 with liquidity shortages. Earlier credit expansion during the real estate boom was followed by slower deposit growth due to a number of factors including the new rule to disclose income sources for depositors. The rapid credit growth and slower deposit growth raised c/d ratio to an unprecedented level of above 90% on average and resulted in a slowing a decline in credit extended by many different types of financial institutions . Commercial banks, in particular found it increasingly difficult to extend fresh credit to their clients.

Borrows started to experience debt serving problem as rollovers became difficult.

The credit of bank is also known as loan and advance which is the total sum of loan, advance, investment, overdraft, local and foreign bills purchased and discounted. Banks high ratio of loan and advance indicates that better mobilization of collected deposit and low ratio of loan and advances indicates collected deposit could not utilized in the different portfolio. It is able to estimate high liquidity problems. But it should be noted that too high ratio may not be better from its liquidity point of view. This ratio is calculated by dividing total credit or loan and advances by total deposits of related banks. The following table shows the credit deposit (C/D) ratio of NBL & HBL of the study period.

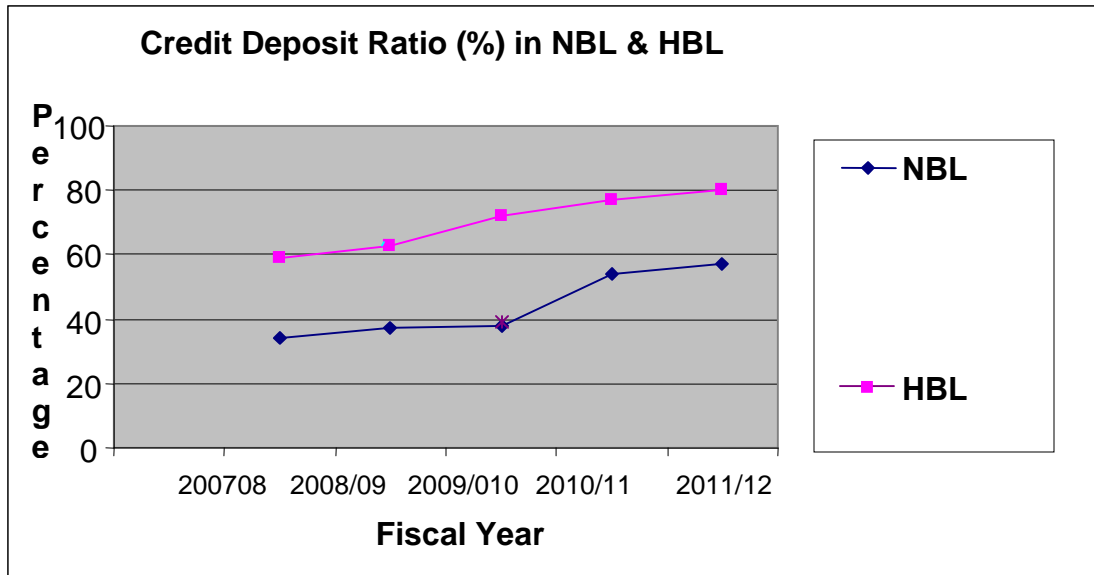
Table 4: Credit Deposit (C/D) Ratio % for NBL

F/Y	2011/12	2010/11	2009/10	2008/09	2007/08	Average
Banks						
HBL	80.57	77.43	73.58	63.37	59.22	70.83

Sources- Annual report of NBL 2012

The credit deposit ratio is also presented in a figure for a visible indication of change in the ratio.

Figure 4: Credit Deposit (C/D) ratio for NBL& HBL



The above tables and figure shows total credit and deposit ratio position of NBL& HBL, An in depth analysis of these ratios is done below:

The credit deposit (C/D) ratio of NBL is in increasing trend which indicates that the bank is able to increase fund mobilize capacity. The maximum C/D ratio of NBL is 50.07% in fiscal year 2011/12 and minimum C/D ratio is 34.72% in fiscal year 2007/08. The ratio was increased by 2.48%, 1.78%, 15.96% and 2.13% in fiscal year 2008/09 , 2009/010, 2010/011, 2011/12 respectively than its respective previous fiscal years. The C/D ratio of NBL is 44.58% on average in study period of 5 years.

The credit deposit (C/D) ratio of HBL is in increasing trend which indicates that the management have formulated the strategies to maximize the lending on profitable sectors of economy. The maximum C/D ratio of HBL is 80.57% in fiscal year 2011/12 and the minimum C/D ratio of HBL is 59.22% during the fiscal year 2007/08. The C/D of HBL during the fiscal year 2007/08. The C/D ratio of HBL increased by 4.15%, 10.21%, 3.85%

and 3.14% in fiscal year 2008/09, 2009/10, 2010/11 and 2011/12 respectively than its previous fiscal years. The average C/D ratio of HBL is 70.83% during the study period.

C/D ratio of banking sector is 88%, slightly below the level seen during the same review period in fiscal year 2011. The liquidity position of commercial banks has improved and their C/D ratio has declined from 81% in April to 77% in July 2011. The lower C/D ratio indicates that the higher liquidity position of banks and vice versa. But lower C/D ratio will reduce interest income of banks because of reducing the lending. Thus a bank should make a policy of maintain C/D ratio at profitable point with less liquidity risk.

Technically, a bank can grant 93% (deposit less CRR and average cash in vault maintained by commercial banks) of its deposits as loan and advance. But in reality, we do not find commercial banks maintaining C/D ratio to such an extent. Why do not banks lend as high as 93% of its deposits? Or why do some banks maintain a better C/D ratio than others do, provided all banks need to maintain the same CRR and operate in similar condition.

