# CHAPTER I

# INTRODUCTION

## 1.1 Background of the study

National development of any country depends upon the economic development of that country and economic development is supported by financial infrastructure of that country. Banks constitute an important segment of financial infrastructure of any country. Bank came into existence mainly with the objective of collecting the idle funds and mobilizing them to productive sectors causing overall economic development, which finally leads to national development of the country. “A bank can be defined as a ‘financial department store’ which renders a host of financial services besides taking deposits and giving loans.”(Dahal & Dahal, 2002: 7) Bank pools the fund scattered in the economy and mobilizes them to the productive sector in the form of loans and advances. Bank is a financial institution, which deals with money by accepting various types of deposits, disbursing loan and rendering various types of financial services. It is the intermediary between the deficit and surplus of the financial resources. “Banking when properly organized, aids and facilitates growth of trade and industry and hence of national economy. In the modern economy banks are to be considered not as dealers in money but as the leaders of development. Banks are not just the storehouses of the country’s wealth but are the reservoirs of resources necessary for economic development.” (Radhaswami & Vasudevan, 1991: 29)

It cannot be denied that the issue of development rests upon the mobilization of resources and banks deals in the process of channelizing the available resources in the needed sector. Commercial banks collect deposits from the public and the largest portion of the deposited money is utilized in disbursing loans and advances. The balance sheets of the commercial banks reflect deposits constitute a major portion of the liabilities and loans and advances constitute a major portion of the assets. Similarly the profit of the bank depends upon the spread that it enjoys between the interest it receives from

the borrowers and that to be paid to the borrowers. An average bank generates 60-70% of its revenues through its lending activities. The return that the bank enjoys of deposit mobilization through loans and advances is very attractive but they do not come free of cost and free of risk. There is risk inherent in lending portfolio. Banking sector is exposed to number of risk like interest rate risk, liquidity risk, credit risk, borrower's risk etc. Such risks in excessive form had led many banks to go bankrupt in a number of countries.
Amongst the many risk that the bank faces one of the most critical is the borrower's risk – the risk of non-payment of the disbursed loans and advances. Failure to collect money disbursed may sometimes results in the bank's inability to make repayment of the money to the depositors and return to the shareholders. The risk involved is so high that it can bring bank to a verge of bankruptcy. The bankers have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving. If a bank behaves irresponsibly, the cost born by the economy is enormous. "Banking system is volatile and sensitive sectors of national economy, which requires effective monitoring and efficient supervision. Smooth and effective regulation of banking activities is a must for sustainable economic growth of a country. The regulatory agency should always be watchful of banking activities carried out by governmental & non-governmental banking and financial institution." (Gandhi, 2002: 31)

Due to their central role in the economy, governments and central banks try their best to rescue banks from such situations. Hence to protect the banks from such situation and protect depositors and shareholders money, central bank issues various directives and guidelines from time to time with modifications and amendments for the sound regulation of the banking system. All the banks have to abide by the rules and regulation issued by the central bank. Of the many directives, there are ten directives relating to the banking prudential regulation/norms to be followed by the banks.

### 1.1.1 Brief History of Evolution of Banking

The evolution of banking industry had started a long time back, during ancient times. There was reference to the activities of moneychangers in temple of

Jerusalem in the New Testament. In ancient Greece, the famous temples of Delphi and Olympia served as the great depositories for peoples' surplus funds and these were the centers of money lending transactions. However as a public enterprise, banking made its first beginning around the middle of twelfth century in Italy. The Bank of Venice, founded in 1157 was supposed to be the most ancient bank. Following it were established the Bank of Barcelona and the Bank of Geneva in 1401 and 1407 respectively. Subsequently Bank of Amsterdam set up in 1609, which was very popular then. The Bank of Venice and the Bank of Geneva continued to operate until the end of eighteenth century. With the expansion of commercial banking activities in Northern Europe, there sprang up a number of private banking houses in Europe and slowly it spread throughout the world.

However, the development of banking in Nepal is relatively recent. Like other countries, landlords, moneylenders, merchant, goldsmith etc are the ancient bankers of Nepal. Though establishment of banking industry was very recent, some crude banking operations were in practice even in the ancient times. In the Nepalese Chronicle, it was recorded that the new era known as Nepal Sambat was introduced by Shankhadhar, a Sudra merchant of Kantipur in 880 A.D. after having paid all the outstanding debts in the country. This shows the basis of money lending practice in Ancient Nepal. The establishment of "Tejarath Adda" during the year 1877 A.D. was the first step in institutional development of banking sector in Nepal. Tejarath Adda did not collect deposit from public but granted loans to public against the collateral of bullions. Consequently the major parts of the country remain untouched from these limited banking activities. The development of trade with India and other countries increase the necessity of the institutional banker, which can act more widely to enhance the trade and commerce and to touch the remote non-banking sector in the economy. Reviewing this situation, the "Udyog Parishad" was constituted in 1936 A.D. One year after its formulation, it formulated the "Company Act" and "Nepal Bank Act" in 1937 A.D.

Modern banking practices emerged with the establishment of Nepal Bank Limited in 1934 A.D. However the stand of Nepal Bank Limited alone in total monetary and financial sector was not sufficient and satisfactory. Thus Nepal Rastra Bank was set up on 2013.01.14 as a central bank under Nepal Rastra Bank Act 2012 B.S. Similarly on 2022.10.10 Rastriya Banijya Bank was established as a fully government owned commercial bank. With the emergence of RBB, banking service spread to both the urban and rural areas but customers failed to have taste of quality/competitive service because of excessive political and bureaucratic interference. For industrial development, Industrial Development Centre was set up in 2013 B.S which was converted to Nepal Industrial Development Corporation (NIDC) in 2016 B.S. Similarly Agricultural Development Bank (ADB) was established in 2024.10.07 with an objective to promote agricultural products so that agricultural productivity could be enhanced through introduction of modern agricultural techniques.

Despite all these efforts of the government, financial sector was sluggish. With the opening of Nabil Bank Limited (erstwhile Nepal Arab Bank Limited) in 2041.03.29, the door of opening commercial banks was opened to the private sector. NABIL emerged as the first joint venture bank when the banking industry is totally dominated by Government and Semi-Government banks mainly to revitalize the economy by accelerating productivity in various sectors and to provide efficient customer service. Having observed the success on NABIL based on marketing concept and also because of liberal economic policy adopted by the successive governments, many commercial banks have been established till date. The table no. 1.1 shows the list of licensed commercial banks as on Mid- January 2008.

**Table No. 1.1**

**List of Licensed Commercial Banks**

**Mid-November 2007**

| S. N. | Name of the Bank | Operation Date (A.D) | Head Office |
|---|---|---|---|
| 1 | Nepal Bank Limited | 1937.11.15 | Kathmandu |
| 2 | Rastriya Banijya Bank | 1966.01.23 | Kathmandu |
| 3 | Agriculture Development Bank | 1968.01.02 | Kathmandu |
| 4 | Nabil Bank Ltd. | 1984.07.16 | Kathmandu |
| 5 | Nepal Investment Bank Ltd. | 1986.02.27 | Kathmandu |
| 6 | Standard Chartered Bank Nepal Ltd. | 1986.01.30 | Kathmandu |
| 7 | Himalayan Bank Limited | 1993.01.18 | Kathmandu |
| 8 | Nepal SBI Bank Limited | 1993.07.07 | Kathmandu |
| 9 | Nepal Bangladesh Bank Limited | 1993.06.05 | Kathmandu |
| 10 | Everest Bank Limited | 1994.10.18 | Kathmandu |
| 11 | Bank of Kathmandu Limited | 1995.03.12 | Kathmandu |
| 12 | Nepal Credit & Commerce Bank | 1996.10.14 | Siddharthanagar |
| 13 | Lumbini Bank Limited | 1998.07.17 | Narayangadh |
| 14 | Nepal Ind. & Commercial Bank | 1998.07.21 | Biratnagar |
| 15 | Machhapuchhre Bank Limited | 2000.10.03 | Pokhara |
| 16 | Kumari Bank Limited | 2001.04.03 | Kathmandu |
| 17 | Laxmi Bank Limited | 2002.04.03 | Birgunj |
| 18 | Siddhartha Bank Limited | 2002.12.24 | Kathmandu |
| 19 | Global Bank Limited | 2007.01.02 | Birgunj |
| 20 | Citizens Bank International Ltd. | 2007.06.21 | Kathmandu |
| 21 | Prime Bank Limited | 2007.09.24 | Kathmandu |
| 22 | Sunrise Bank Limited | 2007.10.12 | Kathmandu |
| 23 | Bank Of Asia Limited | 2007.10.12 | Kathmandu |

Source : (Banking & Financial Statistics, Mid July, 2003: 30)

### 1.1.2 Brief Profile of the Subjected Banks

**Nepal Bank Limited (NBL)**

Nepal's first commercial bank, Nepal Bank Limited established on 13th Kartik 1994 B.S.(1937 A.D.) in the technical assistance of Imperial Bank of India under 'Nepal Bank Act 1937', was inaugurated by His Majesty king Tribhuwan Bir Bikram Shah Dev. The establishment of NBL laid the foundation of institutional banking system in the country. "Nepal Bank Limited had a Herculean responsibility of attracting people toward banking sector from the predominant money lenders' net and of expanding banking services." Nepal Bank Limited was headquartered in Kathmandu and had altogether 117 branches in different urban and semi urban parts of the country. There are 3,415 employees working in the bank. As NBL was established prior to Nepal Rastra Bank, i.e. Central Bank, it carried out the function of commercial bank as well as of the Central Bank until the inception of NRB. Now in the presence of a separate central bank, it is providing wide range of commercial banking services.

Even being one of the largest and oldest banks of the country, the financial health of the bank was very bad. Due to its ill health, under financial sector reform programme of NRB in technical assistance program of World Bank and DFID, a management team "ICCMT" consisting of International Bankers form Bank of Scotland (Ireland) has been appointed in NBL in July 22, 2002 to restructure the bank for two years contract and it was renewed after two years. Recently NRB is looking for new management team. NBL was established as a joint venture of government and private individuals. At first the government owned the majority of the share. Now the government owns only 40% share with the suggestion of World Bank to transfer the ownership to the private sector for better functioning of the financial sector. The present shareholding pattern is as follows.

<u>Share Holding Pattern</u>

| | |
|---|---|
| Nepalese Government | 40.49% |
| Nepalese General Public | 59.51% |

### Nabil Bank Limited (NABIL)

Nabil Bank Limited formerly named as Nepal Arab Bank Limited was established on July 12th 1984 under a technical service agreement with Dubai Bank Limited, Dubai, which was later merged with Emirates Bank, UAE. It is the pioneer joint venture bank of Nepal. NABIL is the only joint venture bank with 28 points of representation in various parts of the country. NABIL is amongst the most successful bank in Nepal registering strong growth in the balance sheet footings as well as profits year after year. The initial capital of Rs 30 million has grown to Rs 2,560.34 million as at mid July 2007. NABIL launched its operation with the marketing concept. NABIL has also been a pioneer in introducing modern banking and innovative products in Nepal like consortium finance, credit card etc. NABIL is the sole banker to a multitude of International Aid Agencies, Non-Government Organization, Embassies and Consultants in the Kingdom. NABIL has been providing wide range of banking services to various parts of the society. NABIL bank ranks among the top three financial institution in Nepal in terms of market share of handling Nepal's trade. NABIL bank is being managed by a team of qualified and highly experienced professionals. There are altogether 427 employees working in the bank.

<u>Share Holding Pattern</u>

| | |
|---|---|
| NB International Limited, Ireland | 50% |
| Local Financial Institution | 20% |
| Nepalese Public | 30% |

### Standard Chartered Bank Nepal Limited (SCBNL)

Standard Chartered Bank Nepal Limited, formerly known as Nepal Grindlays Bank Limited, was established in 1987 as the third Joint Venture Bank of Nepal in technical collaboration with ANZ Grindlays Bank. In 2000, ANZ Grindlays Bank was amalgamated in Standard Chartered Banking Group and 50% share of Nepal Grindlays Bank was transferred to Standard Chartered Banking Group. Consequently the name of the bank has been changed as Standard Chartered Bank Nepal Limited. SCBN has altogether 15 branches/outlets within the kingdom. SCBNL is also one, which comes under the top three financial institution of Nepal and has also won the

“Banker of the Year” award in 2002. There are altogether 351 employees working in the bank.

<u>Share Holding Pattern</u>

| | |
|---|---|
| Standard Chartered Grindlays Bank Limited | 50% |
| Nepal Bank Limited | 33% |
| Nepalese Public | 17% |

## 1.2 Focus of the study

Bank disburses loans and advances for certain predetermined fixed periods or every loans and advances has its maturity period or expiry date and the borrowers must repay the loans by the maturity period but there is no certainty that all the loans are recovered by the maturity date. Some loans are recovered within the maturity period but some loans cannot be recovered even after its maturity and remain as non-performing assets of the bank. Banks in Nepal are in poor health. Increasing non-performing asset (NPA) is one of the severe problems of the Nepalese banks. The total NPA of Nepalese banking sector is estimated to be about 15%. As per the data of Credit Information Bureau (CIB) there are altogether 2225 blacklisted borrowers as on 16 July 2007. Banks investment in the form of loans and advances are not giving desired return. Banks are facing problems in recovering the granted loans that had turned to NPA. The nationalized two commercial banks namely Nepal Bank Ltd. and Rastriya Banijya Bank have non-performing assets to the extent of 20% and 30% respectively. Now a days, in most of national newspaper, it can be seen that government owned commercial banks are publishing names of borrowers who defaulted in making payment of the bank loans. Even the private and joint venture banks are also facing the problem of increasing NPAs. This problem may lead to bankruptcy of bank and failure of banking system adversely affecting the depositors and other parties of the society. The below table shows the NPL status of different banks as on mid July 2007.

**Table No. 1.2**

**Bankwise NPL**

| Name of the Banks | Mid July 2007 | | |
|---|---|---|---|
| | Total Loans Rs In Million | NPL | |
| | | % | Amount |
| Nepal Bank Limited | 13,757 | 13.49 | 1,856 |
| Rastriya Banijya Bank | 25,395 | 29.16 | 7,405 |
| Agriculture Development Bank Ltd. | 27,153 | 14.97 | 4,065 |
| NABIL Bank Limited | 15,903 | 1.12 | 178 |
| Nepal Investment Bank Limited | 17,769 | 2.37 | 422 |
| Standard Chartered Bank Nepal Limited. | 10,790 | 1.83 | 197 |
| Himalayan Bank Limited | 17,794 | 3.61 | 642 |
| Nepal SBI Bank Limited | 10,065 | 4.56 | 459 |
| Nepal Bangladesh Bank Limited | 5,855 | 38.19 | 2,236 |
| Everest Bank Limited | 14,083 | 0.80 | 113 |
| Bank of Kathmandu Limited | 9,694 | 2.51 | 243 |
| Nepal Credit and Commerce Bank Limited | 5,122 | 30.63 | 1,569 |
| Lumbini Bank Limited | 4,945 | 20.37 | 1,007 |
| Nepal Industrial & Commercial Bank Limited | 9,129 | 1.11 | 101 |
| Machhapuchhre Bank Limited | 7,320 | 1.16 | 85 |
| Kumari Bank Limited | 9,062 | 0.73 | 66 |
| Laxmi Bank Limited | 6,529 | 0.35 | 23 |
| Siddhartha Bank Limited | 6,320 | 0.34 | 22 |
| Global Bank Ltd. | 2,603 | - | - |
| Citizens Bank International Ltd. | 2,026 | - | - |
| Prime Bank Ltd | N.A | | N.A |
| Sunrise Bank Ltd. | N.A | | N.A |
| Bank of Asia Nepal Ltd. | N.A | | N.A |

*- N.A Stands for Not applicable as the banks came into operations after Mid July 2007*

In order to rescue banks from financial distress, to safeguard depositors' interest and to ensure stability in the economy, NRB issues directives from time to time related to various aspects of the banks. NRB Directive No. 2 (2001) is related to loan classification and provisioning of commercial banks. As per this directive commercial banks are supposed to categorize the loans disbursed into four different categories on the basis of ageing of its past dues and each category of loan requires certain percentage of it to be provisioned for the probable loss. Going through the old directives regarding loan loss provision, banks has to classify the loans into six different categories and as per that directive, for a loan to be bad the time period of past due was 5 years but with the new directive, that period has also been reduced. This means the previously categorized substandard loan will now be a doubtful loan and doubtful loan will be bad. Accordingly more provision has to be made for probable loss in years to come than previous years.  The provisioning amount is taken by deducting from the profit of the bank. Hence there is great impact of loan loss provision (LLP) in the profitability of the banks. The provision of the loan means the net profit of the bank will come down by that amount. Increase in loan loss provision decrease the profit of the bank leading to decrease in dividends to the shareholder. However adequate loan loss provision strengthens the financial health of the banks by controlling credit risk and safeguards the depositor's money leading to overall economic development of the country.

## 1.3 Statement of the problem

After the liberalizations started in 1980s, the financial sector made some progress and prudent regulatory measures have been introduced by central bank. However actual performance of the financial institution could not improve. Commercial banks/financial institutions 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 research has been conducted to find out the solution of following problems

- ⇒ What is the proportion of non-performing loan in the selected commercial banks?
- ⇒ What are the factors leading to accumulation of non-performing loan?

⇒ What are the guidelines and provisions pertaining to loan classification and loan loss provisioning?

⇒ What is the relationship between loan and loan loss provision in selected commercial banks?

⇒ What is the impact of loan loss provision on the profitability of the commercial banks?

## 1.4 Objectives of the study

⇒ To find out the proportion of non-performing loan in the selected commercial banks.

⇒ To find out the factors leading to accumulation of non-performing loan in commercial banks.

⇒ To study and analyze the guidelines and provisions pertaining to loan classification and loan loss provisioning.

⇒ To find out the relationship between loan and loan loss provision in the selected commercial bank.

⇒ To study the impact of loan loss provision on the profitability of the commercial banks.

## 1.5 Significance of the study

Through literature of review it has been found that there are no research regarding non-performing loans & loan loss provisioning. 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 significant to bankers, shareholders, depositors, further researchers, students etc.

## 1.6 Limitations of the study

- ⇒ Only Nepalese commercial banks have been considered for the study and three banks have been selected as samples for the study.
- ⇒ The period of the study is limited from fiscal year 2002/03 to 2006/07.
- ⇒ Because of the strict policy of the commercial banks the study is mainly based on secondary data. The data published in annual reports of respective banks, articles, publication, journals etc have been taken into consideration. Any misrepresentation, mistakes, omission etc may affect the outcome to the study. Thus, the reality of study depends on secondary sources of data and questionnaires filled and responses given by the respondents.
- ⇒ All the analysis in this study is based on the date as of end of fiscal year i.e. mid July of respective years. Any abnormality in this date may affect the conclusion of the study.

## 1.7 Organization of the study

This research work has been divided into five chapters, namely Introduction, Review of Literature, Research Methodology, Data presentation and Analysis and finally Summary, Conclusion and Recommendation.

The first chapter includes various aspects of this study like background of the study, focus of the study, statement of the problem, objective of the study, significance of the study and limitations of the study.

The second chapter incorporates review of theoretical and related literature regarding the subject matter.

The third chapter deals with the research methodology, which consists of research design, sources of data, population and sample along with different statistical and financial tools used in the study.

The fourth chapter includes presentation and analysis of data using different statistical tools and major findings.

The final or fifth chapter includes summary  recommendation and conclusion regarding the subject matter.

After the completion of introductory chapter, some relevant literatures in the form of books, policies, directives, journals, articles, and previous thesis are going to be reviewed in the next chapter.

# CHAPTER II

# REVIEW OF LITERATURE

In this chapter effort has been made to examine and review some of the related books, articles published in different economic journals, bulletins, dissertation papers, magazines, newspapers, and websites. In brief, this chapter includes review of following:

2.1 Conceptual/Theoretical Review

2.2 Review of Books

2.3 Review of Relevant NRB Directives

2.4 Review of Relevant Articles/Journals

2.5 Review of Previous Relevant Thesis

2.6 Research Gap

## 2.1 Conceptual Review

Under this heading the concept and meaning of some of the terms used in the study has been discussed.

### 2.1.1 Loans and Advances

Commercial bank's main function is to create credit from its borrowed fund. The bank doing so converts its liability into active asset. Loans and advances are the assets coming from such activities. Loans and advances dominate the asset side of the balance sheet of any bank and also constitute the primary sources of income to the banks. They are also the least liquid of the bank's entire asset. Loans and advances may take different forms and are allowed against various types of securities. Loans, overdrafts, discounting of bills of exchange etc are some of the forms of bank lending. Granting loans and advances always carries a certain degree of risk. This loans and advances are also regarded as risky assets of banks.

### 2.1.2 Past Due/Overdue

An amount due under any credit facility is treated as past due or overdue when it has not been paid on the due date fixed by the bank.

### 2.1.3 Loan Classification

Loan classification refers to the process banks use to review their loan portfolio and assign loans to categories or grades based on the perceived risk and other relevant characteristics of loans and as per guidelines of central banks. The process of continual review and classification of loans enables banks to monitor the quality of their loan portfolios and when necessary to take remedial action to counter deterioration in the credit quality of their portfolios. In most of the countries, a number of days a past due payments represents a minimum condition for loan classification purposes. However some criteria which exhibit forward looking features are also considered. In the context of Nepal, as per guidelines of NRB, loans are classified into four categories namely, Pass, Substandard, Doubtful and Loss.

### 2.1.4 Performing Loans

Performing Loans are those loans that repay principle and interest timely to the bank from the cash flow it generates. In the context of Nepal, the loans classified as ‘Pass’ category is termed as performing loan.

### 2.1.5 Non-performing Loans/Non Performing Asset (NPL/NPA)

These are the loans that do not repay principle and interest timely to the bank. NPL has many different meanings, which varies from country to country. In some countries non-performing loans means, the loan is impaired. In some countries, it means that the payments are past due, but there are significant differences among countries how many days a payment should be in arrears before past due status is triggered. Nevertheless, a rather common feature of NPL appears to be that a payment if ‘more than 90 days past due. In Nepal also, if the loan is past due for over 3 months, it is non-performing loans. Hence the loans falling under Substandard, Doubtful and Loss categories are regarded as Non-performing loans.

### 2.1.6 Loan Loss Provision

Loan loss provision is the accumulated fund that is provided as a safeguard to cover possible losses upon classification of risk inherited by individual loans. There is risk inherent in every loan. Hence provisioning is made as cushion against possible losses and to reflect the true picture of the bank's asset. Hence there is practice of showing net loan (Total Loans – Loan Loss Provision) in financial statements. The amount of loan loss provision is directly correlated to total credit of the bank. The amount required for provisioning depends upon the level of NPAs and their quality. High amount of provision is an indication of that bank's credit portfolio needs serious attention. One percent provision of total credit is an ideal position as it is the minimum requirement for all good loans. In Nepal, 1%, 25%, 50% & 100% provisioning should be made for Pass, Substandard, Doubtful and Loss loans respectively.

## 2.2 Review of Books

Mr. Bhuwan Dahal and Mrs Sarita Dahal in their book "A Hand Book to Banking" have dealt with different aspects of banking. As per their view, banks have gained paramount trust in the public and they are rendering wide range of services covering different strata of society.

