

**NON-PERFORMING ASSETS AND PROFITABILITY IN
COMMERCIAL BANKS OF NEPAL**

A Proposal

By

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Exam Roll No: 660/2016

T.U. Regd. No: 7-2-302-96-2012

Submitted in partial fulfillment of the requirement for the degree of

Master of Business Studies (MBS)

In the

Faculty of Management

Tribhuvan University

Kirtipur, Kathmandu

Dec, 2018

CHAPTER I INTRODUCTION

1.1 General Background

Non-performing Assets [NPA] means the amount of loan that the individual Commercial bank had provided and the consumer has not paid it until the time is already matured. Once the distributed loan is not returned timely by clients and becomes overdue then, it is known as Non-Performing Assets for the bank. Reduction of NPA has always been a significant problem for every commercial banks and proper attention for the management of the NPA now has got the top priority. Due to various hurdles on the way of management of NPA, commercial banks are now losing their profitability and struggling for the existence. Authentic history of banking tells that it deals with lending and collection of money. However, it followed the basic law of demand and supply where persons having excess money lent to persons who needed it for more productive purposes and were willing to pay a price for this. The operations were limited to the money lender knowing every person he lent money to.

NPA means booking of money in terms of bad asset, which occurred due to wrong choice of client. Because of the money getting blocked the prodigality of bank decreases not only by the amount of NPA but NPA lead to opportunity cost also as that much of profit invested in some return earning project/asset. So NPA does not affect current profit but also future stream of profit, which may lead to loss of some long-term beneficial opportunity. Another impact of reduction in profitability is low ROI (return on investment), which adversely affect current earning of bank, (Balasubramaniam)

Loans and advances granted by commercial banks are highly beneficial to individuals, firms, companies and industrial concerns. The growth and diversification of business activities are effected to a large extent through bank financing. Loans and advances granted by banks help in meeting short-term and long term financial needs of business enterprises. Granting loans and advances for economic growth is the prime duty of banks. Lending by the banking sector is generally encouraged because it has the more effect of

funds being transferred from the system to productive purposes, thereby the economy grows. However the process of lending also carries a risk called credit risk, which arises from the failure of borrower. Non-performing Asset refers to loans that are in risk of default, (Ibrahim & Thangavelu, 2014)

Profitability is main outcome for any business. However it is a benchmark for banking industry and NPAs has direct impact on profitability of bank as legally banks are not allowed to book income on such accounts at the time banks are force to make provision on such asset as per the reserve bank of India (RBI) (Balasubramaniam, 2012)

1.2 Statement of the Problems and Research Questions

High level of NPA is a matter of grave concern for the bank and public alike because bank credit is the catalyst to the economic growth of the country. Rapid rise in NPA level brings an adverse economic environment to the country. In order to have a permanent presence in the market, bankers must have enough vigilance to control the NPA within a reasonable limit.

Commercial banks in Nepal have been facing several problems like lack of smooth functioning of economy, different policies and guidelines of NRB, political instability, security problem, poor information system, over liquidity caused by lack of good lending opportunities, increasing non-performing assets etc. In the present context where Nepalese banks are facing the problem of increasing NPAs, more amounts have to be allocated for loan loss provision. As earlier mentioned, the provision amount is taken out by deducting from the profit of the bank; the bank's profit might come down. This study will try to sick the answer of the following questions

1. What is the recent trend of the NPA and the net profit of the selected commercial banks in Nepal?
2. What is the impact of NPA on net profit of the selected commercial banks in Nepal?

1.3 Purpose of the Study

Increasing NPA has now become the major issue for every commercial bank. Every bank now has put the NPA management under the top priority and is functioning to reduce the major part of it from the assets side of their balance sheet. The main purpose of the study is to access the non-performing assets of the different banks under the study. The other specific purpose of the present study is listed as follows:

1. To analyze the recent trend of the NPA and net profit of the selected commercial banks in Nepal.
2. To analyze the impact of NPA on net profit of the selected commercial banks in Nepal?

