CHAPTER - I
INTRODUCTION

Banking sector plays an important role in the economic development of the country. Commercial Banks (CB) are one of the vital aspects of this sector, which deals in the process of channelizing the available resources in the needed sector. It is the intermediary between the deficit and surplus sector of the economy. There are two types of financial institutions in the economy to play the role of intermediary i.e. Depository financial institution and Non depositary financial institutions. Commercial Banks, Development Banks and Finance Companies (in Nepalese context) are the examples of depository financial institutions whereas Employee Provident Fund, Insurance Companies etc. are the examples of non-depository financial institutions. All the economic activities are directly or indirectly channeled through these financial institutions. Surplus sector keeps their surplus money as deposits in the banks and hence banks can provide such funds to deficit sector in the form of loans and advances.

Financial institutions play a major role in the proper functioning of an economy. These institutions act as an intermediary between the sectors who deposit and who borrow. These institutions accept deposits and in turn lend it to sectors that are in need of financial resources. These institutions make the flow of investment easier. So we cannot deny the role a bank plays in developing an economy. It pools the funds scattered in the economy and mobilizes them to the productive sector. But these institutions inherent a large amount of risk, which cannot be, denied either. If a bank behaves irresponsibility, the costs borne by the economy are enormous. A larger amount of depositors' money is at stake.

Bank came into existence mainly with the objectives of collecting the idle funds, mobilizing them into productive sector and causing an overall economic development. The bankers have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving.

1.1 Evolution of Banking Industry

Banking has crossed various phases to come to the modern form. Some sort of banking activities had been carried out since the time immemorial. Traditional forms of banking were traced during the civilization of Greek, Rome and Mesopotamia.

The evolution of banking industry had started a long time back, during ancient times. There was reference to the activities of moneychangers in the temple of Jerusalem in the New Testament. According to Alfred Marshall-"In Greece, the temples of Delphi and other safer places acted as store houses for the precious metals before the days of coinage and in later times, they lent out money for public and private purposes at interest through they paid none themselves. Private money changers began with the task of reducing many metallic currencies more or less exactly to a common unit of value and went on to accept money on deposit at interest and to lend it out at higher interest permitting meanwhile drafts to be drawn on them." Indeed the traces of "rudimentary banking" were found in the Chaldean, Egyptian and Phoenician history.

The development of banking in ancient Rome roughly followed the Greek pattern. Banking suffered oblivion after the fall of the Roman Empire after the death of Emperor Justinian in 565 A.D, and it was not until the revival of trade and commerce in the Middle Ages that the lessons of finance were learnt anew from the beginning. Money lending in the middle Ages was, however, largely confined to the Jews since the Christians were forbidden by the canon law to indulge in the sinful act of lending money to others on interest. However, as the hold of the Church loosened with the development of trade and commerce about the thirteenth century Christians also took to the lucrative business of money – lending, there by entering into keen competition with the Jews who had hitherto monopolized the business.

As a public enterprise, modern banking sowed its seed in the middle of the twelfth century in the medieval Italy. Bank of Venice, set up in 1157 in Venice, Italy is regarded as the first modern bank. Subsequently, Bank of Barcelona and Bank of Genoa were established in 1401 and 1407 respectively. The Bank of Barcelona and Bank of Genoa continued to operate until the end of the eighteenth century. The Lombard (The Royal Bank of Scotland Group) migrated to England and other parts of

Europe from Italy are regarded for their role in the development and expansion of the modern banking. With the expansion of commercial activities in Northern Europe there sprang up a number of private banking houses in Europe and slowly it spread throughout the world. Bank of Amsterdam set up in 1609 was very popular then. The General Bank of India was set up in the year 1786 is regarded as the first bank in India. In Nepal, modern banking started from the establishment of Nepal bank Limited (NBL) in 1994 B.S.

These modern banks gradually replaced goldsmiths and money lenders. Merchants, goldsmiths and money lenders are said to be the ancestors of modern banking.

1.2 Development & Growth of Banking Industry in Nepal

In the country, the development of banking is relatively recent. The record of banking system in Nepal gives detail account of mixture of slow and steady evolution in the financial and global economy of Nepalese life. Involvement of landlords, rich merchants, shopkeepers and other individual money lenders has acted as fence to institutional credit in presence of unorganized money market.

Though establishment of banking industry was very recent, some crude bank operations were in practice even in the ancient times. In Nepalese Chronicle, it was recorded that the new era known as Nepal Sambat was introduced by Shakhadhar, a Sudra merchant of Kantipur in 879 or 880 A.D. after having paid all the outstanding debts in the country. This shows the basic of money lending practice in ancient Nepal. Towards the End of 8^{th} century, Gunkam Dev had borrowed money to rebuild the Kathmandu valley. In 11^{th} century, during Malla regime there was an evidence of professional moneylenders and bankers. It is further believed that money lending business, particularly for financing the foreign trade with Tibet, became quite popular during regime of Mallas. However, in the absence of any regulatory measures, the unscrupulous moneylenders were known to have charged exorbitant rates of interest and other extra dues on loans advanced.

Like other countries goldsmith, merchants and money lenders were the ancient bankers of Nepal. Tejrath Adda established during the tenure of the then Prime

Minister Ranoddip Singh during the year 1877 A.D. (1933 B.S.) was the first step towards the institutional development of banking in Nepal. Tejrath Adda did not collect deposits from the public but gave loans to employees and public against the bullion. Tejrath Adda was fully subscribed by the Government of Kathmandu valley, which played a vital role in the banking system. This establishment helped the general public to provide credit facilities at a very low rate of 5 percent. The Tejrath Adda distributed credit facilities to the public especially on the collateral of gold and silver. Several branches were opened in different part of the country. Hence the establishment of Tejrath Adda could be regarded as pioneer foundation of banking in Nepal. “Tejrath Adda” was running smoothly for flow decades.

The main defects of this institutions soughed as there was no other financial institution set-up and there was not effort to expand the services. Above all of the defects, this institution did not accept any deposits from the public. In the absence of saving mobilization the “Adda” faced financial problems making it impossible to Carter to the credit and service need of the general population throughout the country. After that again, for a long time, several unorganized bankers and indigenous moneylender continued to flourish as the sole provider of the credit and services to the general public.

At the same time, the government started trade with India and Tibet. And the various indigenous bankers handled even the trade, because transfer of the money could be safely made only through these bankers in the absence of modern banking institutions. Hence, the need of banking intuition was realized. This was even strongly supported by the situation caused during 1934 AD’s earthquake where there was a need of finance for the reconstruction of works.

Reviewing these situations the “Udyog Parishad” (Industrial Development Board) was constituted in 1936 A.D. One year after its formulation, it formulated the “Company Act “and “Nepal Bank Act “in 1937 A.D.

Banking in modern sense started with the inception of Nepal bank Limited (NBL) on B.S. 1994. Nepal Bank Limited had a Herculean responsibility of attracting people toward banking sector from pre-dominant money lenders’ net and of expanding

banking services. Being a commercial bank, it was natural that NBL paid more attention to profit generating business and preferred opening branches at urban centers.

Government however had onus of stretching banking services to the nook and corner of the country and also managing financial system in a proper way. Thus, Nepal Rastra Bank (NRB) was set up on B.S. 2013.01.14 as a Central Bank under functioning as the Government's bank and has contributed to the growth of financial sector. The major challenge before NRB today is to ensure the robust health of financial institutions. Accordingly, NRB has been trying to change them and has introduced a host of prudential measures to safeguard the interest of the public. NRB is yet to do a lot to prove them an efficient supervisor. NRB really requires strengthening their policy making, supervision and inspection mechanism.

Integrated and speedy development of the country is possible only when competitive banking service reaches nooks and corners of the country. Keeping this in mind, government set up Rastriya Banijya Bank (RBB) in B.S. 2022.10.10 as a fully government owned commercial bank.

As the name suggest, commercial banks are to carry out commercial transaction only. But commercial banks had to carry out the functions of all types of financial institutions. Hence, Industrial Development Centre (IDC) was set up in 2013 for industrial development. In 2016, IDC was converted to Nepal Industrial Development Corporation (NIDC). Similarly, Agriculture Development Bank (ADB) was established in B.S. 2024.10.07 to provide finance for agricultural produces so that agricultural productivity could be enhance by introducing modern agricultural techniques. Moreover, Security Exchange Centre was established in 1976 to enhance capital market activities. Securities Exchange Centre was renamed Nepal Stock Exchange (NEPSE) in 1993. NEPSE opened its trading floor on 13 January 1994.

With the establishment of RBB and ADB, banking service spread to both the urban and rural areas. NRB also gave incentive to NBL to expand their branches to rural areas. This helped the common people reduce their burden of paying higher rate of interest to money lenders and absolved them from kowtowing before money lenders.

It is natural expectations of customers keep on increasing. Once they got banking services they were expecting improvement and efficiency. However, excess political and bureaucratic interference and absence of modern managerial concept in these institutions was hurdle in this regard. Banking service to the satisfaction of customers was a far cry. Establishment of the Nepal Arab Bank Limited (renamed as Nabil Bank Limited since 1st January 2002) as a first joint venture bank in Nepal in B.S. 2041.03.29 (12 July 1984), was proved to be a milestone in the history of banking. Nabil Bank gave a new ray of hope to the sluggish financial sector. Then whole lot of commercial banks was opened in Nepal.

The banking sector is an important part of the national economy. Banks take deposits, support the payment system and provide the largest source of funds on the market. Safe and sound banking system is of crucial importance for the financial stability and sustainable development. Nepal has a special characteristic of bank dominated financial sector. As the domestic capital and stock markets are in the initial stage of development, the banking sector largely dominates the entire financial sector.

The growth of financial sector in Nepal is much better compared to other sectors in the country. The economic reforms initiated by the Government more than one and half decade ago have changed the landscape of several sectors of the Nepalese economy including the financial sector. Despite the decade's conflict and political insurgency, this sector has continued to grow. Over the past 20 years, Nepal's financial sector has become deeper and the number and type of financial intermediation has grown rapidly. Within this period, the Nepalese financial sector has grown significantly both in terms of business volume as well as size of assets and market. Nepal has a reasonably diversified financial sector, as evidenced by the number and variety of institutions that play an active role in this sector, relative to Nepal's small and underdeveloped economic base.

Nepal Rastra Bank (NRB), the central bank of Nepal, established in April 26, 1956, under the NRB Act 2012 is the sole authority for licensing and supervising banks and financial institutions in Nepal. The Act has empowered Nepal Rastra Bank to grant license to banks and financial institutions as well as to monitor, inspect and supervise them. The Act also empowers NRB to undertake resolution measures in order to

protect the interest of depositors. NRB has the authority even to revoke licenses in case of violation of prudential norms and relevant laws and regulations.

NRB's regulatory and supervisory regime is limited to the commercial banks, Development banks, Finance companies, Micro-credit development banks, saving and credit co-operatives and non-government organizations licensed by Nepal Rastra Bank. The following table depicts the types and number of financial institution licensed by NRB by mid-July 2009.

Table: 1.1

Number of Financial Institution

Type of Financial Institutions	**Number of Institutions in Mid July**									
	1980	**1985**	**1990**	**1995**	**2000**	**2005**	**2006**	**2007**	**2008**	**2009**
Commercial Banks	2	3	5	10	13	17	18	20	25	26
Development Banks	2	2	2	3	7	26	28	38	58	63
Finance Companies	-	-	-	21	45	60	70	74	78	77
Micro Credit Development Banks	-	-	-	4	7	11	11	12	12	15
Saving and Credit Co-operatives	-	-	-	6	19	20	19	17	16	16
Nongovernment Organizations	-	-	-	-	7	47	47	47	46	45
Total:	**4**	**5**	**7**	**44**	**98**	**181**	**193**	**208**	**235**	**242**

(Source: Bank and Financial Statistics, Mid July, 2009, No. 53)

The first conventional bank in Nepal was the Nepal Bank Limited, established in 1937 A.D. followed by Rastriya Banijya Bank in 1966 A.D. These two banks are the pioneers of the Nepalese Banking industry. They have the largest network and they have their operations even in remote areas of the country. Rastriya Banijya Bank is fully owned by the Government while the Government has controlling stake in Nepal Bank Limited. As the financial market was barred for private investors till the mid 1980s, these two banks were the only players in the banking industry. The economic liberalization policy adopted in the mid 1980s brought about a surge in the banking industry. A large number of banks were established and the number continues to grow even today.

