CHANGES IN INTEREST RATE AND THEIR EFFECT ON DEPOSIT AND LENDING VOLUME OF COMMERCIAL BANKS IN NEPAL:
A Comparative Study of Himalayan Bank Ltd. and NMB Bank Ltd.

Proposal

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CHAPTER - I

INTRODUCTION

1.1 Background of the Study:

Financial intermediation helps to promote economic growth through the process of saving mobilization and promotion of productive investment in the country. In this process, financial institutions generally pay certain prevailing rate of interest on deposit and receive the higher rate of interest from lending. The differential interest margin is basically incentives to financial institution to cover their operational costs and contribute to the worth of the equity holder. The determination of interest rate is more and less governed by the market forces. But the differential rate is mostly influenced by operational efficiencies and profits margins of financial institutions i.e. commercial banks.

In other words financial intermediation has two fold viz. deposit and credit. Mainly commercial banks used to possess this sort of fold. They get money from one side in the form of deposit and they provide it to borrower in other side. It always charged higher interest rate in comparison to depositors and the differences between there will be the profit of commercial banks.

Interest rate is one of the important tools for shaping economy.It plays the dominant role in borrowing and lending. Simply interest rate is a payment for the use of money. So when savers deposit their saving in the banks that time banks pay certain amount of interest on saving amount because of used this money to lend other customers. It is the price charged a borrower must pay to secure loanable funds from lender for an agreed-upon period. It is the price of credit. But unlike other prices in the economy. The rate of interest is really a ration or two quantities: the money cost of borrowing divided by the amount of money actually borrowed, usually expressed on an annual percentage basis. The cost of borrowing money, measured in rupee per year rupee borrowed, is the interest rate (Samuelson; 1991:465).

Interest rate policy in Nepal was directly controlled and regulated by the central bank i.e. NRB before the economy was completely liberalized in 1991. The control on interest rate in the earlier period was motivated by a number of factors. First, there was limited competition in the banking system as the two largest Government controlled bank dominated the market. Second, the direct control of deposit rates was potentially effective for mobilizing domestic saving at a higher level of interest rates. Third, the direct control of interest rates provided a convenient vehicle for Concessionary credit allocation to the priority sector. Bista (2048) "Issue in interest rate policy" NRB samachar , Kathamandu, NRB Publication

When we examine how money affects economic activity, we will focus on the interest rate, which is often called, "The price of money". Interest is the payment made for the use of money. The interest rate is the amount of the interest paid per unit of time expressed as a percentage of the amount borrowed. In others words, people must pay for opportunity to borrow money. The cost of borrowing money, measured in rupee per year per rupee borrowed, is the interest rate (Samuelson; 1991)

But the following the deregulation of interest rates, the deposit rate particularly those of commercial banks, however, went on declining whereas the lending rates either remained constant or declined marginally causing the spread to go up. This spread rate of commercial banks has a direct bearing on saving and investment and thus on economic growth of the country because the commercial banks hold dominant portion of financial intermediation.

Thus my study attempts to evaluate the impact of structural change in interest rates on deposit and portfolio lending and glance into the possibilities of further reforming the prevailing interest rate regime.

An introduction of Himalayan Bank Ltd. (HBL):

Himalayan Bank was established in 1993 in joint venture with Habib Bank Limited of Pakistan. Despite the tough competition in the Nepalese Banking sector, Himalayan Bank has been able to maintain a lead in the primary banking activities- Loans and Deposits.

Legacy of Himalayan lives on in an institution that's known throughout Nepal for its innovative approaches to merchandising and customer service. Products such as Premium Savings Account, HBL Proprietary Card and Millionaire Deposit Scheme besides services such as ATMs and Tele-banking were first introduced by HBL. Other financial institutions in the country have been following our lead by introducing similar products and services. Therefore, we stand for the innovations that we bring about in this country to help our Customers besides modernizing the banking sector. With the highest deposit base and loan portfolio amongst private sector banks and extending guarantees to correspondent banks covering exposure of other local banks under our credit standing with foreign correspondent banks, we believe we obviously lead the banking sector of Nepal. The most recent rating of HBL by Bankers' Almanac as country's number 1 Bank easily confirms our claim.