"A bank is judged on the basis of Capital, Assets Quality, Management, Earning, Liquidity and Sensitivity to market risk (CAMELS). Almost all the government banks are running at loss. Though almost all the private sector banks are showing profit, it is very difficult to call them sound if appraised from CAMELS approach. Some banks have very low Capital Adequacy Ratio (CAR) while some banks have piled up Non Performing Assets (NPAs). Similarly banks don't have proper system in place for management of market risks. The people have been raising questions over the correctness of credit classification and provisioning of some banks. Should the suspicion come true, it will prove very costly to the depositors, creditors and national economy as a whole. It would be prudent to advise NRB to strictly implement its recently introduced directive so that other banks avert the fate of NBL, RBB & NIDC." (Dahal & Dahal, 2002: 21)

They stated that loans and advances dominate the asset side of the balance sheet of any bank and earnings from such loans and advances occupy a major space in income statement. “Most of the banks failures in the world are due to shrinkage in the value of the loan and advances. Hence loan is known as risky assets. Risk of non-repayment of loan is known as credit or default risk. Performing loans have multiple benefits to the society while non-performing loan erodes even existing capital. If loan is given to viable project not only lenders and borrower but also the whole society gets benefit but society loses its scarce capital if loan is given to project which is not viable.”

As per their view, there is risk inherent in every loan and efforts should be made to have proper control in every step of loan management. They further suggested that bank should not take risk above certain degree irrespective of returns prospects. “Though all the loans are good at the time of disbursement, with the passage of time, they show the sign of problem. Based on the health of the loan, the loan should be classified and provided accordingly. Provisioning is made as cushion against possible losses and to reflect the true picture of bank’s assets. Hence there is practice of showing net loan (Total Loan – Loan Loss Provision) in financial statements. The bank should comply with the statutory regulation relating to loan classification and provisioning.”

Mr. Shakespeare Vaidya in his book “Project Failures and Sickness in Nepal, Challenges to Investors for Investment Risk Management” has discussed about the early warning system for investment risk management. In this book, the author has also envisaged number of examples about crisis created by the banks in the world. As per his view, banking sector cannot ignore any sector of the economy on the basis of its good and bad and there is vital role of financial institutions in regards to bad accounts.

“Nepalese financial institutions have made significant progress especially during this decade, although they are still far behind the developed markets. In spite of having great risk management i.e. focused on collateral rather than on project, credit culture is a new aspect both to the investors and corporate.

Unless we have a credit culture, they will end up nowhere. ---- How to identify a good bank? Huge deposits, high technology, strong marketing, broad branching network etc? Finally we arrive the point – collection of the loans, on the whole, private sector banks have lower non-performing assets (NPAs) than their public sector counterparts. NPAs are the loans that cannot be or have not been recovered. The government owned banks suffer acutely from this, as they have to lend to various priority sectors, at the whims of their political masters and then forget everything about the money forever." (Vaidya, 1998: 21)

With the growing number of financial institutions, market economy, economic liberalization etc industrial sickness in Nepal has phenomenal proportions in the last few years. Much of the amounts of almost all leading financial institutions are blocked in sick company, which can be witnessed from the auction notice published regularly in newspaper. Credit risk is the first risk, which keeps the bank moving in the market. The loans provided against the securities are simply a promise to pay. When borrowing customers fail to make part or all of their promised interest and principal payments, it leads bank to suffer losses that can eventually erode bank's capital. Because owner's capital is usually no more than ten percent of the volume of loans and risky securities, and often much less than that, it cannot absorb too many defaults on loans and securities before bank capital simply becomes inadequate to absorb further losses. At this point, the bank fails and will close unless the regulatory authorities elect to keep it afloat with government loans until a buyer can be found or until the bank becomes viable by reducing its non performing assets.

"Banks and financial institution invoke penal measure when an installment of a term loan is defaulted. This is simply a banking procedure to offend the borrowers in case of defaults, however it is not the complete panacea for project failures. The follow up machinery to enquire into the reasons for the default is generally slow in movement or maximum time would have already been consumed when banks normally acknowledge the failure of the projects. The consequence is that by the time, lending institution is able to ascertain the causes for the first default, more installments are overdue.

Delays in implementation schedule, cost escalation in mid-stream, inadequate cash generation or siphoning of fund are few of the factors responsible for default. A lending institution unless it has an effective monitoring system, may miss these signs of potential sickness. The first default should be ample evidence that something is out of order and the term lending institution should take immediate steps to review the position n detail before go out of hand."

Finally he concludes " In order to safeguard the banks from the financial crisis likely to be arise form the project failures and sick units, that is, non performing loans, the government needs to do a number of things and fast. It must bring a broad rules for poor financial institutions, transferring bad loans to bridge bank or loan recovery agency, remove many non-performing loans from even healthier bank's balance sheets, beef up regulation, supervision and disclosure, improve ability to banks to sell the collateral that backs soured loans, and recapitalize the banking system."

## 2.3 Review of Relevant NRB Directives

NRB issues various directives relating banking regulations and prudential norms. Among various directives issued in 2001 directive No. 2 is relating to loan classification and provisioning.

### Directives Relating To Loan Classification and Provisioning (Directive No. 2)

Effective FY 2058/59 (2001/02), banks shall classify outstanding loan and advances on the basis of aging of principal amount into the following 4 categories.

**Pass**

Loans and advances whose principal amount are not past due and past due for a period upto 3 (Three) months shall be included in this category. These are classified and defined as **Performing Loans**.

**Substandard**

All loans and advances that are past due for a period of 3 months to 6 months shall be included in this category.

**Doubtful**

All loans and advances which are past due for a period of 6 months to 1(one) year shall be included in this category.

**Loss**

All loans and advances which are past due for a period of more that 1 (one) 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.

Loans and Advances failing in the category of Sub-standard, Doubtful, and Loss are classified and defined as **Non-Performing Loan**.

The respective overdue periods of Pass, Sub-standard and Doubtful loans shall be considered for higher classification from the next day of date of expiry of the overdue period provided for each class.

**Additional arrangement in respect of Pass Loan**

Loans and advances fully secured by gold, silver, fixed deposit receipts and Nepal Governments' securities shall be included under "Pass' category. However, where collateral of fixed deposit receipt or Nepal Governments' securities or NRB Bonds is placed as security against loan for other purposes, such loan has to be classified on the basis of ageing. Loans against FDRs of other banks shall also qualify for inclusion under Pass loan.

**Additional arrangement in respect of "Loss" Loan**

Even if the loan is not past due, loans having any or all of the following discrepancies shall be classified as 'Loss"

a) No security at all or security that is not in accordance with the borrower's agreement with the bank.
b) The borrower has been declared bankrupt.

c) The borrower is absconding or cannot be found.
d) Purchased or discounted bills are not realized within 90 days from the due date.
e) The credit has not be used for the purpose originally intended
f) Owing to non-recovery, initiation as to auctioning of the collateral has passed six months and if the recovery process is under litigation.
g) Loans provided to the borrowers included in the blacklist and where the credit information Bureau blacklists the borrower.

*Note*:

Bills Purchased/Discounted are to be classified into Loss Loan where they are not realized within 90 days from due date. This is departure from the normal classification rules applicable to other loans. Accordingly, it Bills would have only two classification Viz. Pass and Loss.

**Additional arrangement in respect of term loan**

In respect of term loans, the classification shall be made against the entire outstanding loan on the basis of the past due period of overdue installment.

**Loan Loss Provisioning**

The loan loss provisioning, on the basis of the outstanding loans and advances and bills purchases classified as per this directives, shall be provided as follows:

| Classification of Loan | Loan Loss Provision |
|---|---|
| Pass | 1 Percent |
| Substandard | 25 Percent |
| Doubtful | 50 Percent |
| Loss | 100 Percent |

Loan Loss provision set aside for Performing loan is defined as “General Loan Loss Provision” and Loan loss provision set aside for Non Performing loan is defined as “Specific Loan Loss Provision”.

Where the banks provide for loan loss provisioning in excess of the proportion as required under the directives of NRB, the whole amount of such additional provisioning may be included in General Loan Loss Provision under the supplementary Capital.

### Additional Provisioning in the case of Personal Guarantee Loans

Where the loan is extended only against personal guarantee, a statement of the assets, equivalent to the personal guarantee amount not claimable by any other shall be obtained. Such loans shall be classified as per above and where the loans fall under the category of Pass, Substandard and doubtful, in addition to the normal loan loss provision applicable for the category, an additional provision by **20-percentage point** shall be provided. Classification of such loans and advances shall be prepared separately. Hence the loan loss provision required against the personal guarantee loan will be 21%, 45%, and 70% for Pass, Substandard and Doubtful category respectively.

### Rescheduling and restructuring of Loan

In respect of loans and advances falling under the category of Substandard, Doubtful or Loss, banks may reschedule or restructure such loans only upon receipt of a written plan of action from the borrower citing the following reason. ;

a) The internal and external causes contributing to deterioration of the quality of loan.
b) The reduced degree of risk inherent to the borrower/enterprise determined by analyzing its balance sheet and profit and loss account in order to estimate recent cash flows and to project future ones, in addition to estimate recent cash flows and to project future ones, in addition to assessing market conditions.
c) Evidence of existing of adequate loan documentation.
d) An evaluation of the borrower/enterprise's management with particular emphasis on efficiency, commitment and high standards of business ethics.

**Loan Loss Provisioning in respect of rescheduled, restructured or swapped loan**

a) Except for priority sector, in respect of all types of rescheduled or restructured or swapped loan, if such credit falls under Pass category according to NRB directives, loan loss provisioning shall be provided at minimum 12.5%.
b) In case of rescheduling or restructuring or swapping of insured or guaranteed priority sector credit, the loan loss provisioning shall be provided at one fourth of the percentage mentioned in clause (a)
c) In respect of swapped loans, the bank accepting the loans in swapping has to provide loan loss provision classifying the loan under the same classification as were existing. The bank accepting the loan in swapping shall obtain certification from the concerned bank of financial institution as to the existing classification.

**Provisioning Against Priority Sector Credit**

Full provisioning as per normal loan loss provisioning shall be made against the uninsured priority and deprived sector loans. However in respect of insured loans the requisite provisioning shall be 25% of the percentage normal loan loss provisioning. The required provisioning in the case of insured priority/ deprived sector credit is as follows:

| | |
|---|---|
| Pass | 0.25% |
| Substandard | 5.00% |
| Doubtful | 12.50% |
| Loss | 25.00% |

In case of rescheduling, restructuring or swapping of insured or guaranteed priority sector credit, the proportion of loan loss provision would be 3.125% (being 25% of 12.5%).

## 2.4 Review of Relevant Articles/Journals

### "Loan Loss Provision Rises Notably"

In a post report titled 'Loan Loss Provision Rises Notably' published in The Kathmandu Post, the reporter had made an Endeavour to highlight some facts and figures regarding loan loss provision of commercial banks. "The banking sector is witnessing a huge surge in loan loss provisioning reserves lately. The increment is primarily a result of a directive issued by Nepal Rastra Bank (NRB) in 2001 that introduced stringent loan provisioning criteria for commercial banks. As per data recently released by the central bank, the total loan loss provision in the country's banking sector increased from around Rs 21,313 million in mid-July 2001 to Rs 23,956.06 million in mid-July 2007. The increment is over 12.40 per cent..." (The Kathmandu Post, 2007: 6)

The reporter further states that apart from the two technically insolvent government-invested banks, loan provision of other joint venture private banks has also risen significantly and the notable increments seen in the loan loss provisioning amounts is due to the eight-point prudential directives that the central bank issued in mid-2001 to all commercial banks.

The reporter concludes, "The directives laid down stringent guidelines relating to loan loss provisioning to ensure a good health of the overall banking system. The directive requires loans to be provisioned to the extent of cent percent if payment is defaulted for one year. Likewise, the directives require loans to be provisioned to the extent of 25 per cent if payment is defaulted for over three months and 50 per cent if the period of default extends beyond six months. The earlier directive required progressive provisioning of loans, but allowed a maximum of three years, unlike the present system of just a year, for loans to be provisioned to the extent of cent per cent."

### "Credit Sector Reform & NRB"

Mr. Binam Ghimire in his article titled "Credit sector reform and NRB" has tried to highlight the effects of change or amendment in NRB directives regarding loan classification and loan loss provisioning. "Although the circumstances leading to financial problem or crisis in many Nepali banks differ in many respects, what is common across most of the banks is the increased size of non performing assets (NPAs). To resolve the problem of the losses or likely losses of this nature facing the industry, NRB has, as the central bank, amended several old directives and issued many new circulars in the recent years." (Ghimire, 2007: 47-49)

As opined by him, since majority of the loans of most of the commercial banks of the country at present falls under substandard, doubtful and even loss categories, loan loss provisioning now compared to previous arrangement would be dramatically higher. The new classification and provisioning norms are very lendable as they help to strengthen banks financially. He added that we also must remember that the old system remained in force from 1991 to 2001, which was probably the most volatile decade of the business operation of the country. He has indicated that Loan loss provisioning as a percentage of total credit of mid-July 2001 was 5.2% but as mid-July 2007, it has jumped to 10.84 %. If only private banks are considered, it was 2.12% of mid-July 2001 where as it is 5.22% as of mid-July 2007. The total increment in LLP is Rs 2643.06 million and the total increment in credit is Rs 120,661.92. He has also stated that tightening provisioning requirements on NPL is essential to ensure that banks remain liquid even during economic downturns.

In the conclusions he has mentioned that in the recent years NRB has worked for management and reform of the credit of the financial institution more seriously and NRB has adopted reforms aimed not just at dealing with problem banks but also at strengthening banking supervision to reduce the likelihood of future crisis. "All prudential directives of NRB in connection of Credit sector reform have been made revised on after April 2001. To adapt to such changes there can be some difficulties and for a better & harmonized reform NRB should continue to be supportive, proactive and also participative to take opinions of bankers for a change in regulation/policy taking place in the future."

**"Non-Performing Assets: A need for rationalization"**

In the article by Mr. Deependra B Chhetri, titled "Non Performing Assets : A need for Rationalization", the writer has attempted to provide connation of the term NPA and its potential sources, implication of NPA in financial sector in the South East Asian Region. He had also given possible measures to contain NPA. "Loans and advances of financial institutions are meant to be serviced either part of principal of the interest of the amount borrowed in stipulated time as agreed by the parties at the time of loan settlement. Since the date becomes past dues, the loan becomes non-performing asset. The book of the account with lending institution should be effectively operative by means of real transaction effected on the part of the debtor in order to remain loan performing." (Chhetri, 2064: 17)

As stated by the writer, the definition of NPA differs from country to country. In some of the developing countries of Asia Pacific Economic Cooperation (APEC) forum, a loan is classified as non-performing only after it has been arrear for at least 6 months. Similarly, it is after three months in India. Loans thus defaulted are classified into different categories having their differing implication on the asset management of financial institution. He also stated that NPAs are classified according to international practice into 3 categories namely Substandard, Doubtful and Loss depending upon the temporal position of loan default. "Thus the degree of NPA assets depends solely on the length of time the asset has been in the form of non obliged by the loanee. The more time it has elapsed the worse condition of asset is being perceived and such assets are treated accordingly." (Chhetri, 2064: 18)As per Mr. Chhetri's view, failure of business for which loan was used, defective and below standard credit appraisal system, credit programme sponsored by Government, slowdown in economy/recession, diversion of fund are some of the factors leading to accumulation of NPAs.

He said that there is serious implication of NPAs, on financial institution. He further added that the liability of credit institution does not limit to the amount declared as NPA but extend to extra amount that requires by regulation of supervisory authority in the form of provisioning as the amount required for provisioning depends upon the level of NPAs and their quality. As per his view, rising level of NPAs create a psyche of worse environment especially in the financial sector. He mentioned that by reviving the activities of the financial institution like waiving interest, rescheduling the loan, writing off the loan, appointing private recovery agent, taking help of tribunals and law of land etc NPAs can be reduced.

Finally he concluded that financial institutions are beset with the burden of mounting level of NPAs in developing countries. “Such assets debar the income flow of the financial institution while claiming additional resources in the form of provisioning thereby hindering gainful investment. Rising level of NPAs cannot be taken as stimulus but the vigilance demanded to solve the problem like this, eventually will generate vigor to gear up the banking and financial activities in more active way contributing to energizing growth.” (Chhetri, 2064: 21)

**‘Why Asset Management Co. is considered the best option to resolve the non performing loan problem?’**

Mr. Bhishma Raj Dhungana in his article titled has tried to highlight one of the approach mainly Asset Management Company (AMC) for resolving the problem of NPL. As per him, AMC is the specialized financial intermediary to manage the non-performing and distress loans of banks and financial institutions who buy the NPL from financial institution and take necessary steps to recover the maximum value from the acquired assets. As per his view, if NPLs are not resolved in time there would be inherent direct of indirect costs to the economy. As stated by him NPL may arise due to the external factors like decrease in market value of collateral, deterioration in borrower’s repayment capacity, economic slowdown, borrower’s misconduct, improper credit appraisal system, lack of risk management practice, ineffective credit monitoring and supervision system. Hence he suggested that, NPL should be kept at minimum level and the specialized institution such as AMCs should manage the distressed loans.

He says that, both traditional approach and AMC are available to deal with NPL problem. Under traditional approach, bank handles the NPL's in its own way especially through recovery unit who focus on continuing negotiation with the borrower and give top priority to the loan recovery. As opined by the writer, this approach is useful in dealing with small business loans where personal touch is adopted but for big loans this approach does not work. "AMCs seems as the only realistic option when the financial sector recovery is the underlying objective in financial system where the institution fail to resolve the NPL problem through their own effort."(Dhungana, 2062: 125) He states that the main advantage of establishing AMC is that AMC is able to move in an expeditious manner removing the distraction of managing NPLs from the banking system and frees up resources within the financial institutions allowing them to concentrate on their core activities.

He concludes, "As in most of the countries, Nepalese Financial system is largely dominated by the banking sector. The banking sector is severely affected by the NPL problem, It is estimated that the NPL of the Nepalese Banking system is around 16%. Therefore there is no doubt that it has serious implication on the economic performance of the country. It will be the eclipse in the development of financial soundness in the economy, if not controlled in time. However, traditional or AMC root can be practiced to get recovery from this sickness of the financial system, the AMC root may be more effective approach to be quick recovery as it has been experienced around the world." (Dhungana, 2062: 12)

**"Doubtful Debtors and Changed New Provision"**

The article titled as above was written by Mr. Suman Sapakota, which was published in Nepal Bank Patrika, Jestha-Magh 2063. As per his view, the main purpose of establishment of bank in to collect idle fund general public disburses them to needy people/institution in the form of loans and advances. Loans and advances are given for a certain period of time but it is not sure that all the loans are recovered within time. The function of any commercial bank is considered successful only when the loans and advances are recovered easily within stipulated time. Hence it is often said that, it is easy to disburse loans but as much hard to recover loans and interest.

He stated that as per new provision, loans and advances are classified on the basis of ageing of past dues and collateral value. On that basis loans and advances need to be classified into four categories namely, Pass, Substandard, Doubtful and Loss. With the change in time and demand, change was made in provision of loan classification and provisioning. He has also mentioned that previously loans and advances are categorized into six categories as Pass, Acceptable, Indicative substandard, Substandard, Doubtful and Loss. With the old provision the loan would be non performing only if it is past due for more that 1 year but as per new provision, the loan would be non performing if the loan is past due for more than three months.

He opined by the writer, these changed provisions would contribute to healthy, transparent and increased risk bearing capacity of the banks. If NPL increases it affects adversely to the various sectors. Hence the writer concluded with the hope that the new provision if properly implemented would help to reduce NPL and helps banks from financial crisis.

**“Bad Loans of Banking Sector – Challenges and Efforts to Resolve it”**

Mr Him Pd. Neupane, in his article titled as above, has thrown some views regarding bad loans of banking sector. As mentioned by him there was various types of risk inherent in the credit. One, who manages risk, earns profit. He further added that the recent financial crisis in banking sector is due to weak accounting procedures, defect in loan classification, lack of transparency, loss control measures etc.

Like the other writers, Mr. Neupane has also stated that NPL is the indicator of financial crisis and the factors leading to NPL is economic slowdown, recession, bad intention of the borrower, lack of credit policy, increase in interest rate etc. NPL increases resource mobilization cost and reduce profit-earning capacity of the bank. He has also mentioned that the international standard of acceptable NPA is 4% but there is about 16% NPL in Nepalese banking sector which is due to high level of NPL of two nationalized banks. As stated by the writer, the major implications of NPL are banks cannot return depositors money on demand and it limits lending capacity of the bank. The writer has suggested internal and external measures for reducing NPL and its effect. Internal measures comprise classification of loans and advances and providing provisions for probable loss and external measures comprises of help from Credit Information Bureau (CIB), appointment of Asset Management Company (AMC) and Debt Recovery Tribunal (DRT).

He concludes, "Banks must give priority for reducing NPA. He has also mentioned that many countries are adopting various measures for reducing loan loss. Recently the president of Philippines has announced tax rebate system for reducing NPA. Now it is high time to improve bad debts of banking sector with firm determination." (Neupane, 2064, 141-146)

**"Portion of NPA in Commercial Banks – High in Public, Low in Private"**

(Sapkota, 2006: 5)

Mr. Narayan Sapkota has written an article titled "Portion of NPA in Commercial Banks – High in Public, Low in Private" which was published in Rajdhani on 19 May 2006. In this article Mr. Sapkota has stated that the problem of NPL is seen less in private banks in comparison to Public banks. The NPA of two big nationalized banks being about 30% of the total loans is very serious situation. He further mentioned that in order to improve this situation and to make healthy banking environment, financial reform programme has been brought as its consequences, the management of two big banks was handed to foreign company on a contract but the ratio of NPA was not reduced.

Even most of the privately owned banks has NPA within international standard, some privately owned bank's NPA is higher that international standard. As per international standard 4% NPA is acceptable. He also states that, Nepal's total NPA of banking sector is 16%, which is very high.

**"Failed state vis-à-vis, failed banking system"**

In an article titled “Failed state vis-à-vis, failed banking system” by Rudra Sharma & Bashu Dev, it was stated that, banks in Nepal are in poor health and the ill health of the banking system is seen in its worst form in the nationalized & specialized public sector. They have large amount of classified loan burden and hence the survival of the nationalized banks is at stake. They stressed that banking sector is in need of sustained efforts to pull it out of deepening crisis and the laws governing loan recovery should be corrected.