Table: 1.2

List of Commercial Banks in Nepal (Mid January 2009)

SN	Name of Bank	Operation Date	Corporate Office
1	Nepal Bank Limited (NBL)	1937/11/15	Kathmandu
2	Rastriya Banijya Bank (RBB)	1966/01/23	Kathmandu
3	NABIL Bank Limited (NABIL)	1984/07/16	Kathmandu
4	Nepal Investment Bank Limited	1986/02/27	Kathmandu
5	Standard Chartered Bank	1987/01/30	Kathmandu
6	Himalayan Bank Limited (HBL)	1993/01/18	Kathmandu
7	Nepal SBI Bank Limited (NSBI)	1993/07/07	Kathmandu
8	Nepal Bangladesh Bank Limited	1993/06/05	Kathmandu
9	Everest Bank Limited (EBL)	1994/10/18	Kathmandu
10	Bank of Kathmandu Limited	1995/03/12	Kathmandu
11	Nepal Credit and Commerce Bank	1996/10/14	Siddharthanagar
12	Lumbini Bank Limited (LBL)	1998/07/17	Narayangadh
13	Nepal Industrial & Commercial B	1998/07/21	Biratnagar
14	Machhapuchhre Bank Ltd	2000/10/03	Pokhara
15	Kumari Banl Limited	2001/04/03	Kathmandu
16	Laxmi Bank Limited	2002/04/03	Birgunj
17	Siddartha Bank Limited	2002/12/24	Kathmandu
18	Agriculture Development Bank	2006/03/16	Kathmandu
19	Global Bank Limited	2007/01/01	Birgunj
20	Citizens Bank International Ltd	2007/06/21	Kathmandu
21	Prime Commercial Bank Limited	2007/09/24	Kathmandu
22	Sunrise Bank Limited	2007/10/12	Kathmandu
23	Bank of Asia Nepal Limited	2007/10/12	Kathmandu
24	Development Credit Bank	2001/01/23	Kathmandu
25	Nepal Merchant Bank	1996/11/26	Kathmandu
26	Kist Bank Ltd	2003/02/21	Kathmandu
27	Janta Bank Ltd	2010/05/15	Kathmandu

(*Source: Bank and Financial Statistics, Mid July, 2009, No. 53)*

The NBL was incorporated in 1937 under the Nepal Bank Act of 1937 with an authorized capital share of Rs. 100 Lakhs. At first, the majority of share was owned by the government. Now government owns only 40 percent share with the suggestion of World Bank to transfer the ownership to the private sector for better functioning of the financial sector. But it not breeds results as expected .It provides financial facilities and services through its 96 branches.

In 1956, the Central Bank, Nepal Rastra Bank (NRB) was established. It was established with the purpose of developing Banking system in the country to promote industry, trade and agriculture as well as to circulate Nepalese currency all over the country.

Rastriya Banijya Bank was another important bank to be established in Nepal This bank was established in government sector in 2022 (1966) under the Banijya Bank Act 2021 (1965) according to the recommendation of the Nepal Rastra Bank with its head office in Kathmandu. It provides financial services through its 116 branches to rural and urban areas of the nation.

Nepal Arab Bank Limited is the first bank established in joint investment in Nepal with its head office in Kathmandu. This bank was established in 2041 (1985) under the Commercial Bank Act 2031 (1974) and the Companies Act 2021 (1965). In short form, it is called Nabil Bank. It is established with the permission of the central bank (the Nepal Rastra Bank). There are Nepalese and foreign investors in it. This bank, by making a good profit, has provided the employment to many persons. It has opened many branch offices. It has been giving banking services by using extra modern technologies. It is a very popular bank. It has the 17 branches.

Agricultural Development Bank was established in B.S.2024/10/07 to provide finance for agricultural produces so that agricultural productivity could be enhance by introducing modern agricultural techniques .It was operation as at commercial bank as 2006/03/16 with its head office in Ramshahapath Kathmandu. It has been performing commercial banking activities through its 47 branches over the country.

1.3 Synopsis of Nepal Bank Limited

History

His Majesty King Tribhuvan inaugurated Nepal Bank Limited on Kartik 30,1994 Bikram Sambat. This marked the beginning of an era of formal banking in Nepal. Until then all monetary tractions were carried out by private dealers and trading center.

Then Prime Minister Maharaja Juddha Shumsher J.B.R. speaking on the occasion with the kind permission of His Majesty the King stated this work which is being done in the larger interest of the nation is a great moment for me. Until today a bank could not be opened in Nepal. Therefore this bank, which is being established under the name of Nepal Bank Limited to fill that, need and to be inaugurated by His Majesty the King, is a moment of great joy and happiness.

The Bank's objectives to render service to the people whether rich or poor and to contribute to the nation's development will also need the support and best wishes of all, which I am confident, will be forthcoming.

In that era, very few understood or had confidence in this new concept of formal banking. Rising equity shares were not easy and mobilization of deposits even more difficult. This was evident when the bank floated equity shares worth NRs. 2,500,000, but was successful only in raising NRs. 842,000.

"In the absence of any bank in Nepal the economic progress of the country was being hampered and causing inconvenience to the people and therefore with the objective of fulfilling that need by providing service to the people and for the betterment of the country, this law in hereby promulgated for the establishment of the Bank and its operation"

The total deposits for the first year was NRs. 17,02,025 where current deposits was about NRs. 12,98,898 fixed was about NRs. 3,88,964 and saving was NRs. 14,163. Loan disbursed and outstanding at the end of the first year was NRs. 1,985,000.

From the very conception and its creation, Nepal Bank Ltd, was as joint venture between the government and the private sector. Out of 2500 equity shares of NRs. 100 face value, 40% was subscribed by the government and the balanced i.e. 60% was offered for the sale to private sector. There were only 10 shareholders when the bank first started.

The oldest bank of Nepal, Nepal Bank Ltd (NBL) was inaugurated by Late King Tribhuvan Bir Bikaram Shah Dev on 1994 B.S. Kartik 30, Monday 5:15 pm (1938

A.D.). NBL's authorized capital was Rs. 10 million (1 crore) & issued capital Rs. 2.5 million (25 lakh) of which paid-up capital Rs. 842 thousand with 10 shareholders, most of them Ranas. Out of 25000 equity shares of Rs.100 face value, 40% was subscribed by the government & balance was offered for sale to the private sector. The preliminary expenses of Rs.20,000 was occurred. The total deposit in the first year was Rs.17,02,025 divided into current account Rs.12,98,898, fixed account Rs.3,88,964 & saving account Rs.14,163. The total assets at the end of the first year was Rs.28,40,000 with net profit of Rs. 99,000 & the loan disbursed & outstanding at the end of the first year was Rs.19,85,000.

There were only 12 employees & the first director was Commanding General Bahadur Shumsher Jung Bahadur Rana(1994/7/30-1996/3/25). The first chief manager was Indian, Mr. Thakur Singh Kathait. NBL's one of the director general Sardar Gunjman Singh has also an important place in the establishment of NBL. The logo of the bank was prepared by Late Balkrishan Sama. The first branch of NBL was Kathmandu Banking Office.

The present land & building of NBL was own only on 2007B.S. by the hard work of that time Director general Bijay Shamsher Jung Bahadur Rana.Since, Ashwin 1st 2002 B.S: the first paper notes of Rs.5,Rs.10 & Rs.100 were brought into use from Sadar Mulukhana of GON. So, NBL one of the objectives at that time was also to remove I.C. from the market & replace with N.C. It is also the first bank of Nepal to establish under the principle of joint venture (joint venture between the government & the general public).

One of the unforgettable moment for the NBL is in the September 1987, issue of Financial Times Publication, *"The Banker"* from the Britain listed NBL at 193rd position in the list of 200 big banks of Asia.

Vision Statement of Nepal Bank Limited

"To remain the leading financial institution of the country".

Mission Statement of Nepal Bank Limited

Nepal Bank Limited seeks to provide an environment within which the bank can bring unique financial value and services to all customers. It will be a sound institution where depositors continue to have faith in the security of their funds are receive reasonable returns; borrowers are assured of appropriate credit facilities at reasonable prices; other service- seekers receive prompt and attentive service at reasonable cost; employees are paid adequate compensation with professional career growth opportunities and stockholders receive satisfactory return for their investment.

Values Statement of Nepal Bank Limited

At Nepal Bank Limited, we believe that our banking should be based on: Respect, service and safety for the customers we serve Respect, reward and opportunity for the people with whom we work Respect, cooperation and support for the economic community of Nepal

Objectives of Nepal Bank Limited

Nepal Bank Limited has the following objectives

- Continue to maintain leading share of banking sector with a significant presence in all major geographical areas in the country.
- Provide competitive and customer oriented banking services to all customers through competent and professional staff.
- Reclaim leadership within the national financial community.

Table: 1.3

Shareholding Composition of Nepal Bank Limited

S.N	Ownership	Percent
1	Government of Nepal	40.49
2	'A' Class Financial Institutions	4.92
3	NRB Licensed Financial Institutions	3.42
4	Other Institutions	0.52
5	General Public	49.94
6	Others	0.71
	Total:	100

(Source: Annual Publication of NBL)

Table: 1.4

Service Offered by Nepal Bank Limited

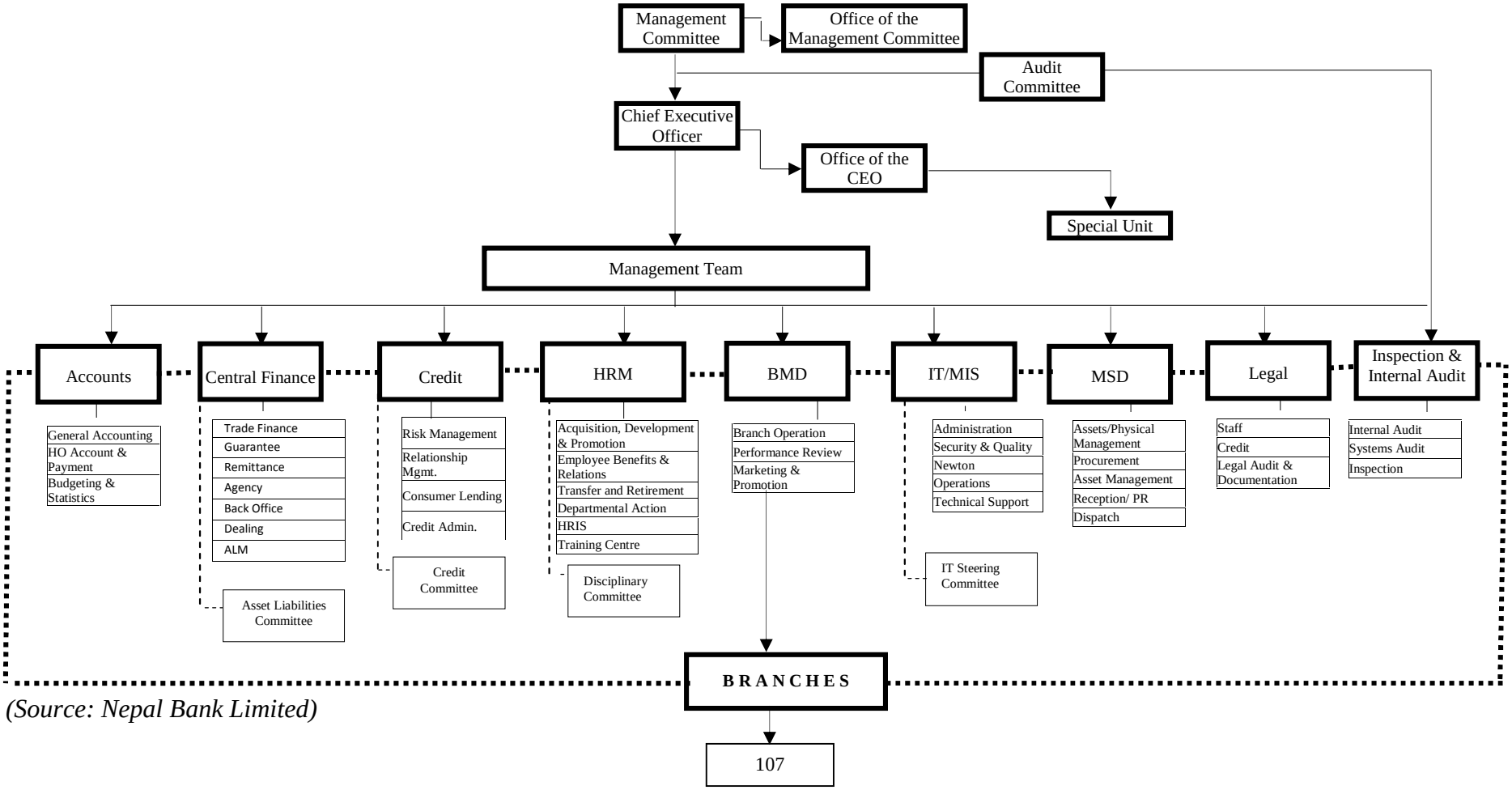
Service Types	S.N	Service Products
Deposit	1	Saving Deposit
	2	Fixed Deposit (1months to 2year)
	3	Current Deposit
Loan & Advances (Funded Business)	1	Gold and Silver
	2	Loan against First class Bank Guarantee
	3	Loan against mortgage of Government Security
	4	Working Capital (Demand Loan , Cash Credit, Overdraft, Pledge loan, Hypothecation, Bridge gap)
	5	Hire purchase
	6	Project Loan
	7	Trust Receipt Loan
	8	Structure Demand Loan
	9	Auto Loan (Commercial)
Loan & Advances (Funded Consumer)	1	Auto Loan
	2	Personal Loan (Term)
	3	Personal Loan (Overdraft)
	4	Home Loan
	5	Margin Lending
Loan & Advances (Non Funded)	1	Performance Bond Guarantee
	2	Bid Bond Guarantee
	3	Advance Payment Guarantee
	4	Letter of Credit
Other Service	1	Remittance (Web and Draft)
	2	ABBS
	3	ATM
	4	Agent of Western Union

Source: Annual Publication of NBL

1.4 Organization Structure of the Nepal Bank Limited

Chart: 1.1

Organization Structure of the Nepal Bank Limited



(Source: Nepal Bank Limited)

1.5 Financial Sector Reform & Management taken by ICCMT

With the economic liberalization initiated in mid-1980s, the Nepalese financial system witnessed significant developments. For instance, the financial system consisted of only two commercial banks and few other financial institutions before liberalization. During the post-liberalized regime spanning almost two decades, the financial system has reasonably developed, diversified, and enriched. As of April 2004, the financial system consisted of 17 commercial banks, 19 development banks, 5 regional rural development banks (RRDBs), 116 postal saving banks, 58 finance companies, 33 saving and credit cooperative societies involved in limited banking activity, 44 nongovernment micro-credit institutions, one stock exchange with the network of brokers and securities dealers, 18 insurance companies, one employees' provident fund, one credit guarantee and deposit insurance corporation, and one Citizen Investment Trust. Of these institutions, the commercial banks, development banks, RRDBs, finance companies, financial cooperatives and NGOs are under the regulatory framework of Nepal Rastra Bank (NRB). While the insurance board regulates the insurance companies and the securities board regulates the stock exchange, the other institutions are under the overall regulation of the government.