Among the composition of major assets of banks, loans and advances are considered less liquid because they cannot be sold before maturity if banks need cash in hurry. Another problem associated with loans and advances is that they are considered the most risky assets, the on that carry the highest borrower default rate. The risky nature of loan is what compels a bank to maintain more capital.

4.3. Analysis of productive, passive or Non-performing loan to various sectors:

The qualitative analysis of loan disbursement can be done through the productive loan and non-performing loan of commercial banks. Here, we divided these quality indicators of loan into two parts for depth analysis for the study period.

4.3.1 Analysis of productive loan to various sectors:

Productive loan may be defined as the income employment generating loan made by commercial banks may not lend its all proportion of loan to productive sector because the unproductive sector loan like real estate loan, home loan etc have higher return with low risk. Unproductive sector loan only increase the profit of banks but not helps to economics growth. Productive sector of the economic are service sector, industrial sector mainly. These sectors directly contribute to the economy and GDP of nation.

Higher the productive loan to total to loan ratio to indicates that the particulars banks has higher amount of investment in productive sector of economy and the productive loan to total loan ratio is calculated by dividing total productive loan by total loan of same bank. Total productive loan is the sum of service sector loan, industrial sector loan and farming sector loan. Unproductive loan is the sum of real estate loan and personal home loan. The following show the amount of productive loan and the ratio of productive loan to total loan of NB and HBL during the study period.

Table 5: Amount of productive loan and productive loan to total loan ratio (%)

F/Y		2011/12	2010/11	2009/10	2008/09	2007/08	Average
Name of Bank							
NBL	Amount in Million	23290	21398	14891	12566	11036	

	Percent of Total Loan	87.20	90.82	84.54	84.84	81.65	85.81
HBL	Amount in Million	28174	25202	21847	17179	15161	
	Percent of Total Loan	85.46	86.54	85.61	85.13	85.21	85.59

Sources: Banking and financial statistics, NRB 2012

Applying test of significance

Ho (Null Hypothesis) : There is insignificant difference between the loan disbursement and its Productive utilization.

H₁ (Alternative Hypothesis): There is significant difference between the loan disbursement and its Productive utilization.

Here, $t = 5.4927$

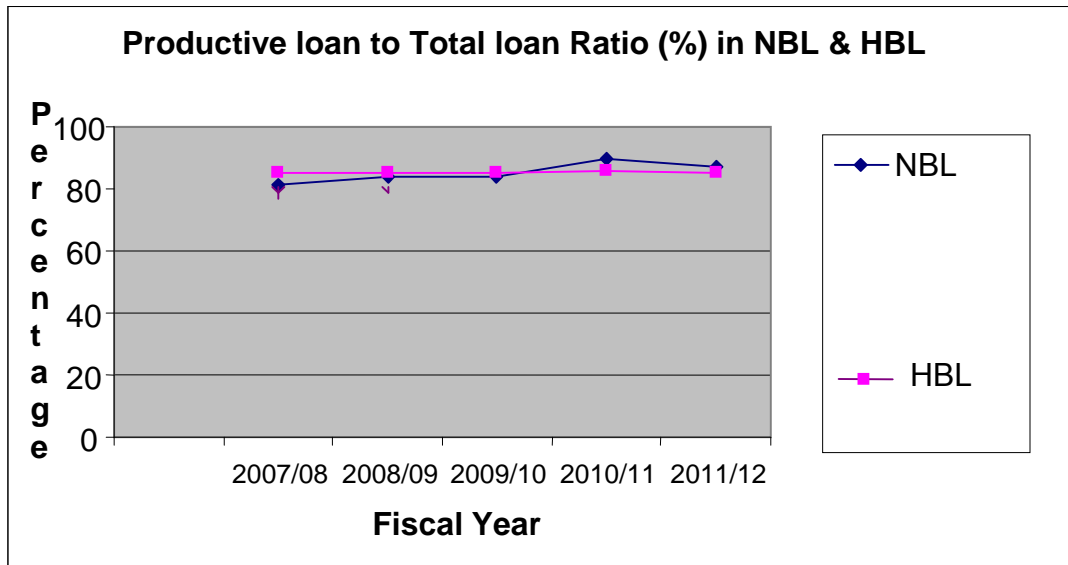
$t_{0.05} = 2.306$

$t_{0.01} = 3.355$

Since the calculated value of t is greater than its tabulated value at 0.01 and 0.05 level of significance and, therefore H₁(Alternative Hypothesis) is accepted. It implies that the commercial banks have not been able to utilize its lone management in an efficient manner.

The above productive loan ratio is also presented in a figure for a visible indication of change in the ratio:

Figure 5: Productive loan to total loan ratio of NBL & HBL



The above table and figure shows the amount of productive loan and the ratio of productive loan to total loan during the study period for NBL & HBL. An in depth analysis of above data is done below:

The productive loan to total loan ratio of NBL is increase trend on average. It indicates that the bank has a policy of lending increase to productive sector or the cause of decrease in collection of deposit than lending. The maximum productive loan ratio of NBL is 90.82% in fiscal year 2010/11 and the minimum productive loan ratio is 81.65% in fiscal year 2007/08. The ratio was increase by 3.19% in fiscal year 2007/08 decrease by 0.3% in fiscal year 2009/10; increase by 6.28% in fiscal year 2010/11; decrease by 30.62% in last fiscal year 2011/12 than in respective previous fiscal year. NBL has 85.81% productive loan on average during the five years period.