1.4 Significance of the Study

The research is based on the impact of NPA on profitability of commercial banks. Currently, some Nepalese commercial banks are facing huge amount of Non-Performing Assets. Banks should minimize NPA level to achieve their financial goal.

Increasing non-performing loan followed by increased loan loss provision is one of the challenges faced by commercial banks in the present context. Proper classification of loans and adequate loan loss provisioning strengthens the financial health of the banks and also reflects the true picture of bank's asset. This research will be able to deliver some of the present issues, latest information and data regarding non-performing loan and loan loss provisioning. Hence this study will be significance to shareholders, bankers, depositors, students and further researchers.

Loans and advances are the most profitable of all the assets of a bank. These assets constitute primary sources of income to the bank. It means interest earned from such loan and advances occupy major space in income statement of the bank. Since loans and advances are more profitable than any of other assets, the bank is willing to lend as much as its fund as possible. But it has to be careful about the safety of such loans and advances. It is very important, therefore, to remember that most of the banks failures in the world are due to the shrinkage on the value of loans and advances. Hence loan is known as risky assets. Risk of non-repayment of loan is known as credit risk or default

risk. Performing loan/assets has multiple benefits while non-performing loan/ assets erode even existing capital. Therefore, success of any bank doesn't depend upon how much money a bank is able to lend, but it depends upon the quality of the loan. So success of a bank depends upon the amount of performing assets/ loan. Performing assets are those loans that repay principal and interests to the bank from the cash flow it generates.

Nepal Government has just enacted the debt recovery act approved the long waited regulation on debt recovery to speed up the financial reforms in the financial sector. The proposed study will make comparison between the NPA of commercial banks of Nepal and International standard. It will also check the NPA level between the commercial banks. It will wipe out some misconception that general people having about NPA of commercial banks

1.5 limitations of the Study

Every study has its limitations. The main limitation of this study is that, this study is mainly based on secondary data, published books, unpublished reports, public documents, articles of different writers, annual reports of the selected banks and so on. Errors are inevitable but we have to give full effort to minimize them. We have to do many things staying within many types of limitations and boundaries. The study has been subject to the following limitations.

1. Data are taken from banks secondary sources (like financial reports, websites etc.).
2. The study would mainly focus Non-Performing assets of Commercial Bank of Nepal and doesn't cover other aspects.
3. This study has taken 4 commercial banks among 28 commercial banks.
4. This research is based on data and information of only five fiscal years.

1.6 Chapter plan

The study on relationship between NPA and profitability of commercial Banks has been divided into five chapters respectively; Introduction, Literature Review, Methodology, Results and Conclusion.

Chapter-I: Introduction

The introduction chapter deals with the general background and the subject matter of the study. It consists of introduction of research study, which explains the focus of the study, statement of the problem, purpose of the study, significance of the study and limitations of the study.

Chapter-II: Literature Review

In the second chapter, the relevant and pertinent literature and various studies have been reviewed. The review has been made in terms of the theoretical background of banking principles that are relevant to this research work.

Chapter-III: Methodology

The third chapter briefly explains about the research methodology, which has been used to evaluate the NPA and profitability position of banks under consideration. This chapter consists of research design, sample and population, sources of data, and statistical and financial tools and techniques to measure the NPA and profitability position of commercial Banks.

Chapter-IV: Results

In the fourth chapter, the data required for the study has been presented, analyzed and interpreted by using various tools and techniques of financial management and statistics to present the result relating to the study.

Chapter V: Conclusion

The fifth chapter is the final chapter of the study, which consists of the summary of the four earlier chapters. This chapter tries to draw out a conclusion of the study and attempts to offer various suggestions and implications for the improvement of the future performance of the banks under review. Finally, bibliography and appendices are also included at the end of the study.