Along with the numerical growth and other institutional developments of the financial sector, the deposits and credits are expanding though the qualitative aspects of the financial system still require much improvement as reflected in the inadequacy of the banks and financial institutions in providing increased benefits to the general public and in contributing adequately to the economic development through raising income level, creating employment opportunities and building internal strength for the growth of the institutions themselves. Though various reform efforts were undertaken in the past, to create a healthy financial sector as a pre-requisite to sustained economic growth by getting rid of the various institutional and structural deficiencies that still characterize the system, further FSR measures need to be continued, initiated and implemented.

Drawing on the inadequacies of the piecemeal attempts of the past reforms, it has been felt necessary to initiate and expedite the process of comprehensive reform and other improvement measures. Hence, the moves toward current comprehensive

financial sector reform program reflect the strategic change to get rid of the extremely difficult situation that the financial system of Nepal has undergone. With the reform initiatives have came the changes in the attitude towards the State owned commercial banks as more emphasis now has been placed on commercial orientation, privatization, managerial culture, greater autonomy and accountability. Therefore, HMG came out with the financial sector reform program by encompassing a wider coverage of issues for their improvement. To accomplish the reform, HMG has obtained financial assistance from IDA, DFID, and ADB so that the financial sector reform program could be launched with a wider coverage, prospective and well defined set of objectives.

The clearly identified and addressed agenda of reform in the financial sector strategy statement of HMG are the following:

- Build a strong central bank,
- Build and maintain strong banking and non-banking sector,
- Improve existing legal and judicial aspects of financial system,
- Improving auditing and accounting standards within the banking sector,
- Promote financial discipline through adequate disclosure and competition,
- Initiate more focused interventions toward the programs for the up liftman of the poor,
- Re-orient the activities of HMG and NRB from being active participant (Owner) of the financial institutions to a regulatory body.

The strategy paper of HMG has assigned important and enhanced role, responsibility and accountability to the central bank. The government has fully supported the efforts of NRB in strengthening banking supervision and enforcing the regulations. Obviously, NRB has been assigned to focus and handle following reform activities in the financial sector:

- Reforming the financial sector legislations and regulations,
- Strengthening of bank supervision and inspection,
- Restructuring and privatization of RBB and NBL,
- Enhancing competition in the banking sector and streamlining of ownership structure,

- Discouraging multiple banking practices,
- Reforming the auditing and accounting capabilities,
- Creation of broad-based banking,
- Establishment of Bankers' Training Institute, Assets Management Corporation (AMC) and Credit Rating Agency in Nepal,
- Restructuring of Credit Information Bureau,
- Strengthening of Regional Rural Development Banks,
- Revamping research and financial monitoring strength of NRB,
- Meeting sectoral financing requirements and establishment of development banks at the regional level,
- Broadening and deepening of financial system in Nepal,
- Initiating restructuring program for ADB and NIDC.

After suffering huge loss & facing many problems by NBL; as a component of the financial sector reform program; GON decided to give the management of bank to the foreign management team. At the same time, World Bank decided to give loan of U.S$24 million on 1st phase & U.S.$75 million on 2nd phase under highly popular Financial Sector Reform Program (FSRP). The agreement was done between GON & the World Bank on Oct. 28th 1999. From July 22nd, 2002(2059 Ashad 17), NBL was taken on contract for two years with an agreement to improve financial position .As per contract the agreement was extend for plus one year in August, 2004. As per agreement, International Development Agency (IDA) provide loan amounting to U.S.$ 550000 toward the restructuring & privatizing.

The Management Contractor of NBL

- Bank of Scotland-Ireland
- The International Chamber of Commerce (I.C.C.M.T)-Management Team-France
- International Business & Technical Consultant Inc.-U.S.A
- R. Bajracharya & Co. (Chartered Accounts)-Nepal
- P.P. Pradhan & Co. (Chartered Certified Accounts)-Nepal
- Human Resource Development Center HURDEC(Pvt.) Ltd.-Nepal

The ICCMT assumed its assignment in NBL on July 22, 2002. The management team has completed the Financial Analysis of the NBL and the preparation of Management Plan and the Budget Plan for the Bank. The team had come up with clear vision, mission, goals and objectives of the bank. Asset-Liability Management Committee (ALCO), Executive Committee (EXCO), Credit Committee (CC), Relation Management Division (RMD), Credit Administration and Review Division (CARD), Special Asset Group (SAG), and several special Task Forces had been established to create, apply and reinforce internationally accepted norms and modalities in the bank. The norms and modalities are focused toward identifying bank risk and enhance the loan risk rating systems in the bank. New Credit Policy Guide, Guidelines for Credit Decision Process, and Problem Loan Guide had been prepared and implemented.

A continuous negotiation and dialogue with big defaulters had been initiated and around Rs. 4.90 billion of loan 10 categorized as NPA had been recovered in cash and restructured within the one and half year period. Despite the best efforts of the management team, loan recovery of the bank could not be considered as satisfactory. Hence, the management team has had to make more serious efforts to loan recovery. On other fronts, new accounting manual and chart of accounts have been introduced in the bank. Around 1,000 staff in the NBL has received the accounting training. The pending audits of FY 2000/01, and 2001/02 were completed and the financial audit of every year has also been completed on time. A detailed Human Resource Master Plan has been prepared and, accordingly, to get the bank in right size, the scheme of VRS has been able to reduce the staff level by 2,500. The loss position of the bank has been reduced significantly. Interest income to loan and advances ratio increased to 7.52 percent from 5.66 percent. Interest expenses as percent of the total deposits was reduced to 4.58 from 4.97. Despite various efforts, NBL has still 15 percent of NPL and negative net worth. There are still a lot of areas to be improved in NBL. After solving all the major problems of the bank, the restructuring process is expected to be successful to introduce a new credit culture, sound HR development program, scientific, and modern IT/MIS platform to instill profit-oriented atmosphere, an in-built self-monitoring mechanism and customer service culture.

The consulting firm that had been handling the management of troubled Nepal Bank Limited (NBL) for the last five years unilaterally terminated the management contract

on 2007July 22, citing inadequate cooperation from the central bank. Letter signed by the country director at the WB Nepal office has also alleged that Nepal Rastra Bank (NRB) failed to create a conductive environment for the operation of the NBL and has asked for decisive action satisfactory to the WB to restore the operational autonomy of the NBL management team.

In the face of increased interference by NBL's board and unions in the day-to-day operation of the bank, NRB has not taken necessary measures to ensure effective control over NBL as required by the agreement signed in June 2004, said the letter.

After some day, on Friday (July 27), the NRB took over the management of NBL and appointed a new team to operate the NBL. The three member team is led by NRB director Dr. Binod Atreya and included Laxmi Prapanna Niraula and Numnath Poudel.

1.6 BOD and AGM of NBL

When the overall condition and the performance of NBL was at worse; the rescue management was handed over to ICCMT by suspending the then existing BOD. What so ever was the causes behind the poor performance of NBL; the then BOD was main responsible for such a bad position of the bank as they could not initiated the remedy action. Since NBL is still under the way of restructure and reform; the AGM has also been suspended and the management team appointed by the NRB has been managing the NBL.

Being the oldest bank of Nepal and having huge network even on remote area; the large numbers of Nepalese people pursue NBL for all types of banking service. NBL is back bone of Nepalese economy as the economic activities in remote area is possible only with the support of NBL. In order to strengthen the national economy of country the well being of NBL is necessary and that is the main cause why the BOD and AGM of NBL has been suspended and the Management is taken over by NRB.

1.7 Perception of the Problem

Nepal Bank Limited is a pioneer bank of the country and it shall not be seemed to be exaggerated that; without Nepal Bank Limited the history of bank in Nepal would be uncompleted. Monetization of Nepali currency in Nepalese economy was possible only after the establishment of Nepal Bank Limited and the speed of industrialization in Nepal were accelerated only with the active support of the Nepal Bank Limited. Nepal Bank Limited had played the role of central bank up to the 14 years of its establishment and it had initiated (Encouraged) the banking culture in Nepalese society.

Despite of such an amazing and glorious history; Nepal Bank Limited has been facing lots of problem in regards of the bank operation and customer service. Negative net worth, operating loss, Negative capital adequacy ratio, huge volume of nonperforming loan, increasing volume of nonbanking assets and decreasing trend of net interest income indicates that the Nepal bank's performance is below than the average performance of the Nepalese banking industry.

Bank helps in the process of capital formation by accumulating scattered money from the surplus sector of the society and it also helps to accelerate the economic activity in the society. Since the Nepal Bank has opened its most of branches in remote area; it has highly supported to capital formation in the country and also to enhance the economic activity in rural area of Nepal. In the light of such a great contribution in Nepalese economy; we can conclude that Nepal Bank is back bone of national economy.

Through this research study; I shall try to track out the causes of poor performance of Nepal Bank Limited. This study shall also focus on the evaluation of the effectiveness of "Financial Sector Reform Program" in Nepal Bank Limited. As per the plan of "Financial Sector Reform Program"; the management of Nepal Bank had been given to ICC Management Team for five years and through this research study I shall try to evaluate the performance of ICCMT in Nepal Bank Limited. Basel II is the worldwide accepted guiding principle of every bank and through this research I shall try check the implementation of Basel concept in Nepal Bank.

The findings of any research will be unreliable if the data used on the research is unreliable. In order to boost up the reliability of the findings of this research; data shall be collected from various Reports of Nepal Rastra Bank, Report of World Bank and from audited financials of Nepal Bank Limited. This research is based on the secondary data and if needed primary data shall also be collected. For the research last five years data have been collected.

1.8 Objectives of the Study

Following are the objectives of the study:

i. Analyzing financial performance of NBL by calculating the value of different financial indicator. The value ascertained of financial indicator by using different mathematical technique shall depict the financial position of the bank. The status of financial position shall also helps to analyze the financial performance.

ii. Comparing the financial performance of the NBL with the banking industry average. The value ascertained of financial indicator shall be used to compare the financial performance of NBL with the banking industry average. Such types of comparisons with banking industry would help to track out the financial strength and weakness of the bank.

iii. Comparison of financial position of NBL with the Basel II accord. The Basel II Framework describes a more comprehensive measure and minimum standard for capital adequacy. It seeks to improve on the existing rules by aligning regulatory capital requirements more closely to the underlying risks that banks face. Basel II Framework is intended to promote a more forward-looking approach to capital supervision, one that encourages banks to identify the risks they may face, today and in the future, and to develop or improve their ability to manage those risks.

iv. Evaluation of management effectiveness of ICCMT. As per the policy of Financial Sector reform program the management of NBL was handed over to international management team called ICCMT. There is opposite views in regards the management effectiveness of ICCMT in NBL. Analysis of financial indicator of that period would help to evaluate the effectiveness of their management.

1.9 Limitation of the Study

Following are the limitations of the study:

i. Though a commercial bank has several aspect of feature, this study concentrates only on the financial aspect of NBL.
ii. The period of study covers only of five years. (2005- 2009)
iii. The data used in the study are both primary and secondary based on the information provided by the bank. The truth of the research is based upon the data available from the bank.
iv. Though there are twenty-five commercial banks operating in Nepal, this study considers only one commercial bank i.e. NBL for the study.

1.10 Significance of the Study

Support of banking activity is important for the economic development in general and reduction of poverty and unemployment in particular. Due to this need, there are many commercial and joint venture banks to cater to the needs of people. So, providing banking service to people and enterprises is very crucial to the country. If Deposit mobilization and disbursement & collection of loan are done properly and rationally; that can help to reduce unemployment and poverty of Nepal. So any commercial bank has its main motto, goal and mission is to collect more and more deposits and disburse it rationally.

In the current situation only of some banks are able to satisfy their customers from all sectors. Some banks are failed to collect properly and some fail to disburse in proper sector. In the context of Nepal, there is no any research work in “implementation of Basel concept” in banking sector. There is lots of research work on the other performances of commercial banks but this specific function does not seem given importance before. Therefore this study is an effort to bring forth the facts related to Basel concept implemented by NBL in the expectation that it will be add to the management literature the idea and findings related to this bank. It is an attempt to help the bank improve its performance and be able to face competition. It is believed that the study will be useful for the students, teachers and researchers.

1.11 Scheme of the Study

For the systematic presentation of the reports the research is divided in to the following chapters:

Chapter - I: Introduction

This chapter covers the general background and information of banking sector in Nepal and NBL. It also included the banking statistics and service offered by NBL.