The productive loan to total loan ratio of HBL is in constant trend at near 85% which indicates that the bank has policy of lending to productive sector as same ratio with increase in total loans. HBL has maximum productive loan ratio of 86.54% fiscal year 2010/11 and the minimum ratio is 85.132 % in fiscal year 2008/09. The deviation between maximum ratio and minimum ratio is only 1.41 % which shows the consistency of productive loan lending by HBL during the study period. The productive loan ratio was decrease by 0.08 % in fiscal year 2008/09; increase by 0.48 % and 0.93 % in fiscal year 2009/10 and 2010/11 respectively and decrease by 1.08 % in last fiscal year 2011/12 than its respective previous fiscal year. The bank has average productive loan ratio of 85.59 % during the study period.

4.3.2. Analysis of passive or Non-performing loan (NPL) to various sectors:

Any loan and advance classified as sub-standard, doubtful and loss asserts are considered as non-performing in Nepal. Non-performing loan is defined as a bank investment, which is not generating any kinds of earning. In other words the investment is outdated or dead, which can not produce any kinds of returns. Non-performing assets in fact to some extent show operational efficiency of any commercial bank.

It will be imperative to define the terms non- performing assets and non performing loans. Generally, non-performing assets relates to non-performing financial assets. In the context the non-performing assets are defined as debt instrument whose obligors are unable to discharge their liabilities as they become due. The term debt interment refers to both loans

and bonds. There for non performing assets comprise the wider area of assets portfolio where as the non performing loan is referred to distressed loans classified as per regulations of the central banks and financial intuition. Since, the loan being the significant components on financial assets portfolio, non performing loans and non performing assets portfolio, non performing loans and non performing assets are interchanging, but if there are no other assets other than loans to denote, it will be better to say non performing loans.

Going by the definition of regulating authorities all lending are NPL if repayment of principle and or interest is defaulted by more than three months. NPL in the Nepalese Banking Sector has been increasing since early 1990 and its main sources are two public sector banks RBB and NBL. As per the directive of NRB Directive banks and other financial intuition should required to classify there loans and advance into following four categories'

◆ **Pass:** Loans and advances whose principle amounts are not past due and past due for a period up to 3 month shall be included in this category. These are classified and defined as Performing Loans.

◆ **Sub-standard:** All loans and advances that are past due for a period of 3 month to 6 months shall be included in this category.

◆ **Doubtful:** All loans and advances which are past due for a period of 6 month to 1 year shall be included in this category.

◆ **Loss:** All loans and advances which are past due for a period of more than 1 year as well as advances which have least possibility of recovery

or considered unrecoverable and those having thin possibility of even partial recovery in future shall be included in this category.

Loan and Advances falling in this category of Sub-Standard, Doubtful and loss are classified and defined as Non-Performing Loan.

Non performing loans arise due to several reasons. Conceptually, non performing loans in banks arise due to asymmetric related to the problem of adverse selection of borrowers and the problem of moral hazard on the parts of borrows. A commercial bank also expected to make allocation of its credit on the basis of risk return characteristics of the borrowers. When a bank cannot distinguish between projects according to their underlying risk characteristics, it will have relatively inferior credit portfolio. Inferior credit portfolio arise due to poor screening process of credit, inability on the part of the bank to appraise credit properly, too much emphasis on collateral relatively to cash flows of the project, vested interest on the part of credit appraiser political and other undue influence in selecting the project etc. Such problems of adverse selections of borrower leads to increasing non-performing loans in the bank.

The problems of hazard arise due to borrowers' dishonesty in the sense that the borrower willingly defaults in the repayment of interest and principal. One of the causes of this problem is inability of the bank to distinguish borrowers according to their intension. The other causes are inadequate and ineffective legal environment for loan recovery, and absence of culture and proper code of conduct in business. In such case the cost of non- payment of loan is less than gain made by the borrowers from the non- payment.

The problem of moral hazard is seen on the parts of banks too. Since, interest cannot be booked in the non- performing loan, financial intuitions tend to roll over such loans to jack up their profit. They lend more loans to bad borrowers to pay interest and principle. This ever greeting process postpones the problem of buy time exacerbating the situation in the further. Further, as the financial institution are required to earn more from fewer assets, there is the tendency to take up more risky assets to become non-performing is higher. Beside there is also huge opportunity cost involved due to non- performing loans. As the cost of fund of banks with higher non-performing loan is higher, borrowers pay higher interest rate on the loans obtained from such banks. This affected the competitive advantage of such banks.

In some case banks policy to reward employees on the basis of loan target without considering the recovery aspect itself cause non- performing loan. Similarly the policy of the banks to provide rebate on interest in defaulted loan also provokes borrowers to postpone timely payment of interest and loan instalments. Promoter- banker nexus and promoter-politician nexus also cause non-performing loan. In some cases collusion between bankers and borrowers in the name of rehabilitation of sick units also aggravates the problems on non-performing loans. Over optimism toward ones project and faulty project preparation with wrong demand projection and cash flow estimation on the parts of the borrowing also creates non performing loans. Borrowing inability to judge downside risk and there capability to bear such risk also make than vulnerable to downward swing in the economic

Beside swing in macroeconomic factor, international scenarios and unexpected events also lend to non performing loans. Non performing loan also arise due to the legal farm work existing in the country. Legal farm work at present is to some extend debtors know that financial intuitions can do little to force payment and size collateral. The judiciary process in recovering debt is also lengthy and enforcement of law is weak.