CHAPTER - II

REVIEW OF LITERATURE

The review of literature for the concerned subject matter for the present study has been presented in this chapter. Here, in this chapter review of concept of financial performance tools and techniques of concept of liquidity and profitability performance related research studies, regulating relating to commercial banks is strived to present briefly. The main purpose of doing research is reviewing and gaining new knowledge and the reviewing. The literature of the related documents helps the researcher to reach near his purpose. This chapter highlights upon the existing literature.

2.1 Theoretical Review

2.1.1 Concept of Non-Performing Assets

The assets of bank which do not perform any role in getting profit to the organization, such assets are called Non-performing Assets. Non-Performing Asset (NPA) is defined as an advance, where payment of interest or repayment of installment of principal (in case of term loans disbursed by the commercial banks) or both remains unpaid for a certain period, (Ibrahim & Thangavelu, 2014).

NPA is an advance which is considered written off, for bank has made provisions, and which is still held in banks' books of account. Gross NPA (non-performing asset) refers to overall quantity of loans that have gone bad debts. It consists of all the nonstandard assets like as sub-standard, doubtful, and loss asset. an asset makes non-performing when it stops to generate income for the bank. Recently an asset was measured as non-performing asset (NPA) stand on the concept of 'Past Due'. A non-performing asset was examined as credit in respect of which interest of principal has remained 'past due' for a particular time, (Dudhe, 2017)

According to Reserve Bank of India "An asset becomes non-performing when it ceases to generate income for the bank. Earlier an asset was considered as non-performing asset (NPA) based on the concept of 'Past Due'. A 'non-performing asset' (NPA) was defined

as credit in respect of which interest and/or installment of principal has remained 'past due' for a specific period of time."

Loan is defined as a sum of money transferred to another for temporary use, to be repaid with or without interest according to terms of the loan agreement written in the accompanying bond, note, mortgage or other document of indebtedness. However, in financial terms loan or debt means principal or interest availed of to the borrower against the security. Debt means the money that bank owes or lends to individual or person.

Likewise, the term loan is defined as a lending, a sum of money, Delivery by one party and receipt by another party upon agreement expressed to implied, to repay it with or without interest, (Boerne & Colwell, 1997)

NPAs affect profitability, liquidity, and solvency of the bank. Continuous decline in profitability due to increase in NPAs would ultimately jeopardize the viability of the bank. Mounting NPAs reduce the interest spread of the bank (Brahmananda, 1999).

2.2 Concept of Profitability

Profitability refers to the net income of the Bank where company's revenues exceed its expenses. Income is generated from the activities of the Banks and expense is the cost of resources which are used to generate profit. Profitability is the main objective of the companies. Businesses cannot survive in the market for the long run without profitability. So evaluating past profitability, calculating current profitability and foretelling future profitability is very important for the company. Revenue and expense are shown at the income statement which refers to the profitability of the company while cash inflow & cash outflow are shown at cash flow statement which refers to the liquidity of the company, (Das, Chowdhury, Rahman, & Dey, 2015)

The word profitability is composed of two words, namely, profit and ability. The term profit has been explained above and the term ability indicates the power of a business entity to earn profits. The ability of a concern also denotes its earning power or operating performance. The profitability may be defined as the ability of a given investment to earn a return from its use, (Aulsian, 2014)

2.3 Review of Related Studies

Various studies have been conducted in different aspect of commercial banks and JVBs. The conclusion of the previous studies on the different aspects of commercial Banks is relevant to this study. Thus, the studies of previous articles, journals and thesis are reviewed in this regard.

2.3.1 Review of Journal and Articles

Nawaz (2012) has studied recently banks witnessed rising non-performing credit portfolios and this significantly contributed to financial distress in the banking sector. Banks collect deposits and lends to customers but when customers fail to meet their obligations problems such as non-performing loans arise. This study evaluates the impact of credit risk on the profitability of Nigerian banks. Financial ratios as measures of bank performance and credit risk were the data collected from secondary sources mainly the annual reports and accounts of sampled banks from 2004 - 2008. Descriptive, correlation and regression techniques were used in the analysis. The findings revealed that credit risk management has a significant impact on the profitability of Nigeria banks. Therefore, management need to be cautious in setting up a credit policy that might not negatively affects profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits.