Chapter - II: Literature Review

This Chapter includes the review of relevant studies. Journals and books and unpublished dissertations related to the study have been reviewed.

Chapter - III: Research Methodology

This chapter contains research methodology which includes general introduction, research design, period covered, nature and source of data, research question and special tools used.

Chapter - IV: Presentation and Analysis of Data

This chapter includes the analysis and presentation of data collected through various source.

Chapter - V: Summary, Conclusion and Recommendation

It is the most important chapter. This chapter presents the finding of the study and advice to remove weakness and difficulties.

And at last if it is necessary or required to show appendix to get clear picture of this study then that shall be presented.

CHAPTER - II
REVIEW OF LITERATURE

This chapter is categorized under two main heading: Conceptual Frame work and Review of related studies. Conceptual frame work is concerned with fundamental of supportive text that will ensure the interpretation whether it is under the principles and doctrine of the theories related to the topic or not. Review of related studies is about the studies of previous thesis and research in similar topics. Effort will be made to draw gap between past studies and present one.

2.1 Conceptual Framework

2.1.1 Finance

Finance is the science of funds management. The general areas of finance are business finance, personal finance and public finance. Finance includes saving money and often includes lending money. The field of finance deals with the concepts of time, money and risk and how they are interrelated. It also deals with how money is spent and budgeted" *(Petal; 1961: 237).*

"Finance is basically the methodology of allocating financial resources, with a financial value, in an optimal manner to maximize the wealth. There are three major decisions to be made in this allocation process: capital budgeting, financing, and dividend policy" *(Encyclopedia Britannica Online; 2010: 115).*

The definition of finance is the provision of funds or loan supplied to an individual or company. Often this term is used for the study of economics and how money is controlled. It can be also defined as the management of funds and capital required by a business and private activities. Management of finance has also developed into a specialized branch within the financial sector and is carried out by finance managers.

Finance can also be defined as:

- The branch of economics that studies the management of money and other assets.
- The management of money and credit and banking and investments

- The commercial activity of providing funds and capital, the science of raising and expending the public revenue.

2.1.2 Financial Resource

“The availability of money in the form of cash, securities, creditors, loan facilities, capital etc; possessed by an organization is financial resources” (*https://www.myfinancialresources.org/home/home).* When implementing a new business concept; only one definition captures the real essence of capital: "It takes money to make money." From the aspiring entrepreneur designing new software in a home office to the executive of a multinational corporation looking to expand foreign distribution channels, launching any new business concept requires capital, or money, as a basis to execute the business plan. One of the most common reasons businesses fail is a lack of or inappropriately structured capital resources.

For the sake of simplicity, capital is the amount of financial resources needed to implement and execute a business plan. Before a business sells its first product or service, it needs financial resources for product development, sales, marketing, administrative support, the company's formation, and countless other critical business functions.

Capital should not be perceived as just the amount of "cash on hand" but rather the amount of financial resources available to support the execution of a business plan.

“While financial resources come in countless forms, types, and structures, two basic types of financial resources are available to most businesses: debt and equity” *(Helfert; 2001:45).*

- Debt represents a liability or obligation of a business. Debt is generally governed by mutually agreed upon terms and conditions as provided by the party extending credit. For example, a bank lends Rs. 2 million to a company to purchase additional production equipment to support expansion. The bank establishes the terms and conditions of the debt agreement, including the interest rate, repayment term, collateral required, and other elements. These terms and conditions must be adhered to by the company, or it runs the risk of default.

- Equity represents an investment in the business, usually doesn't have set repayment terms, but the owners of the equity investments do have a right to future earnings — they may be paid dividends or distributions if profits and cash flows are available. For example, a software technology company requires Rs. 2 million in capital to develop and launch a new software solution. A venture capitalist group invests the required capital under the terms and conditions present in the equity offering, including what their percentage ownership in the company will be, rights to future earnings, representation on the board of directors, conversion rights, and so on. The company isn't required to remit any payments to the capital source per a set repayment agreement but has given up a partial right to ownership (which can be even more costly).

Of course, many variations, alternatives, subtypes, and classifications are present for each type of capital. If it were as easy as debt versus equity, there wouldn't be much need for bankers, accountants, venture capitalists, and the like. We may be wondering whether debt or equity capital is best suited for our company. This decision really depends on the company's stage in terms of its operating history, industry profile, profitability levels, asset structure, future growth prospects, and general capital requirements, as well as where the sources of capital lie.

2.1.3 Financial Resource Deployment

Finance makes resource available for the deployment in industry, business and also to full fill the personal needs. Without having financial resources it is impossible to establish business and industry and even it is difficult to span daily life for human being. The motive to deploy financial resource may differ among the financial resource holder but the decision of deployment of financial resource need to be rational. Since the research is concerned with the banking sector; focus is given here about the use of available financial resource by a bank. Although; bank is an institution established to avail financial resource to deficit sector of the economy but bank itself need to think and plan rationally regarding the use of financial resource in deficit sector as loan. Not only loan; but there are other numerous sector where bank can deploys its financial resources.

Bank need to use some of its resources towards the development of operating capacity. Investment in fixed assets i.e. building, furniture, computer software, computers and modern technology, shall lead to enhancement in operating capacity. Only having operating capacity would not be enough to achieve the organizational goal but it needs to utilize the operating capacity. In order to utilize the operating capacity it is also needed to invest in operating (Working) assets. The capacity generated by investing in fixed assets can only be exploited with the support of working assets.

Apart from the use of financial resources in fixed and operating assets, organizations also need to use their resources in meeting of recurring nature of daily expenses i.e. salary, wages, stationary, travel, internet, e-mail, postage etc.

2.1.4 Financial Statement

"Financial statement is a written report that quantitatively describes the financial health of a company. This includes an income statement and a balance sheet, and often also includes a cash flow statement. Financial statements are usually compiled on a quarterly and annual basis" *(Helfert; 2001: 102).*

"Financial statements for banks present a different analytical problem than manufacturing and service companies. As a result, analysis of a bank's financial statements requires a distinct approach that recognizes a bank's somewhat unique risks. Banks take deposits from savers, paying interest on some of these accounts. They pass these funds on to borrowers, receiving interest on the loans. Their profits are derived from the spread between the rate they pay for funds and the rate they receive from borrowers. This ability to pool deposits from many sources that can be lent to many different borrowers creates the flow of funds inherent in the banking system. By managing this flow of funds, banks generate profits, acting as the intermediary of interest paid and interest received and taking on the risks of offering credit" *(Epstein & Jermakowicz; 2007: 37).*

"Financial statements (or financial reports) are formal records of the financial activities of a business, person, or other entity. In British English, including United Kingdom company law, financial statements are often referred to as accounts,

although the term financial statement is also used, particularly by accountants. Financial statements provide an overview of a business or person's financial condition in both short and long term. All the relevant financial information of a business enterprise presented in a structured manner and in a form easy to understand, is called the financial statements. There are four basic financial statements *(Epstein & Jermakowicz; 2007: 31).*

"Balance sheet: also referred to as statement of financial position or condition, reports on a company's assets, liabilities, and Ownership equity at a given point in time. In financial accounting, a balance sheet or statement of financial position is a summary of a person's or organization's balances. Assets, liabilities and ownership equity are listed as of a specific date, such as the end of its financial year. A balance sheet is often described as a snapshot of a company's financial condition. Of the four basic financial statements, the balance sheet is the only statement which applies to a single point in time. A company balance sheet has three parts: assets, liabilities and ownership equity. The main categories of assets are usually listed first and typically in order of liquidity. Assets are followed by the liabilities. The difference between the assets and the liabilities is known as equity or the net assets or the net worth or capital of the company and according to the accounting equation, net worth must equal assets minus liabilities" *(Epstein & Jermakowicz; 2007: 33).*

"Income statement: also referred to as Profit and Loss statement (or a "P&L"), reports on a company's income, expenses, and profits over a period of time. Profit & Loss account provide information on the operation of the enterprise. These include sale and the various expenses incurred during the processing state. Income statement, also referred as profit and loss statement (P&L), earnings statement, operating statement or statement of operations, is a company's financial statement that indicates how the revenue (money received from the sale of products and services before expenses are taken out, also known as the "top line") is transformed into the net income (the result after all revenues and expenses have been accounted for, also known as the "bottom line"). It displays the revenues recognized for a specific period, and the cost and expenses charged against these revenues, including write-offs (e.g., depreciation and amortization of various assets) and taxes. The purpose of the income statement is to show managers and investors whether the company made or lost money during the

period being reported. The important thing to remember about an income statement is that it represents a period of time. This contrasts with the balance sheet, which represents a single moment in time*" (Epstein & Jermakowicz; 2007: 35).*

"Statement of retained earnings**:** The Statement of Retained Earnings (also known as Equity Statement, Statement of Owner's Equity for a single proprietorship, Statement of Partner's Equity for partnership, and Statement of Retained Earnings and Stockholders' Equity for corporation) is one of the basic financial statements as per Generally Accepted Accounting Principles, and it explains the changes in a company's retained earnings over the reporting period. It breaks down changes affecting the account, such as profits or losses from operations, dividends paid, and any other items charged or credited to retained earnings. A retained earnings statement is required by Generally Accepted Accounting Principles (GAAP) whenever comparative balance sheets and income statements are presented. It may appear in the balance sheet, in a combined Therefore, the statement of retained earnings uses information from the income statement and provides information to the balance sheet. Statement of retained earnings are part of the balance sheet (another basic financial statement) under "stockholders equity," and is mostly affected by net income earned during a period of time by the company less any dividends paid to the company's owners / stockholders. The retained earnings account on the balance sheet is said to represent an "accumulation of earnings" since net profits and losses are added/subtracted from the account from period to period. The general equation can be expressed as: Ending Retained Earnings = Beginning Retained Earnings - Dividends Paid + Net Income*" (Warren; 2008: 421).*

"Statement of cash flows*:* reports on a company's cash flow activities, particularly its operating, investing and financing activities. In financial accounting, a cash flow statement, also known as statement of cash flows or funds flow statement is a financial statement that shows how changes in balance sheet and income accounts affect cash and cash equivalents, and breaks the analysis down to operating, investing, and financing activities" *(Warren; 2008: 429)*The statement captures both the current operating results and the accompanying changes in the balance sheet. As an analytical tool, the statement of cash flows is useful in determining the short-term viability of a company, particularly its ability to pay bills. International Accounting Standard 7

(IAS 7) is the International Accounting Standard that deals with cash flow statements. People and groups interested in cash flow statements include:

- Accounting personnel, who need to know whether the organization will be able to cover payroll and other immediate expenses
- Potential lenders or creditors, who want a clear picture of a company's ability to repay
- Potential investors, who need to judge whether the company is financially sound
- Potential employees or contractors, who need to know whether the company will be able to afford compensation

For large corporations, these statements are often complex and may include an extensive set of notes to the financial statements and management discussion and analysis. The notes typically describe each item on the balance sheet, income statement and cash flow statement in further detail. Notes to financial statements are considered an integral part of the financial statements.

2.1.5 Financial Analysis

"Financial Analysis refers to the assessment of a business to deal with the planning, budgeting, monitoring, forecasting, and improving of all financial details within an organization" *(Ittelson; 1998: 07).* Financial analysis refers to an assessment of the viability, stability and profitability of a business, sub-business or project. It is performed by professionals who prepare reports using ratios that make use of information taken from financial statements and other reports. These reports are usually presented to top management as one of their bases in making business decisions. Based on these reports, management may:

- Continue or discontinue its main operation or part of its business;
- Make or purchase certain materials in the manufacture of its product;
- Acquire or rent/lease certain machineries and equipment in the production of its goods;
- Issue stocks or negotiate for a bank loan to increase its working capital;
- Make decisions regarding investing or lending capital;
- Other decisions that allow management to make an informed selection on various alternatives in the conduct of its business.

Financial analysts often assess the firm's:

- **Profitability:** its ability to earn income and sustain growth in both short-term and long-term. A company's degree of profitability is usually based on the income statement, which reports on the company's results of operations;
- **Solvency:** its ability to pay its obligation to creditors and other third parties in the long-term;
- **Liquidity:** its ability to maintain positive cash flow, while satisfying immediate obligations;
- **Stability:** the firm's ability to remain in business in the long run, sustain without having to significant losses in the conduct of its business. Assessing a company's stability requires the use of the income statement and the balance sheet, as well as other financial and non-financial indicators.

Ratio analysis enables the analyst to compare items on a single financial statement or to examine the relationships between items on two financial statements. After calculating ratios for each year's financial data, the analyst can then examine trends for the company across years. Since ratios adjust for size, using this analytical tool facilitates inter company as well as intra company comparisons. Ratios are often classified using the following terms: profitability ratios (also known as operating ratios), liquidity ratios, and solvency ratios. Profitability ratios are gauges of the company's operating success for a given period of time. Liquidity ratios are measures of the short-term ability of the company to pay its debts when they come due and to meet unexpected needs for cash. Solvency ratios indicate the ability of the company to meet its long-term obligations on a continuing basis and thus to survive over a long period of time. In judging how well on a company is doing, analysts typically compare a company's ratios to industry statistics as well as to its own past performance.

2.1.6 Financial Performance

“A subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial performance analysis focus on financial statement and the

significant relationship that exists among the various contained in this regard. “Analyzing financial performance is a process of evaluating financial statements to obtain a better understanding of a firm’s position and performance” (*Knight and Bertoneche; 2001)* .