In conclusion the factors contributing to high level of NPL can be classified into two groups. The first is the internal factor which mainly comprises of weakness of particular banks of financial intuition in the credit management and oversight deficiencies. If preventive measures are applied in the intuitional level, the bank them selves to some extend can resolve the problems of NPLs. Similarly, another aspect related with the external factors beyond the control of the bank and financial intuition.

The following table shows the non performing loan and non performing loan ratio to total loan for NBL& HBL during the fiscal year 2007/08 to fiscal year 2011/12

Table 6: Non performing loan (NPL) or passive loan of NBL & HBL

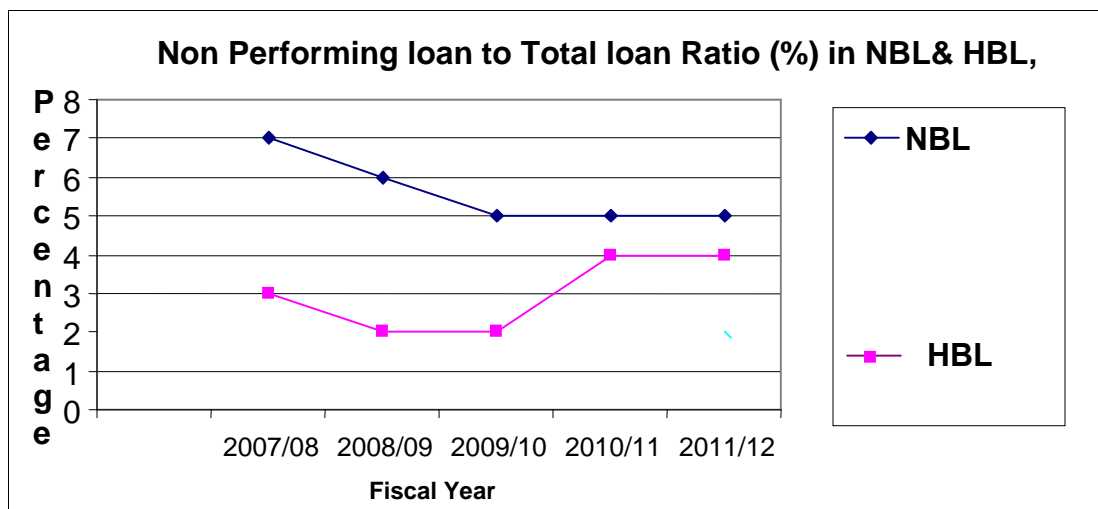
Name of Bank		F/Y	2011/12	2010/11	2009/10	2008/09	2007/08	Average
		NBL	Amount in Million		1438	1219	966	1031
Percent on Total loan			5.38	5.17	5.49	6.96	7.06	6.01
HBL	Amount in Million		1391	1208	551	477	641	
	Percent on Total loan		4.22	4.05	2.16	2.36	3.61	3.33

	Percent on Total loan	0.62	0.61	0.88	0.93	1.88	0.85
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Sources- Annual report of NBL & HBL 2012

Above NPL ratio is also presented in figure for a visible indicates of change in the ratio:

Figure 6: Non Performing loan to total loan ratio (%)



The above table and figure show that total non performing loans of other banks is in decaling trend except HBL. The non performing loan ratio is calculated by dividing total non performing loan by total loan of banks. An in depth analysis of these ratio is done below.

The table shows that the NPL is decreasing gradually in the period of study but not as targeted for NBL. NBL has higher NPL ratio than other

banks the maximum NPL ratio for banks is 7.06% in fiscal year 2007/08 and the minimum ratio is 5.17% in fiscal year 20010/11. Here the NPL ratio was

decreased by 0.10%, 1.47% and 0.32% in fiscal year 2007/08, 2009//10 and 2010/11 respectively than its respective previous years. The NBL has 6.01% NPL ratio on average during the study period.

The NPL ratio for HBL is slightly in increasing trend it indicates that the bank can not manage its loan efficiently. The higher NPL ratio for HBL is 4.22% in fiscal year 2011/12 and the minimum ratio is 2.16% in fiscal year 2009/10. Here the ratio for HBL decreased by 1.25% and 1.99% and 0.07% in fiscal year 2010/11 and 2011/12 respectively previous fiscal year. The bank has 3.33% NPL ratio on average during the study period. Bank move towards in some risk free assets would decrease the non performing loan, the non-performing loan may be increased by reduce the investment opportunity in general small and cottage industry. So the banks are decrease utilization of deposit amount in loan and advance and want to increase mobilization of deposit in government securities, share and debenture.

4.4 Impact on Income Employment Generation by productive Investment by Commercial Banks.

Since, the Nepalese economic characterize by the subsistence agriculture, which is traditional, non mechanized and livelihood oriented sector, poverty has been emerged as one of the threatening challenge along with the increasing population over dependency of the population of the substance agricultural, which is traditional , non mechanize and livelihood oriented sector, poverty has been emerged as population over dependency of the population on the subsistence agricultural accompanied with slow industrial growth has result unemployment and disguised unemployment, which have

further accelerated poverty. In the economics like Nepal where there is technological deprivation, lack of Innovation and lack of alternative source of employment tremendous effort is required in order to improve the situation of the poverty stricken sections of the population.