An introduction of NMB Bank Ltd (NMBBL):

NMB Bank Limited licensed as "A" class financial institution by Nepal Rastra Bank in May 2008 has been operating in the Nepalese Financial market for over twenty years and is one of the leading commercial banks in the banking industry.

The Bank has a Joint Venture Agreement with Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO), wherein FMO holds 20% of the Bank's shares and is the largest shareholder of the Bank. In September 2016, the Bank signed a Joint Venture Agreement with Nederlandse Financierings-Maatschappij voor Ontwikkelingslanden (FMO), the Dutch development bank following which FMO became the single largest share holder of the Bank. The alliance with FMO positions the NMB Bank in becoming the market leader in managing environmental & social risks and the leading player in renewable energy and agribusiness.

1.2 Focus of the Study:

In this section brief introduction of only two banks is given which is supposed to be useful to finish research work smoothly. Most of the public limited financial institutions in Nepal are profit motivated. These organizations survive who can make for these organizations is the interest spread between sources and uses of funds. The main focus of this study is to examine the influencing factors interest rate in Nepalese banking sector taking financial institution as sample commercial banks. Interest rate is believed as one of the most important factors for the development of financial institutions and financial system as a whole. This study also attempts to analyze the methods used by various financial institutions to calculate the interest. The study is also concentrated on whether the theories on interest rate founded by various economists match in Nepalese context or not. Since interest rate is the main concern of every individual who saves (deposits) and borrows money, it is important to study about interest rate. Therefore this study focuses on the interest rate of sample financial banks and the central bank's role regarding interest rate.

1.3 Statement of Problem:

The acceleration of economic development slowly started taking place among developing countries. But they are still facing various hindrances in the way of economic development. However each hindrance is different for each nation. Nepal, due to its own peculiar condition is facing numerous problems. Nepal has to build up infrastructure for the economic development. The main among numerous problems is the lack of capital.

For many years, the indigenous individual, wealthy agriculturists landlords, merchants and traders conducted some banking activities. These unorganized private moneylenders used to extend loans to the people on the collateral of land, house, and precious metals. This resulted in worsening the economic condition of the poor people. In today's world investment is needed highly in every sector of the economy. For that banking and financial institutions are also equally important for providing credit at cheaper rate and enhance deposits providing higher interest rate. People keep their savings idle because they are provided with less interest. In lending, investors are charged high interest rate so the investment is not done in the useful and priority sector. Instead investment is done in unproductive and wasteful sector. The basic problem arises from fact that Nepal Rastra Bank, the central bank of the country, maintains, and is expected to continue, selective and discretionary controls on the interest structure of banks and financial institutions. It has however, not been able to develop consistent interest rate policy. Changes in interest rate offered and charged by commercial banks can be used to attain basic national economic goals. It follows from this approach that money and capital in developing economy are complementary assets so that raising the real rate of interest on money would tend to increase both the volume of real financial savings and investment and subsequently, the growth rate of the economy. As a result interest rate plays a very important role in underdeveloped country like Nepal where the demand for capital is increasing at every field of the economy. An appropriate interest rate can divert investment in proper field. In short, interest on deposit must be able to increase the amount of deposit by encouraging people to save their income. On the other hand, the lending rate of interest must be attractive to the borrowers, so that they will be able to enjoy benefits by utilizing borrowed fund. This is possible only when the fund-seeking people will be able to earn more than what they pay as interest while borrowing. Thus the appropriate interest rate policy contributes to accelerate the economic development of the nation. But, whether Nepal is able to attain such situation or not is a matter of concern for us. With the above-discussed problem this study attempts to answer the following questions:

- What are the interest rates offered and charged by different commercial banks of Nepal on deposits and loans?
- How much has the interest rate been fluctuated within different time period?
- How far change in interest rate has influenced total amount of deposits and loan advances?
- What are the different ways banks charges interest rate on deposits and loans?