Financial performance means measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firm's return on investment, return on assets, value added, etc (*Knight and Bertoneche; 2001).*

There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt.

Below are seven ways to measure the financial performance of a business. Three appear on the financial statements, three do not, and one is outside the business altogether. We can see these three on company’s financial statements: *[Online]*. *Available*: *<http://www.davidsterncfo.wordpress.com Financial + Performance >, 2010.*

Profit

The creation (profit) or consumption (loss) of wealth over a certain period of time is profit/loss. Other words for profit are “earnings”, “net income”, and “the bottom line”. A full measurement of profit must include owner’s compensation. More profit is good.

Cash Flow

The difference between the amounts of cash you end up with at the end of a certain period of time versus how much you started with. More positive cash flow is good.

Balance Sheet Strength

Generally speaking, company’s assets relative to its liabilities at a specific point in time indicate the balance sheet strength. More assets (what the company owns) and

fewer liabilities (what the company owes) results in a stronger balance sheet. A stronger balance sheet is good.

The next three usually do not appear on the financial statements:

Risk

Business is risky, we might not get paid by a customer, we might default on a debt, our company might get sued, etc. Risk is sometimes defined as probability times consequence, the likelihood of something occurring multiplied by the damage it would cause. To earn the same dollar of profit with less risk is good. Or, to earn more profit with the same amount of risk is good. Hence, there is a risk/reward relationship. Risk is often not priced correctly, as we learned all too well through the collapse of gigantic U.S. financial institutions.

Owner's Time Invested

How many hours per day, week, month, and year do you put into your business? To earn the same dollar of profit while investing less of your time is good.

Valuation

What is the fair market value (FMV) of your business? Is it rising or falling? In addition to providing current income, businesses create wealth for their owners by having a resale value. When it comes time for you to execute your exit strategy, a higher business valuation is better. This last way to measure financial health is outside the company realm altogether:

Business Owner's Net Worth

Financially, the purpose of a business is to create wealth for its owners. Does the owner(s) have substantial investments in retirement accounts, real estate, and other holdings? Has the owner's net worth increased a result of money she/he has taken out of the business? Look to the owner's personal balance sheet for a full understanding of a small business' financial performance.

2.2 Review of Basel II

As it has already been stated in the objectives of the study that the focus of this study is toward the comparison of financial performance of Nepal Bank Limited with Basel

II and industry average; we need conceptual clarity regarding the Basel II. On ward to this; I have tried to explain about the core concept of Basel II.

Basel Capital accord is a capital adequacy framework developed by the Basel committee. In 1988, the Basel Committee decided to introduce a capital measurement system commonly referred to as the Basel Capital Accord. This system provided for the implementation of a credit risk measurement framework with a minimum capital standard of 8% by end-1992, which is also known as "Basel – I". Since 1988 this framework has been progressively introduced not only in member countries but also in virtually all other countries.

“Basel-II is also a capital adequacy related standard framed by Basel committee. After the successful implementation of 1988 accord in more than 100 countries, the Basel Committee on Banking Supervision reached an agreement on a number of important issues for promoting best and uniform banking practices as well as setting standards and guidelines for supervisory function. Following extensive interaction with banks, industry groups and supervisory authorities that are not members of the Committee, the revised framework was issued on 26 June 2004. The latest revision on the framework was issued on November 2005” (*http://www.bis.org/ publ/bcbsca.htm).*

“The Basel-II aims to replace Basel I and to make the capital framework more risk sensitive. Basel II has recommended major revision on the international standard on bank's capital adequacy, which requires banks to implement risk management policies that align capital adequacy assessment with underlying credit risk, market risk, and operational risk. The Basel II has been introduced basically for the protection of depositor's interest by preserving the integrity of capital in Banks” (*http://www.bis.org/publ /bcbsca.htm).*

Basel Committee

The Basel Committee, established by the central bank Governors of the Group of Ten countries (G-10) at the end of 1974, meets regularly four times a year. It has about twenty-five technical working groups and task forces, which also meet regularly.

The Committee's members come from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, The Netherlands. Spain, Sweden, Switzerland, United Kingdom and United States Countries are represented by their central bank and also by the authority with formal responsibility for the supervision of banking business where this is not the central bank.

The Basel Committee provides a forum for regular cooperation on banking supervisory matters. Over recent years, it has developed increasingly into a standard-setting body on all aspects of banking supervision, including the Basel II regulatory capital framework.

The Committee encourages contacts and cooperation between its members and other banking supervisory authorities. It circulates to supervisors throughout the world both published and unpublished papers providing guidance on banking supervisory matters.

The Committee does not possess any formal supranational supervisory authority, and its conclusions do not, and were never intended to have legal force. Rather, it formulates broad supervisory standards and guidelines and recommends statements of best practice in the expectation that individual authorities will take steps to implement them through detailed arrangements - statutory or otherwise - which are best suited to their own national systems In this way, the Committee encourages convergence towards common approaches and common standards without attempting detailed harmonization of member countries' supervisory techniques.

Is Basel-II Mandatory?

Basel-II has been designed to provide options for banks and banking systems world-wide, the Basel Committee acknowledges that moving towards its adoption in the near future may not be the first priority for all central banks in all non-G10 countries in terms of what is needed to strengthen their supervision.

“Basel II aims to build on a solid foundation of prudent capital regulation, supervision, and market discipline, and to enhance further risk management and financial stability. As such, the Committee encourages each national supervisor to

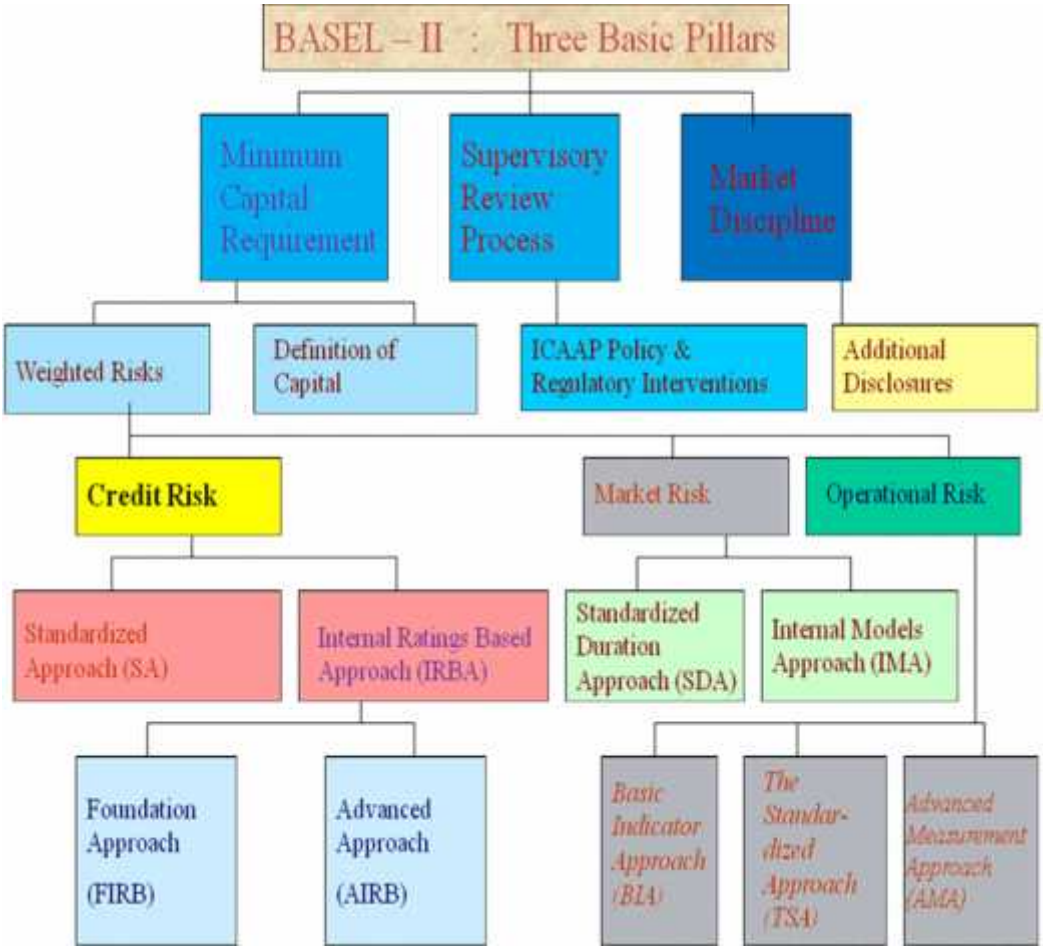
consider carefully the benefits of the new Framework in the context of its own domestic banking system and in developing a timetable and approach to implementation. Given resource and other constraints, these plans may extend beyond the Committee's implementation dates. That said, supervisors should consider implementing key elements of the supervisory review and market discipline components of the new Framework even if the Basel II minimum capital requirements are not fully implemented by the implementation date National supervisors should also ensure that banks that do not implement Basel II are subject to prudent capital regulation and sound accounting and provisioning policies" (*www.nrb.org.np/.../Basel_II_ImplementationFAQ_on_Basel_II_in_Nepalese_ Perspective.pdf).*

Approaches of Basel II Implementation

A major innovation of the proposed Basel II is the introduction of distinct options for the calculation of three types of risk. For credit, operational and market risk, there are different approaches of increasing risk sensitivity to allow banks and supervisors to select the approach or approaches that they believe are most appropriate to the stage of development of banks' operations and of the financial market infrastructure. The following table identifies primary approaches available by risk type.

Chart: 2.1

Three Basic Pillars of Basel - II



(Source: http://www.bis.org/publ/bcbsca.htm)

"International Convergence for Capital Measurements and Capital Standards: Revised Framework" alias Basel II under Pillar 1, provides three distinct approaches for computing capital requirements for credit risk and three other approaches for computing capital requirements for operational risk. These approaches for credit and operational risks are based on increasing risk sensitivity and allow banks to select an approach that is most appropriate to the stage of development of bank's operations" (*www.nrb.org.np/.../Basel_II_Implementation_on_Basel_II_in_Nepalese_Perspective.pdf).*

"The product and services offered by the Nepalese Banks are still largely primitive and conventional, in comparison to other economies. This coupled with the various

inherent limitations of our system like the absence of credit rating agencies makes the advanced approaches like Internal Ratings Based Approach or even Standardized Approach impractical and unfeasible. Thus, at this juncture, this framework prescribes Simplified Standardized Approach (SSA) to measure credit risk while Basic Indicator Approach and an indigenous Net Open Position Approach for measurement of Operational Risk and Market Risk respectively" (*www.nrb.org.np/ Basel_II_Implementation_on_Basel_II_in_Nepalese_Perspective.pdf).*

Effective Date

All banks within the scope of this framework should adopt the prescribed approaches by Mid July 2008 (Fiscal Year 2065/066).

Parallel Run

"In order to ensure a smooth transition to new approach prescribed by this framework, a parallel run for the whole year from Mid July 2007 (Fiscal Year 2064/065) has been envisioned. During this period, besides fulfilling the responsibilities under the prevailing directives, banks shall be required to compute their capital adequacy requirements, based on this framework, on a quarterly basis. The so arrived result should be reported to their respective board of directors as well as to the Nepal Rastra Bank in the prescribed formats. Any shortfall in the capital adequacy requirement in accordance with this framework shall not constitute a default during this review period. However, the failure to submit the returns stipulated in this framework shall constitute non-compliance"

(*www.nrb.org.np/.../Basel_II_Implementation_on_Basel_II_in_Nepalese_Perspective. pdf).*

Implementation of Advanced Approaches

"This framework prescribes the most simplest of the available approaches at the initial phase with a vision to move onto more complex and risk sensitive approaches as the market gradually gains maturity. However, banks willing to adopt advanced approaches, even for internal purposes, should obtain prior written approval from Nepal Rastra Bank on providing evidences that they have the resource and the capability to adopt the proposed approaches"

(*www.nrb.org.np/.../Basel_II_Implementation_on_Basel_II_in_Nepalese_Perspective*

pdf).

"A bank will not be allowed to choose to revert to a simpler approach once it has been approved for a more advanced approach without supervisory approval. However, if a supervisor determines that a bank using a more advanced approach no longer meets the qualifying criteria for advanced approach, it may allow the bank to revert to a simpler approach for some or all of its operations, until it meets the conditions specified by the supervisor for returning to a more advanced approach" (*www.nrb.org.np/.../Basel_II_Implementation_on_Basel_II_in_Nepalese_Perspective. pdf).*

Is the Basel Concept Applied in Banks Only?

The purpose of Basel II, which was initially published in June 2004, is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

Basically the Basel concept is developed for bank use but the other institutions dealing with funds may also apply this concept. Basel assumes that the risk arises during the business transaction can be managed by the use of the owners capital along with other tools. If the owner's capital is useful tool for managing risk; not only for banks but Basel concept is useful to other institutions also.

2.2.1 Eligible Capital Funds

Definition of Capital

Qualifying capital consists of Tier 1 (core) capital and Tier 2 (supplementary) capital

elements, net of required deductions from capital. Thus, for the purpose of calculation of regulatory capital, banks are required to classify their capital into two parts as follows;

a. Core Capital (Tier 1)

The key element of capital on which the main emphasis should be placed is the Tier 1 (core) capital, which comprises of equity capital and disclosed reserves. This key element of capital is the basis on which most market judgments of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete.