They have also mentioned that, the directive regarding loan classification and loan loss provisioning is tighter than it was proposed previously. They have also stated that NRB is pressuring banks to enforce prudential norms from which ordinary shareholders and depositors stand to benefit but investors are in risk. Investors want NPAs being recovered. They had also stated the saying of Dr. Tilak Rawal “For worse economic crisis is inevitable in the country if leading banks of Nepal fail to introduce immediate reform to counter growing NPAs. NPL is the cause of banking distress.” “Political pressure to lend to uncreditworthy borrowers and poor accounting practices is the main reason why the government owned banks have incurred substantial levels of NPL. In Nepal, NPL have accounted for between 40-50% of total loans of government owned banks. ” (Sharma & Phulara, 2007, 41)

The writers concluded that Nepalese banking system is not a successful one. “Poor performance in banking system has triggered more problems to other economic fundamentals. As these problems were coupled with other political problems and increasing insurgency, it went up to the extent of talks being made about the vicinity of Nepal towards a failed state.” (Sharma & Phulara, 2007, 43)

**“Asset Management Company: East Asia’s Experience”**

The article titled above was published in editorial of Nepal Bank Limited Newsletter of Magh 2063. In this editorial, the writer has expressed some views regarding Asset Management Company models to resolve NPA problems in the context of East Asian countries. He has stated that, east

Asia's financial system are burdened with a large volume of non performing assets which impede the ability of financial institution to serve the prudent intermediation need of their communities. "To resolve NPA problems and help restore the health and confidence of the financial sector, the countries in East Asia have used one or more asset management company (AMC) models. The most common AMC model used centralizes this activity in a government agency. However, some countries have opted for a more decentralized approach involving the creation of several 'bank based' AMCs." As per his view if the country's NPA problems are limited or concentrated and government can afford to take a gradual approach, a bank based AMC would be appropriate where as if NPA problem is more pervasive and the country's business culture and legal infrastructure are less developed, then centralized government based strategy would be more appropriate.

"In Thailand, the government dealt promptly and decisively with NPA problems in finance companies but has not done the same for the banking sector where NPA problems are still pervasive. ---- The government policy of encouraging state owned and private banks to establish their own AMCs appears overly optimistic and is likely to require substantial government coordination and financial support. ------ In Indonesia, the NPA problems appear to be the most severe by far, of all the countries surveyed. ---- In Malaysia, the government promptly reduced NPA problems by transferring them to a centralized, government-run AMC. While it is too early to tell, the approach appears well coordinated and comprehensive. ------- The Korean government has achieved major strides in addressing the loan problems in the financial sector. The government AMC faces an important challenge but is actively working to improve its management of distressed assets. ------- In Philippines, problem assets are significant in the extent but substantially less than in other East Asian countries. The experience of the AMC in the Philippine provides valuable insights into the importance of operational independence."

**"Modus Operandi of Risk Appraisal in Bank Lending"**

Mr. Shiba Raj Shrestha, Director NRB in his article titled as above has tried to highlight different aspects of credit risk management. As per his view, as the effective risk management is central to good banking, the tradeoff between risk and return is one of the prime concerns of any investment decision whether long-term or short-term. He concludes, "Effective credit risk management allows a bank to reduce risks and potential NPAs. It also offers other benefits. Once banks understands their risks and their costs, they will be able to determine their most profitable business, thus, price products according the risk. Therefore, the banks must have an explicit credit risk strategy and supported by organizational changes, risk measurement techniques and fresh credit process and systems. There are five crucial areas that management should focus on;

a. Credit sanctioning and monitoring process
b. Approach to collateral.
c. Credit risk arises from new business opportunities.
d. Credit exposures relative to capital or total advances
e. Concentration on correlated risk factors.

Apart form these; the bank management should regularly review all asset quality issues including portfolio composition, big borrower exposures, and development in credit management policy and process." (Shrestha, 2062, 55-64) He is hopeful that the banks adopt good risk management practices and will be able to reap both strategic and operational benefit.

**"Financial sector hobbled with chaos, fragility"**

The article titled "Financial sector hobbled with chaos, fragility" by Mr. Gopal Tiwari was published in The Himalayan Times on July 14, 2007. Mr. Tiwari states that Nepal's financial sector is moving like a 'sinking boat'. As per his view financial institution have failed in delivering beneficial services to needy people by developing credit-giving centers in rural areas without which sustained economic growth is impossible. On the other hand banks and financial institutions have enough liquidity but they are finding it difficult to find suitable places for investment.

“Problems such as insecurity lack of market research from banks, low investment opportunities, weak operational policies for carrying out financial transaction, among others have contributed to the problems of this sector. Despite central bank’s directives regulating banks and financial institution, private and government banks are functioning haphazardly. ----- Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB), the two largest banks, occupy about 30 percent of the country’s banking assets. Effective reform of these two is key to improved performance of the whole sector. The process currently underway to reform these two institutions, despite paying huge amounts to foreign experts, has not given expected results.------ Besides NBL and RBB, the Non Performing Assets (NPA) of some private banks also very high. If the government and central bank allow the financial sector reforms to focus only on RBB and NBL, it might become a futile effort. The current management of RBB and NBL have not been able to reduce their NPL even after two years, which have crossed over 40%. Earlier KPMG had calculated NPL at 30-35 percent. The central bank itself says, despite efforts NBL has high NPLs and negative capital of Rs 9.75 billion.” (Tiwari, 2007: 7)

The writer suggested that the forthcoming budget should not remain a document merely but should address financial sectors ills with a wide vision. He further recommended that in order to create a well regulated, prudent, market oriented, competitive and strong financial system in Nepal, the government should look to build upon its indigenous strength and improve upon its regional ties to improve its efficiencies.

**Interview / Opinion Excerpts**

Mr. Yuba Raj Khatiwada , executive director NRB & President of Management Association of Nepal, while giving interview with New Business Age said, “Growth of NPAs has been faster than growth of credit. Management is not professional for many banks, they seem to run by the strength of capital not by expertise.” (Khatiwada, 2005: 34)

Mr. Shovan Dev Pant, Ex-CEO Nabil Bank Limited, while giving interview with Business age said, “Due to slowdown in world economy and the deteriorating law and order situation of the country, many sectors of the economy are already sick. When any sector of economy catches the cold, bank shall starts sneezing. From this perspective, the banking industry as a whole is not robust. However, bank's like NABIL having strong risk management system, sound capital, adequate provisioning, quality of staff and large clientele base can withstand any contingencies."(Pant, 2004: 31)

Mr. Narendra Bhattarai, Ex-CEO Nepal Bangladesh Bank, while giving interview with Business Age said, "The current economic slump has severely affected the banking sector. Particularly it has adversely affected the recovery of interest and principal of loan resulting in high non performing assets." (Bhattarai, 2003: 72)

Mr. Narendra Bhattarai, Ex-CEO, Nepal Bangladesh Bank, while giving opinion in The Himalayan Times said "The budget 2004-05 should look into the banking sector's problems very seriously. Due to fragile law and order situation prevailing in the country and on-going political uncertainties resulting in numerous bandhs, and strikes, the level of non performing loans (NPL) in most banks have increased alarmingly. As per existing government stipulations, five percent of total bank loans, are allowed as NPL. According to existing Nepal Rastra Bank directives, Income tax assessment are done incorporating five percent NPLs, which increases the volume of 'income tax' burden on banks that already are under a lot of pressure. Therefore the provision of NPL should also be applicable for income tax assessment. Banks and financial institutions pay a higher tax by five percent than what the corporate sector is paying. " (Bhattarai, 2004: 7)

Himalaya SJB Rana, Chairman Himalayan Bank Limited, while giving interview with New Business Age said, "You perhaps unwittingly omitted to mention another measure taken to reduce the NPA - that is the setting up of a special judicial court or tribunal to hear the loan recovery cases. So, now before filing a case in the regular courts, the first step from the bank will be to file it with the tribunal. This law was passed after lots of follow up by us bankers. But even after the bank wins the case from the court and takes the collateral into its possession the bank may find it difficult to sell the property, as is the case even today. The buyers simply do not come forward. When they come they are very few and often they join hands and offer a very small amount. There is a sort of a buyers' market here. So, the AMC was proposed. At this moment I cannot say whether this AMC will or will not work well in Nepal. Globally, there are mixed reports. As I have heard, AMCs could not do well in Latin America while they did very well in Thailand, Philippines and Malaysia. Our central bank people have gone there (Thailand, Philippines and Malaysia) and studied how the AMCs functioned there and they are trying to model the proposed AMC of Nepal accordingly. But I think the success of AMC depends on the leadership of the AMC." (Rana, 2006, 35)

## 2.5 Review of Related Thesis

**Mr. Lila Prasad Ojha** has carried out research on "Lending Practices: A study on Nabil Bank Limited, Standard Chartered Bank Nepal Limited and Himalayan Bank Limited". His main objectives of study are to analyze, the various aspects of bank's lending in various sector of economy, the individual bank's performance regarding the lending quantity, quality, efficiency and its contribution in total income. The problems, conclusion and recommendation figured out by him in this thesis are discussed as below.

As stated by him, over liquidity caused due to lack of good lending opportunities, risk arising due to mismanagement of lending portfolio, increasing non-performing assets etc is some of the problems that is facing by Nepalese banking sector. His main objective is to analyze the various aspects of bank's lending in various sector of economy, the individual bank's performance regarding the lending quantity and quality.

He concludes "The highest growth rate, proportionately high volume of loans and advances, the best contribution in priority and agricultural sector and the high level of deposits mobilization of HBL has put this bank in the top position in the lending function. However the better activity ratio of SCBNL has proved this bank the best in managing the lending portfolio according to the demand of profit oriented business. The high volume of lending activities and high volume of productive sector loan of NABIL has put the bank in the top position in absolute terms.--The increasing provision on loan loss and high volume of non-performing assets in NABIL & HBL certainly attracts the high attention of any person interested with these banks. The high volume of NPA of HBL may have caused due to the failure of industrial and agricultural sector. NABIL's increased NPA may have caused due to the accumulated bad debts that is kept behind the curtain to show the high efficiency of management." (Ojha, 2002: 57)

He suggested that following the normal guidelines of NRB and acting upon this also reduce many of the credit risk arising from borrowers. He recommended banks to be more cautious and realistic while granting loans and advances. As suggested by him, the major solution of reducing the risk is to avoid lending in more risky area until the bank does not fully satisfy itself regarding the future viability of the project. He further suggested that the establishment of Asset Management Co. (AMC), which helps commercial banks in collecting their debts and improving their credit rating efficiency, should be initiated. As per his opinion, lack of proper credit appraisal, default by blacklisted borrower and professional defaulter, the over confidence in commercial banks regarding credit appraisal efficiency and negligence in taking information from credit information bureau has caused many of the bad debts in these banks.

**Ms. Shama Bhattarai** in her study "Implementation of Directives Issued by Nepal Rastra Bank: A Comparative Study of Nepal SBI Bank Limited and Nepal Bangladesh Bank Limited" has made an attempt to analyze various aspects of NRB Directives with respect to Capital Adequacy and Loan Classification and Provisioning. As per her view the process of continual review and classification of loans and advances enables banks to monitor the quality of their loan portfolios and to take remedial action to counter deterioration in the credit quality of their portfolios.

She concluded that with the new provisions the banks will have its provision amount increasing in coming years and subsequently profitability of the banks will also come down. However, the true picture of the quality of the assets will be painted in the coming years to come. She recommends, “The banks should be very careful while analyzing the paying capacity of its credit clients. With longer period of past due, the bank will end up increasing its provisions which will keep the bottom line low if the bank is not careful.” (Bhattarai, 2004: 31)

**Mr. Raja Ram Khadka** in his thesis on ‘ A study on the Investment Policy of Nepal Arab Bank Limited in comparison to other Joint Venture Banks of Nepal’ has concluded that NABIL is comparatively less successful in on balance sheet utilization a well as off balance sheet operations than that of other JVBs. Mr. Khadka warned that in coming days NABIL may be behind in the competitive market if it cannot mobilize its resources as efficiently as other JVBs. He recommended, “The bank must utilize depositors’ money as Loans and Advances to get success in competitive banking environment. The largest item of the bank in the asset side is Loans and Advances. Negligence in administrating this asset could be the main cause of a liquidity crisis in the bank and one of the main reasons of a bank failure.” (Khadka, 1998: 42)

**Mr. Santosh Pandey** has carried out study on ‘ Nepal Rastra Bank – Directives Their Implementation and Impact on the Commercial Banks- A Case Study of Himalyan Bank Limited’ with the objectives to find out the impact of changes in NRB directives on the performance of the commercial banks and to find out whether the directives were implemented or not.

“The directives if not properly addressed have potential to wreck the financial system of the country as they are the only tool of the NRB to supervise and monitor the financial institutions. The directives in themselves are not that important unless properly implemented. The implementation part depends upon the commercial banks. In case commercial banks are making such huge profit with full compliance of NRB directives, then the commercial banks would deserve votes of praise because they would then be instrumental in the economic development of the country. --- All the changes in NRB directives made impacts on the bank and the result are the followings:

- Increase in operational procedures of the bank which increases the operational cost of the bank.
- A short term decrease in profitability which result to lesser dividends to shareholders and lesser bonus to the employees.
- Reduction in the loan exposure of the bank, which decreases the interest income but increase the protection of the depositor's money.
- Increase protection to the money of the depositors through increased capital adequacy ratios and more stringent loan related documents.
- Increase demand for shareholder's contribution in the banks by foregoing dividends for loan loss provisions and various other reserves to increase the core capital.

All the aforesaid results lead to one direction; the bank will be financially healthy and stronger in the future. HBL will be able to withstand tougher economic situations in the future with adequate capital and provision for losses. The tough time through which the bank is undergoing at present will prevail only for a couple of years but in the long run, it will be strong enough to attract more deposits and expose itself to more risk with capital cushion behind it. The quality of the assets of the banks will become better as banks will be careful before creating credit. Ultimately, the changes in the directives will bring prosperity not only to the shareholders but also to the depositors, the employees and the economy of the country as a whole." (Pandey, 2002: 52)

He recommended that the bank has to make its monitoring and follow up department stronger needs to give priority in human resource development through training to its staffs and make them efficient enough to monitor and collect already disbursed loans.

**Ms. Sabitri Shrestha** in her thesis "Impact and Implementation of Nepal Rastra Bank(NRB)'s Guidelines (Directives) on Commercial Banks: A study of Nabil Bank Limited and Nepal SBI Bank Limited"  has tried to find out the impact of NRB directives on commercial banks . She has also made effort to find out whether the directives are actually implemented and are being monitored by NRB or not. She has stated that both NABIL and Nepal SBI are implementing the NRB directives.

She concludes "All the changes in NRB directives made both positive and negative impacts on the commercial banks. Even though this study is limited to only two sample i.e. Nabil bank and Nepal SBI Bank, 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 commercial banks. Apart from, loan exposure has been cut down to customers due to the borrower limits have been brought down by NRB. Therefore reduction in loan amount results to decrease in the interest income. This will decrease the profits of the banks in coming years. Decline in the profitability results less shareholder dividends & bonus to employees. ------ Not only the negative sides but also there are positive sides of new directives. Recently the problems of banks are increasing operating cost and decreasing loan amount resulting decrease in profits of the banks. But it shows it is only for short term because the directives are more effective to protect the banks from bad loans, which protect the banks from bankruptcy as well as protection of deposits of depositors. Increase in capital adequacy ratio strengthen the bank's financial position, loan related provision will made safety of loans except the risk reducing provisions will protect the bank from liquidation.--------- Above all, it can be concluded that newly issued directives are more effective than previous one although it has brought some problems towards banks. To decrease the decreasing profits of the banks, they should research the alternatives such like more investments in other business, bank should adopt new technology according to the demand of time and must not depend on only interest income for profits." (Shrestha, 2003: 29)

**Ms. Anju Khadka** has carried out research on "A Comparative Study on Investment Policy of Commercial Banks" with an objective to find out the relationship between deposits, investment, loans and advances and net profit.

She has made the following conclusion while comparing the performance of NBL with NABIL, SCBNL and NIBL.

She concludes "NBL is comparatively less successful in on balance sheet as well as off-balance sheet operations than that of other CBs. It predicts that in the coming days if it could not mobilize and utilize its resources as efficiently as other CBs to maximize the returns, it would lag behind in the competitive market of banking.---Profitablility positions of NBL is comparatively worse than that of other CBs. ---It predicts that NBL may not maintain the confidence of shareholders, depositors and its all customers if it cannot increase its volume even in future." (Khadka, 2002: 49)

As the banks experience many difficulties in recovering the loans and advances and their large amount is being blocked as non performing assets, she suggested that there is an urgent need to workout a suitable mechanism through which the overdue loan can be realized.

**Ms. Anjana Shilpakar** in her thesis "A Study on Lending Practices of Finance Companies of Nepal" aimed to analyze performance of finance company regarding lending quantity and quality and its contribution in profitability. She concluded that Loans and Advances is one of the main sources of income of finance companies. This is what is also shown by the high degree positive correlation between total income and Loans and advances. "Loan Loss Provision is like a by-product of Loans and Advances, thus, with Loans and Advances, Loan Loss Provision does increase in synchronize." (Shilpakar, 2003: 35)

She recommended that Loans and Advances of finance companies are increasing and so are the Non-Performing Loans and Loan Loss Provision. Hence extra efforts should be enforced to control over NPL.

## 2.6 Research Gap

From the study it has been found that increasing non-performing loan followed by increased loan loss provision is one of the challenges faced by commercial banks in the present context. Some researches were done in which matters relating to loan loss provisioning has been discussed but no research was found in detailed analysis of non-performing loan and loan loss provisioning. Hence the researcher had attempted to fill this research gap by taking reference of Nabil Bank Limited, Nepal Bank Limited and Standard Chartered Bank Nepal Limited. This research will be able to deliver some of the present issues, latest information and data regarding loan classification and loan loss provisioning.

After reviewing the relevant literatures, the next chapter concentrates in the research methodology applied in the study.

# CHAPTER III

# RESEARCH METHODOLOGY

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. In it, the various sequential steps that are generally adopted by the researcher, studying his research problem among with certain objectives in view are studied. A research methodology helps us to find out accuracy, validity and suitability. Research is a systematic inquiry of any particular topic and methodology is the method of doing research in a well manner. Hence research methodology is the systematic study of research problem that solves them with some logical evidence. The research methodology adopted in the present study as discussed as below:

## 3.1 Research Design

Research design is the specification of methods and procedures for acquiring the information needed. It is the plan, structure and strategy of investigation conceived so as to obtain answers to research questions and to control variance. This research will follow analytical and descriptive research design.

## 3.2 Populations and Sampling

Population refers to the entire group people, events or things of interest that a researcher wishes to investigate. Since this study is about loan classification and loan loss provisioning of commercial banks, the population for this study comprised all the licensed commercial banks of the country.

A list of licensed commercial banks was obtained from NRB. There are altogether 23 commercial banks in Nepal. The commercial banks of Nepal can be categorized into two types namely Public Sector and Private Sector. Public sector banks include three old banks NBL, RBB and ADB and private sector banks comprise remaining 20 banks. Out of the total population following 3 commercial banks were selected as samples for this study by using judgmental sampling method.

- ⇒ Nepal Bank Limited (NBL)
- ⇒ Nabil Bank Limited (NABIL)
- ⇒ Standard Chartered Bank Nepal Limited (SCBNL)

Nepal Bank Limited was selected from public sector commercial bank and two major joint venture banks NABIL and SCBNL were selected from private sector commercial banks so that the study could represent true picture of commercial banks.

## 3.3 Method & Sources of Data Collection

Both primary and secondary data has been used in this study.

3.3.1 **Primary Data:** A set of questionnaire were asked with some bank professionals & their answers were used as a primary source of data.

3.3.2 **Secondary Data:** For secondary data following documents has been used;

- ⇒ Laws, guidelines and directives regarding the subject matter.
- ⇒ Annual reports, newsletter, broachers etc of the subjected banks
- ⇒ Text books
- ⇒ Articles published in newspapers, Journals, Magazines, and other publications
- ⇒ Unpublished thesis and dissertation
- ⇒ Various reports published by NRB, CIB etc
- ⇒ Various related websites
- ⇒ Besides above any kind of other sources, such as assertions, interviews, remarks/opinion by the experts that provides valuable data and conclusion regarding the subject matter has been considered in this study.

## 3.4 Data Collection Techniques

Primary data has been obtained through questionnaire, direct interviews, field visit and telephonic inquires. The annual reports of NABIL & SCBNL were collected from concerned banks. The annual reports of NBL were published in Gorkhapatra and the same was referred for the study. Various publications of NRB were collected from the website of NRB. Similarly reports of Credit Information Bureau (CIB) have been collected from the website of CIB. The reference of NRB directives and guidelines has been executed from Nabil Bank Limited and website of NRB. Various reports, textbooks, journals, and unpublished dissertation have been obtained by visiting TU Central Library and Shanker Dev College Library.

## 3.5 Data Analysis Tools

The data collected from different sources are recorded systematically and identified. The available information is grouped as per the need of the research work in order to meet research objectives. The collected data are presented in appropriate forms of table and charts. For analysis purpose different kinds of appropriate mathematical, statistical and financial tools have been applied. Further to represent the data in simple form diagrams and graphs have also been used.

### 3.5.1 Financial Tools

While adopting financial tools, a ratio is used as a benchmark for evaluating the financial position and performance of any firm. “Financial analysis is the process of identifying the financial strength and weakness of the firm by properly establishing relationship between the items of the balance sheet and profit and loss account.” (Pandey, 1999: 108) “Financial analysis is the use of financial statements to analyze a company’s financial position and performance and to assess future financial performance.” (Subramanya, Halsey, 2003: 108)

#### 3.5.1.1 Ratio Analysis

Ratio Analysis is the widely used tool of financial analysis. A ratio is simply one number expressed in terms of another and as such it expresses the numerical or quantitative relationship between two variables. Ratio analysis reflects the relative strengths and weakness of any organization and also indicates the operating and financial growth of the organization. “Ratios help to summarize large quantities of financial data and to make quantitative judgment about the firm’s financial performance. The relationship between two accounting figures expressed mathematically is known as financial ratios” Even though there are many ratios, only those ratios have been calculated which are related to the subject matter. Following ratios have been computed and analyzed in this study.

**Loans and Advances to Total Assets Ratio**

Loans and advances of any commercial banks represent the major portion in volume of total assets. The ratio of loans and advances to total assets measures the volume of loans and advances in the structure of total assets. The high degree of ratio indicates the good performance of the banks in mobilizing its fund by way of lending functions. However in its reverse side, the high degree is representative of low liquidity ratio. Granting loans and advances always carries a certain degree of risk. Thus this asset of banking business is regarded as risky assets. Hence this ratio measures the management attitude towards risky assets. The low ratio is indicative of low productivity and high degree of safety in liquidity and vice versa. This ratio is calculated as follows

$$\text{Loans and advances to total asset ratio} = \frac{\text{Loans and advances}}{\text{Total Asset}}$$

**Loans and Advances to Total Deposit Ratio (CD Ratio)**

The core banking function is to mobilize the funds obtained from the depositors to borrowers and earn profit and CD ratio is the fundamental parameter to ascertain fund deployment efficiency of commercial bank. In other words this ratio is calculated to find out how successfully the banks are utilizing their total deposits on credit or loans and advances for profit generating purpose as loans and advances yield high rate of return. Greater CD ratio implies the better utilization of total deposits and better earning, however, liquidity requirements also needs due consideration. Hence 70%-80% CD ratio is considered as appropriate. This ratio is calculated by dividing total credit by total deposit of the bank.