Banking industry has acquired a key positive in mobilizing resources for financial and socio economic development of a country. No function is more important to the economic and its constituent part than financing. Banks assists both the flow of goods and services from the producer to consumers and the financial activities of the government. Banking provides the country with a money system of making payment and is an important part of the financial system, which makes loans to maintain and increase the level of consumption and production in the economic. Banks are among the most important financial intuitions in the economy and essential business in thousand of local town and cities. In this context, there is much confusion about exactly what a bank is certainly, banks must be identified by the function (services and roles) they perform in the economy. Banks are financial intermediates, similarly to credit union saving and loan associations, and other intuition selling financial services. The term financial intermediary simply means a business that interacts with two types of individuals or intuitions whose current expenditure for consumptions and investment exceed their current receipts of income and whose there for need to raise funds externally by negotiation loans with and issuing securities to other units on the other hands, surplus fund to save and invest. Therefore there should be someone who can bridge these two individuals or intuitions so that those who have surplus funds can be diverted to the deficit units. Hence, banks are that institutions that

performs this indispensable task to intermediating between two individuals and intuitions in order to raise funds and than loaning those funds to deficit spending individuals or intuitions.

“Nepal Rastra Banks is the ultimate authority that can regulated to the commercial banks to finance in pointy sector (like agricultural sector, service sector, small scale industries etc.) at consessional interest rates set by the government which is happening in Nepal” (vaidya, 1999:67)

Agricultural and industrial sector cannot run without capital and the other hand commercial banks have unutilized resources. So, the directives issued by NRB to commercial banks in 2010 to invest at least 3% of their outstanding loan and advance including bills purchased and discounted in deprived sector.

Commercial banks may mobilize its banks deposit by investing its fund in different securities issue by government and other financial or non financial companies. Now, effort has been made to measure the extend to which the banks are successful in mobilizing the total deposits on investment. In the process of portfolio management of banks assets, various factors such as availability of fund liquidity requirement, central banks norms etc are to be considered in general, share, debenture and NBR bond for a commercial bank. Commercial banks are the main source of credit for various sector of the economy. It helps to accumulate the fund and flow it to the productive sector for investment from unproductive sector. The productive investment include the investment sector like Agriculture, Industry, Service, Tourism Trade etc. which is directly contributes the economy and growth of GDP.

In term of banks contribution to the different sector of the economy, which contributes to the different development of the country poverty is one of the most complex problem with origin in the both national and international domains, which has been measure in terms of income and expenditure level. In Nepal, poverty its eradication theme was always kept in mind even during the formulation of the first five years plan. NRB in 1981-82 introduce intensive banking program with the aim of reducing poverty of rural people. Under this program commercial branches (30 in rural and 16 in urban) It is the first poverty focus credit program of commercial bank to fulfil their social banking objective. There are 317 branches still involving in the priority sector credit program.

4.5 Major Finding

The following findings are found from secondary data are stated during the time of the study:

Liquidity Position:

The financial sector has come under stress since late 2008 with liquidity shortages global financial crisis originated from USA. Earlier credit expansion during the real estate boom was followed by slower deposit growth due to a number of including the new rule to disclose income sources for depositors. The repaid credit growth and slower deposit growth raised C/D ratio to an unprecedented level of above 90% on average, and resulted in a slowing or decline in credit extended by many different types of financial institutions. Commercial banks in particular, found it increasingly difficult to extend fresh credit to their clients. Borrowers started to experience debt servicing problems as rollovers became difficult.

Cash Reserve Ratio (CRR) :

The CRR was reduced from 5.5 % to 5% by NRB in the fiscal years, which was implemented by all banks. As a result inter bank rates among category 'A' banks (Commercial Banks) declined to the low single digit levels. However, smaller financial institution continues to suffer from tight liquidity position and pay higher inter-bank rates.

Credit Deposit Ratio (C/DR):

The C/D ratio of bank was in increasing trend during the study period 2007 to 2012. Increasing trend of C/D ratio is the indicators of increasing liquidity risk. C/D ratio of banking sector is 88% in fiscal year 2012 an average.

Farming sector loan:

Farming sector loan of commercial Banks was in increasing trend. As a result agriculture sector contributed more than 50% of GDP in fiscal year 2012.

Service sector loan:

Service sector loan of commercial Banks was slightly in increasing trend but at very low position than other sector. Service sector performance was faltering which was contributes 36% of GDP. Although it was the main growth driver during fiscal year 2007-2010 with an average of 6% annual growth, its performance weakened to 3% in fiscal year 2011. Slower remittance growth in part contributed to the liquidity shortages at financial intuitions, reading new credit extension-lowering both real estate transactions and prices.

Industrial sector loan:

Industrial loan lending by commercial Banks was slightly in decreasing trend. The industrial sector of Nepalese economy was suffering from political uncertainties, load shading and labour problems which increased the risk in this sector. As a result commercial Banks reduced linking of industrial sector. The anti-money laundering regulation was used in 2012 also adversely affected real estate and construction industry.

Non-performing loan (NPL):

Non-performing loan ratio of banks was above 3% of average which was not a good symbol for banks. But the trend of NPL) was decreasing slightly. Higher the C/D ratio higher will be the NPL.

Productive loan:

Productive loan of commercial Banks is the sum of industrial sector loan, farming sector loan and service sector loan except real estate loan and personnel home loan. Productive loan of commercial Banks was in increasing trend at level of more than 75% of total loans. It contributes to grow the income and employment generation capacity of economy. NRB has not any regulations related to productive sector lending for commercial Banks. But the regulation related with unproductive loan i.e. real estate loan and personnel home loan positively affect the productive loan.