1.4 Objectives of the Study:

The main objective of the study is to analyze the interest rates structures and their impact on deposits and lending of HBL and NMBBL. The specific objectives are as follows:

- To analyze the interest rates structure of sample banks in different time periods.
- To evaluate the effect of deposit interest rate on deposit volume and flow.
- To examine the effect of lending interest rate on volume and flow of credit exposure.
- To compare the sample banks in terms of the effect of interest rate on deposit and lending.

1.5 Review of Literature

It is an integral and mandatory process in research works that consist of reviewing research studies and other relevant proposition in the related area of the study so that all kind of information, conclusion and discrepancies could be known and

further study can be conducted. The impact of interest rate structure in deposit collection and it mobilization through loans is an important aspect of financial field. So this study intends to find the impact of interest rate change in deposit and lending of commercial banks. Thus, to have feedback this chapter devotes on the conceptual framework, revision of interest rate policy, theories of Interest Rates and review of books, papers, thesis, articles and policy document.

According to the Keynes community's liquidity preferences and quantity of money determines the level of rate of interest. These three things liquidity preferences, quantity preferences (quantity of money) and rate of interest are negatively correlated. At low rate of interest the liquidity preference of community is high and it is low at high rate of interest. It is Keynes who gave interest rate a small but significant role the neo-classical as the modern theory of the rate of interest is an offspring of the marriage between classical and Keynesian theory. Hicks developed this in 1937. He gave birth to a new theory by combining the above theories. Following the classical approach, investment has been treated as a negative function of interest rate while saving has been regarded as a positive function of interest rate. Similarly, following the Keynesian approach, the liquidity preference or the demand for the money has been treated as a function of income and the rate of interest while the supply of the money has been treated as being autonomously determined by the monetary authorities. Prof. Carver considers interest "as the income which goes to the owner of capital.

Thus Deposit collection and fund mobilization in different sector is the main function of Commercial Banks. Commercial Banks are also generated income from fee-based activities rather than always depending upon fund based activities. Interest factor is the main factor in fund activities of Commercial banks. Interest rate affects on the collection of deposits, lending, and mobilization of saving and profit position. From appropriate interest rate, Commercial Banks fix their decision that "whether to control the loans to flow the saving".

The level of interest rate is set by the interaction of supply and demand of Fund. Generally, the higher interest rates attract more deposits and lower interest rates on loans attract more loans and vice –versa. However, in Nepal, due to existence of some uncommon practices, the interest rate does not seem to have such impacts on

deposits and credits. We may notice that, at some time there is increase in loan demand in spite of rising rates or increase in deposits even when deposit rates are reduced. People deposit in the banks not only for interest earning but also for safety. Funds from the banks are much cheaper than that from unorganized moneylenders. Therefore, loan demand in bank always tends to increase even at higher interest rate. Further more, an increase in economic and business activity always increase funds demand.

Thus the interest rate is the price of money, the price of renting the use of the resources for a specified period of time. Again, it is the price a borrower must pay to secure scarce lonable funds from a lender for an agreed upon time period. The rate of interest is really a ratio of two quantities: the money cost of borrowing divided by the amount of money actually borrowed, usually expressed on an annual percentage basis. An important aspect of interest rate policy is the setting of an appropriate margin between the lending and deposit rate. If the margin is too high, banks will make excessive profits and this lead to waste of saved resources. If it is too low it will discourage intermediation and devitalize financial institutions. Hence it can be concluded that changes in interest rate structure produces either positive or negative impact upon the growth of developing economy. When such amendments are introduced without thinking seriously, the more spread rate effects negatively rather than positive ones.