Abdelrahim (2013) identified various challenges regarding the effectiveness of credit risk management that are of vital importance to Saudi banks. They include: low quality of assets, inadequate training, weak corporate governance, lack of credit diversification, granting credit ceiling exceeding customer's repayment capacity, absence of risk premium on risky loans, priority of loan guarantees at expense of customer repayment capacity, absence of analysis of customer's financial position, corruption of some credit officers and priority of profit at expense of credit safety. To alleviate these challenges, he recommends for Saudi Arabian banks to have a comprehensive strategy for managing credit risk, to strengthen the role of credit risk committee, to implement Basel III accord, and to adopt available sophisticated technique to mitigate credit risk.

Kurawa & Garba (2014) devoted effort to assess the effect of credit risk management on the profitability of Nigerian banks during the period 2002 to 2011 using the generalized least square regression technique as a methodology. The credit risk management indicators used in this study are default rate, cost per loan asset and capital adequacy ratio. The profitability ratio indicator like many other studies is ROA. The findings of this study show that default rate, cost per loan assets and capital adequacy ratio have a significant positive relationship with ROA. The authors recommend that it is necessary for Nigerian banks to practice scientific credit risk control, improve their efficacy in credit analysis and loan management, and minimize the high incidence of non-performing loans and their negative effect on profitability

2.4 Research Gap

From the review of various literatures, it has been found this researcher works have been done on the study of its compliance and analysis of NPA through loan loss provision, non-performing loans, and Profitability. But previous researcher has been found that the NPA has negative impact on profitability. Total lending ,interest rate in market, operating profit Nature of non-performing assets are also the factor that effect profitability in Nepalese commercial banks .Previous researcher using few samples but this researcher using four samples taking 10 years data.

CHAPTER-III METHODOLOGY

3.1 Research Approach

This study seeks to analyze and evaluate the effect of non-performing assets on profitability of the selected bank and provide suggestions on the basis of the evaluation. To accomplish this objective descriptive research approach has been adopted. It tries to describe and analyze all these facts that have been collected for the purpose of the study. Mostly the secondary data have been used for the research study. The data are collected from the various websites, annual reports of the respective banks etc. Hence, the research design is made by collecting the information from the different source and data have been tabulated and analyzed by using various financial and statistical tools. The financial tools include ratio analysis. Similarly, the statistical tools include average mean, standard deviation and coefficient of variation, coefficient of correlation.

3.2 Sampling Procedure

The universe of the study is all commercial banks of Nepal operating and facilitating credit products to its customers. There are 28 commercial banks in Nepal. All the banks have been involving the banking activities since long and offering credit to its customers. Out of them, five commercial banks have been chosen on judgmental sampling method. The sample consists four commercial bank that have good banking image. The Everest Bank limited (EBL) is the joint venture of Punjab National Bank (PNB). Himalayan Bank Limited (HBL) is the joint venture of Habib Bank of Pakistan. The Nepal NSBL (NSBL) is the subsidiary of State Bank of India (SBI). The NABIL Bank is owned by the different Nepalese Investors. In this way sample bank consists bank from different background and performing capacity.

3.3 Research Instrument

This research instruments included secondary data. In this research data collected from the annual reports of the commercial Banks and annual supervision report of NRB.

3.4 Collection of Data

The study is mainly based on the secondary data collected from the different published sources i.e. internal secondary data and external secondary data. The annual reports of respective banks, various reports from NRB and other reports are used to collect the secondary data. Besides these, other essential data and information were collected from some published and unpublished documents. The research has also consulted the library to gather necessary data and information during the course of research work.

3.5 Data Analysis Tools

The collected data analyzed with the help of different financial and statistical tools.

3.5.1 Financial Tools

The financial tool is one of the most important tool, which includes ratio analysis and the other one financial statement analysis have been used in this study. Financial tools are used to examine the financial strength and weakness of bank. Although there are many financial ratios, only selected ratios are used in this study.