Impact of NRB Directives on the Commercial Banks:

This research study is based on the secondary data. The new directives have both positive and negative impact on commercial banks.

Positive impact:

- i. Maintaining the capital adequacy enhanced the financial strength of the banks.
- ii. Maintaining and reducing the risk on activities of commercial banks would protect from bankruptcy and it kept the deposits of depositors safe that maintain the bank's reputation.
- iii. Loan loss provisioning minimized the credit risk.
- iv. Directives issued by NRB are very important to keep the sound financial health of the banks, to protect the bank from bankruptcy as well to protect the deposits of general public .It makes safety of loans. Overall, the directives strengthen the financial conditions of the banks.
- v. Accounting policy keeps a systematic and permanent record of all financial transactions of the business, which protects the property of the business.

Negative impact:

- (i) Provision of single borrower limit has made the banks either to increase its core capital or reduce the loan amount to single borrower.
- (ii) Fund based and non-fund based limits has been reduced which makes the banks to cut down the loan disbursement amount.

- (iii) Change in the accounting policy so that accounting policy lay down by NRB may have negative impact on commercial banks.
- (iv) Because of removing secondary reserve, banks have to increase the primary reserve to maintain the liquidity ratio
- (v) Banks have been facing decreasing profitability as a result of following directives .Due to decrease in credit exposure of interest income from loan has decreased as a result it will decrease profit of banks in coming years. Overall negative impact of banks are facing now is the decreasing profitability with decreasing loan amount.

CHAPTER V

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1. Summary:

This research is about the NRB's guidelines on commercial bank and its impact and implementation. The loan related directives have been taken as guidelines. The study includes only five selective directives. Among the 20 directives related to banking regulations and prudential norms. There are Thirty-two commercial banks in Nepal but in this study only two commercial bank viz. Nepal Bank Ltd., Himalayan Bank Ltd is selected as example. This study reveals that the increasing provisioning amount would decrease the profitability of the commercial banks .The banks have categorized the loan amount into four different categories. The increasing loan loss-provisioning amount decreases the profit of the banks and vice-versa. Banks are following the directives but in some cases like supplementary capital and balance at NRB there is shortfalls. The excess amount of core capital in supplementary capital and 1% excess amount of total deposits in balance at NRB can compensate this shortfall. Banks are

required to increase their primary reserve to remove secondary reserve effective from 22 July 2002. As a whole it can be seen that new directives are made with a view to protect the deposits of depositors and for safety of loans, which enhances the financial strength of the banks. Even that it has adverse effect in profitability of the banks but this decreasing profit will affect the banks only for short term. Although the study is limited to only two banks, it however allows knowing that there is a significant impact of such directives on the various aspects of the commercial banks. However NRB directives help to maintain stability of commercial banks in the financial market and to uplift the banking sector in Nepal to international standards.

Although Nepali's financial system has grown rapidly over the past decade, it still lacks the competitive environment critical for ensuring that financial intermediation benefits borrowers, depositors, other users of financial services and shareholders. The lack of competition reflected the fragmentation of the system, but it also stems from the dominance of the two large (but inefficient) government established commercial banks, which accounts for more than half the commercial banking system's assets. The result is that the Nepali people have enjoyed only marginal benefit from the liberalization of financial sector. Coverage of branches of all the other private banks should be made mandatory in different parts of the country.

5.2 Conclusions

Even though this study is limited to only two sample i.e., Nepal Bank Ltd., Himalayan Bank Ltd, among entire population, it clears the new directives issued by NRB make good impact more than bad impact on the various aspects of the banks. It can be seen that the provision has been changed and

the increased provisioning amount has decreased the profitability of the commercial banks. Apart from it, loan exposure has been cut down to customers due to the borrower limits have been brought down by the NRB. Therefore, reduction in loan amount results to decrease the interest income from loans, which will decrease the profits of the banks in coming years. Decreasing profitability always push-towards lesser dividends to the shareholders, and lesser bonus to employees. Besides, the change in the single obligor limits, all the commercial banks have to increase their core capital, which will increase the expenses. Thus, recently main problems faced by banks are increasing operating cost and decreasing loan amount resulting decrease in profits of the banks.

Apart from negative sides, it also has positive sides. Recently the problems of banks are increasing operating cost and decreasing loan amount resulting decrease in profits of the banks. But it is only for short term because the directives are more effective to protect the banks from bad loans, which protect the bank from bankruptcy as well as protection of deposits of depositors. Increased in capital adequacy ratio strengthen the bank's financial position, loan related provision will make safety of loans except that risk reducing provision will protect the banks from liquidation. The accounting policy of NRB will help to win the trust of concerned people like shareholders, depositors, employees etc. because of making transparent, true and fair pictures of business. This will improve the reputation of the banks and increase the goodwill

Finally, the changes in directives may bring flourish to all the people shareholders, depositors and employees and the economy of the country as a whole.

5.3 Recommendations

The recommendations to Nepal Bank Ltd., Himalayan Bank Ltd. and also to Nepal Rastra Bank are presented based on the analysis of data i.e., secondary data, major findings of the study and conclusions in order to improve the performance by avoiding shortcomings.

Recommendations to Nepal Bank Ltd. and Himalayan Bank Ltd

On the basis of the analysis, directives issued by NRB are found very important not only to build the commercial banking in Nepal but also to maintain country's economic stability. Thus it is why the banks should obey its directives and rules. All two Banks are implementing the directives' rules and regulations laid down by NRB. They are good in maintaining the provisions of the directives. Even then some recommendations seem relevant based on findings from the study. The following recommendations are presented as follows:

✚ The banks have to make its Internal Audit and Inspection Department strong to make sure that the directives are properly implemented otherwise the penalties should be paid for violation of rules of directives, which may lead to unfavourable conditions.