The BCBS has therefore concluded that capital, for supervisory purposes, should be defined in two tiers in a way which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings.

"In order to rank as Tier 1, capital must be fully paid up, have no fixed servicing or dividend costs attached to it and be freely available to absorb losses ahead of general creditors. Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1" *(http://www.federalreserve.gov/generalinfo/basel2/).*

b. Supplementary Capital (Tier 2)

"The Supplementary (Tier 2) Capital includes reserves which, though unpublished, have been passed through the profit and loss account and all other capital instruments eligible and acceptable for capital purposes. Elements of the Tier 2 capital will be reckoned as capital funds up to a maximum of 100 percent of Tier 1 capital arrived at, after making adjustments referred to in 2.4. In case, where the Tier 1 capital of a bank is negative, the Tier 2 capital for regulatory purposes shall be considered as zero and hence the capital fund, in such cases, shall be equal to the core capital"
(http://www federalreserve.gov/generalinfo/basel2/).

2.2.2 Elements of Tier 1 Capital

(http://www.Federalreserve.gov/Generalinfo/ basel2/)

- Paid up Equity Capital.
- Irredeemable non-cumulative preference shares which are fully paid-up and with

the capacity to absorb unexpected losses. These instruments should not contain any clauses, which permit redemption by the holder or issuer upon fulfillment of certain condition. Banks should obtain prior approval of NRB for this kind of instruments to qualify as a component of core capital.

- Share Premium
- Proposed Bonus Equity Share
- Statutory General Reserve.
- Retained Earnings available for distribution to shareholders.
- Un-audited current year cumulative profit, after all provisions including staff bonus and taxes. Where provisions are not made, this amount shall not qualify as Tier 1 capital.
- Capital Redemption Reserves created in lieu of redeemable instruments.
- Capital Adjustment reserves created in respect of increasing the capital base of the bank.
- Dividend Equalization Reserves.
- Other free reserves
- Any other type of reserves notified by NRB from time to time for inclusion in Tier 1 capital

2.2.3 Elements of Tier 2 Capital

(http://www.Federalreserve.gov/generalinfo/ basel2/)

- Cumulative and/or redeemable preference shares with maturity of five years and above.
- Subordinated term debt fully paid up with a maturity of more than 5 years; unsecured and subordinated to the claim of other creditors, free of restrictive clauses and not redeemable before maturity. Since, subordinated term debt is not normally available to participate in the losses; the amount eligible for inclusion in the capital adequacy calculations is limited to 50% of core capital. Moreover, to reflect the diminishing value of these instruments as a continuing source of strength, a cumulative discount (amortization) factor of 20% per annum shall be applied for capital adequacy computations, during the last 5 years to maturity. The banks should obtain written approval of NRB for including any subordinated debt instruments (like Debenture/Bonds) in supplementary (Tier-2) capital.

- Hybrid capital instruments. Those instruments which combine certain characteristics of debt and certain characteristics of equity. Each such instrument has a particular feature, which can be considered to affect its quality as capital. Where these instruments have close similarities to equity, in particular when they are able to support losses on an ongoing basis without triggering liquidation, they may be included in Tier 2 capital.
- General loan loss provision limited to a maximum of 1.25% or total Risk Weighted Exposures. The loan loss provision in respect of the rescheduled/restructured loans and specific loan loss provision in respect of Non Performing Assets shall not be included under this category. However, provisions created in excess of the regulatory requirements or provisions which is not attributable to identifiable losses in any specific loans shall be allowed to be included in the General Loan Loss Provision and shall be eligible for Tier II capital subject to a maximum of 1.25% of total risk weighted exposures. Banks shall be required to disclose the cases where additional provisions have been made.
- Investment adjustment reserves created as a cushion for adverse price movements in bank's investments.
- Revaluation reserves often serve as a cushion against unexpected losses but may not be fully available to absorb unexpected losses due to the subsequent deterioration in market values and tax consequences of revaluation. Therefore, revaluation reserves will be eligible up to 50% for treatment as Tier 2 capital and limited to a maximum of 2% of total Tier 2 capital subject to the condition that the reasonableness of the revalued amount is duly certified by the internal auditor of the bank.
- Exchange equalization reserves created by banks as a cushion for unexpected losses arising out of adverse movements in foreign currencies.
- Other reserves
- Any other type of reserves notified by NRB from time to time for inclusion in Tier 2 capital

2.2.4 Deductions from Core (Tier 1) Capital

(http://www.federalreserve.gov/generalinfo/basel2/)

Banks shall be required to deduct the following from the Tier 1 capital for capital adequacy purposes. The claims that have been deducted from core capital shall be exempt from risk weights for the measurement of credit risk.

- Losses suffered in the current period as well as those brought forward from previous periods,
- Book value of goodwill.
- Fictitious assets to the extent not written off (e.g. VRS expense, preliminary expense, share issue expense, deferred revenue expenditure, etc.).
- Investment in equity of financial institutions licensed by Nepal Rastra Bank'.
- All Investments in equity of institutions with financial interest.
- Investments in equity of institutions in excess of the prescribed limits.
- Investments arising out of underwriting commitments that have not been disposed within a year from the date of commitment.
- Reciprocal crossholdings of bank capital artificially designed to inflate the capital position of the bank.
- Any other items as stipulated by Nepal Rastra Bank, from time to time.

2.2.5 Capital Funds

(http://www.federalreserve.gov/generalinfo/basel2/)

The capital fund is the summation of Tier 1 and Tier 2 capital. The sum total of the different components of the tier 2 capitals will be limited to the sum total of the various components of the Tier 1 capital net of deductions as specified in 2.4. In case the Tier 1 capital is negative, Tier 2 capital shall be considered to be "Nil" for regulatory capital adequacy purposes and hence, in such a situation, the capital fund shall be equal to the Tier 1 capital.

2.2.6 Minimum Capital Requirements

(http://www.nrb.org.np/.../basel_ii_implementation_on_basel_ii_in_Nepalese_Perspective.pdf) Unless a higher minimum ratio has been set by Nepal Rastra Bank for an individual bank through a review process, every bank shall maintain at all times, the

capital requirement set out below:

a. A Tier 1 (core) capital of not less than 6 per cent of total risk weighted exposure;
b. A total capital fund of not less than 10 per cent of its total risk weighted exposure.
c. The Capital Adequacy Ratio (CAR) is calculated by dividing eligible regulatory capital by total risk weighted exposure. The total risk weighted exposure shall comprise of risk weights calculated in respect of bank's credit, operational and market risks.

$$\text{Tier 1 CAR} = \frac{\text{Eligible Tier 1 Capital Funds}}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

$$\text{Total CAR} = \frac{\text{Eligible Total Capital Funds}}{\text{Credit Risk RWA} + \text{Market Risk RWA} + \text{Operational Risk RWA}}$$

2.2.7 Credit Risk

(http://www.Federalreserve.gov/generalinfo/basel2/)

Credit risk is the major risk that banks are exposed to during the normal course of lending and credit underwriting. Within Basel, there are two approaches for credit risk measurement: the standardized approach and the internal ratings based (IRB) approach. Due to various inherent constraints of the Nepalese banking system, the standardized approach in its simplified form, Simplified Standardized Approach (SSA), has been prescribed in the initial phase.

2.2.8 Simplified Standardized Approach (SSA)

(http://www.bis.org/publ /bcbsca.htm)

In comparison to Basel I, SSA aligns regulatory capital requirements more closely with the key elements of banking risk by introducing a wider differentiation of risk weights and a wider recognition of credit risk mitigation techniques. The advantage of implementing this approach is twofold. This approach allows transitional advantage for countries like us by avoiding excessive complexities associated with the advanced approaches of Basel II while at the same time it will produce capital ratios more in line with the actual economic risks that banks are facing, compared to the present

Accord.

Under this approach commercial banks are required to assign a risk weight to their balance sheet and off-balance sheet exposures. These risk weights are based on a fixed weight that is broadly aligned with the likelihood of a counterparty default.

All claims including loans & advances as well as investments shall be risk weighed net of specific provisions. Generally provision related to any receivable or investment is not defined as general or specific. In such situation, the total provision against any claim/exposure (other than the loans and advances) shall be considered as specific provision. However, provisions eligible for the supplementary capital shall not be allowed for netting while calculating risk weighted exposures.

In order to be consistent with the Basel-II framework, the credit risk for the regulatory capital purpose shall be computed by segregating the exposure in the following categories.

- Claims on government & central bank
- Claims on other official entities
- Claims on banks
- Claims on corporate & securities firms
- Claims on regulatory retail portfolio
- Claims secured by residential properties
- Claims secured by commercial real state
- Past due claims
- High risk claims
- Other assets
- Off balance sheet items

2.2.9 Risk Measurement and Risk Weights

(http://www.nrb.org.np)

a. Claims on Government & Central Bank

- All claims on Government of Nepal and Nepal Rastra Bank shall be risk weighed at 0 %.
- Claims on foreign government and their central banks shall be risk-weighted on

the basis of the consensus country risk scores of **export credit agencies** (ECA). As detailed below, each ECA risk scores will correspond to a specific risk weight category:

ECA risk scores	0-1	2	3	4 to 6	7
Risk weights	0%	20%	50%	100%	150%

b. Claims on Other Official Entities

- Claims on the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community will receive a 0% risk weight.
- Following **Multilateral Development Banks** (MDBs) will be eligible for a 0% risk weight.
  - World Bank Group, comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC),
  - Asian Development Bank (ADB),
  - African Development Bank (AfDB),
  - European Bank for Reconstruction and Development (EBRD),
  - Inter-American Development Bank (IADB),
  - European Investment Bank (EIB),
  - European Investment Fund (EIF),
  - Nordic Investment Bank (NIB),
  - Caribbean Development Bank (CDB),
  - Islamic Development Bank (IDB), and
  - Council of Europe Development Bank (CEDE).
- The standard risk weight for claims on other Multilateral Development Banks will be 100%.
- Claims on public sector entities (PSEs)' will be risk-weighted as per the ECA country risk scores.

ECA risk scores	0-1	2	3 to 6	7
Risk weights	20%	50%	100%	150%

c. Claims on Banks

- All claims, irrespective of currency, on domestic banks/financial institutions that fulfill Capital Adequacy Requirements will be risk weighed at 20% while for the

rest, it will be 100%.

- Other claims on a bank shall be risk weighed as per the ECA Country risk score subject to the floor of 20% as follows:

ECA risk scores	0-1	2	3 to 6	7
Risk weights	20%	50%	100%	150%

d. Claims on Corporate & Securities Firms

- The risk weight for claims on domestic corporate, including claims on insurance companies and securities firm will be 100%.
- The claims on foreign corporate shall be risk weighed as per the ECA Country risk score subject to the floor of 20% as follows:

ECA risk scores	0-1	2	3	4 to 6	7
Risk weights	20%	50%	100%	100%	150%

e. Claims on Regulatory Retail Portfolio

Claims that qualify all criteria listed below and approved by management under product poligy7 may be considered as regulatory retail portfolio. Exposures included in such a portfolio may be risk-weighted at 75%, except for past due loans. However, all credit products to qualify under regulatory retail portfolio category must be approved by Nepal Rastra Bank.

- **Criteria**
  - **Orientation Criteria:** - exposure is to an individual person or persons or to a small business
  - **Product Criteria:** - The exposure takes the form of any of the following:
    - Revolving credits and lines of credit, (including overdraft, hypothecation etc.)
    - Term loans and leases (e.g. hire purchase, auto loans and leases, student and educational loans') and,
    - Small business facilities and commitments,
  - **Granularity Criteria:** - NRB must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. No aggregate exposure' to one counterpart can exceed 0.5 % of the overall regulatory retail portfolio.
  - **Low Value Individual Criteria**: - The maximum aggregated retail exposure to one counterpart cannot exceed an absolute threshold of Rs.5 million (Nepalese

Rupees Fifty Lakhs)

f. Claims Secured by Residential Properties

- Lending fully secured by mortgages on residential property, that is or will be occupied by the borrower or that is rented, will be risk-weighted at 50% subject to the fulfillment of all the following criteria. Banks should apply to NRB for approval of product paper relating to this type of lending.
  - Existence of substantial margin (minimum 40% of Distress Value) of security over the amount of the loan.
  - Valuation is done by an Expert Valuator empanelled by the bank, stating the basis of valuation and standards followed. Mortgaged land must be revalued once every two years. Revaluation of building on depreciation basis shall be accepted.
  - Documentation is complete with the witness/guarantee from all undivided family members.
- Where, above mentioned criteria are not met, qualifying residential mortgage loan shall be risk-weighted at 75%.
- The unsecured portion of any residential mortgage loan shall be risk weighed at 150%.
- When claims secured by residential properties are or have been past due" at any point of time during the last two years, they shall be risk-weighted at 100%, net of specific provisions.

g. Claims Secured by Commercial Real Estate

- Claims secured by mortgages on commercial real estate', except past due, shall be risk-weighted at 100%.

h. Past due claims

- Any loan, except for claim secured by residential property, which is past due for more than 90 days, will be risk-weighted at 150% net of specific provision.

l. High risk claims

- 150% risk weight shall be applied for venture capital and private equity investments.
- Exposures on Personal loan and credit card receivables shall attract a risk

weight of 150%.