- i) **Return on Assets Ratio** Return on total assets or simply return on assets, measures the productivity of the assets. This ratio judges the effectiveness in using the total fund supplied by the owners and creditors. ROA is calculated as under;

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

ii) Return on Equity Ratio Return on equity relates the profitability of a company to equity shareholders' equity. ROE measures the company's profitability in terms of return to equity shareholders. It is calculated as under:

$$\text{ROE} = \frac{\text{Net Profit}}{\text{Shareholder's Equity}}$$

Where,

Shareholder's Equity = Share Capital + Reserve & Surplus

3.5.2 Statistical Tools

Various statistical tools can be used to analyze the data available to the researcher. These tools are used in research in order to draw the reliable conclusion through the analysis of financial data. Following tools are used for our purposes:

i) Average/Mean

An average is a single value related from a group of values to represent them in some way, a value, which is supposed to stand for whole group of which it is a part, as typical of all the values in the group. There are various types of averages. The value of the Arithmetic Mean is obtained by adding together all the items and by dividing this total by the number of items.

Mathematically, Arithmetic Mean (AM) is given by,

$$\bar{X} = \frac{\sum X}{n}$$

Where, \bar{X} = Arithmetic mean

$\sum x$ = Sum of all the values of the variable

n = Number of observations or year

ii) Standard Deviation (SD)

Risk is defined as the variability of the returns of a period. The one-period rate of return is the basic random variable used in measuring an investment's risk. One such measure of

risk is the standard deviation. Standard deviation is defined as the positive square root of the mean of the square of the deviation taken from arithmetic mean. Risk on individual assets or standard deviation for assets can be calculated using historical returns with this equation.

$$\sigma = \sqrt{\frac{\sum(X - \bar{X})^2}{N}}$$

$\sum(X - \bar{X})^2$ = Sum of the squares of the deviations measured from mean, and

N = Number of Observations

iii) Coefficient of Variation (CV)

The coefficient of variation reflects the relation between standard deviation and mean. The relative measure of dispersion based on the standard deviations known as coefficient of variation. The coefficient of dispersion based on standard deviation multiplied by 100 is known as the CV. It is used for comparing variability of two distributions; the CV is defined as,

$$CV = \frac{SD}{Mean} \times 100, \frac{\sigma}{X} \times 100$$

iv) Coefficient of correlation (r)

Correlation analysis deals to determine the degree of relationship between two or more variables. In correlation analysis, only one variable is treated as dependent and one or more variables are treated as independent. The correlation coefficient between two variables X and Y, denoted by r, is a numerical measure of linear relationship between them. The correlation coefficient is a statistical measure that calculates the strength of the relationship between the relative movements of the two variables. The range of values for the correlation coefficient bounded by 1.0 on an absolute value basis or between -1.0 to 1.0. If the correlation coefficient is greater than 1.0 or less than -1.0, the correlation measurement is incorrect. A correlation of -1.0 shows a perfect [negative correlation](#),

while a correlation of 1.0 shows a perfect [positive correlation](#). A correlation of 0.0 shows zero or no relationship between the movements of the two variables.

Correlation analysis enables to have an idea about the degree and direction of the relationship between the two variables under study. However, it fails to reflect upon the cause and effect relationship between the variables. The coefficient of correlation, denoted by r is computed as under

$$r = \frac{N \sum XY - \sum X \cdot \sum Y}{\sqrt{N \sum X^2 - (\sum X)^2} \sqrt{N \sum Y^2 - (\sum Y)^2}}$$

v) Regression Analysis

Regression is a statistical method for investigating relationships between the variables by the establishment of an approximate functional relationship between them. It is considered as a useful tool for determining the strength of relationship between two (Simple Regression) or more (Multiple regression) variables. It helps to predict or estimate the value of one variable when the value of other variable/variables is known. The regression line of dependent variable (Y) on independent variable (X) is given by;

$$Y = a + bX \dots \dots \dots (I)$$

Where, a = constant

b = regression coefficient

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