✚ Liquidity and profitability are like two wheels of one cart so banks cannot run in the absence of only one of them. One can be achieved only at the cost of the others. Only liquid banks can attract more low cost deposits, which helps in reducing interest expenses and give loan to good customers at lower rate, which results in requirement of less provision and high net profit. So, banks should increase their primary reserve to

maintain the liquidity risk.

✚ Credit Deposit Ratio for all banks are in increasing trend. Higher C/D ratio earn more profit by making loan and advance but too high ratio may not be better from its liquidity point of view. So the banks should make a balance of assets to ensure both profitability and liquidity.

✚ Non- performing loan (NPL) of the banks should be less than 3 % but NBL and HBL has higher than 3% and other banks is not in targeted level. To reduce NPL Banks should increase their investment on risk free assets like treasury bills and treasury bonds. Without minimizing NPL of these banks Nepalese financial sector can not be improved.

✚ During the research it is seen that banks are recently facing the decreasing profitability due to reduction in loans amount and its interest income but it is only for short term. There are other sources, which banks should adopt to increase its profits. Banks can increase its banking services not only in the heart of capital city but also in distant area. Banks must adopt the new technology such as information technology so that it will be timely able to update management information system, internal house keeping, and reports.

Recommendations to NRB

Based on the research study, the interest rate offered by banks on deposits has been lower than the inflation rate; there is a strong case for bringing it up. But the method adopted recently by the central bank to bring about the correction is far from logical. Ordering banks to increase this rate and

reducing the rate charged on loans, the central bank has indicated that it is going back to regulate system discarded long ago.

No doubt, the huge difference between the interest rates on the deposits accepted and the loans advanced by banks, called the “Spread” must be minimised. It should, however, be borne in mind that the spread is an intermediation margin and if it is high it indicates two possibilities- either the level of efficiency is low in this market or there isn't enough competition.

Experience shows that the increased number of banks or finance companies is not sufficient to ensure better competition. A new bank is more likely to emulate the functioning of the existing banks. Alternatively avenues should be made available for the small savers to park their saving and for the borrowers to borrow funds. As of today, they have nowhere else other than banks to approach. The existing stock market has very limited options for them.

Almost every bank has been focusing only in strengthening its legal department by hiring full-time lawyers as well as outside consultants. While activities in marketing, credit risk analysis and monitoring the loan portfolio are still rudimentary. This naturally makes the banks' investments highly risky and the interest rate they have to charge the borrowers are bound to be high in order to cover the risks. Financing professionally managed corporate is less risky and some of them are getting back finances at interests rates lower than the highest interest rates the banks pay on the deposits.

Therefore, Nepal Rastra Bank should immediately start measures where the banks become more efficient, for example, in risk analysis and monitoring the portfolios. But these measures must be market-oriented. One such step would be issuing publicly tradable securities by NRB itself. Similarly, even private limited companies should be encouraged to borrow from the general people by issuing publicly tradable securities. The Credit Information Company (that is now limited to a blacklisting of the companies can be easily developed as such as agency to rate such securities.

NRB is making all the government bonds tradable in the stock exchange signals one step in the right direction, but it is not going to be sufficient. NRB must come out with more actively in the market to spur competition and make it imperative for the banks to be more efficient.

On the basis of the responses made by commercial banks about the directives NRB should make the following activities.

- ◆ NRB need to be practical, whichever rules made by NRB should not make rules only to meet the international standards but it must be useful to the context of Nepal.
- ◆ NRB has to make its supervisory system stronger to make sure that banks are not violating the rules of NRB.
- ◆ In the question of action taken by NRB in case of violation of rules, NRB may think before decide. NRB should not suspend the license of such bank at once and charging fine may be wrong some cases.

◆ The newly issued directives have certain changes in provisions. Its main objective is to protect the deposits of the depositors and to uplift the banking system in Nepal to international standards. But, to combat the problems associated with the directives NRB, it needs to carry out proper homework and consultation with different banking experts. They become irrelevant if they are not implemented.

◆ To reduce the credit risk and bad quality of assets in the bank's balance sheet, Credit Information Bureau should be strengthened.

◆ At last, NRB may have made provision for such banks, which meet

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Appendix -1

List of Commercial Banks

Mid- March-2012

Rs. In million

S.No.	Names	Operation Date(A.D.)	Head Office	Paid up Capital
1	Nepal Bank Ltd.	1937	Kathmandu	380
2	Rastriya Banijya Bank	1966	Kathmandu	1172
3	Nepal Arab Bank Ltd (renamed as Nabil Bank Ltd)	1984	Kathmandu	2029
4	Nepal Indo-Suez Bank Ltd. (renamed as Nepal Investment Bank Ltd.)	1986	Kathmandu	3012
5	Nepal Grindlays Bank Ltd. (renamed as Standard Chartered Bank Nepal Ltd.)	1987	Kathmandu	1610
6	Himalayan Bank Ltd.	1993	Kathmandu	2400
7	Nepal SBI Bank Ltd.	1993	Kathmandu	2102
8	Nepal Bangladesh Bank Ltd.	1994	Kathmandu	2009
9	Everest Bank Ltd.	1994	Kathmandu	1391
10	Bank of Kathmandu Ltd.	1995	Kathmandu	1604
11	Bank of Ceylon Ltd. (renamed as Nepal Commercial and Credit Bank Ltd.)	1996	Siddharthanagar	1400
12	Lumbini Bank Ltd.	1998	Narayangadh	1430