- Investments in the paid-up equity of institutions, which are not listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk weighed at 150% net of provisions.
- Investments in the paid-up equity of institutions, which are listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk weighed at 100% net of provisions.
- Where loan cannot be segregated/or identified as regulatory retail portfolio or qualifying residential mortgage loan or under other categories, it shall be risk weighed at 150%.

j. Other assets

- With regard to other assets, following provisions have been made;
  - Interest receivable/claim on government securities will be risk-weighted at 0%.
  - Investments in equity or regulatory capital instruments issued by securities firms will be risk-weighted at 100%.
  - Cash in transit shall attract risk weight of 20%.
  - Cash items in the process of collection will be risk-weighted at 20%. For this purpose, cash items shall include Cheque, Draft, and Travelers Cheques.
  - Fictitious assets that have not been deducted from Tier 1 capital shall be risk weighed at 150%.
  - Other assets will be risk-weighted at 100% net of provision.

k. Off Balance Sheet Items

- Off-balance sheet items under the simplified standardized approach will be converted into equivalent risk weight exposure using risk weight as follows:

Table: 2.1

Off Balance Sheet Exposure

Items	Risk Weight
Any commitments those are unconditionally cancelable at any time by the bank without prior notice or that effectively provide for automatic cancellation due to deterioration in a borrower's credit worthiness (for example: bills under collection).	0%
Forward exchange contracts.	10%
Short Term Trade-related contingencies: Contingent liabilities arising from trade-related obligations, which are secured against an underlying shipment of goods for both issuing and confirming bank and are short term in nature. This includes documentary letters of credit, acceptances on trade bills, shipping guarantees issued and any other trade-related contingencies with an original maturity up to six months.	20%
Undertaking to provide a commitment on an off-balance sheet items	20%
Unsettled' securities and foreign exchange transactions between bank to bank and between bank and customer	20%
Long Term Trade-related contingencies: Contingent liabilities arising from trade-related obligations, which are Secured against an underlying shipment of goods for both issuing and Confirming bank and are long terms in nature. This includes documentary letters of credit, acceptances on trade bills, shipping guarantees issued and any other trade-related contingencies with an original maturity of over six months.	50%
Performance-related contingencies: Contingent liabilities, which involve an irrevocable obligation to pay a third party in the event that counterparty fails to fulfill or perform a contractual non- monetary obligation, such as delivery of goods by a specified date etc. This includes issue of performance bonds, bid bonds, warranties, indemnities, underwriting commitments and standby letters of credit in relation to a non-monetary obligation of counterparty under a particular transaction.	50%
Irrevocable Credit Commitments: Any un-drawn portion of committed credit lines. This shall include all unutilized limits in respect of Working Capital Finance of revolving nature e.g. Overdraft, Hypothecation, Trust Receipt Loan etc.	Up to 50%
Repurchase agreements, securities lending, securities borrowing, reverse repurchase agreements and equivalent transactions This includes repo/reverse repo, sale and repurchase agreements and asset sales with recourse, where the credit risk remains with the purchasing bank.	100%
Direct credit substitutes: Any irrevocable off-balance sheet obligations which carry the same credit risk as a direct extension of credit, such as an undertaking to make a payment to a third party in the event that a counter party fails to meet a financial obligation or an undertaking to a counterparty to acquire a potential claim on another party in the event of default by that party, constitutes a direct credit substitute. This includes potential credit exposures arising from the issue of financial guarantees and credit derivatives, confirmation of letters of credit (acceptances and endorsements), issue of standby letters of credit serving as financial guarantees for loans, securities and any other financial liabilities, and bills endorsed under bill endorsement lines (but which are not accepted by, or have the prior endorsement of, another bank).	100%
Unpaid portion of partly paid shares and securities	100%

Other Contingent Liabilities	100%

2.2.10 Credit Risk Mitigation

(http://www.nrb.org.np/Basel_II)

Banks may use a number of techniques to mitigate the risks to which they are exposed. The prime objective of this provision is to encourage the banks to manage credit risk in a prudent and effective manner. As such, credit risks exposures may be collateralized 14 in whole or in part with cash or securities, or a loan exposure may be guaranteed by a third party. Where these various techniques meet the minimum conditions mentioned below, banks which take eligible financial collateral are allowed to reduce their credit exposure to counterparty when calculating their capital requirements to take account of the risk mitigating effect of the collateral. However, credit risk mitigation is allowed only on an account by account basis, even within regulatory retail portfolio.

As a general rule, no secured claim should receive a higher capital requirement than an otherwise identical claim on which there is no collateral. Similarly, the effects of the CRM shall not be double counted and capital requirement will be applied to banks on either side of the collateralized transaction: for example, both repos and reverse repos will be subject to capital requirements.

Those portions of claims collateralized by the market value of recognized collateral receive the risk weight applicable to the collateral instrument. The remainder of the claim should be assigned the risk weight appropriate to the counter party.

Where the same security has been pledged for both the funded and non funded facilities, banks should clearly demarcate the value of security held for funded and non funded facility.

a. Minimum Conditions for Eligibility

In order to obtain capital relief towards credit risk mitigation, there are certain basic condition that needs to be fulfilled. Supervisors will monitor the extent to which banks satisfy these conditions, both at the outset of a collateralized transaction and on an on-going basis.

⁾ Legal Certainty

Collateral is effective only if the legal mechanism by which collateral is given is robust and ensures that the lender has clear rights over the collateral to liquidate or retain it in the event of default. Thus, banks must take all necessary steps to fulfill local contractual requirements in respect of the enforceability of security interest. The collateral arrangements must be properly documented, with a clear and robust procedure for the timely liquidation of collateral. A bank's procedures should ensure that any legal conditions required for declaring the default of the customer and liquidating the collateral are observed. Where the collateral is held by a custodian, the bank must seek to ensure that the custodian ensures adequate segregation of the collateral instruments and the custodian's own assets. Besides that, banks must obtain legal opinions confirming the enforceability of the collateral arrangements in all relevant jurisdictions.

⁾ Low Correlation with Exposure

In order for collateral to provide protection, the credit quality of the obligor and the value of the collateral must not have a material positive correlation. For example, securities issued by the collateral provider - or by any related group entity - would provide little protection and so would be ineligible.

⁾ Maturity Mismatch

The maturity of the underlying exposure and the maturity of the hedge should both be defined conservatively. The effective maturity of the underlying should be gauged as the longest possible remaining time before the obligor is scheduled to fulfill its obligation. The collateral must be pledged for at least the life of the exposure. In case of mismatches in the maturity of the underlying exposure and the collateral, it shall not be eligible for CRM benefits.

⁾ Currency Mismatch

Ideally the currency of the underlying exposure and the collateral should be the same. Where the credit exposure is denominated in a currency that differs from that in which the underlying exposure is denominated, there is a currency mismatch. Where mismatches occur, it shall be subject to supervisory haircut of 10%.

⁾ Risk Management

While CRM reduces credit risk, it simultaneously may increase other risks to which a bank is exposed, such as legal, operational, liquidity and market risks. Therefore, it is imperative that banks employ robust procedures and processes to control these risks, including strategy; consideration of the underlying credit; valuation; policies and procedures; systems; control of roll-off risks; and management of concentration risk arising from the bank's use of CRM techniques and its effect with the bank's overall credit profile. In case where these requirements are not fulfilled, NRB may not recognize the benefit of CRM techniques.

⁾ Qualifying Criteria for Guarantee

A guarantee (counter guarantee) to be eligible must represent a direct claim on the protection provider and must be explicitly referenced to specific exposures or a pool of exposures, so that the extent of the cover is clearly defined and irrefutable. Other than non-payment by a protection purchaser of money due in respect of the credit protection contract it must be irrevocable in that there must be no clause in the contract that would increase the effective cost of cover as a result of deteriorating credit quality in the hedged exposure. It must also be unconditional in that there should be no clause in the protection contract outside the control of the bank that could prevent the protection provider from being obliged to pay out in a timely manner in the event that the original counter party fails to make the payments due.

On the qualifying default or non-payment of the counter party, the bank may in a timely manner pursue the guarantor for any monies outstanding under the documentation governing the transaction. The guarantor may make one lump sum payment of all monies under such documentation to the bank, or the guarantor may assume the future payment obligations of the counter party covered by the guarantee. The bank must have the right to receive any such payments from the guarantor without first having to take legal actions in order to pursue the counter party payment.

b. Eligible Collaterals

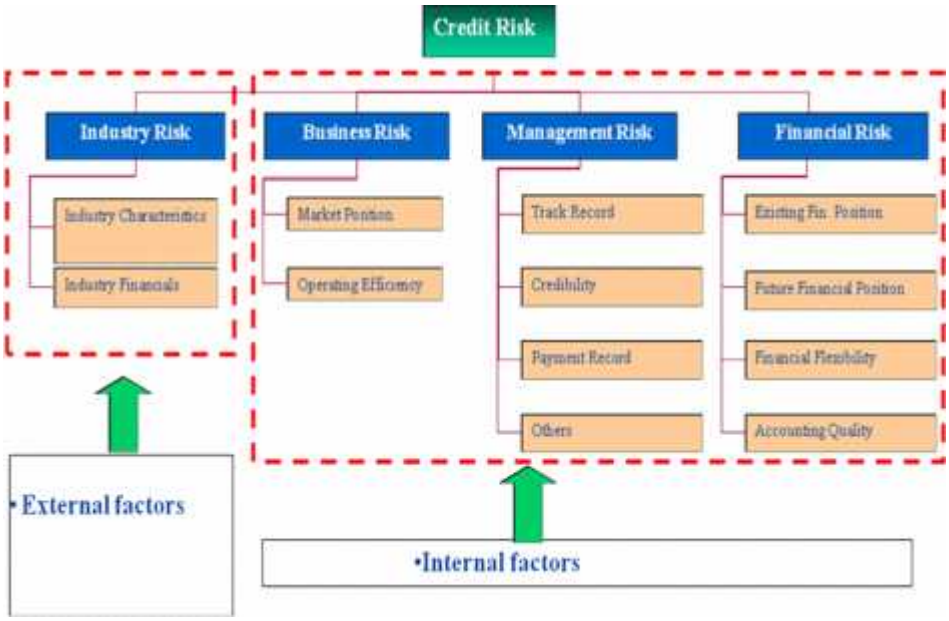
- Cash deposit (as well as certificates of deposit or fixed deposits or other deposits) with the bank.
- Fixed Deposit Receipts/Certificates of deposits/other deposits of other Banks, who fulfill the capital adequacy requirements, subject to a 20% supervisory haircut.
- Gold.
- Securities issued by the Government of Nepal and Nepal Rastra Bank.
- Guarantee of the Government of Nepal
- Financial guarantee/counter guarantee of domestic banks who meet the minimum capital adequacy requirements subject to a haircut of 20%.
- Securities/Financial guarantee/Counter guarantee issued by sovereigns.
- Securities/Financial guarantee/Counter guarantee issued by MDBs in the list specified in 3.3 b (3 & 4)
- Securities/Financial guarantee/Counter guarantee issued by banks with ECA rating 2 or better. The supervisory haircut shall be 20% and 50% for the banks with ECA rating of 0-1 and 2 respectively.

c. Methodology for using CRM

- *Step 1:* Identification of accounts eligible for capital relief under credit risk mitigation.
- *Step 2:* Assess the value of the exposure and the eligible collateral.
- *Step 3:* Adjust the value of the eligible collateral in respect of the supervisory haircut in terms of currency mismatch and other eligibility requirements.
- *Step 4:* Compare the adjusted value of the collateral with the outstanding exposure.
- *Step 5:* The value of the eligible CRM is the lower of the adjusted value of the collateral and the outstanding exposure.
- *Step 6:* Plot the eligible CRM in the appropriate category of credit risk.

Chart: 2.2

Credit Risk Assessment Process



(Source: http://www.bis.org/publ/bcbsca.htm)

2.2.11 Operational Risk

"Operational risk is the risk of loss resulting from inadequate internal processes, people, and systems, or from external events. Operational risk itself is not a new concept, and well run banks have been addressing it in their internal controls and corporate governance structures. However, applying an explicit regulatory capital charge against operational risk is a relatively new and evolving idea. Basel II requires banks to hold capital against the risk of unexpected loss that could arise from the failure of operational systems" *(http://www.nrb.org.np/Basel_II).*

"The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way, for example, by its dealers, lending officers or other staff exceeding their authority or conducting business in an unethical or risky manner. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters" *(http://www.nrb.org.np/Basel_II).*

2.2.12 Basic Indicator Approach *(http://www.nrb.org.np/Basel_II)*

Under the basic indicator approach, banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.NRB shall review the capital requirement produced by this approach for general credibility, especially in relation to a bank's peers and in the event that credibility is lacking, appropriate supervisory action under Review Process shall be considered.

Figure for the years; in which annual gross income is negative or zero, should be excluded from both the numerator and denominator, when calculating the average. In case where the gross income for all of the last three years is negative, 5% of total credit and investments net of specific provisions shall be considered as the measurement for operational risk under the review process.

The capital charge for operational risk may be expressed as follows:

$K_{BIA} = GI \times \alpha$

K_{BIA} = Capital charge for operational risk under Basic Indicator Approach

GI = average annual gross income last 3 yrs.