Loans & Advances to Total Deposit Ratio = $\frac{\text{Loans and advances}}{\text{Total Deposit}}$

### Non-Performing Loans to Total Loans and Advances Ratio

This ratio determines the proportion of non-performing loans in the total loan portfolio. Higher ratio implies the bad quality of assets of banks in the form of loans and advances. Hence lower NPL to total credit ratio is preferred. As per international standard only 4% NPL is allowed but in the context of Nepal 10% NPL is acceptable. It is calculated as follows:

Non performing loans to total loans and advances = $\frac{\text{Non Performing Loans}}{\text{Total Loans Advances}}$

### Loan Loss Provision to Total Loans and Advances Ratio

This ratio describes the quality of assets in the form of loans and advances that a bank is holding. Since there is risk inherent in loans and advances, NRB has directed commercial banks to classify its loans into different categories and accordingly to make provision for probable loss. Loan loss provision signifies the cushion against future contingency created by the default of the borrower in payment of loans and ensures the continued solvency of the banks. Since high provision has to be made for non-performing loan, higher provision for loan loss reflects increasing non-performing loan in volume of total loans and advances. The low ratio signifies the good quality of assets in the volume of loans and advances. It indicates how efficiently it manages loan and advances and makes efforts to cope with probable loan loss. Higher ratio implies, higher portion of NPL in the total loan portfolio. This ratio is calculated as follows:

Loan Loss Provision Ratio = $\frac{\text{Loan Loss Provision}}{\text{Total Loans Advances}}$

**Provision Held to Non-performing loan**

This ratio determines the proportion of provision held to non-performing loan of the bank. This ratio measures upto what extent of risk inherent in NPL is covered by the total loan loss provision. Higher ratio signifies that the banks are safeguarded against future contingencies that may create due to non-performing loan or in other words banks have cushion of provision to cope the problem that may be cause due to NPL. Hence higher the ratio better is the financial strength of the bank. This ratio is calculated as follows:

$$\text{Provision Held to Non performing loan} = \frac{\text{Total Loan Loss Provision}}{\text{Non performing Loan}}$$

**Return on loans and advances**

This ratio indicates how efficiently the bank has employed its resources in the form of loans and advances. It is the ratio of net profit and total loans and advances of a bank. Net profit refers to that profit which is obtained after all types of deduction like employee bonus, tax, provision etc. Hence this ratio measures bank's profitability with respect to loans and advances. Higher the ratio better is the performance of the bank. It is calculated as below:

$$\text{Return on loans and advances} = \frac{\text{Net Profit}}{\text{Total Loans Advances}}$$

### 3.5.2 Statistical Tools

Statistical tools are the mathematical techniques used to facilitate the analysis and interpretation of numerical data. "Statistical Analysis is one particular language, which describes the data and makes possible to talk about the relations and the difference of the variables." (Gupta, 1997: 21) Following statistical tools have been used in this study.

#### 3.5.2.1 Percentages

A percent is a number of hundredth parts one numbers to another. Uses of percentages make the data much simpler and grasp. It is the simplest statistical device used in interpretation of phenomenon. It can reduce everything to a common base and thereby helps in meaningful presentation.

Mathematically, let A represent the base used for comparison, B represent the given data to be compared with the base, then the percentage of given number in the base may be calculated as

$$\text{Percentage (P\%)} = \frac{B}{A} \times 100$$

### 3.5.2.2 Measures of Central Tendency

Measures of central value are simple statistical treatments of distribution that attempts to find the single figure to describe the entire distribution. It is the best possible value of a group of variables that singly represents to whole group. In the statistical analysis the central value falls with in the approximately middle value of the whole data. Among the several tools of measuring central value, the mean has been used in this analysis where and when necessary. The mean is the arithmetic average of a variable. Arithmetic Mean of a series is given by

$$\text{Mean } (\overline{X}) = \frac{\sum X}{N}$$

### 3.5.2.3. Measures of Dispersion

Dispersion measures the variation of the data from the central value. The central value alone is not enough to analyze the quality of data regarding its variability. With the light of dispersion, an average becomes more powerful and meaningful. Following tools of measuring dispersion has been used in this study.

### 3.5.2.4 Standard Deviation

Standard deviation (S.D.) is the most popular and the most useful measure of dispersion. It indicates the ranges and size of deviance from the middle or mean. It measures the absolute dispersion. Higher the value of standard deviation higher is the variability and vice versa. It is the positive square root of average sum of squares of deviations of observations from the arithmetic mean of the distribution. It can be calculated as follows:

$$\text{Standard Deviation } (\sigma) = \sqrt{\frac{\sum (X - \overline{X})^2}{N}}$$

### 3.5.2.5 Coefficient of Variation

The percentage measure of coefficient of standard deviation is called coefficient of variation. The less is the C.V the more is the uniformity and consistency and vice versa. Standard deviation gives an absolute measure of dispersion. Hence where the mean value of the variable is not equal it is not appropriate to compare two pairs of variables based in S.D. only. The coefficient of variation measures the relative measures of dispersion, hence capable to compare two variables independently in terms of their variability.

$$\text{Coefficient of variation (C.V)} = \frac{\sigma}{\overline{X}} \times 100$$

### 3.5.2.6 Correlation Coefficient (r)

Correlation refers to the degree of relationship between two variables. Correlation coefficient determines the association between the dependent variable and independent variable. If between the variables, increase or decrease in one cause increase or decrease in another, then such variables are correlated variables. “ Correlation may be defined as the degree of linear relationship existing between two or more variables. Two variables are said to be correlated when the change in the value of one is accompanied by the change of another variable.” (Sthapit Gautam Joshi Dangol, 2003: 362) There are different techniques of calculating correlation coefficient. Among various techniques we have used Karl Pearson coefficient of correlation. It is calculated as follows:

$$\text{Correlation Coefficient (r)} = \frac{\sum xy}{N\sigma_x \sigma_y}$$

Where,

$x = X - \overline{X}$ $\quad\quad$ $y = Y - \overline{Y}$

$\sigma_x =$ Standard Deviation of Series X

$\sigma_y =$ Standard Deviation of Series Y

N = No. of pairs of observation

On simplification of the equation of r, we obtain the following formula for computing r.

$$r = \frac{\sum xy}{\sqrt{\sum x^2 . \sum y^2}}$$

The Karl Pearson Coefficient of correlation always falls between –1 to +1. The value of correlation in minus signifies, the negative correlation and in plus signifies the positive correlation. If,

$r = 0$, There is no relationship between the variables

$r < 0$, There is negative relationship between the variables

$r > 0$, There is positive relationship between the variables

$r = +1$, The relationship is perfectly positive.

$r = -1$, The relationship is perfectly negative.

The reliability of the correlation coefficient is judged with the help of probable error (P.E). It is calculated as follows:

$$\text{Probable Error (P.E.)} = \frac{0.6745(1-r^2)}{\sqrt{N}}$$

Where, r = correlation coefficient

N= No. of pairs of observation.

If $r > 6$ P.E, then the correlation coefficient is significant and reliable.

If $r <$ P.E, then the correlation coefficient is insignificant and there is no evidence of correlation.

### 3.5.3 Trend Analysis

Trend Analysis is one of the statistical tools which is used to determine the improvement or deterioration of its financial situation. Trend analysis informs about the expected future values of various variables. The Least square method has been adopted to measure the trend behaviors of these selected banks. This method is widely used in practices. The formula of least square method for the straight line is represented by the following formula.

$$Y_c = a + bX$$

Where,

$Y_c$ = Trend Values

a = Y intercept or the computed trend figure of the Y variable, when X = 0

b = Slope of the trend line of the amount of change in Y variable that is associated with change in 1 unit in X variable.

X = Variable that represent time i.e. time variable

The value of the constants "a" and "b" can be determined by solving the following two normal equations.

$\sum Y = Na + b\sum X$ ……………...(i)

$\sum XY = a\sum X + b\sum X$ …………(ii)

Where, N = number of years

But for simplification, if the time variable is measured as a deviation form its mean i.e. mid point is taken as the origin, the negative value in the first half of the series balance out the positive values in the second half so that ($\sum X = 0$. The values of constant "a" and "b" can easily be determined by using following formula.

a = $\frac{\sum Y}{N}$

b = $\frac{\sum XY}{X^2}$

**3.5.4 Diagrammatic and Graphical Representation**

Diagrams and graphs are visual aids that give a bird eye view of a given set of numerical data. They represent the data in simple and readily comprehensive form. Hence various bar diagrams, pie charts and graph have been used for presentation and analysis of data.

After highlighting the research methodology, the next chapter concentrates on presentation and analysis of the study.

# CHAPTER IV

# PRESENTATION AND ANALYSIS OF DATA

In this section raw form of data collected from various sources are changed into an understandable presentation using financial as well as statistical tools supported by diagrams and graphs as mentioned in the previous chapter. This chapter is the heart of the study as all the findings, conclusions and recommendations are going to be derived form the calculations and analysis done in this section.

## 4.1 Financial Analysis

### 4.1.1 Loans and Advances to Total Asset Ratio

Loans and advances of any commercial banks represent the major portion in volume of total assets. The ratio of loans and advances to total assets measures the volume of loans and advances in the structure of total assets. The high degree of ratio indicates the good performance of the banks in mobilizing its fund by way of lending functions. However in its reverse side, the high degree is representative of low liquidity ratio. Granting loans and advances always carries a certain degree of risk. Thus this asset of banking business is regarded as risky assets. Hence this ratio measures the management attitude towards risky assets. The low ratio is indicative of low productivity and high degree of safety in liquidity and vice versa.

**Table No. 4.1**

**Loan & Advances to Total Asset Ratio(%)**

Rs. In Million

| Year | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| (Mid July) | Loans & Advances | Total Asset | Ratio (%) | Loans & Advances | Total Asset | Ratio (%) | Loans & Advances | Total Asset | Ratio (%) |
| 2003 | 18,132 | 39,816 | **45.54** | 8,114 | 16,523 | **49.11** | 6,000 | 21,000 | **28.57** |
| 2004 | 17,938 | 44,162 | **40.62** | 8,549 | 16,745 | **51.05** | 6,694 | 23,642 | **28.31** |
| 2005 | 16,867 | 47,045 | **35.85** | 10,944 | 17,186 | **63.68** | 8,421 | 22,171 | **37.98** |
| 2006 | 12,879 | 35,919 | **35.86** | 13,278 | 22,330 | **59.46** | 9,206 | 25,776 | **35.71** |
| 2007 | 13,751 | 42,606 | **32.27** | 15,903 | 27,630 | **57.56** | 10,790 | 29,078 | **37.11** |
| **Mean** | | | **38.03** | **Mean** | | **56.17** | **Mean** | | **33.54** |
| **S.D** | | | **5.14** | **S.D** | | **6.02** | **S.D** | | **4.72** |
| **C.V** | | | **13.52** | **C.V** | | **10.73** | **C.V** | | **14.08** |

(Source : Annual Reports & Websites of Concerned banks)

The above table no.4.1 exhibits the loans and advances to total assets of three banks for five consecutive years. This ratio shows decreasing trend in NBL but SCBNL and

NABIL shows fluctuating trend. The overall ratio of the three banks has been ranged from 28.31% of SCBNL in 2004 to 63.68% of NABIL in 2005. The mean ratio of NBL, NABIL and SCBNL is 38.03%, 56.17% and 33.54% respectively. Hence among the three banks, NABIL has the highest proportion of loans and advances in the total asset structure followed by NBL and then SCBNL. This infers that SCBNL has the lowest degree of investment in risky assets. The management of SCBNL is risk averse as they have invested higher proportion of their asset in risk free or nominally risky assets like treasury bills, debentures, National Saving Bonds (NSBs) etc.

The standard deviation of NBL, NABIL and SCBNL are 5.14, 6.02 & 4.72 and C.V.s are 13.52%, 10.73% & 14.08% respectively. (Appendix 3)Thus it can be interpreted that NBL has higher deviation than NABIL and SCBNL. This is due to the decreasing trend in loan and advances. But SCBNL has the higher variation among three banks. NABIL is moderate in terms of deviation and variability of ratio during the study period.

### 4.1.2 Loans and Advances to Total Deposit Ratio

This ratio is often called Credit Deposit ratio (CD ratio). The core banking function is to mobilize the funds obtained from the depositors to borrowers and earn profit and CD ratio is the fundamental parameter to ascertain fund deployment efficiency of commercial bank. In other words this ratio is calculated to find out how successfully the banks are utilizing their total deposits on credit or loans and advances for profit generating purpose as loans and advances yield high rate of return. Greater CD ratio implies the better utilization of total deposits and better earning, however, liquidity requirements also needs due consideration. Hence 70%-80% CD ratio is considered as appropriate. This ratio is calculated by dividing total credit or loans and advances by total deposit of the bank.

## Table No. 4.2

## Loan & Advances to Total Deposit Ratio (%)

Rs. In Million

| Year | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| (Mid July) | Loans & Advances | Total Deposit | Ratio (%) | Loans & Advances | Total Deposit | Ratio (%) | Loans & Advances | Total Deposit | Ratio (%) |
| 2003 | 18,132 | 35,014 | **51.79** | 8,114 | 13,448 | **60.34** | 6,000 | 18,756 | **31.99** |
| 2004 | 17,938 | 35,735 | **50.20** | 8,549 | 14,119 | **60.55** | 6,694 | 21,161 | **31.63** |
| 2005 | 16,867 | 35,934 | **46.94** | 10,944 | 14,587 | **75.03** | 8,421 | 19,335 | **43.55** |
| 2006 | 12,879 | 35,830 | **35.94** | 13,278 | 19,347 | **68.63** | 9,206 | 23,061 | **39.92** |
| 2007 | 13,751 | 39,008 | **35.25** | 15,903 | 23,342 | **68.13** | 10,790 | 24,640 | **43.79** |
| **Mean** | | | **44.02** | **Mean** | | **66.53** | **Mean** | | **38.18** |
| **S.D** | | | **7.89** | **S.D** | | **6.19** | **S.D** | | **6.01** |
| **C.V** | | | **17.92** | **C.V** | | **9.30** | **C.V** | | **15.75** |

(Source : Annual Reports & Websites of Concerned banks)

The above table no.4.2 exhibits the loans and advances to total deposit of three banks for five consecutive years. This ratio shows decreasing trend in NBL and increasing trend in NABIL and SCBNL. The overall ratio of the three banks has been ranged from 31.99% of SCBNL in 2003 to 75.03% of NABIL in 2005. NABIL has the highest ratio for the whole period. The mean ratio of NBL, NABIL and SCBNL is 44.02%, 66.53% & 38.18% respectively. Hence among the three banks, NABIL has the highest proportion of loans and advances in the total deposit followed by NBL and then SCBNL. It signifies that NABIL and NBL have been ahead in utilizing depositor's money on loans and advances with the objective to earn profit.  This infers that SCBNL has very low investment in the form of loans and advances. The management of SCBNL is risk averse as they have invested higher proportion of their deposit in risk free or nominally risky assets like treasury bills, debentures, National Saving Bonds (NSBs) etc.

The standard deviation of NBL, NABIL and SCBNL are 7.89, 6.19 & 6.01 and C.V.s are 17.92%, 9.30% & 15.75% respectively. (Appendix 3) Thus it signifies that NBL has higher deviation with higher degree of variation in this ratio. Eventhough SCBNL has least deviation but moderate in terms of variation. NABIL is moderate in terms of deviation and has least variability during the study period.

### 4.1.3 Non-Performing Loans to Total Loans and Advances Ratio

This ratio determines the proportion of non-performing loans in the total loan portfolio. As per NRB directives the loans falling under category of substandard, doubtful and loss are regarded as non-performing loan. Higher ratio implies the bad quality of assets of banks in the form of loans and advances. Hence lower NPL to total credit ratio is preferred. As per international standard only 5% NPL is allowed but in the context of Nepal maximum 10% NPL is acceptable.

**Table No. 4.3**
**Non-Performing Loans to Loans & Advances (%)**

Rs. In Million

| Year (Mid July) | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| | NPL | Loans & Advances | Ratio (%) | NPL | Loans & Advances | Ratio (%) | NPL | Loans & Advances | Ratio (%) |
| 2003 | 10,965 | 18,132 | **60.47** | 450 | 8,114 | **5.55** | 248 | 6,000 | **4.13** |
| 2004 | 4,773 | 17,938 | **26.61** | 274 | 8,549 | **3.21** | 242 | 6,694 | **3.61** |
| 2005 | 4,080 | 16,867 | **24.19** | 140 | 10,944 | **1.28** | 227 | 8,421 | **2.69** |
| 2006 | 1,774 | 12,879 | **13.77** | 178 | 13,278 | **1.34** | 190 | 9,206 | **2.07** |
| 2007 | 2,090 | 13,751 | **15.20** | 175 | 15,903 | **1.10** | 197 | 10,790 | **1.83** |
| **Mean** | | | **28.05** | **Mean** | | **2.50** | **Mean** | | **2.87** |
| **S.D** | | | **18.96** | **S.D** | | **1.91** | **S.D** | | **0.99** |
| **C.V** | | | **67.58** | **C.V** | | **76.51** | **C.V** | | **34.46** |

(Source : Annual Reports & Websites of Concerned banks)

The above table no. 4.3 exhibits the ratio of non-performing loans to loans and advances of NBL, NABIL and SCBNL for five consecutive years. The figure represented in the above table no. 5 shows that NBL has the highest ratio through out the study period and also shows increasing trend. NABIL shows the least ratio during the study period. SCBNL is moderate in this ratio and shows decreasing trend. NABIL's and SCBNL's decreasing trend of NPL is the result of effective credit management of bank and its efforts of recovering bad debts through establishment of Recovery Cell. The overall ratio has been ranged from 1.10% of NABIL in 2007 to 60.47% of NBL in 2003. The mean non-performing loan to total loan ratio of NBL, NABIL & SCBNL are 28.05%, 2.50%, and 2.87% respectively. This ratio is significantly high of NBL in comparison to other two banks and portrays the critical condition of the banks. NBL has NPL very much higher than the acceptable standard of 10%. The average percentage of NPL to total loan of NABIL and SCBNL is below the prescribed standard.

The standard deviation of NBL, NABIL and SCBNL are 18.96, 1.91 & 0.99 and C.V.s are 67.58%, 76.51% & 34.46% respectively. (Appendix 3). Thus it signifies that SCBNL has the least deviation and also lower degree of variation in this ratio. Among the three banks, NABIL is moderate in terms of deviation but has higher degree of variability and NBL has the highest deviation but the moderate variability of ratio during the study period. Since NPL is one of the causes of banking crisis, NBL and even other two banks should give serious attention to this matter.

#### 4.1.4 Loan Loss Provision to Total Loans and Advances Ratio

This ratio describes the quality of assets in the form of loans and advances that a bank is holding. Since there is risk inherent in loans and advances, NRB has directed commercial banks to classify its loans into different categories and accordingly to make provision for probable loss. Loan loss provision signifies the cushion against future contingency created by the default of the borrower in payment of loans and ensures the continued solvency of the banks. Since high provision has to be made for non-performing loan, higher provision for loan loss reflects increasing non-performing loan in volume of total loans and advances. The low ratio signifies the good quality of assets in the volume of loans and advances. It indicates how efficiently it manages loan and advances and makes efforts to cope with probable loan loss. Higher ratio implies, higher portion of NPL in the total loan portfolio.

**Table No. 4.4**
**Loan Loss Provision to Loans & Advances (%)**

Rs. In Million

| Year (Mid July) | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| | LLP | Loans & Advances | Ratio (%) | LLP | Loans & Advances | Ratio (%) | LLP | Loans & Advances | Ratio (%) |
| 2003 | 10,161 | 18,132 | **56.04** | 358 | 8,114 | **4.41** | 304 | 6,000 | **5.07** |
| 2004 | 9,056 | 17,938 | **50.48** | 359 | 8,549 | **4.20** | 284 | 6,694 | **4.24** |
| 2005 | 8,648 | 16,867 | **51.27** | 361 | 10,944 | **3.29** | 278 | 8,421 | **3.30** |
| 2006 | 3,974 | 12,879 | **30.86** | 353 | 13,278 | **2.66** | 270 | 9,206 | **2.93** |
| 2007 | 2,383 | 13,751 | **17.33** | 350 | 15,903 | **2.20** | 288 | 10,790 | **2.67** |
| **Mean** | | | **41.20** | **Mean** | | **3.35** | **Mean** | | **3.64** |
| **S.D** | | | **16.47** | **S.D** | | **0.96** | **S.D** | | **0.99** |
| **C.V** | | | **39.97** | **C.V** | | **28.51** | **C.V** | | **27.29** |

(SOURCE : ANNUAL REPORTS & WEBSITES OF CONCERNED BANKS)

The above table no. 4.4 exhibits the ratio of loan loss provision to loans and advances of NBL, NABIL and SCBNL for five consecutive years. The figure represented in the above table no. 6 shows that NBL has the highest ratio through out the study period. NABIL shows the least ratio during the study period and SCBNL is moderate in loan loss provision ratio. The overall ratio has been ranged from 2.20% of NABIL in 2007 to 56.04% of NBL in 2003. The mean loan loss ratio of NBL, NABIL & SCBNL are 41.20%, 3.35%, and 3.64% respectively. This ratio of NBL is significantly high in comparison to other two banks. Higher LLP is indicative of poor and ineffective credit policy, higher proportion of non-performing asset and poor performance of the economy. Hence the greater ratio of NBL suggest that there is high proportion of NPL in the total loans and advances & decreasing trend of loan loss provision ratio of NABIL and SCBNL explains that both the has been successful to reduce its non performing loan resulting to decreasing LLP.

The standard deviation of NBL, NABIL and SCBNL are 16.47, 0.96 & 0.99 and C.V.s are 39.97%, 28.51% & 27.29% respectively (Appendix 3). Thus it signifies that NBL has higher deviation with higher degree of variation in this ratio. Among the three banks, NABIL is moderate in terms of variability and SCBNL has the least variability of ratio during the study period.

### 4.1.5 Provision Held to Non-Performing Loan Ratio

This ratio determines the proportion of provision held to non-performing loan of the bank. This ratio measures upto what extent of risk inherent in NPL is covered by the total loan loss provision. Higher ratio signifies that the banks are safeguarded against future contingencies that may create due to non-performing loan or in other words banks have cushion of provision to cope the problem that may be cause due to NPL. Hence higher the ratio better is the financial position of the bank.

**Table No. 4.5**
**Provision Held to Non-Performing Loan (%)**

Rs. In Million

| Year (Mid July) | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| | LLP | NPL | Ratio (%) | LLP | NPL | Ratio (%) | LLP | NPL | Ratio (%) |
| 2003 | 10,161 | 10,965 | **92.67** | 358 | 450 | **79.56** | 304 | 248 | **122.58** |
| 2004 | 9,056 | 4,773 | **189.73** | 359 | 274 | **130.73** | 284 | 242 | **117.36** |
| 2005 | 8,648 | 4,080 | **211.96** | 361 | 140 | **258.04** | 278 | 227 | **122.58** |
| 2006 | 3,974 | 1,774 | **224.06** | 353 | 178 | **197.95** | 270 | 190 | **141.87** |
| 2007 | 2,383 | 2,090 | **114.02** | 350 | 175 | **199.80** | 288 | 197 | **145.93** |
| **Mean** | | | **166.49** | **Mean** | | **173.21** | **Mean** | | **130.06** |
| **S.D** | | | **59.42** | **S.D** | | **69.09** | **S.D** | | **12.89** |
| **C.V** | | | **35.69** | **C.V** | | **39.88** | **C.V** | | **9.91** |

(Source : Annual Reports & Websites of Concerned banks)

The above table no. 4.5 exhibits the ratio of provision held to non-performing loan of NBL, NABIL and SCBNL for five consecutive years. The overall ratio has been ranged from 79.56% of NABIL in 2003 to 258.04% of NABIL in 2005. The mean ratio of NBL, NABIL & SCBNL are 166.49%, 173.21%, and 130.06% respectively This ratio of NABIL is significantly high in comparison to other two banks and portrays that the bank has adequate provision against non-performing loan but this ratio of SCBNL is comparatively lower.