1.6 Significance of the Study:

Interest rate structure being very much sensitive, but also crucial aspect of economic development, much research work has not been found on this topic. Many researchers have not been provided more emphasis about its effect on economic development. Even Depositors and loan holders do not seriously undertake their own exploitation of Commercial banks though high spread rate of interest. So this study will be helpful to public to understand interest rate structure of Commercial banks. Interest rate charged by Commercial banks on loan influences the investment habit of people and again interest offered on deposit also effect on deposit collection and saving mobilization of the nation. This study will also help the policy makers to make strong policy regarding interest rate charged on deposits and lending and also help to teachers, researchers, students &

common people providing some valuable information about interest rate, deposit and lending.

1.7 Research Methodology

In general, Research Methodology is a way to systematically solve the research problem. It may be understood as a science of studying how research is done scientifically. This chapter deals with the various systematic steps adopted by the researcher in gathering all the information required for the study and making sense of the data collected. It covers research design, nature and sources of data, population and sample, data collection procedures and the various tools and techniques used for analyzing the collected data.

1.7.1 Research Design

A research design is the arrangement of condition for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. Research designs serves as a framework for the study, guiding the research instruments to be utilized, and the sampling plan to be followed.

This research is basically designed to analyze the liquidity and the credit management practices of the commercial banks of Nepal, mainly Himalayan Bank Ltd. and NMB Bank Ltd. Descriptive and Analytical approaches were adopted to evaluate the liquidity and credit position of these banks. The study was widely based upon secondary data collected over the past years.

1.7.2 Population and Sample

Commercial banks now operating in Nepal, only two commercial banks have been selected as samples from the population. These two sample banks are Himalayan Bank Ltd. and NMB Bank Ltd., which have been selected for the present study. Similarly, financial statements of these two banks from past year periods have been taken as secondary data samples.

1.7.3 Sources of Data and Data Collection Procedure

This research study has been heavily based on secondary data only. The secondary data was collected through various secondary outlets such as Published and unpublished economic bulletins and financial statements of the concerned banks, ‘Banking and Financial Statistics’ reports of Nepal Rastra Bank, Economic Survey book, Published studies and reports of various foreign professors and writers, published articles on newspapers and online and various internet websites.

1.7.4 Data Analysis Tools

To make the data more specific and reliable, the researcher used two types of tool for analysis, Financial and Statistical Tools. Financial tools include various ratio analyses that specifically measured the liquidity and credit position of the banks while the Statistical tools include arithmetic mean, standard deviation, correlation coefficient and other statistics that measure the performance, relationship and significance of calculated statistics. These tabulated data were carefully analyzed and presented in tables and bar charts.

1.8 Limitations of the Study

This study is being based on secondary data extracted from published sources is not exact and hundred percent genuine. Though there are many financial institutions in the financial system including banks, finance companies, micro- credit development banks, and ruler development banks play significant role in economic development by accepting deposits and then lending to public. But whole study based on comparative study of two leading banks. Resources-time, money constraints and inaccessibility of sufficient information limit this study.

Although this study will try its utmost care to cover most of the important sectors, it is still subjected to following limitations:

- The study is associated only to the deposit and Lending of Himalayan Bank Limited and NMB Bank Ltd.
- In this study, only selected financial and statistical tools and techniques are used, and therefore, the data calculations may contain some error.
- The study will be based only on the past years periods data
- The study relies heavily on secondary data only.
- The whole study is only based on the data of fiscal years period from the F.Y. 2010/11 to 2016/17.

1.9 Organization of the Study

The whole study is divided into five chapters.

Chapter I: The introduction part of the study contains background & introduction, focus of study, statement of problem, objectives of study, significance of the study, and limitations of the study and organization of study.

Chapter II: Review of Literature consists of conceptual framework, revision of Interest Rates Policy, theories of interest rate, economics factors affecting interest rate, factors affecting interest rate and review of related studies

Chapter III: Research methodology focuses on research design, population and sample, sources of data, data analysis tools and presentation.

Chapter IV: The body part of this study includes analysis and interpretation of data of related topic based on annual reports of sample banks and NRB reports

Chapter V: The last chapter includes summary, conclusion and recommendation of the study.

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