

# **CAPITAL ADEQUACY & LOAN LOSS PROVISION OF COMMERCIAL BANKS**

(With Reference To NRB Directives)

## **A THESIS PROPOSAL**

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# **CHAPTER - I**

## **INTRODUCTION**

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

Nepal though rich in its natural beauty and resources, stands at the bottom even among the least developed countries. Nepal is at its development phase, it is rich in art and craft, culture and religion. During the period of Rana regime, rare developmental activities were seen at. After the emergence of democracy, Nepal proceeding in the path of development step by step. Its developmental move is seen in each and every sector but not so satisfactorily. In the least developed countries like Nepal, plans and policies are developed either from the technical assistance of donor agencies or the local talents are used. As a result, the planning part of the development effort remains generally good as against implementation. So, to boost up the economy, proper supervisory and monitoring body is essential. In the context of the favorable macroeconomic indicators and based on the concept of competitive financial system, Nepal Rastra Bank has been implementing the policy of monetary so as to provide dynamism to the economy. In the light of the global that a strong, well managed, and efficient financial system would contribute positively to the sustainable development of the economy, the NRB has set its priority in devising and implementing appropriate legal, regulatory, managerial, and supervisory policies and provisions aimed at building a sound and stable financial sector.

Banking system occupies an important place in a nation's economy. A banking institution is indispensable in a modern society. It plays a vital role in the development of economy of the country and forms the core of the money market in an advanced country. In the current background of the rapid expansion of the bank and financial intuition network along with the financial sector liberalization, the implementation of this monetary policy will enhance the effectiveness of the NRB to undertake appropriate regulation, supervision and monitoring responsibilities for the qualitative development of the financial sector. For supervision, regulation and monitoring of Banks and financial institutions, NRB has issued NRB Directives. NRB has set down various rules and regulation for banks and the banks has to follow them. So, NRB is also known as banker's bank. If the banks do not follow the rules and regulations issued by the central bank, the bank will be obliged to pay penalties. Generally, to bring uniformity and

to amend the rules and regulations, NRB issues directives to the commercial banks from time to time and amends them on “need basis”. The commercial banks have to modify their functions accordingly.

## **1.2 Focus of the Study**

The present study focuses on the capital structure of the selected commercial banks of Nepal. Special attention has been made to examine the capital availability in the respective banks in comparison with the benchmarks set out by the central bank (Nepal Rastra Bank). Further, an attempt has also been made to examine the loan loss provision practiced in these commercial banks vis-à-vis stability requirements as directed by NRB. To simplify the study, sampling method has been taken out of 32 commercial banks, only three commercial banks has been selected, namely, Nabil Bank Limited, Standard Chartered Bank Nepal Ltd and Everest Bank Ltd.

## **1.3 Statement of Problems**

In 21<sup>st</sup> century, the increasing trend of banking sector in the country, there is a mushrooming growth of commercial banks in private sector as well as in joint venture. A large number of banking, serving in the small sector will obviously increase the top competition for survival which might leads to keen rivalry among them to occupy the bigger part. So there may offering of uneconomic rate of interest, including in risky enterprises, unhealthy competition etc. such situations may endanger the deposits of general public. The directives are related to various performances of the banks and the banks are required to follow the directives. There are 22 directives related to the banking supervision and regulations.

In the beginning, due to lack of proper regulations Nepalese Commercial banks could not recognize the importance of the quality credit and banking sector failed to witness the expected developments. Viewing the need of structural reform amidst these adverse implications, NRB has issued suitable directives to run commercial banks in a healthy competitive manner to ensure the sustainable developments of the overall banking system. As the banking sector is highly affected by various negative factors of the economy, this sector is facing numerous problems as

stated above. Among them the following problems are especially focused for this research purpose.

1. By the year 2070 B.S. all commercial banks are required to have capital base of two billion. It is felt that some commercial banks will have difficulty to fulfill these requirements.
2. As per one of the current directions issued by Nepal Rastra Bank, commercial banks are required to arrange for loan loss provision as per the classification of loans advances. It is beamed that this has been same disciplinary in providing for the loan losses.

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

NRB has under taken various activities for the banking and financial development since its establishment. NRB has issued various directives for commercial banks and other financial institutions for regulation, supervision and monitoring. The overall objective of the study is to review directives of the NRB related to commercial banks. But special attention is given to capital adequacy and loan loss provision of commercial banks. The specific objectives of this study are given below.

1. To assess capital adequacy position of selected commercial banks and compare their performance with the concerned directives of NRB.
2. To study the loan loss provision of selected commercial banks and compares their provision with the concerned directive of NRB.
3. To make necessary recommendations to the commercial banks and Nepal Rastra Bank for improvement in the findings of the early two objectives of this study.

#### **1.5 Significance of the Study**

NRB is the main figure of this research study. NRB directives being only the tools of NRB to supervise monitor and control the financial institution, it obviously play important role in the development of commercial banks of Nepal. It issues 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 country depends on the directives of the central bank and its central role.

1. This research will help commercial banks to reassess their strategies and policies to cope with the development created by the recent changes made in the directives by NRB.
2. It helps NRB to find out condition of the compliance of directives, their shortcoming and take necessary actions.
3. This study will have importance on various groups but it is particularly dedicated to Nepal Restra Bank, commercial banks and financial institutions, depositors, borrowers, shareholders and other stake holders of the banks and financial institutions, and other research on similar matters.