The standard deviation of NBL, NABIL and SCBNL are 59.42, 69.09 & 12.89 and C.V.s are 35.69%, 39.88% & 9.91% respectively (Appendix 3). Thus it signifies that SCBNL has the lowest deviation along with the least degree of variation in this ratio. Among the three banks, NBL is moderate in terms of both deviation and variability and NABIL has the highest deviation and highest variability of ratio during the study period.

### 4.1.6 Return on loans and advances

This ratio indicates how efficiently the bank has employed its resources in the form of loans and advances. This ratio is calculated by dividing net profit of the bank by total loans and advances. Net profit refers to that profit which is obtained after all types of deduction like employee bonus, tax, provision etc. Hence this ratio measures bank's profitability with respect to loans and advances. Higher the ratio better is the performance of the bank.

**Table No. 4.6**
**Return on Loans & Advances (%)**

Rs. In Million

| Year (Mid July) | NBL | | | NABIL | | | SCBNL | | |
|---|---|---|---|---|---|---|---|---|---|
| | Net Profit (Loss) | Loans & Advances | Ratio (%) | Net Profit | Loans & Advances | Ratio (%) | Net Profit | Loans & Advances | Ratio (%) |
| 2003 | (252) | 18,132 | **(1.39)** | 416 | 8,114 | **5.13** | 507 | 6,000 | **8.45** |
| 2004 | (1,207) | 17,938 | **(6.73)** | 455 | 8,549 | **5.33** | 538 | 6,694 | **8.03** |
| 2005 | 1,730 | 16,867 | **10.26** | 520 | 10,944 | **4.75** | 536 | 8,421 | **6.37** |
| 2006 | 1,207 | 12,879 | **9.37** | 635 | 13,278 | **4.78** | 659 | 9,206 | **7.16** |
| 2007 | 418 | 13,751 | **3.04** | 686 | 15,903 | **4.31** | 692 | 10,790 | **6.41** |
| **Mean** | | | **2.91** | **Mean** | | **4.86** | **Mean** | | **7.28** |
| **S.D** | | | **7.20** | **S.D** | | **0.39** | **S.D** | | **0.94** |
| **C.V** | | | **247.26** | **C.V** | | **8.02** | **C.V** | | **12.90** |

(Source: Annual Reports & Websites of Concerned banks)

The above table no. 4.6 exhibits the ratio of return on loans and advances of NBL, NABIL and SCBNL for five consecutive years. The figure represented in the above table no. 7 shows that SCBNL has the highest ratio through out the study period except in year 2005 and 2006. NABIL is moderate in this ratio and shows decreasing trend. NBL is in loss in first two years but after that it is in profit during the study period. The overall ratio has been ranged from (6.73) % of NBL in 2004 to 10.26% of NBL in 2005. The mean ratio of NBL, NABIL & SCBNL is 2.91%, 4.86%, and 7.28% respectively. Since SCBNL's net profit is the highest among all the three banks, this ratio is also the highest.

The standard deviation of NBL, NABIL and SCBNL are 7.20, 0.39, &0.94 and C.V.s are 247.26%, 8.02% & 12.90% respectively (Appendix 3). Thus it signifies that NABIL has the least deviation with moderate degree of variation in this ratio. Among the three banks, SCBNL is moderate in terms of deviation & least in variability. NBL has the highest deviation with the highest variability of ratio during the study period. Thus it can be concluded that even though NBL has the highest exposure on loans and advances, the bank has failed to earn return on loans and advances.

Following figure no. 4.1, 4.2 & 4.3 represents five years Performing Loans, Non Performing Loans and Loan Loss Provision of NBL, NABIL & SCBNL.

**Figure No. 4.1**

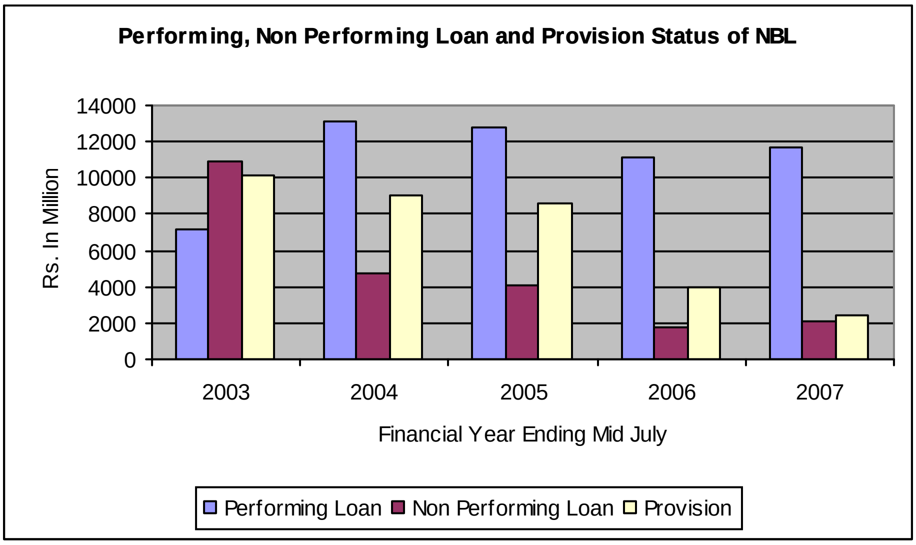


**Figure No. 4.2**

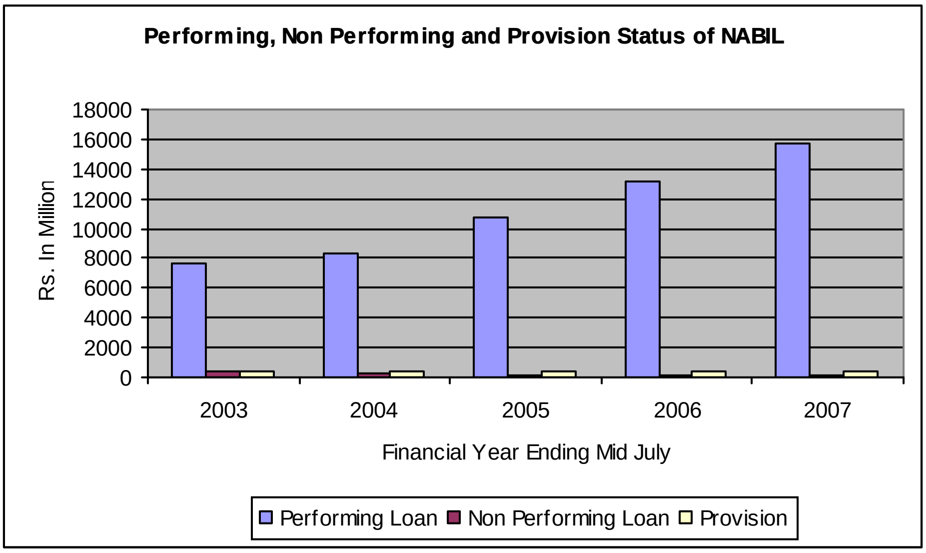
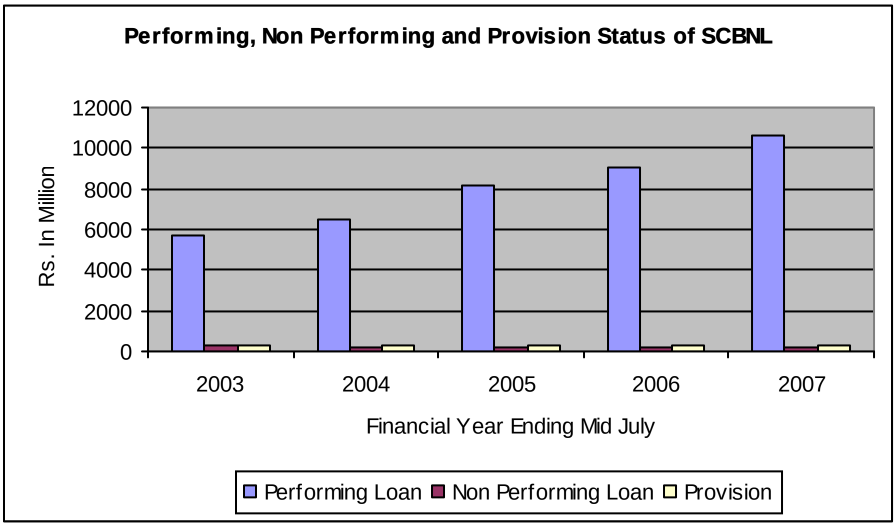



**Figure No. 4.3**




### 4.1.7 Analysis of Loan classification and Loan Loss Provisioning Directives

Nepal Rastra Bank, being central bank of Nepal issues and amends various directives regarding banking regulation from time to time in order to streamline the financial activities and rescue the banks from financial crisis. In 2001, NRB amended several old directives and issued many new circulars regarding banking regulation and operation. In this course the directive regarding loan classification and provisioning was also changed. As per old provision, which remained in force for about 10 years, the loans were to be categorized into two groups, namely large loans and small loans. All the loans below Rs 100,000 were regarded as small loans and rest as large loans. The classification of large loans were to be made in six categories on the basis of some clearly defined and some not so clearly defined parameters while small loans were categorized on the basis of period of past due. The directive was not clear where the borrower had wide fluctuation with respect to some financial indicators. In such case the borrower would qualify for different ratings under each indicator. Due to these difficulties the new loan classification and provisioning rule came in effect from July 16, 2001. The table no. 16 below presents the major changes brought by the new directives issued in 2001.

**Table No. 4.7**

**Comparative Table of Loan Classification and Provisioning**

| Area of Changes | Old Directive (Effective from March 22, 1991 to July 15, 2001) | New Directive (Effective from July 16, 2001 onwards) |
|---|---|---|
| Basis of classification | Classification to be made on the basis of ageing of past dues for small loans and on the basis of certain financial ratios for large loans. | Classification to be made on the basis of ageing of past dues for all loans. |
| Loan Categorization & Provisioning | Loans are to be classified into six categories with following percent provision.<br><br>**LoanCategory** — **Provision**<br>Good — 1%<br>Acceptable — 1%<br>Evidence of Substandard — 5%<br>Substandard — 25%<br>Doubtful — 50%<br>Bad — 100% | Loans are to be classified into four categories with following percent provision.<br><br>**Loan Category** — **Provision**<br>Pass — 1%<br>Substandard — 25%<br>Doubtful — 50%<br>Loss — 100% |
| Overdue Period | **Loan Category** — **Overdue Period**<br>Good — Not Overdue<br>Acceptable — upto 1 month<br>Evidence of Substandard — 1 to 6 months<br>Substandard — 6 mths to 1 yr.<br>Doubtful — 1 yr. to 5 yrs.<br>Bad — more than 5 yrs.<br><br>The period of overdue of each category of loan is longer. | **Loan Category** — **Overdue Period**<br>Pass — Not Overdue & Due upto 3 months<br>Substandard — 3 to 6 mths.<br>Doubtful — 6 mths to1 yr.<br>Loss — more than 1 yr.<br><br>The period of overdue of each Category of loan is shorter. |

Source : NRB Directives

The above table no.4.7 exhibits that the present directives of loan classification and provisioning is tighter than the previous one. Hence this leads to increment in loan loss provision requirement. However in the present context where Nepalese banking sector is severely affected by increasing non-performing loan, tightening loan loss provisioning requirements on loans and advances is essential to safeguards the banks from banking crisis and to ensure that the banks remain liquid even during economic downturns.

**Analysis of Classification of Loans and Provisioning as per New Directive**

As per the new directive, loans and advances are to be classified into four categories, namely Pass, Substandard, Doubtful & Loss with respective provisioning 1%, 25%, 50% % 100% on the basis of ageing of past dues. Besides this in case of insured priority and deprived sector loan, the provisioning requirement is one-fourth of that of normal loan loss provisioning requirement. Hence the respective provisioning requirement for Pass, Substandard, Doubtful & Loss Loan are 0.25%, 6.25%, 12.5% and 25% of the outstanding loan. In case of rescheduled or restructured or swapped loan, if such loans falls under Pass category, the minimum provisioning requirement is 12.5 % and if this is the case of priority sector loan, 3.125% provisioning should be provided for probable loss. Further if the loan is granted only against personal guarantee, where the loan falls under the category of Pass, Substandard and Doubtful, in addition to the normal Loan Loss Provision applicable for the category, an additional 20% must be provided. Hence in this case the provisioning required for Pass, Substandard and Doubtful is 21%, 45% and 70% respectively. Hence it can be concluded that Loan Loss Provision required for different category of loan ranges as follows:

| **Loan Category** | **Loan Loss Provision** (Ranges from) |
|---|---|
| Pass | 0.25% to 21.00% |
| Substandard | 6.25% to 25.00% |
| Doubtful | 12.50% to 50.00% |

Loss 25.00% to 100.00%

In addition to overdue basis, loans and advances have to be classified as Loss on the basis of other factors like CIB blacklisting, collateral value, misuse of fund, bankruptcy of the borrower etc. The loan falling under Pass category is termed as Performing loan and the loan falling under remaining three categories is termed as Non-performing loan. The LLP set aside for Performing Loan in defined as General Loan Loss Provision (GLLP) and LLP set aside for Non Performing Loan is defined as Specific Loan Loss Provision (SLLP). Besides this, if a bank provides any provision in excess of the proportion as required under the directives of NRB, the whole amount of such additional provision may be included in GLLP.

The new directive issued in 2001, regarding loan classification and provisioning was effective from fiscal year 2001/02.The data regarding loan classification and provisioning of three banks as per new directive, for mid July 2003 and mid July 2007 has been analyzed as follows.

**Table No. 4.8**

**Loan Classification and Provisioning of NBL**

Rs. In Million

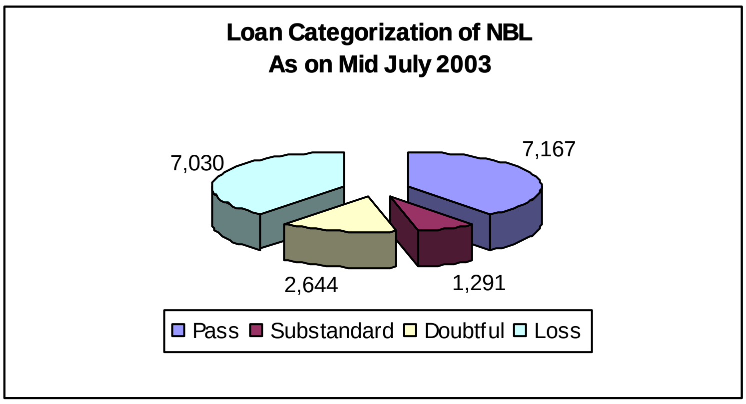
| | As on Mid July 2003 | | | | As on Mid July 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| **Particulars** | **Loan O/S** | **% of Total Loan** | **LLP** | **% of Total LLP** | **Loan O/S** | **% of Total Loan** | **LLP** | **% of Total LLP** |
| **Performing Loan** | **7,167** | **39.53** | **84** | **0.83** | **11,661** | **84.80** | **319** | **13.39** |
| Pass | 7,167 | 39.53 | 84 | 0.83 | 11,661 | **84.80** | 319 | **13.39** |
| | | | | | | | | |
| **Non Performing Loan** | **10,965** | **60.47** | **7,852** | **77.27** | **2,090** | **15.20** | **2,064** | **86.61** |
| Substandard (SS) | 1,291 | 7.12 | 298 | 2.93 | 17 | **0.12** | 5 | **0.21** |
| Doubtful (DF) | 2,644 | 14.58 | 760 | 7.48 | 29 | **0.21** | 15 | **0.63** |
| Loss | 7,030 | 38.77 | 6,794 | 66.86 | 2,044 | **14.86** | 2,044 | **85.77** |
| | | | | | | | | |
| **Additional Provision** | | | **2,225** | **21.9** | | | | |
| | | | | | | | | |
| **TOTAL** | **18,132** | **100** | **10,161** | **100** | **13,751** | **100** | **2,383** | **100** |

(Source : NBL & NRB)

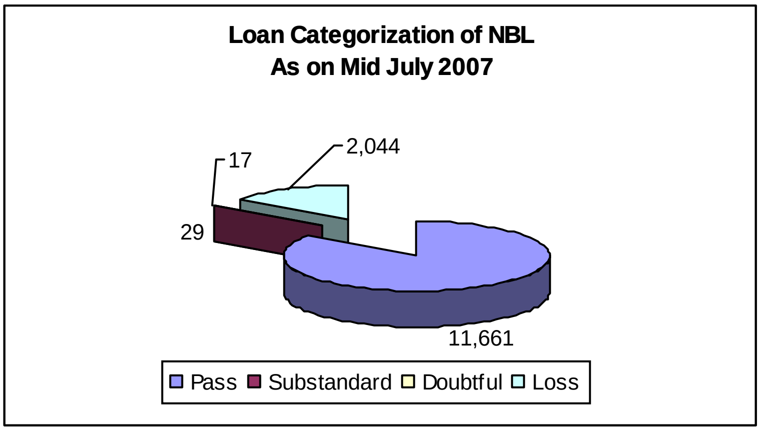
The above table no.4.8 shows different categories of loans and advances and the provision provided to each category of loans of NBL for the fiscal year 2002/03 and 2006/07. In 2003, the total loan outstanding of NBL was Rs 18,132 million out of which non-performing loan was Rs. 10,965. Out of total loan Pass, SS, DF & Loss loan comprises 39.53%, 7.12%, 14.58% & 38.77% respectively. Hence it is clear that 39.53% of total loan is performing and remaining 60.47% is non-performing. Besides this in 2003, NBL has the highest degree of Loss loans followed by DF loan and then SS loan in total NPL. Similarly out of total provision provided of Rs 10,161 million, out of which, Pass, SS, DF & Loss loan comprises 0.83%, 2.93%, 7.48% & 66.86% respectively. Besides this regular provision, additional of Rs 2,225 comprising 21.90% was also provisioned by the bank. Hence out of total LLP, GLLP comprises 22.73% and SLLP comprises remaining 77.27 %.

In 2007, the total loan outstanding of NBL has decreased to Rs 13,751 million and its non-performing loan has decreased to Rs. 2.383. Out of total loan Pass, SS, DF & Loss loan comprises 13.39%, 0.21%, 0.63% & 85.77% respectively. In 2007, Pass loan have increased but DF, SS & Loss loan has decreased. It signifies increasing asset quality of the bank but also it is higher than the standard. The higher proportion of Loss account in the total asset quality of the bank is also an indicative of the very critical condition of the bank. Similarly the total LLP of the bank has decreased to Rs 2,383 million, out of which, Pass, SS, DF & Loss loan comprises 13.39%, 0.21%, 0.63% & 85.77% respectively. Hence out of total LLP, GLLP comprises 13.39% and SLLP comprises remaining 86.61%. Following pie charts or figures no. 8 & 9 represents the loan categorization of NBL for two fiscal years.

**Figure No. 4.4**



## Figure No. 4.5




## Table No. 4.9

## Loan Classification and Provisioning of NABIL

Rs. In Million

| Particulars | As on Mid July 2003 | | | | As on Mid July 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Loan O/S | % of Total Loan | LLP | % of Total LLP | Loan O/S | % of Total Loan | LLP | % of Total LLP |
| **Performing Loan** | **7,664** | **94.45** | **123** | **34.36** | **15,725** | **98.88** | **249** | **71.14** |
| Pass | 7,664 | 94.45 | 123 | 34.36 | 15,725 | **98.88** | 249 | **71.14** |
| | | | | | | | | |
| **Non Performing Loan** | **450** | **5.55** | **235** | **65.65** | **178** | **1.12** | **101** | **28.86** |
| Substandard (SS) | 77 | 0.95 | 18 | 5.03 | 120 | **0.75** | 56 | **16.00** |
| Doubtful (DF) | 279 | 3.44 | 137 | 38.27 | 14 | **0.09** | 7 | **2.00** |
| Loss | 94 | 1.16 | 80 | 22.34 | 44 | **0.28** | 38 | **10.86** |
| **TOTAL** | **8,114** | **100** | **358** | **100** | **15,903** | **100** | **350** | **100** |

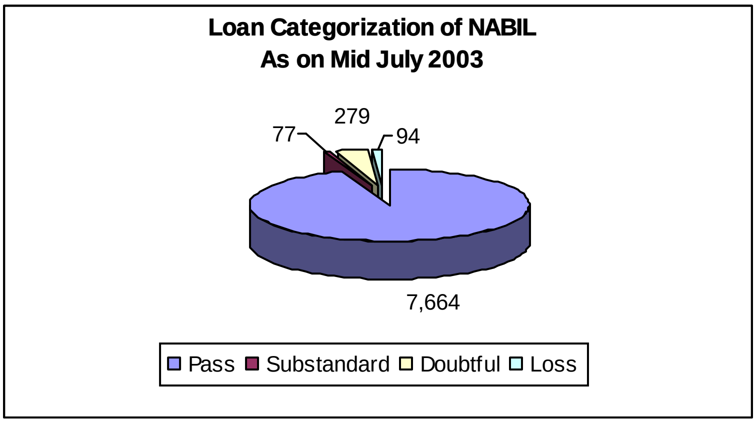
(Source : Annual Reports)

The above table no. 4.9 shows different categories of loans and advances and the provision provided to each category of loans of NABIL for the fiscal year 2002/03 and 2006/07. In 2003, the total loan outstanding of NABIL was Rs 8,114 million. Out of the total loan, pass, substandard, doubtful and loss loan comprises 94.45%, 0.95%, 3.44% & 1.16% respectively. Hence it is clear that 94.45% of total loan is performing and remaining 5.55% is non-performing. Besides this in 2003, NABIL has the highest degree of DF loans followed by Loss loan and then SS loan in total NPL. Similarly out of total provision provided of Rs 358 million, 34.36% comprises for pass loan and the provision provided for SS, DF & Loss loan comprises 5.03%, 38.27% & 22.34% respectively making provision for non-performing loan 65.65 % of total LLP. Hence it can be understood that the General LLP comprises 34.36% and Specific LLP comprises 65.65% of total LLP.