13	Nepal Industrial and Commercial Bank Ltd.	1998	Biratnagar	1311
14	Machhapuchhre Bank Ltd.	2000	Pokhara	1627
15	Kumari Bank Ltd.	2001	Kathmandu	1485
16	Laxmi Bank Ltd.	2002	Birgunj	1613
17	Siddhartha Bank Ltd.	2002	Kathmandu	1618
18	Agriculture Development Bank Ltd	2006	Kathmandu	9474
19	Global Bank Ltd	2007	Birgunj , Parsa	1601
20	Citizens Bank International Ltd	2007	Kathmandu	2101
21	Prime Commercial Bank Ltd	2007	Kathmandu	245
22	Bank of Asia Nepal Ltd	2007	Kathmandu	2000
23	Sunrise Bank Ltd	2007	Kathmandu	2015
24	DCBL Bank Ltd	2008	Kamaladi, Kathmandu	2000
25	NMB Bank Ltd	2008	Babarmahal, Kathmandu	2000
26	Kist Bank Ltd	2009	Kathmandu	2000
27	Janata Bank Nepal Ltd	2010	Kathmandu	1400
28	Mega Bank Nepal Ltd	2010	Kathmandu	1631
29	Commerz & Trust Bank Nepal Ltd	2010	Kamaladi, Kathmandu	1400
30	Civil Bank Ltd	2010	Kamaladi, Kathmandu	1200
31	Century Commercial Bank Ltd	2011	Putalisadak, Kathmandu	1080
32	Sanima Bank Ltd	2012	Nagpokhari, Kathmandu	2016

Source: Banking and financial statistics, NRB, 2012

Appendix-2

Nepal Bank Ltd and Himalayan Bank Ltd Statement of Total Deposit, Total Loans, Advance of Bills purchased and Non- performing loan

In Million

F/Y		2011/12	2010/11	2009/ 10	2008/ 09	2007/ 08
Name of Banks						
NBL	Total Deposit	46,804	42,882	45194	39823	38932
	Total Loan	26709	23560	17614	14814	13517
	Non performing loan	1438	1219	966	1031	954
HBL	Total Deposit	40920	37611	34681	31842	30048
	Total Loan	32968	29123	25519	20179	17793
	Non performing loan	1391	1208	551	477	641

Source: Annual Report of NBL and HBL 2012

Appendix-3

Nepal Bank Ltd and Himalayan Bank Ltd Credit Deposit Ratio

In percentage

F/Y	2011/12	2010/11	2009/10	2008/09	2007/08	Average
Banks						
NBL	57.07	54.94	38.98	37.20	34.72	44.58
HBL	80.57	77.43	73.58	63.37	59.22	70.83

Sources- Annual report of NBL and HBL 2012

Appendix- 4

Nepal Bank Ltd and Himalayan Bank Ltd Classification of sector wise loan

Rs In Million

F/Y		2011/12	2010/11	2009/10	2008/09	2007/08
Name of Banks						
NBL	Farming loan	6502	4605	2965	2016	1626
	Service loan	7212	7331	5109	3094	2846
	Industrial loan	9575	9461	6816	7456	6564
HBL	Farming loan	4966	3851	3708	2708	2409
	Service loan	6118	5992	5013	4490	3783
	Industrial loan	17089	15359	13125	9980	8968

Source: Banking and financial statistics, NRB 2012

Appendix- 5

Nepal Bank Ltd and Himalayan Bank Ltd. Amount of Productive and Unproductive loan

Rs in million

F/Y		2011/12	2010/11	2009/10	2008/09	2007/08
Name of Bank						
NBL	Productive loan	23290	21398	14891	12566	11036
	Unproductive loan	3414	3536	2723	2247	2480
HBL	Productive loan	28174	25202	21847	17179	15161
	Unproductive loan	4794	3919	3672	2999	2632

Source: Banking and financial statistics, NRB 2012

Appendix- 6

Test of significance

Let, amount of productive loan in million = x_1 , amount of unproductive loan in million = x_2 ,

X_1	$(X_1 - \bar{x}_1)^2$	X_2	$(X_2 - \bar{x}_2)^2$
16636.2	70713.4	2881	933078.7
21512.6	26443454.98	3603.2	59418.94
11654.4	22239524.17	3551	87592.32
20962.6	21089402.98	5984.4	4568649.75
11085.6	27927842.7	3215.2	399120.70
$X_1 = 81851.4$	$(X_1 - \bar{x}_1)^2 = 9777093.28$	$X_2 = 19234.8$	$-(X_2 - \bar{x}_2)^2 = 6047860.44$

Therefore, $\bar{x}_1 = X_1/n_1 = 81851.4/5 = 16370.28$

$\bar{x}_2 = X_2/n_2 = 19234.8/5 = 3846.96$

Now,

Sample variance, $S^2 = \frac{1}{n_1+n_2-2} [(X_1 - \bar{x}_1)^2 + (X_2 - \bar{x}_2)^2]$

$$= \frac{1}{5+5-2} [9777093.28 + 6047860.44]$$

$$= 12977349.84$$

Therefore sample standard deviation, $S = (S^2)^{1/2} = 3602.41$

Again calculated value of $\tau = \frac{\bar{x}_1 - \bar{x}_2}{S} \times \sqrt{n_1 n_2}$