### **1.6 Limitations of the Study**

This study is a partial requirement of MBS Program. It will mainly be limited by following factors.

1. The study concerns with the directives issued by NRB. There are 22 directives issued by the NRB. It is almost impossible to take in account all the directives issued and make the study on them. So, only two directives are taken into account for the study.
2. To find out the compliance of the directives issued, the study doesn't focus on all the financial institutions. The study is only made for the commercial banks and sampling technique is used to choose three banks out of 32 commercial banks and comparative study is made.

### **1.7 Organization of the Study**

The study has been organized in to five chapters each devoted to some aspects of the study of the NRB directives. The chapters one to five consist of introduction, review of literature, research methodology, presentation and analysis of the data and summary, conclusions and recommendation. To follow the simple research methodology, it is rational behind this kind of organization of the study as:

Chapter -I: Introduction

Chapter -Ii: Review of Literature

Chapter -Iii: Research Methodology

Chapter -IV: Data Presentation and Analysis

Chapter -V: Summary, Conclusion and Recommendations

## **CHAPTER - II**

### **RESEARCH METHODOLOGY**

By research methodology we mean an overall method used while taking part in research activity. “Research methodology refers to the various sequential steps to be adopted by researcher in studying a problem with certain objectives in view” (Kothari, 1994). To perform this activity, the chapter includes Research design, Population and sample, the sampling procedure, data gathering procedure and the data analysis procedures have been included.

#### **2.1 Research Design**

A research design is the specification of methods and procedures for acquiring the information needed. It is the overall operational pattern of framework for the project that stipulates what information is to be collected, from which sources and by what procedures. Thus a research design is a plan for the collection and analysis of data. For research there exists different types of research design like; Historical research, Descriptive research, Case study research, Field study research, analytical research, True experimental research and so on. The research study is made on the directives issued by the central bank on capital adequacy and loan loss provisioning. For this study, we have taken 3 banks out of 32 commercial banks in Nepal. Exploratory and analytical studies will be made to obtain the objectives.

#### **2.2 Population and Samples**

There are all together 32 commercial banks operating in the country. It will be lengthy, time-consuming and vague while taking into consideration of all these institutions. So, only three banks namely Nabil Bank Ltd, Standard Chartered Bank Nepal Ltd, and Everest Bank Ltd are selected as sample on the basis of availability of data and comparative studies are made.

#### **2.3 Sources of Data**

This research study is mainly based on the secondary data that are available in the published form and as well as primary data are also referred. The required data for the study are collected from the concerned organizations. Following are the secondary sources of data used in the study.

- Annual reports, newsletters, broacher etc. of the selected banks.

- Textbooks, articles published in newspapers, journals magazines etc.
- Laws, NRB guidelines, NRB acts etc.
- Banks websites and other relative websites.
- Questionnaire to bank officials, depositors, investors, academicians and Other stake holders of banking sector of Nepal.

## **2.4 Data Collection Techniques**

To collect data, frequent visits were made to the central bank and different commercial banks. Mainly secondary data published and provided by NRB, and concerned commercial banks, annual reports etc are used for research works. Primary data and information were collected from interview and discussion with experts, NRB officials and other required people. Questionnaires were used to the concerned banks to find whether they were fully satisfied by the directives issued and to find the correction measures and suggestions to be made to the NRB to gather primary information.

Besides, to draw the useful information, several visits were made to Central Library, American Center, Rastra bank library, British council, World Bank etc. Internet websites were browsed to get the required information. Except for the stated sources, a detailed review of literature has been carried out to draw the required information.

## **2.5 Data Analysis and Presentation Procedure**

The data are analyzed on the basis of the information gathered from the bank's annual report especially, balance sheet, capital adequacy sheet, loan provisioning sheet etc so as to get the desired objective. Tables, graphs and charts have been presented to analyze and interpret the findings. The comparative study has been made and banks are analyzed and ranked on the basis of their performance. The data gathered from the banks are compared with the directives issued by the central bank and analysis is made on implementation and compliance aspects. Descriptive analysis method is used for analysis of primary data.

## **2.6 Necessary Tools and Techniques for Analysis**

The main analytical tools and techniques used for analysis are as follows.

### **2.6.1 Financial Tools**

For proper financial analysis of data ratio analysis is the best tool. It is very simple analysis tools under which ratios are taken to express the relation between two or more data. Through ratio analysis we can establish the relationship among the data and research into conclusion. Under ratio analysis following ratio related to bank are analyzed.

1. Capital Adequacy Ratio
2. Non Performing Loan to Total Loans and Advances Ratio
3. Provision for NPL to NPL
4. Loan Loss Provision to Total Loan and Advances

### **2.6.2 Statistical Tools**

1. Correlation Coefficient
2. Coefficient of Determination
3. Probable Error

### **2.6.3 Method of Primary Data Analysis**

Data generate through question arise and personal interview of commercial banks bank officials academicians and Depositors are analyzed using descriptive method and are presented in table wherever necessary.

The study is confined in limited banks considering the time constraint. The findings should not be generalized. The study is only focused on commercial banks which have been relating to the NRB directives. Since data of the study is of non- experimental type; chance of observation errors may take place. Similarly, primary data are based on survey of personal interview and questionnaire; there can be selective bias because of non- response error. So this study is just to fulfill the partial requirement of the MBS of Tribhuvan University.



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