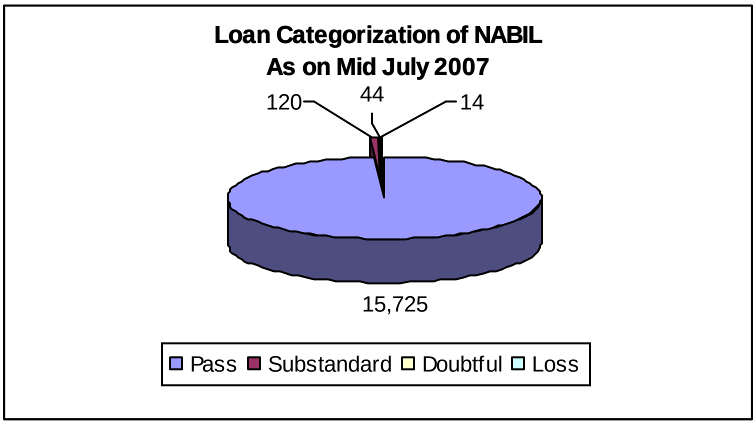
In 2007, the total loan outstanding of NABIL has increased to Rs 15,903 million. Out of total loan Pass, SS, DF & Loss loan comprises 98.88%, 0.75%, 0.09% & 0.28% respectively. In 2007, SS loan has increased but Pass, SS & Loss loan have decreased. Similarly out of total LLP of Rs 350 million, the respective % of Pass, SS, and DF & Loss loan is 71.14%. 16.00%, 2.00% and 10.86%. Hence out of total LLP, GLLP comprises 71.14% and SLLP comprises remaining 28.86%. The two years data shows that the proportion of all the categories of loans except Pass and SS loan has decreased. Accordingly provision amount has also increased in Pass and SS loan. In

2003, NABIL has the highest % of DF loan to total NPL but in 2007, it is SS loan. In 2003, NABIL has Rs. 450 million but in 2007 it is Rs 101 million which indicates the increasing asset quality of the bank. Following pie charts or figures no. 10 & 11 represents the loan categorization of NABIL for two fiscal years.

**Figure No. 4.6**



## Figure No. 4.7




## Table No. 4.10

## Loan Classification and Provisioning of SCBNL

Rs. In Million

| Particulars | As on Mid July 2003 | | | | As on Mid July 2007 | | | |
|---|---|---|---|---|---|---|---|---|
| | Loan O/S | % of Total Loan | LLP | % of Total LLP | Loan O/S | % of Total Loan | LLP | % of Total LLP |
| **Performing Loan** | **5,752** | **95.87** | **94** | **30.82** | **10,593** | **98.17** | **106** | **36.81** |
| Pass | 5,752 | 95.87 | 94 | 30.82 | 10,593 | **98.17** | 106 | **36.81** |
| | | | | | | | | |
| **Non Performing Loan** | **248** | **4.13** | **211** | **69.18** | **197** | **1.83** | **182** | **63.19** |
| Substandard | 7 | 0.12 | 2 | 0.66 | 16 | **0.15** | 4 | **1.39** |
| Doubtful | 130 | 2.16 | 98 | 32.13 | 66 | **0.61** | 63 | **21.88** |
| Loss | 111 | 1.85 | 111 | 36.39 | 115 | **1.07** | 115 | **39.93** |
| | | | | | | | | |
| **TOTAL** | **6,000** | **100** | **305** | **100** | **10,790** | **100** | **288** | **100** |

(Source : Annual Reports)

The above table no.4.10 shows different categories of loans and advances and the provision provided to each category of loans of SCBNL for the fiscal year 2002/03 and 2006/07. In 2003, the total loan outstanding of SCBNL was Rs 6,000 million. Out of the total loan, pass, substandard, doubtful and loss loan comprises 95.87%, 0.12%, 2.16% & 1.85% respectively. Hence it is clear that 95.87% of total loan is performing and remaining 4.13% is non-performing. Besides this in 2003, SCBNL has the highest degree of DF loans followed by Loss loan and then SS loan in the total NPL. Similarly out of total provision provided of Rs 305 million, 30.82% comprises for pass loan and the provision provided for SS, DF & Loss loan comprises 0.66%, 32.13% & 36.39% respectively making provision for non-performing loan 69.18 % of total LLP. Hence it can be understood that the General LLP comprises 30.82% and Specific LLP comprises 69.18% of total LLP.

In 2007, the total loan outstanding of SCBNL has increased to Rs 10,790 million. Out of total loan Pass, SS, DF & Loss loan comprises 98.17%, 0.15%, 0.61% & 1.07% respectively. In 2007, the entire loan has increased except DF Loan. Similarly out of total LLP of Rs 288 million, the respective % of Pass, SS, and DF & Loss loan is 36.81%, 1.39%, 21.88% and 39.93%. Hence out of total LLP, GLLP comprises 36.81% and SLLP comprises remaining 63.19%. As non performing loan has decreased accordingly provision amount has also decreased. Following pie charts or figures no. 12 & 13 represents the loan categorization of SCBNL for two fiscal years.

**Figure No. 4.8**

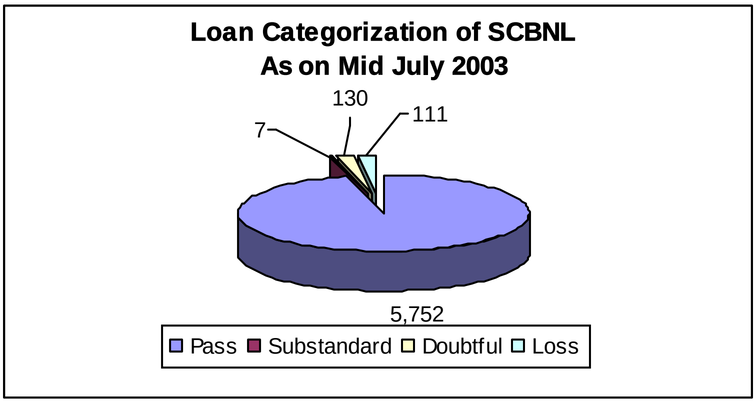
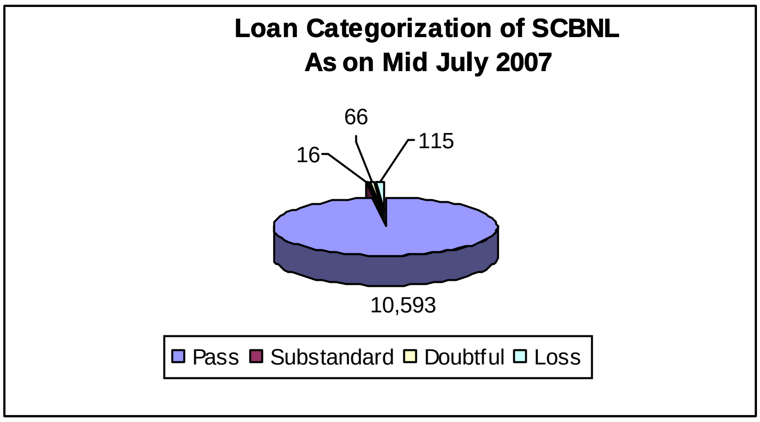



**Figure No. 4.9**



**Effect on profitability**

Latest Loan Loss Provision norm have a great impact on profitability of the banks. As earlier mentioned, Loan Loss Provision is deducted from the profit of the bank. Therefore the net profit of the bank will come down by the amount of provision. Hence increase in LLP means lesser net profit resulting to less Earning Per Share (EPS), less Dividend Per Share (DPS) or no dividend at all and finally lower Market Value Per Share (MVPS). If any banks make profit less than the amount of provision to be made, it may have to show losses in the balance sheet. For instance the LLP of NBL, NABIL & SCBNL as on mid July 2007 is Rs 2,383 million, Rs 350 million & Rs 288 million respectively. Hence the net profit of NABIL & SCBNL is reduced by the respective provisioned amount.

However, the impact of Loan Loss Provision on profitability of banks is of short term. After few years, when banks have enough provision for loss loans & have sound credit management, the profitability will again pick up. Hence in long term

basis banks will enjoy greater cushion against loan disbursed and improve their financial strength leading to increased profitability.

## 4.2 Statistical Analysis

### 4.2.1 Correlation

#### 4.2.1.1Correlation Between Loan Loss Provision and Loans and Advances

The correlation between LLP and loans and advances shows the degree of relationship between these two items. How a unit increment in loans and advances affect the loan loss provision is measured by this correlation. Here loans and advances is independent variable and LLP is dependent variable.

**Table No. 4.11**

**Correlation between LLP and Loans and Advances**

| Banks | Correlation Coefficient (r) | Probable Error (P.E.) | 6 * P.E |
|---|---|---|---|
| **NBL** | 0.9510 | 0.0288 | 0.1728 |
| **NABIL** | (0.8563) | 0.0805 | 0.4830 |
| **SCBNL** | (0.4904) | 0.2291 | 1.3746 |

Above table no. 4.11 explains the relationship between loans and advances and LLP.(Appendix 4) Here the correlation coefficient of NBL is 0.9510 and it is more than 6 times the value of its P.E. and even more than P.E., the correlation coefficient is significant. In other words, the total LLP of NBL is correlated with the loans and advances during the study period. The correlation coefficient is positive as the loans and advances are decreasing and also LLP is decreasing due to decrease in non-performing loan of NBL. The correlation coefficient of NABIL is -0.8563 and its P.E. is 0.0805 and 6P.E. is 0.4830. Since r is less than P.E. and also less than 6 P.E., there is negative correlation between LLP and loans and advances of NABIL. So, correlation coefficient is said to be insignificant. It is due to increasing trend in loan and advances and decreasing trend in LLP because of decrease in NPL. The correlation coefficient of SCBNL is -0.4904 and it is less than P.E. and also less than six times the value of P.E.. Hence there is negative correlation between LLP and Loans and advances of SCBNL and its correlation coefficient is insignificant. This is due to increasing trend in loan and advances and decreasing trend in LLP due to decrease in NPL.

### 4.2.1.2 Correlation between Loan Loss Provision and Non Performing Loan

The correlation between LLP describes the relationship between LLP and NPL. How a unit increases in NPL effect the LLP is exhibited by this correlation. Here non-performing loan is independent variable and LLP is dependent variable. As earlier mentioned NPL are the loan falling on the category of Substandard, Doubtful and Loss loan and the respective provisioning requirement is 25%, 50% and 100%. Higher the NPL higher will be the provisioning amount.

**Table No. 4.12**
**Correlation between Loan Loss Provision and Non Performing Loan**

| Banks | Correlation Coefficient (r) | Probable Error (P.E.) | 6 * P.E |
|---|---|---|---|
| **NBL** | 0.7817 | 0.1173 | 0.7038 |
| **NABIL** | 0.2890 | 0.2765 | 1.659 |
| **SCBNL** | 6280 | 0.1827 | 1.0962 |

Above table no. 4.12 explains the relationship between LLP and NPL. (Appendix 4) Here all the three banks have positive correlation between LLP and NPL. That means increment in NPL leads to increment in LLP. The correlation coefficient of NBL is 0.7817 and its P.E and 6P.E are 0.1173 and 0.7038. Since correlation coefficient (r) is greater than 6 times the value of P.E., the correlation coefficient is significant and reliable. In other words, the total LLP of NBL is highly correlated with the non performing loan during the study period and the increase in LLP of NBL is due to increase in NPL for the bank. The correlation coefficient of NABIL is 0.2890 and its P.E. is 0.2765 and 6P.E. is 1.659. In case of NABIL r is less than 6 times the value of P.E. but greater than the P.E. Hence its correlation coefficient is said to be insignificant and there is high degree of positive correlation between LLP and NPL on NABIL .The correlation coefficient of SCBNL is 0.6280 .It is less than six times the value of P.E. but higher than the value of P.E. Hence there is positive correlation between NPL and LLP of SCBNL but the correlation coefficient is not significant. From this also we can understand that NBL has high degree of NPL in comparison to SCBNL and NABIL.

#### 4.2.1.3 Correlation between Loans and advances and Deposit

Deposit is one of the major items of liability side and loans and advances is the major item of asset side of balance sheet of any commercial bank. Bank's disburses loans and advances through the funds received from the depositors. The correlation coefficient between loans and advances and deposit describes the degree of relationship between these two variables. Here deposit is independent variable and loans and advances is dependent variable. Hence how a unit increase in deposit impact in the volume of loans ad advances is exhibited by this correlation coefficient.

**Table No.4.13**
**Correlation between Loans and Advances and Deposit**

| Banks | Correlation Coefficient (r) | Probable Error (P.E.) | 6 * P.E |
|---|---|---|---|
| **NBL** | -0.5785 | 0.2007 | 1.2041 |
| **NABIL** | 0.9672 | 0.0195 | 0.1168 |
| **SCBNL** | 0.8257 | 0.0960 | 0.5760 |

The above table no. 4.13 shows the correlation coefficient, probable error and six times the value of P.E. of three banks (Appendix 4). It shows there is positive correlation between loans and advances and deposit in NABIL and SCBNL but negative correlation in NBL. The respective values of correlation coefficient of NABIL and SCBNL are 0.9672 and 0.8257, which are greater than 6 times the value of their respective probable error. Hence it can be interpreted that the correlation between these two variables in NABIL & SCBNL is certain and significant. That means increase in volume of deposit leads to increment in loans and advances of NABIL & SCBNL. However the deposit and loans and advances in SCBNL has lesser degree of relationship in comparison to NABIL. The correlation coefficient of NBL is –0.5785 with P.E. 0.2007 and 6 times the value of P.E., 1.2041. Since correlation coefficient of NBL is less than six times the value of P.E. and even less than the value of P.E, there is no evidence of correlation and the correlation coefficient is insignificant. The main reason behind this is, NBL's deposit is increasing but its loans and advances are decreasing, as NBL has no further investment in the form of loans and advances

### 4.2.2 Trend Analysis

Trend analysis is a statistical tool, which helps to forecast the future values of different variables on the basis of past tendencies of variable. Trend analysis informs about the expected future values of various variables. Amongst the various methods to determine trend the least square method is widely used in practices. Hence in this study also least square method has been adopted to measure the trend behaviors of these selected banks. However, trend analysis is based on the assumption that past tendencies continues in the future. Under this heading the effort has been made to calculate trend values of following variables from mid July 2003 to mid July 2007 and forecast is done for next five years from mid July 2008 to mid July 2012.

#### 4.2.2.1 Trend Analysis of Loans and Advances

The values of average loans and advances (a), rate of change of loans and advances (b) and trend values of loans and advances of three banks for 10 years from mid July 2003 to mid July 2012 are as follows :( Appendix 5)

**Table No. 4.14**
**Trend Values of Loans & Advances**

Rs. In Million

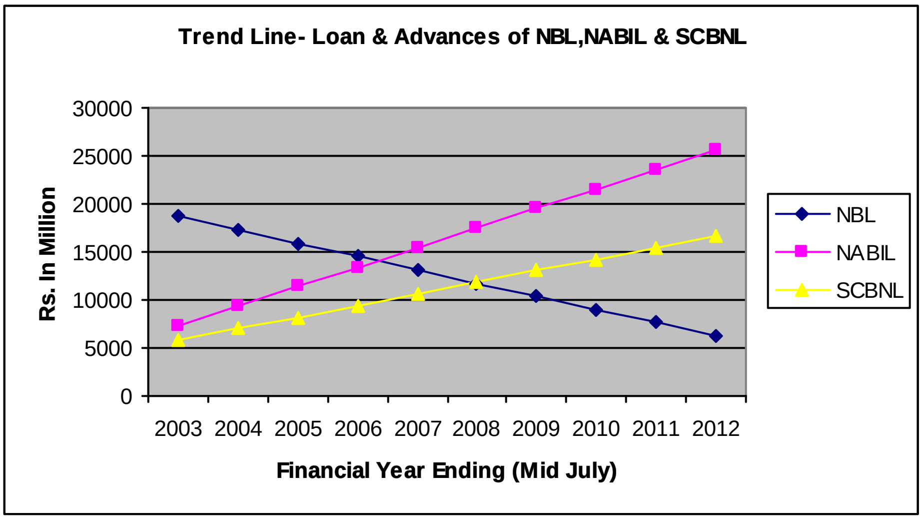
| Years (Mid July) | Banks | | |
|---|---|---|---|
| | NBL<br>a = 15,913.40<br>b = (1,382.10) | NABIL<br>a= 11,357.60<br>b=2,030.70 | SCBNL<br>a= 8,222.20<br>b= 1,209.20 |
| 2003 | 18678 | 7296 | 5804 |
| 2004 | 17296 | 9327 | 7013 |
| 2005 | 15913 | 11358 | 8222 |
| 2006 | 14531 | 13388 | 9431 |
| 2007 | 13149 | 15419 | 10641 |
| 2008 | 11767 | 17450 | 11850 |
| 2009 | 10385 | 19480 | 13059 |
| 2010 | 9003 | 21511 | 14268 |
| 2011 | 7621 | 23542 | 15477 |
| 2012 | 6239 | 25573 | 16687 |

The above table no. 4.14 shows that NBL has decreasing trend but NABIL and SCBNL have increasing trend of loans and advances. The average loans and advances of NBL is Rs 15,913.40, which is decreasing at the rate of Rs 1,382.10 million every year. Loans and advances are expected to decrease from Rs 13,149 in 2007 to Rs 6,239 million in 2012. NABIL's average loans and advances is Rs 11,357.60 and are increasing every year at the rate of Rs

2,030.70 million and that of SCBNL at the rate of Rs 1,209.20 million each year. Hence the expected loans and advances of NABIL are supposed to increase from Rs 15,419 in 2007 to Rs 25,573 million in 2012. The average loans and advances of SCBNL is Rs 8,222.20 million, which is increasing every year at the rate of Rs 1,209.20 million. Accordingly loans and advances of SCBNL is expected to be increase from Rs 10,641 million in 2007 to Rs 16,687 million in 2012.

As NBL is suffering from the problems of bad debts, they are concentrating more on recovering bad debts than the further investment in the form of loans and advances. Hence its loans and advances show decreasing trend. Even though NABIL and SCBNL shows increasing trend, rate of increment of NABIL is higher than that of SCBNL. From this it can be interpreted that SCBNL has policy of low investment in loans and advances. Following figure no. 4 represents the trend line of Loans & Advances of three banks for 10 consecutive years.

**Figure No. 4.10**




### 4.2.2.2 Trend Analysis of Non-Performing Loan

The calculated values of average Non Performing Loan (a), rate of change of NPL(b) and trend values of NPL for 10 years from mid July 2003 to mid July 2012 are as follows : (Appendix 5)

**Table No.4.15**
**Trend Values of Non-Performing Loan**

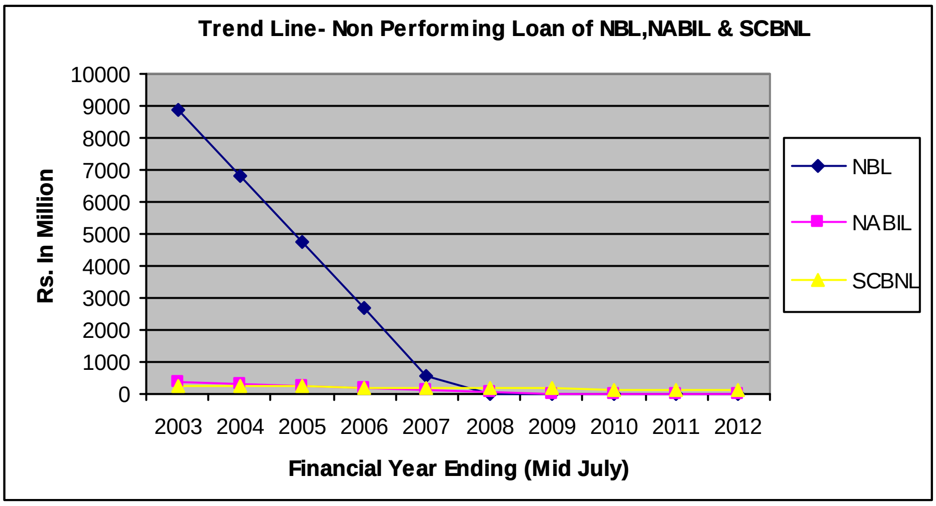
Rs. In Million

| Years (Mid July) | Banks | | |
|---|---|---|---|
| | **NBL a = 4,736.40 b = (2,074.90)** | **NABIL a = 243.40 b = (64.60)** | **SCBNL a = 220.80 b = (15.40)** |
| 2003 | 8886 | 373 | 252 |
| 2004 | 6811 | 308 | 236 |
| 2005 | 4736 | 243 | 221 |
| 2006 | 2662 | 179 | 205 |
| 2007 | 587 | 114 | 190 |
| 2008 | (1448) | 50 | 175 |
| 2009 | (3563) | (15) | 159 |
| 2010 | (5638) | (80) | 144 |
| 2011 | (7713) | (144) | 128 |
| 2012 | (9787) | (209) | 113 |

The above no. 4.15 table shows that all the three banks have decreasing trend of NPL. The average NPL of NBL is Rs 4,736.40, which is decreasing at the rate of Rs 2,074.90 million every year. NPL is expected to decrease from Rs 587 million in 2007 to Rs (9787) million in 2012. NBL is concentrating more on recovering bad debts than the further investment in the form of loans and advances, so its rate of decreasing of NPL is higher. After the certain period the decreasing rate may decrease and the NPL may not be zero. NABIL's average NPL is Rs 243.40, which is decreasing every year at the rate of Rs 64.60 million. Hence the expected NPL of NABIL is supposed to decrease from Rs 114 million in 2007 to Rs (209) million in 2012. The average NPL of SCBNL is Rs 220.80 million, which is decreasing every year at the rate of Rs 15.40 million. Accordingly NPL of SCBNL is expected to decrease from Rs 175 million in 2007 to Rs 113 million in 2012.

NBL has significantly high non-performing loan in the total volume of loans and advances bur its rate of decrease is also very high. If this trend continues, it would able to decrease its NPL dramatically. Due to NABIL's recovery efforts through establishment of Recovery Cell; its NPL has come down in recent years. Hence NABIL shows decreasing trend of NPL. Before few years NPL of SCBNL was relatively lower than that of other two banks, but in the recent years NABIL has the lower NPL. Following figure no. 5 represents the trend line of Non Performing Loan of three banks for 10 consecutive years.

**Figure No. 4.11**




### 4.2.2.3 Trend Analysis of Loan Loss Provision

The calculated values of average Loan Loss Provision (a), rate of change of LLP (b) and trend values of LLP for 10 years from mid July 2003 to mid July 2012 of the three banks are as follows (Appendix 5) :

**Table No. 4.16**
**Trend Values of Loan Loss Provision**

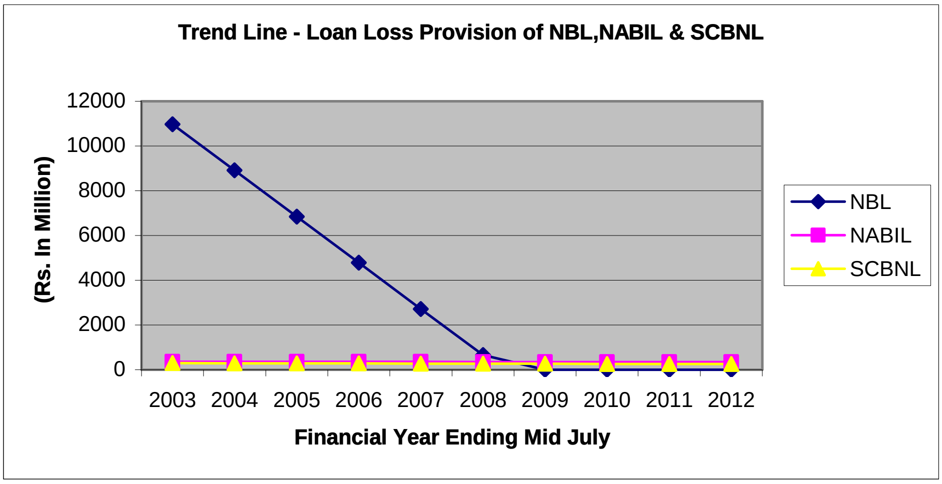
Rs. In Million

| Years (Mid July) | Banks | | |
|---|---|---|---|
| | NBL a = 6,844.40 b =(2,063.80) | NABIL a = 356.20 b = (2.20) | SCBNL a = 284.80 b =(4.60) |
| 2003 | 10972 | 361 | 294 |
| 2004 | 8908 | 358 | 289 |
| 2005 | 6844 | 356 | 285 |
| 2006 | 4781 | 354 | 280 |
| 2007 | 2717 | 352 | 276 |
| 2008 | 653 | 350 | 271 |
| 2009 | (1411) | 347 | 266 |
| 2010 | (3475) | 345 | 262 |
| 2011 | (5538) | 343 | 257 |
| 2012 | (7602) | 341 | 253 |

The above table no. 4.16 shows that all the three banks has decreasing trend of LLP. The average LLP of NBL is Rs 6,844.40, which is decreasing at the rate of Rs 2,063.80 million every year. LLP of NBL is expected to decrease from Rs 2,717 in 2007 to Rs (7602) million in 2012. NABIL's average LLP is Rs 356.20, which is decreasing every year at the rate of Rs 2.20 million. Hence the expected LLP of NABIL is supposed to decrease from Rs 352 million in 2007 to Rs 341 million in 2012. The average LLP of SCBNL is Rs 284.80 million, which is decreasing every year at the rate of Rs 4.60 million. Accordingly LLP of SCBNL is expected to decrease from Rs 276 million in 2007 to Rs 253 million in 2012.

NBL is concentrating to recover the bad debt and decrease the amount of NPL. Its decreasing rate of LLP is very high. As shown on the above table no 14 the LLP amount of NBL is expected to be in negative figures after 2009. But it is not possible because according to the rule of Nepal Rastra Bank the provision should be done in every loan either they are good or bad. NABIL's and SCBNL's decreasing trend of LLP shows that they are successful in reducing the non-performing loans of the bank. Following figure no. 6 represents the trend line of Loan Loss Provision of three banks for 10 consecutive years.

**Figure No. 4.12**



#### 4.2.2.4 Trend Analysis of Net Profit

The calculated values of average Net Profit (a), rate of change of Net Profit (b) and trend values of Net Profit for 10 years from mid July 2003 to mid July 2012 of the three banks are as follows (Appendix 5) :

**Table No. 4.17**
**Trend Values of Net Profit**

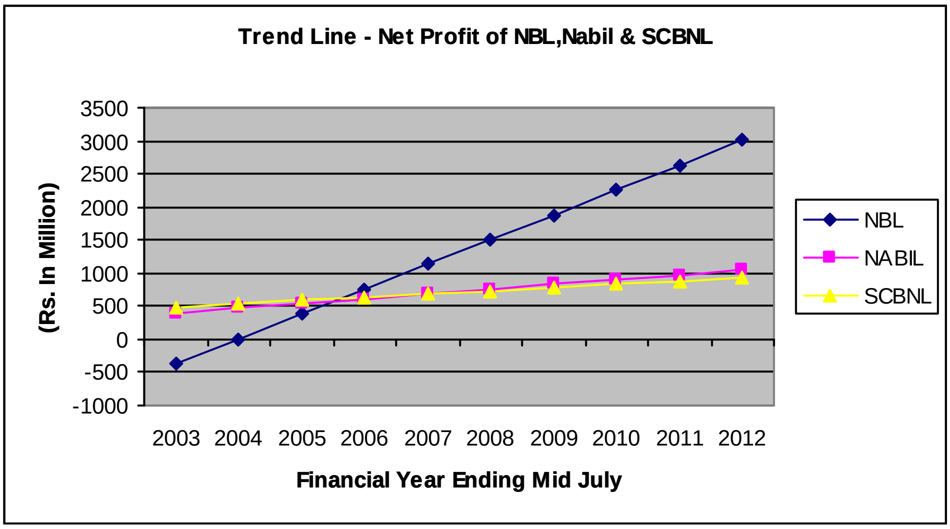
Rs. In Million

| Years (Mid July) | Banks | | |
|---|---|---|---|
| | **NBL a = 379.20 b = 375.40** | **NABIL a = 542.40 b = 72.00** | **SCBNL a = 586.40 b = 49.10** |
| 2003 | -372 | 398 | 488 |
| 2004 | 4 | 470 | 537 |
| 2005 | 379 | 542 | 586 |
| 2006 | 755 | 614 | 636 |
| 2007 | 1130 | 686 | 685 |
| 2008 | 1505 | 758 | 734 |
| 2009 | 1881 | 830 | 783 |
| 2010 | 2256 | 902 | 832 |
| 2011 | 2632 | 974 | 881 |
| 2012 | 3007 | 1046 | 930 |

The above table no. 4.17 shows that all the three banks have increasing trend of Net Profit. NBL's average NP is Rs. 379.20, which is increasing every year at the rate of Rs. 375.40. Hence the expected NP of NBL is supposed to increase from Rs 1,130 million in 2007 to Rs 3,007 million in 2012. NABIL's average NP is Rs 542.40 million, which is increasing every year at the rate of Rs 72.00 million. Hence the expected NP of NABIL is supposed to increase from Rs 686 million in 2007 to Rs 1,046 million in 2012. The average NP of SCBNL is Rs 586.40 million, which is increasing every year at the rate of Rs 49.10 million. Accordingly NP of SCBNL is expected to increase from Rs 685 million in 2007 to Rs 930 million in 2012.

The above figures depicts that NABIL is ahead in generating net profit and its rate of increment of net profit is higher than that of SCBNL. But in the actual SCBNL is generating more profit than the NABIL. It is due to huge fluctuation in the profit of NABIL. However among the three banks, NBL has the highest growth rate and it seems to be abnormal, it due to write back of Loan Loss Provision. Following figure no. 7 represents the trend line of Net Profit of three banks for 10 consecutive years.

**No. 4.13**




## 4.3 Analysis of Questionnaire

The questionnaire was distributed to the concerned department's employees of NABIL, NBL & SCBNL. The questionnaire was distributed to 20 individuals but there were only 18 respondents. After collecting the questionnaire they were tabulated in simple form. For each question the responses were converted to percentage based on the total number of respondents. From the percentage analysis of questionnaire following results were derived.

### Question Number 1

When asked about the importance of the directives related to loan classification and provisioning, 100% of the respondents agreed that the directives are very important.

### Question Number 2

When asked about whether present directive regarding loan classification and provisioning is appropriate and better than the previous one, 94% of the respondent believe that it is better than the previous one while 6% believe previous one is better.

**Question Number 3**

When asked about the impact of new directives on provision for loan loss of commercial bank, 100% of the respondents are of the view that newly issued directives regarding loan classification and provisioning will increase the provision for loan loss.

**Question Number 4**

When asked about the impact of new directives regarding loan classification & provisioning of on the credit exposure of the bank, 61% of the respondents are of the view that there will be no impact on credit exposure but 34 % believe that the credit exposure of the bank will decrease.

**Question Number 5**

When asked about the effect of present loan classification & provisioning directive on the shareholders of the bank, 100% of the respondents think that they shareholders will enjoy lesser dividend and will have their EPS decreased however everyone believes that it is only for short term.

**Question Number 6**

In this question it was asked how the new directive would affect the three factors of the banks, Liquidity, Profitability & Operational Procedure. 94% of the respondents were of the view that, Liquidity & Profitability would decrease and Operational Procedure would increase but remaining 6% were of the view that there would be no effect on all these three factors.

**Question Number 7**

This question was posed mainly to find out which alternative the banks are pondering to cope the problem brought about by the amendment in loan loss provisioning directive. 100% of the respondents said that, they would control credit disbursal by being more stringent and would strengthen the monitoring and follow-up procedures

**Question No. 8**

When asked about to what extent today's banking industry is effected by problem of NPA, 89% of the respondents were of the view that it is severely affected while 11% were of the view that today's banking industry is moderately affected by the problem of NPA.

**Question Number 9**

When asked about the best measure to resolve the problem of NPL, everyone i.e 89% respondents were of the view that setting up a recovery cell is the best measure to confront the problem on NPL while 11% were of the view that hiring Asset Management Company is the best measure.

**Question Number 10**

When asked to rate the major factors leading to NPL. 67% percent believed that it's due to Improper Credit Appraisal System & Ineffective Credit Monitoring & Supervision, followed by 33 % have a say that it's because of economic slowdown & Borrower's Misconduct but there are no respondent found who gave priority for Political Pressure to lend to uncreditworthy borrowers & others.

In overll,94 % of the respondent rated as below:

1. Improper Credit Appraisal System
2. Ineffective Credit Monitoring & Supervision
3. Economic Slowdown
4. Borrower's Misconduct
5. Political Pressure to lend to uncreditworthy borrowers

## 4.4 Major Findings of the Study

From the analysis of data, following major findings have been obtained.

The average loans and advances to total asset ratio of NBL, NABIL & SCBNL during the study period is found to be 38.03%, 56.17% and 33.54% respectively. The relatively low ratio of SCBNL is the indication of risk adverse attitude of the management or they have the policy of investing low in the risky assets i.e. loans and advances. They have higher proportion of their investment in risk free or nominally risky asset like treasury bills, National Saving Bonds etc. Here this ratio is the highest of NABIL. NABIL shows the highest degree of deviation while SCBNL has the highest degree of variation through out the study. NBL is moderate in terms of the ratio, its deviation and variability.

The core banking function is to mobilize the funds obtained from the depositors and how successfully this function have been discharged by the banks is measured by the ratio of loans and advances to total deposit ratio or simply CD ratio. The average CD ratio of NBL, NABIL and SCBNL during the study period is found to be 44.02%, 66.53% & 38.18% respectively. The average ratio of NABIL is highest followed by NBL and then SCBNL. NABIL has the most consistent and least deviated ratio during the study period whereas NBL has higher deviation and variability in this ratio. SCBNL is moderate among the three banks in terms of deviation and variability of ratio.

The analysis of non-performing loans to total loans revealed that, average NPL of NBL, NABIL & SCBNL is 28.05%, 2.50% & 2.87% of total loan respectively. That means 71.95%, 97.50% & 97.13% of total loan of NBL, NABIL & SCBNL is performing loan. Hence NBL has significantly higher proportion of the non-performing loan in the total loans portfolio but this ratio shows decreasing trend, due to hiring the new management team and giving priority to recovery. NABIL, in recent years has shown significant decrement in NPL, which is the result of banks effective credit management and its efforts of recovering bad debts through establishment of Recovery Cell. During the study period this ratio is the least in NABIL. SCBNL is moderate in terms of CD ratio and it is in decreasing trend. SCBNL has the least deviation and NABIL has highest variation whereas NBL has highest deviation and is moderate in variation through out the study period.

Loan Loss Provision ratio of NBL is found to be significantly higher which is around 41.20% in average, followed by SCBNL of 3.64% and NABIL of

3.359%. Since higher ratio is an indication of higher non-performing loan in the total loans and advances NBL's relatively higher ratio is the result of higher proportion of NPL in the total loan. SCBNL's and NABIL's average ratio is around similar in this ratio which means both of the bank's asset quality is improving. NBL has the highest deviation and variation of the ratio.

The average ratio of provision held to non-performing loan of NBL, NABIL & SCBNL was found to be 166.49%, 173.21% & 130.06% respectively. Hence NABIL has significantly higher ratio in comparison to other two banks, which portrays that the bank has adequate provision against non-performing loan but this ratio of SCBNL is comparatively lower. NABIL shows the highest deviation and variability in this ratio followed by NBL and then SCBNL.

The main objective of commercial banks is to earn profit through mobilization of fund. The ratio of returns on loans and advances ratio revealed that NBL seems to be failure to earn return on loans and advances. Eventhough NBL has higher investment in the most income-generating asset i.e. loans and advances, it was in loss since last many years. The average return on loans and advances is 2.91%. SCBNL with an average of 7.28% return on loans and advances has the highest ratio as it is ahead in generating net profit. NABIL is moderate with an average of 4.86% return on loans and advances. NBL has the highest variability followed by SCBNL and then NABIL.

The correlation coefficient between LLP and loans and advances of NBL, NABIL & SCBNL is 0.9510, -0.8563 and -0.4904. Since higher provision has to be provided for non-performing loan, the positive correlation of NBL is the result of high non-performing loans in the total loan portfolio. But it is in decreasing trend due to the effect of giving priority to recover the bad loans. NABIL and SCBNL have negative correlation between LLP and loans and advances but it is more than the 6times P.E. This is due to low proportion of NPL in the total loan portfolio and its decreasing trend.

The correlation between LLP and NPL reveals that there is positive correlation between LLP and NPL in all the three banks. As earlier mentioned higher provision needs to be provided for NPL, higher the NPL higher would be the LLP. The correlation coefficient between these two variables in NBL, NABIL & SCBNL is 0.7817, 0.2890 and 0.6280. The correlation coefficient of NBL is significant but that of NABIL and SCBNL is insignificant. The reason behind this is relatively lower proportion of NPL in the total loan portfolio of NABIL and SCBNL.

While analyzing correlation between loans and advances and deposit, it has been found that NABIL & SCBNL have of positive correlation between these two variables but NBL has negative correlation coefficient. The respective correlation coefficient of NABIL & SCBNL is 0.9672 & 0.8257, which is significant and reliable. In recent years, NBL is concentrating on loan recovery and there was no further investment of the bank in the form of loans and advances but deposits are increasing.

Trend analysis was done based on the data of past five years and forecast was made for next five years. The trend of loans and advances showed decreasing trend in NBL and increasing trend in regards to NABIL & SCBNL but rate of increment of NABIL is higher that than that of SCBNL.  The loans and advances of NBL is decreasing at the rate of Rs 1,382.10 million every year and that of NABIL & SCBNL is increasing at the rate of Rs 2,030.70 million and Rs. 1,209.20 million every year respectively.

From the trend analysis of NPL, it is found that NPL is decreasing in case of all the three banks. The NPL of NBL is decreasing at the rate of Rs 2,074.90 million every year and that of NABIL & SCBNL is decreasing at the rate of Rs 64.60 million and 15.40 million every year respectively. The decreasing trend of NPL in NABIL and SCBNL is due to its efforts towards recovering bad debts. But in case of NBL is due to its effort towards recovering bad debts and there was no further investment of the bank in the form of loans and advances.

From the trend analysis of LLP, it is found that LLP is expected to increase in coming years in case of all the three banks. The LLP of NBL, NABIL and

SCBNL is decreasing at the rate of Rs 2,063.80, Rs. 2.20 and Rs. 4.60 million every year respectively. The decreasing trend of LLP in all the three banks is due to their recovery efforts towards reducing NPL.

From the trend analysis of Net Profit, it is found that NP is expected to increase in coming years in all the three banks. NBL shows increment of net profit at the rate of Rs 375.40 million each year. Similarly Net Profit of NABIL & SCBNL is increasing every year by Rs 72.00 million and Rs 49.10 million respectively. As NBL has high rate of increment, if this trend is to continue, NBL would soon surpass NABIL & SCBNL in providing net profit.

As per the latest directive, loans and advances are to be classified into four categories, namely Pass, Substandard, Doubtful & Loss with respective provisioning 1%, 25%, 50% % 100% on the basis of ageing of past dues. Besides this in case of insured priority and deprived sector loan, the provisioning requirement is one-fourth of that of normal loan loss provisioning requirement. Hence the respective provisioning requirement for Pass, Substandard, Doubtful & Loss Loan are 0.25%, 6.25%, 12.5% and 25% of the outstanding loan. In case of rescheduled or restructured or swapped loan, if such loan falls under Pass category, the minimum provisioning requirement is 12.5 % and if this is the case of priority sector loan, 3.125% provisioning should be provided for probable loss. Further if the loan is granted only against personal guarantee, the provisioning required for Pass, Substandard and Doubtful is 21%, 45% and 70% respectively.

From the analysis of loan classification and provisioning of NBL it has been found that out of total loan Pass, Substandard, Doubtful & Loss loan comprises 39.53%, 7.12%, 14.58% & 38.77% respectively in mid July 2003 & that of mid July 2007 is 13.39%, 0.21%, 0.63% & 85.77%. NBL has the highest proportion of Loss loans followed by Doubtful and then substandard loan out of NPL which is an indication of bad quality of asset of NBL. It has also been found that in besides the regular provisioning requirement; NBL has also provided additional provision of Rs 2,225 million in 2003.

From the analysis of loan classification and provisioning of NABIL, it has been found that out of total loan Pass, Substandard, Doubtful & Loss loan comprises 94.45%, 0.95%, 3.44% & 1.16% respectively in mid July 2003 & that of mid July 2007 is 98.88%, 0.75%, 0.09% & 0.28%. NABIL has the highest proportion of Doubtful loan followed by Loss and then Substandard loan out of total NPL in 2003 but in 2007 there is higher proportion of Substandard loan and but its Doubtful and Loss loan has decreased which is an indication of increasing good quality of asset of NABIL. And performing loan of NABIL has also increased.

From the analysis of loan classification and provisioning of SCBNL it has been found that out of total loan Pass, Substandard, Doubtful & Loss loan comprises 95.87% , 0.12%, 2.16% & 1.85% respectively in mid July 2003 & that of mid July 2007 is 98.17%, 0.15%, 0.61% & 1.07%. In the year 2003 SCBNL has the highest proportion of Doubtful loans followed by Loss and then substandard loan in total non-performing loan. But in the year 2007, all the loans ( SS, DF, Loss) has decreased which is an indication of increasing good quality of asset of SCBNL.

Increasing non-performing loan is one of the burning problems of Nepalese banking sector. Improper credit appraisal system, ineffective credit monitoring & supervision system, economic slowdown, borrower's misconduct, political pressure to lend to uncreditworthy parties etc are the major factors leading to non-performing assets. Setting up recovery cell, hiring Asset Management Company etc are some to the measures to resolve the problem of NPA. Loan classification and loan loss provision also helps to confront the problems thus created due to non-performing loans. Since loan loss provision is deducted from the profit of the bank, increase in provision decrease the profit of the bank by the same amount but this type of negative effect is only for short period. Once the banks have adequate provision and sound credit management, the profitability will again gear up.

After the completion of analysis of data, the next chapter or the final chapter incorporates the summary, conclusions and recommendation regarding the subject matter.

# CHAPTER V

# SUMMARY, RECOMMENDATIONS AND CONCLUSIONS

Finally this chapter includes the summary, conclusions and recommendation based on the result of the analysis of the data.

## 5.1 Summary

Banks play an important role in the economic development of the country as the issue of development always rests upon the mobilization of resources. Bank deals in the process of canalizing the available resources to the needy sector causing overall economic development. This research is aimed at studying the non-performing loan and loan loss provisioning of commercial banks. For this purpose, descriptive cum analytical research design was adopted. Out of the total population of 23 commercial banks, three banks were taken as sample using Judgmental Sampling Method. Nepal Bank Limited was selected from public sector banks and two major joint venture banks, NABIL Bank Limited and Standard Chartered Bank Nepal Limited were selected from private sector banks. Both primary and secondary data have been used in the study. Primary data has been collected through questionnaire, direct interviews & telephonic interviews and annual reports and other publication forms the basis of secondary data. The data collected from various sources are recorded systematically and presented in appropriate forms of tables and charts and appropriate mathematical, statistical, financial, graphical tools have been applied to analyze the data. The data of five consecutive years of the three selected banks have been analyzed to meet the objective of the study.

NBL and NABIL have the highest proportion of the loans and advances in the total asset structure but SCBNL has relatively lower loans and advances in the total asset structure. The credit deposit ratio also shows the same thing. It indicates the risk adverse attitude of the management of SCBNL. There is higher proportion of non-performing loan in the total loans and advances of NBL, which comes around 28.05% on average, which is very much higher than the acceptable standard of minimum 10%. Since higher provision has to be apportioned for NPL, its loan loss provision is also significantly higher than the other two banks. Regarding NPL SCBNL is moderate among the three but it has least LLP. Nabil has the least NPL but moderate in LLP. The ratio of provision held to NPL of NABIL is the highest followed by NBL and then SCBNL.

Eventhough, NBL has the highest proportion of their investment in the most income-generating asset; the bank is unsuccessful in generating returns. Most of the loans of NBL have become non-performing and hence it is not generating any income instead demanded high provision for probable loss. Even NABIL has higher proportion of investment in loans and advances in comparison to SCBNL, its return on loans and advances is comparatively lower. However the high return of SCBNL is not due to its proper lending function but due to low deposit cost, high fee based income, high foreign currency deposit, exchange earning etc.

There is negative correlation between LLP and loans and advances in NABIL & SCBNL but these two variables shows positive correlation in case of NBL. The negative correlation in NABIL and SCBNL is due to decrease in non performing loan in these two banks. The positive correlation in NBL is due to decrement of non-performing loan of NBL. Amount to be provisioned depends upon the non-performing loan and its quality. Higher provision has to be provided for NPL. Hence even though loans and advances do not increase, if in the same loan portfolio NPL increases, LLP will increase. This has also been shown by the positive correlation between LLP and NPL in all the three banks. NABIL and SCBNL have shown positive correlation between loans and advances and deposit but NBL shows negative correlation. NBL is concentrating on loan recovery and hence there was no further investment of deposit in the form of loans and advances but deposit is increasing which is the reason behind the negative correlation between these two variables.

The trend analysis of loans and advances shows increasing trend in n case of NABIL and SCBNL but decreasing trend in NBL. This is because, NBL has no further investment in loans and advances in recent years instead they are concentrating more on recovering bad debts. The trend analysis of Non-performing loan and Loan Loss Provision shows decreasing trend in all three banks. In case of NBL decrease in NPL and LLP is due to concentrating more on recovering bad debts. And in NABIL and SCBNL this is due to recovery efforts towards reducing NPL through establishment of Recovery Cell. The past trend of net profit of all three banks exhibit increasing trend in coming years. Since NBL is concentrating on recovering bad debts its increasing trend of net profit is very high and it continues for some years. After that its increasing trend of net profit will be normal.

As per the latest loan classification and provisioning directives loans and advances have to be categorized into four types namely Pass, Substandard, Doubtful and Loss with respective provisioning of 1%, 25%, 50% and 100%. The loan falling under Pass category is regarded as performing loan and that which falls under remaining three categories is regarded as non-performing loan. NBL has the highest proportion of loss graded loan followed by Doubtful loan in the total NPL which in an indication of bad quality of asset of NBL in the form of loans and advances. NABIL has higher proportion of substandard loan in the total non-performing loan followed by Loss and then doubtful loan. And SCBNL has higher proportion of Loss loans followed by Doubtful and then substandard loans.

Today's banking industry is severely affected by the problem of NPA. Improper credit appraisal system, ineffective credit monitoring & supervision system, economic slowdown, borrower's misconduct, and overvaluation of collateral, political pressures to lend to uncreditworthy parties etc are the major factors leading to non-performing assets. Setting up recovery cell, hiring Asset Management Company etc are some to the measures to resolve the problem of NPA. Loan classification and loan loss provision also helps to confront the problems thus created due to non-performing loans. The latest directive regarding loan classification and loan loss provisioning is very important for maintaining sound financial health of the banks. The new provisioning directives leads to increment in provision amount of the banks leading to decrement in profitability of the bank but this is only for a short run.

## 5.2 Recommendations

⇒ **Hiring AMC:** The high portion of non-performing loan accompanied by higher provision of NBL indicates that the bank's credit portfolio needs serious attention. Hence NBL is recommended to take immediate remedial actions for recovering bad debts. Hiring Asset Management Company (AMC) is recommended for NBL to resolve the problem of mounting non-performing loan.

⇒ **Increase Risk Asset:** SCBNL's contribution to loans and advances is relatively low. Entire economy is largely dependent upon the proper execution of lending function by commercial banks. Low level of lending means, low level of investment resulting to low level of productivity, which may ultimately affect negatively on the national economy. Loans and advances on one hand is the highest income-generating asset and on the other hand it also helps to upgrade the economic health of the country. Hence SCBNL is recommended to increase its investments in productive sector in the form of loans and advances.

⇒ **Increase Loan & Advances:** It has been observed that the loans and advances of NBL are decreasing and less further investment of deposit in recent years. Hence it is recommended for NBL for exploring new areas of investment.

⇒ **Robust Credit Management:** The main factors which leads to Non-Performing Loan are improper credit appraisal system, ineffective credit monitoring and supervision system etc. Besides that negligence in taking information from Credit Information Bureau may also lead to bad debts. Hence all the three banks are recommended to be more cautious and realistic while granting loans and advances. After advancing loans there should be regular supervision and follow up for proper utilization of loan.

⇒ **Applying Timely Training Program:** It is recommended for the banks to initiate training and development programme for the employees to make them efficient and professional in credit appraisal, monitoring and proper risk management.

⇒ **Complying NRB Directives:** Following the directives of NRB and acting upon it also reduce many of the credit risk. Besides there are penalty implication on non-compliance of the directives. Hence all the three banks are recommended to adhere the directives and they are also suggested to come up with a stronger internal audit department to ensure that the directives are properly implemented.

⇒ **NRB support:** The regulation regarding loan classification and provisioning is stringent and tighter than the previous. Hence NRB should not only impose directives but also create supportive environment for the commercial banks. NRB is recommended to strengthen Credit Information Bureau (CIB) so that banks can get required credit information about the borrowers on time. This would help in reducing NPL.

⇒ **Apply Preventive Measures:** It is often said that 'Prevention is better than cure'. Hence it is recommended for all the three banks to take preventive measures before the loan goes to default. All the banks are recommended to have an information system to gather all the possible information and activities about its borrowers so that necessary precautions can be taken in time.

⇒ **Control Measures:** Banks are the pillar of whole economy. And it is widely accepted that the present global economy crisis started with the failure of banking system in USA & gradually touched rest of the counties. As number of banks is considerably growing in our country, it is now felt that perhaps Nepal has become overbanked economy. Quantity is proceeding over quality services. Immense competition can be seen, be it in terms of deposit collection or extending loans. It is now envisaged that these unhealthy practices may lead economy to recession. Whilst bank is a long term business, banks want to increase profit as quickly as possible; this may lead to bad investments which surely have repercussion in longer term. Considering all theses facts NRB is recommended to come up with more rigid & robust policy to maintain optimum amount of banks as required by the country and maintain healthy banking practices for sustainable economical growth.

## 5.3 Conclusions

Liberalization of financial sector started in 1980s with the aim to streamline it. After that the financial sector widened with more banks and financial institutions. The total number stood at 208 in mid July 2007. Regarding banking sector there are 23 commercial banks, 38 development banks and 74 finance companies. Even the financial sector developed rapidly in quantity, but in terms of quality it is far behind the developed countries. Banks came into existence mainly with the objectives of collecting idle funds, mobilizing them into productive sector and causing an overall economic development.

The banker's have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving. Lending is the major function of any commercial bank and it is the most income-generating asset of any commercial bank but there is risk inherent in bank's lending portfolio. In order to cover the risk inherent in the lending portfolio, banks have to make loan loss provision by categorizing the loans into different category as per the NRB directives. Increasing non-performing loan is the serious problem of the banking sector in Nepal. Non-performing asset debar the income flow of the bank while claiming additional resources in the form of provisioning and hinder further gainful investments.

It has been found that NBL has very high portion of non-performing loan resulting to higher provision. Hence even the bank has the highest investment in the most income generating asset i.e. loans and advances, its return is very low. Eventhough in 2007 SCBNL has lower investment in forms of Loans and Advances than of NABIL, its NPL is higher than of NABIL. Among the three banks NABIL has the least non-performing loan but its LLP is more than that of SCBNL. From the above indicators it can be said that NABIL is the best among the three banks in terms of NPL and LLP.

In the conclusion it can be said that ineffective credit policy, political pressure to lend to uncreditworthy borrowers, overvaluation of collateral are the major causes of mounting non-performing assets in government owned banks like NBL. Other factors leading to accumulation of NPAs are weak loan sanctioning process, ineffective credit monitoring & supervision system, economic slowdown, borrower's misconduct etc. Continual review and classification of loans enables banks to monitor quality of their loan portfolios and to take remedial action to counter deterioration in credit quality. In addition to this establishing recovery cell, hiring Asset Management Company are also measures to resolve the problem of NPL. The present loan classification and provisioning directive seems more stringent than the previous one. As a result more provision has to be apportioned leading to lesser profitability but this kind of negative impact is only for short period. Adequate provisioning strengthens the financial health of the banks and makes them able to face any kind of future contingencies.

# BIBLIOGRAPHY

## Books

Dahal, Bhuvan & Sarita (2002). A Hand Book to Banking. 2nd Edition. Kathmandu: Asmita Books & Stationery.

Gupta, S.C. (1992). Fundamental of Statistics. 5th Edition. Bombay: Himalaya Publishing House.

Gupta, S.P. (1997). Statistical Method. 28th Edition. New Delhi: Sultan Chand & Publishers.

Joshi, P.R. (2001). Research Methodology. 1st Edition. Kathmandu: Buddha Academic Publishers & Distributors Pvt. Ltd.

Kothari, C.R. (1984). Quantitative Techniques. 3rd Revised Edition. New Delhi: Vikas Publishing House Pvt. Ltd.

Pandey, I.M. (1999). Financial Management. 8th Edition. New Delhi: Vikas Publishing House.

Pant, Prem R. (1998). Fieldwork Assignment and Report Writing. 1st Edition. Kathmandu: Veena Academic Entreprises Pvt. Ltd.

Radhaswami, M. & Vasudevan, S.V.(1984). A Text Book of Banking (Law, Practice & Theory of Banking). 3rd Edition. New Delhi: S. Chand and Co. Pvt. Ltd.

Shrestha, Sunity & Silwal, Dhruba P.(2002). Statistical Methods in Management. 1st Edition. Kathmandu: Taleju Prakashan.

Sthapit, Dr. A.B., H. Gautam, Joshi, P.R. & Dongol, P.M.(2003). Statistical Methods . 1st Edition. Kathmandu: Buddha Academic Publishers & Distributors Pvt. Ltd.

Timilsina,Yogendra.(1997).Banking Business in Nepal. 3rd Edition. Kathmandu: Ratna Pustak Bhandar.

Vaidya, Shakespeare. (1998). Project Failures and Sickness in Nepal, Challenges to Investors for Investment Risk Management. 1st Edition. Kathmandu : Monitor Nepal.

Weston, J. Fred & Copeland Thomas E.(1990). Managerial Finance. 9th Edition. New York: The Dryden Press

Wild, John J, Subramanyam, K.R & Haskey, Robert F. (2003). Financial Statement Analysis. 8th Edition. USA: MC Graw Hill International

Wolff, Howard & Pant, Prem R. (2002). A Hand Book for Social Science Research and Thesis Writing. 3rd Edition. Kathmandu: Buddha Academic Publishers & Distributors Pvt. Ltd.

**Journals/Articles**

Bhattarai, Narendra. (March 2003) *" I Took up This New Job Because I Eager for Challenges"* Business Age, Vol.5, No. 3 p. 74 (Giving Interview with Business Age)

Bhattarai, Narendra.(July 14, 2004) *"Raise NPL Limit"* The Himalayan Times, p. 7 (Giving Opinion in The Himalayan Times)

Chhetri, Deependra B. (Baisakh 2064) *"Non-Performing Assets: A Need for Rationalization"* Nepal Rastra Bank Samachar, p. 17-21.

Dhungana, Bhisma R. (Poush 2062) *" Why Asset Management Company is Considered the Best Option to Resolve the Non Performing Loan Problem"* Banking Prabardhan 13 , p. 125-127.

Editorial, (Magh 2063), *"Asset Management Company: East Asia's Experience"* Nepal Bank Limited Newsletter, No. 10, p. 2.

Ghimire, Binam R. (November 2007) *"Credit Sector Reform and NRB"* New Business Age, p. 47-49

Khatiwada, Yubaraj. (November 2005) *"Liberalization Was Not Done in Proper Sequence"* New Business Age, p. 34 (Giving Interview with New Business Age)

Neupane, Him P. (Baisakh 2064) *" Bad Loans of Banking Sector – Challenges & Efforts to Resolve It"* Nepal Rastra Bank Samachar, p.141-146

Pant, Shovan D. (September 2004), *"Banking Industry is Not Robust"*, Business Age, Vol. 3, No. 9, p.31 (Giving Interview with Business Age)

Rana, Himalaya S.J.B. (December 2006), "*Golden Days are Gone"*, New Business Age, p. 35 (Giving Interview with New Business Age)

Sapkota, Narayan. (19 May 2006) *"Portion of NPA in Commercial Banks-High in Public, Low in Private"* Rajdhani , p.5.

Sapkota, Suman. (Jestha-Magh 2063) *"Doubtful Debtors and New Changed Provisions"* Nepal Bank Patrika, p.47-50

Sharma, Narayan & Phulara, Bashu D.(February 2007)" Failed State Vis-à-vis Failed Banking System", Business Age, Vol. 5, No. 2, p.41-43

Shrestha, Shiba R. (Ashad 2062) *" Modus Operandi of Risk Appraisal & In Bank Lending"* Banking Prabardhan 8, p.55-64

The Kathmandu Post. (June 21, 2007) p. 6

Tiwari, Gopal (July 14,2007) *"Financial Sector Hobbled with Chaos, Fragility"*, The Himalayan Times, p.7

## Other Reports

Annual Report, (2002/03-2006/07) – Nabil Bank Limited
Annual Report, (2002/03-2006/07) – Standard Chartered Bank Nepal Limited
NRB, Banking and Financial Statistics (July 2003 to July 2007)
NRB Circulars No. 71/058, September 14, 2001.

## Unpublished Master Degree Thesis

Bhattarai, Shama (2004). Implementation of Directives Issued by Nepal Rastra Bank, A Comparative Study of Nepal SBI Bank Limited & Nepal Bangladesh Bank Limited, An Unpublished Master Degree Thesis, TU.

Khadka, Anju (2002). A Comparative Study on Investment Policy of Commercial Banks , An Unpublished Master Degree Thesis, TU.

Khadka, Raja Ram (1998). A Study on Investment Policy of Nepal Arab Bank Limited in Comparision to Other Joint Venture Banks in Nepal, An Unpublished Master Degree Thesis, TU.

Ojha, Lila Prasad (2002). Lending Practices: A Study on Nabil Bank Limited, Standard Chartered Bank Nepal Limited and Himalayan Bank Limited , An Unpublished Master Degree Thesis, TU.

Pandey, Santosh (2002). Nepal Rastra Bank Directives, Their Implementation and Impact on Commercial Banks, A Case Study of Himalayan Bank Limited, An Unpublished Master Degree Thesis, TU.

Shilpakar, Anjana (2003). A Study on Lending Practices of Finance Companies of Nepal, An Unpublished Master Degree Thesis, TU.

Shrestha, Sabitri (2003). Impact and Implementation of Nepal Rastra Bank (NRB)'s Guidelines (Directives) on Commercial Banks ; A Study of Nabil Bank Limited and Nepal SBI Bank Limited An Unpublished Master Degree Thesis, TU.

**Websites**

www.nabilbankltd.com
www.nepalnews.com
www.nepalstock.com
www.nrb.org.np
www.nbl.com.np

# APPENDIX 1

## Questionnaire

Name :________________________

Institution :________________________

Address :________________________

1. How important do you think is the directives related to loan classification and provisioning for a commercial bank?

   - ❑ Very Important
   - ❑ Not Important

2. Do you think, the present directives related to loan classification & provisioning is appropriate and better than the previous one?

   - ❑ Yes
   - ❑ No

3. What will be the impact of new directives on provision for loan loss of commercial banks?

   - ❑ Will increase provision for loan loss.
   - ❑ Will decrease provision for loan loss.
   - ❑ Will have no impact.
   - ❑ Others_____________________

4. What will be impact of loan loss provision on the credit exposure of bank?

   - ❑ Will increase credit exposure.
   - ❑ Will decrease credit exposure.
   - ❑ Will have no Impact.
   - ❑ Others_____________________

5. How do you think the shareholders of the bank are going to be affected by the present loan classification and provisioning directive?

   - ❑ Will enjoy lesser dividend.
   - ❑ Will have their EPS decreased.
   - ❑ Will not be affected at all.
   - ❑ Others_____________________

6. How do you think the following aspects of bank will be affected because of the changes brought in loan classification and provisioning directives?

   Liquidity

- ❑ Increase.
- ❑ Decrease.
- ❑ No effect

Profitability

- ❑ Increase.
- ❑ Decrease.
- ❑ No effect

Operational Procedure

- ❑ Increase.
- ❑ Decrease.
- ❑ No effect

7. How do you think, will the banks cope with the problem brought about by this amendment of loan classification and provisioning directives? Specifically what are the alternatives your management is pondering to cope with the problem thus created?

   - ❑ Will control the credit disbursal by being more stringent.
   - ❑ Will strengthen the monitoring and follow-up procedures.
   - ❑ Will negotiate with Nepal Rastra Bank on the directives.
   - ❑ Others______________________

8. To what extent, today's banking industry is effected by the problem of NPA ?

   - ❑ Not affected.
   - ❑ Nominally affected.
   - ❑ Moderately affected.
   - ❑ Severely affected.

9. Which measure is the best option to resolve the problem of NPA?

   - ❑ Setting up recovery cell.
   - ❑ Hiring Asset Management Company (AMC)
   - ❑ Others________________________

10. What are the major factors, which lead to increasing NPA? (Please Rate)

   - ❑ Improper Credit appraisal system.
   - ❑ Economic slowdown/recession
   - ❑ Ineffective credit monitoring and supervision system.
   - ❑ Political pressure to lend to uncreditworthy borrowers.
   - ❑ Borrower's misconduct.

- Others____________________________

## APPENDIX 2

### Figures from Balance Sheet & Profit & Loss Account

**Total Asset**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 37,742 | 39,393 | 39,816 | 44,162 | 47,045 | 35,919 | 42,606 |
| NABIL | 18,367 | 17,629 | 16,523 | 16,745 | 17,186 | 22,330 | 27,630 |
| SCBNL | 19,703 | 18,443 | 21,000 | 23,642 | 22,171 | 25,776 | 29,078 |

**Total Deposit**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 35,619 | 34,265 | 35,014 | 35,735 | 35,934 | 35,830 | 39,008 |
| NABIL | 15,839 | 15,506 | 13,448 | 14,119 | 14,587 | 19,347 | 23,342 |
| SCBNL | 15,430 | 15,836 | 18,756 | 21,161 | 19,335 | 23,061 | 24,640 |

**Loans and Advances**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 20,419 | 19,253 | 18,132 | 17,938 | 16,867 | 12,879 | 13,751 |
| NABIL | 8,324 | 7,802 | 8,114 | 8,549 | 10,944 | 13,278 | 15,903 |
| SCBNL | 5,681 | 5,696 | 6,000 | 6,694 | 8,421 | 9,206 | 10,790 |

**Non Performing Loan**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 10,373 | 10,834 | 10,965 | 4,773 | 4,080 | 1,774 | 2,090 |
| NABIL | 1,348 | 557 | 450 | 274 | 140 | 178 | 175 |
| SCBNL | 297 | 276 | 248 | 242 | 227 | 190 | 197 |

**Performing Loan**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 10,046 | 8,419 | 7,167 | 13165 | 12787 | 11105 | 11661 |
| NABIL | 6,976 | 7,245 | 7,664 | 8275 | 10804 | 13100 | 15728 |
| SCBNL | 5,384 | 5,420 | 5,752 | 6452 | 8194 | 9016 | 10593 |

**Loan Loss Provision**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | 8,500 | 10,614 | 10,161 | 9,056 | 8,648 | 3,974 | 2,383 |
| NABIL | 600 | 364 | 358 | 359 | 361 | 353 | 350 |
| SCBNL | 274 | 332 | 304 | 284 | 278 | 270 | 288 |

**Net Profit**

| BANKS | 2001 | 2002 | 2003 | 2004 | 2005 | 2006 | 2007 |
|---|---|---|---|---|---|---|---|
| NBL | (2,178) | (3,071) | (252) | (1,207) | 1,730 | 1,207 | 418 |
| NABIL | 291 | 272 | 416 | 455 | 520 | 635 | 686 |
| SCBNL | 431 | 479 | 507 | 538 | 536 | 659 | 692 |

Note :

- The entire figures presented above are rounded off to the nearest million Rs.
- The data presented herein are pertained to mid July of each year.
- The data presented herein are based on the amount mentioned in the annual reports of respective years in case of NABIL & SCBNL. The data of NBL is based on data in websites of www.nepalstock.com , www.nrb.org.np and the annual report to shareholders of NBL published in Gorkhapatra.
- Loans and Advances also include Bill Purchased & Discounted.

# APPENDIX 3

## Calculation of Mean, S.D. & C.V of Loans & Advances to Total Asset Ratio of Nabil (Sample Calculation)

**(Rs. In Million)**

| Years (Mid July) | Ratio (X) % | $(X - \bar{X})$ | $(X - \bar{X})^2$ |
|---|---|---|---|
| 2003 | 49.11 | -7.06 | 49.84 |
| 2004 | 51.05 | -5.12 | 26.21 |
| 2005 | 63.68 | 7.50 | 56.25 |
| 2006 | 59.46 | 3.29 | 10.82 |
| 2007 | 57.56 | 1.38 | 1.92 |
| **N= 5** | $\sum X = 280.86$ | | $\sum (X-\bar{X})^2 = 145.04$ |

We have,

Mean $(\bar{X}) = \frac{\sum X}{N} = \frac{280.86}{5} = 56.17$

Standard Deviation $(\sigma) = \sqrt{\frac{\sum(X-\bar{X})^2}{N}} = \sqrt{\frac{145.04}{5}} = 6.02$

Coefficient of variation (C.V) $= \frac{\sigma}{\bar{X}} \times 100 = \frac{6.02}{56.17} \times 100 = 10.73$ %

Similarly the Mean, S.D. & C.V of other ratios of the three banks have been calculated.

# APPENDIX 4

## Calculation of Correlation Coefficient, P.E. & 6 P.E. of Nabil (Sample Calculation)

**(Rs. In Million)**

| Years (Mid July) | Loans & Advances (X) | LLP (Y) | x = (X – $\overline{X}$) | y = (Y-$\overline{Y}$) | $x^2$ | $Y^2$ | xy |
|---|---|---|---|---|---|---|---|
| 2003 | 8,114 | 358 | -3,244 | 2 | 10,523,536 | 4 | -6,488 |
| 2004 | 8,549 | 359 | -2,808 | 3 | 7,890,481 | 9 | -8,424 |
| 2005 | 10,944 | 361 | -414 | 5 | 171,396 | 25 | -2,070 |
| 2006 | 13,278 | 353 | 1,921 | -3 | 3,690,241 | 9 | -5,763 |
| 2007 | 15,903 | 350 | 4,545 | -7 | 20,657,025 | 49 | -31,815 |
| **N= 5** | p**X= 56,788** | p**Y =1781** | p **$x^2$ =0** | p **$y^2$ =0** | p**$x^2$= 42,932,679** | p**$y^2$= 96** | p**xy= -54,560** |

Mean ($\overline{X}$) = $\frac{\sum X}{N} = \frac{56,788}{5}$ = 11,357.6

Mean ($\overline{Y}$) = $\frac{\sum Y}{N} = \frac{1,781}{5}$ = 356.2

We have, Karl Pearson Correlation coefficient,

Correlation, ( r) = $\frac{\sum xy}{\sqrt{\sum x^2 . \sum y^2}} = \frac{-54,560}{\sqrt{42,932,679 \times 96}}$ = -0.8563

Probable Error (P.E.) = $\frac{0.6745(1-r^2)}{\sqrt{N}} = \frac{0.6745(1-(-0.8563)^2)}{\sqrt{5}}$ = 0.0805

6 P.E. = 6 $\times$ 0.0805 = 0.4830

Similarly the Correlation coefficients, P.E & 6 P.E between different variables of three banks have been calculated.

# APPENDIX 5

## Calculation of Trend Values of Loans & Advances of NBL (Sample Calculation)

**(Rs. In Million)**

| Years (Mid July) | Loans & Advances (Y) | Deviation from Mid July 2003 (X) | $X^2$ | XY | $Y_c = a + bX$<br>$Y_c$ = 15913.40 + (1,382.10) ò X |
|---|---|---|---|---|---|
| 2003 | 18,132 | (2) | 4 | (36,264) | **18,678** |
| 2004 | 17,938 | (1) | 1 | (17,938) | **17,296** |
| 2005 | 16,867 | 0 | 0 | 0 | **15,913** |
| 2006 | 12,879 | 1 | 1 | 12,879 | **14,531** |
| 2007 | 13,751 | 2 | 4 | 27,502 | **13,149** |
| **N= 5** | =p**Y=79,567** | p**X=0** | p **$X^2$ =10** | p**XY=(13,821)** | |

Here,
When, $\Sigma X = 0$, from the two normal equations,

$$a=\frac{\Sigma Y}{N}=\frac{79{,}567}{5}=15{,}913.40$$

$$b=\frac{\Sigma XY}{\Sigma X^2}=\frac{(13{,}821)}{10}=(1{,}382.10)$$

Thus,
Average Loans & Advances (a) = Rs 15,913.40
Rate of change of Loans and Advances (b) = Rs (1,382.10)

Hence, the equation of straight-line trend is

$Y_c = a + bX$
$Y_c = 15{,}913.40 + (1{,}382.10) \times X$

**Expected Trend Values of Loans & Advances (2008-2012)**

| Years (Mid July) | Deviation from Mid July 2003 (X) | $Y_c = a + bX$<br>$Y_c$ = 15,913.40 + (1,382.10) ò X |
|---|---|---|
| 2008 | 3 | **11,767** |
| 2009 | 4 | **10,385** |
| 2010 | 5 | **9,003** |
| 2011 | 6 | **7,621** |
| 2012 | 7 | **6,239** |

Similarly the trend values for other variables of the three banks have been calculated.