α = 15% (Beta factor shall be different for different portfolio)

Gross Income = *net* interest income + *net* non-interest income as lay down by supervisors/ national accounting standards.

i. Gross of any provisions (e.g. for unpaid interest- interest Suspense a/c);
ii. Exclude realised profits/losses from sale of securities in banking book (HTM and AFS)
iii. Exclude extraordinary/ irregular items/ Insurance Income

2.2.13 Grosses Income

(http://www.nrb.org.np/Basel_II)

Gross income is defined as "net Interest Income" plus "non interest income". It is intended that this measure should:

- be gross of any provisions (e.g. for unpaid interest) and write-offs made during the year;

- be gross of operating expenses, exclude reversal during the year in respect of provisions and write-offs made during the previous year(s);
- exclude income recognized from the disposal of items of movable and immovable property;
- exclude realized profits/losses from the sale of securities in the *"held to maturity" category;*
- exclude other extraordinary or irregular items of income and expenditure

  Thus, for the purpose of capital adequacy requirements, gross income shall be summation of:
- Total operating income as disclosed in Profit and Loss account prepared as per NRB directive no.4. The total operating income comprises of:
  - Net Interest Income
  - Commission and Discount Income
  - Other Operating Income
  - Exchange Fluctuation Income
- Addition to the Interest Suspense during the period.

2.2.14 Market Risk

(http://www.nrb.org.np/Basel_II)

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from adverse movements in market prices. The major constituents of market risks are:

- The risks pertaining to interest rate related instruments;
- Foreign exchange risk (including gold positions) throughout the bank; and
- The risks pertaining to investment in equities and commodities.

2.2.15 Segregation of Investment Portfolio

(http://www.nrb.org.np/BaselII)

Banks will have to segregate their investment portfolio into any of following three categories:

- **Held for Trading**

An investment that is made for the purpose of generating a profit from short term fluctuations in price should be classified under this category. An asset should be

classified as held for trading even if it is a part of a portfolio of similar assets for which there is a pattern of trading for the purpose of generating a profit from short term fluctuations in price. These investments should be marked to market on a daily basis and differences reflected in the profit and loss account.

⁾ Held to Maturity

The investments made with positive intent and ability of the bank to hold till maturity should be classified as held to maturity investments. The bank does not have the positive intent to hold an investment to maturity, if any of the following conditions are met:

- Bank has the intent and the ability to hold the asset for only an undefined period; or
- Bank stands ready to sell the asset (other than if a situation arises that is non-recurring and could not have been reasonably anticipated) in response to changes in market interest rates or risks, liquidity needs, changes in the availability of and the yield on alternative investments, changes in financing sources and terms, or changes in foreign currency risk.

  The held to maturity investments should be valued at amortized cost i.e. the cost price less any impairments (if applicable). The impairments should be included in the profit and loss accounts for the period.

⁾ Available for Sale

All other investments that are neither "held for trading" nor "held to maturity" should be classified under this category. These investments should be marked to market on a regular basis and the difference to be adjusted through reserves. Banks are required to maintain Investment Fluctuation Reserve (eligible as Tier 2 capital) to the extent of 2% of available for sale portfolio.

2.2.16 Net Open Position Approach *(http://www.nrb.org.np/Basel_II)*

Out of the various forms of market risk, foreign exchange risk is the predominant one in our country. The effects of other forms of market risk are negligible. Thus, a net open position approach has devised to measure the capital requirement for market risk. As evidenced by its name, this approach only addresses the risk of loss arising out of adverse movements in exchange rates. This approach will be consolidated over

time to incorporate other forms of market risks as they start to gain prominence.
The designated Net Open Position approach requires banks to allocate a fixed proportion of capital in terms of its net open position. The banks should allocate 5 percentages of their net open positions as capital charge for market risk.

2.2.17 Net Open Position *(http://www.nrb.org.np/Basel_II)*

Net open position is the difference between the assets and the liability in a currency. In other words, it is the uncovered volume of asset or liability which is exposed to the changes in the exchange rates of currencies. For capital adequacy requirements the net open position includes both net spot positions as well as net forward positions.

For capital adequacy purposes, banks should calculate their net open position in the following manner:

- Calculate the net open position in each of the foreign currencies.
- Convert the net open positions in each currency to NPR as per prevalent exchange rates.
- Aggregate the converted net open positions of all currencies, without paying attention to long or short positions.

  This aggregate shall be the net open position of the bank.

2.3 Review of Journals, Reports and Articles

Certain useful journals and articles regarding the domestic market, banking, financial statement analysis, monetary credit situation of Nepal and impact & implication of Basel II capital accord have been studied.

Poudel (2002), on *"Banking Challenges Ahead"* focuses on the potential areas where bank should invest to fight the prevailing economic recession. Currently the growth in the profitability of JV Banks has been mainly due to external factors such as the foreign exchange rate but not due to the growth in the real sector of the economy. Therefore; to sustain the current financial position in the long run; banks should have to enter in new area of lending such as hydro power, tourism irrigation etc.

Poudel further explained that saving collection is another factor which is necessary for banks to balance their operations and generate sufficient surplus in their cash flows. In recent years growth rate of bank deposits has declined to about 16% compared against 23% of the past. Mobilization of internal resources in the country demands that banks attract more financial resources from the public.

Poudel (2003), on "*Financial Statement Analysis*" stated that P/L a/c and the accompanying notes are the most useful aspects of the bank's financial statement. We need to understand the major characteristics of bank's balance sheet and profit and loss a/c. The bank's balance sheet is composed of financial claims as liabilities in the form of deposits and as assets in the forms of loans. Fixed assets account forms a small portion of the total assets. Financial innovations; which are contingent in nature considered as off-balance sheet items.

Interest received on loans, advances and investment and interest paid on deposit liabilities are the major components of profit and loss account. The other sources of income are fee, commission, discount and service charges.

The users of the financial statement of a bank need relevant, reliable and comparable information which assists them in evaluating the financial position and performance of the bank and which is useful to them in making economic decisions. The disclosure requirement of banks financial statement has been expressly laid down in the concerned act. Commercial banking act 1974 requires the audited balance sheet and profit and loss account to be published in the leading newspaper for the information of general public.

According to Poudel the principle objectives of analyzing financial statements are to identify:

- Financial adaptability (Liquidity)
- Financial performance (profitability)
- Financial position of Bank (solvency)

Most of the users of the financial statements are interested in assessing the bank's overall performance i.e. profitability which is affected by the following factors.

- The structure of balance sheet and profit and loss account.
- Operating efficiency and internal management system.
- Managerial decisions taken by top management regarding the interest rate, exchange rate, lending policies e.t.c
- Environmental changes (technology, government, competition, economy).

According to Poudel, "other factors to be considered while analyzing the financial statement of bank are the "capital adequacy ratio and liquidity "in the line of the norms set by Bank for International Settlement (BIS). Capital adequacy of a bank is assessed on the basis of risk weighted assets. It indicates a bank's financial strength and solvency."

Presently the capital fund of a bank should not be less than 8% (at least 4% should be in the form of tier-1 capital or core capital) of its risk weighted assets as capital. If the capital fund is not matched with standards; then the bank need to reallocate the existing assets structure in order to maintain the desired level of capital base.

Liquidity is measured by the speed with which a bank's asset can be converted into cash to meet deposit withdrawals and other current obligations. It is also important in view of survival and growth of bank.

Regarding the risk management of bank; different scholars have suggested different suggestions and some of them are as follows:

- Any customer having overdue loan of two years or more in his account should not be given other loan facilities.
- Adequate provisioning or reservations are required in restricting portfolio relating to overdue loans.
- All credit including overdrafts should be given a maturity date and should be subjected to revision at that date and consequently categorize as good, substandard, doubtful and loss loans.

- Financial credit worthiness of the borrower must be evaluated properly before granting the loans.

The above journals focus in the various aspects of the bank's economic environment. NRB press communiqué shows the current domestic market scenario, article by Radha Krishna Poudel concentrates in the challenges of the banking sector. Narayan Prasad Poudel's work stresses in effective way to evaluate the financial performance and other scholars' suggestion are focused towards proper risk management. Whatsoever aspects of the bank have been targeted by the above journal; these all have to be companiable assessed and kept in strict consideration for effective and efficient financial performance of the banks in the Nepalese economy.

In a research entitled "*Impact of New Basel II Capital Accord*", conducted by Federal Reserve (2004), concluded that those banks that will be subject to the new Basel II capital accord probably will have a competitive edge in the market for loans to small- and medium sized businesses.

The study supports the fears that the Basel II banks will have a competitive advantage over other banks because of their lower regulatory capital requirements. In the United States, only the ten or so largest banks will be required to adopt the new accord which is expected to be implemented on January 1, 2007. Other large banks may opt-in to the new accord if they meet certain regulatory requirements, while smaller banks will continue to operate under the Basel I accord adopted in 1988.

The study indicated that the institutions most impacted by the implementation of Basel II would be the regional and other large institutions that do not adopt Basel II, since they typically compete for the same kind of small and medium-size commercial customers as the banks that will be required to comply with Basel II. By contrast, community banks-those with assets of less than $1 billion-will not be significantly impacted because they lend to younger companies and tend to rely more on qualitative information from commercial loan applicants than larger banks. The study looked at the market for credit lines of $1 million or less to small and medium-size private companies.

The study concluded that it was doubtful that the Basel II banks would go after the community bank's commercial customers-even after a capital reduction-because those customers would be considered too risky and might require more capital.
Another Federal Reserve study concluded there was little basis for concern that adoption of Basel II by the large banks would result in significantly increased merger activity with smaller banks.

Duncan (2004), on "*Basel II; "The Agreement Nobody Wanted*" stated that since the mid-1970s the Basel Committee on Banking Supervision has established itself as a central locus of international decision-making in the area of banking rules. With the negotiation of the Basel capital adequacy accord in 1988 it succeeded in creating near-universally accepted minimum standards for bank capital that have contributed to the overall safety and soundness of the international banking system. However, despite its contributions, the accord was quickly perceived to be inadequate and since the early 1990s there began an on-going process of updating and reforming the accord to match changing realities in the world of banking, and the preferences and concerns of major players in the system. A series of adjustments were made to the accord in the early to mid-nineties before the inevitable realization set in that a replacement accord was needed rather than piecemeal reform. In June 1999 the Basel Committee announced that it would begin negotiations on a new capital accord to replace the 1988 agreement. This paper examines the negotiations for the new accord and focuses on the conflicts between major participants, both public and private. It argues that the discussions have witnessed clashes of both interests and ideologies and that as a general rule, national regulatory bodies have acted as agents of their major banks in the negotiating process. Of particular interest in this story is the continued dominance of the United States over European regulatory authorities. At several moments in the discussions the US has presented its European counterparts with a fait accompli in the content of the new accord, and has been willing only to discuss changes to the wording, not substance. Most damning, in spring 2003 after having gained most of the concessions it sought from fellow Basel members, the US announced that it would likely apply the accord to only a handful of banks, thus greatly weakening the potential impact of the accord and calling into question its validity. Bearing these things in mind, this process sheds light on state-private actor relations in banking and

on the controversial exercise of US power in the international regulatory framework. As such the paper will comment on issues at the heart of major concerns in IPE and particularly on the prospects for a rules-based international financial system.

2.4 Review of Thesis

Various writers and researchers have conducted various studies on various aspects of Nepal Bank Limited. The conclusion of some of them has been presented below which may help in summing up this thesis work.

Sharma (2007), in his study titled *"Financial Performance Analysis of Nepal Bank Ltd"* stated the objectives of his study as follows:

a. To examine the financial statement of the bank.
b. To analyze liquidity, turnover and profitability ratio of the bank.
c. To evaluate the earning generating capacity.
d. To provide package of suggestions and possible guidelines to improve the performance of Nepal Bank Ltd based on the findings of the analysis.

In his study he has concluded as follows:
From the analysis of the financial position of the Nepal Bank Ltd from the fiscal year 2056/57 to the fiscal year 2061/62 the collection of deposits and loan investment are increasing satisfactorily and there are also slightly improvement in the operating profit.

The CR of the bank over the six years is 1.986 times on an average. It indicates that the margin for safety for customers has not been maintained properly. But the average ratio is reached nearly at the standard, so it is in satisfactory position. The average of the cash and bank balance to current assets ratio is 38.11% which indicates that the cash and bank balance proportion with respect to the current assets is high position. It indicates that the bank is holding 38.11% cash and bank balance to idle. The average ratio for loan & advance to current assets ratio revealed that 227.00% of current assets have been lent to the customers as loan & advances. It indicates that the bank's fund mobilization position is more satisfactory. The result of the analysis indicates that the share of fixed deposit is high in the total deposit which may be termed as favorable

one from viewpoint of liquidity. The average ratio of cash and bank balance to total deposit is 13.16%, which indicates that cash and bank balance has been maintaining properly against anticipated calls of its depositors. Hence in general the liquidity position of the bank is good enough to meet the short term obligations.

Large amount of loans and advances are given out of total deposits. The fund mobilization of the bank has increased by but it may fail to recover the negative profit from mobilized funds. The bank has not been able to invest a large amount of its deposit on various securities and profitable projects sectors. The average ratio of the total investment to total deposit is 16.94% only, as this investment bears less risk as compared to loans and advances. The average of loan and advance to fixed deposit ratio is 140.93 percent. This means that fund mobilization of the bank has been increased during the period.

The researcher found that the operating efficiency of the bank is not fair enough. But its operating profit to net worth ratio is not bad position, so its position is normal. Interest earned in comparison to total assets is not fair enough; this might be the reason that the bank has normal operating profit. Interest paid to total assets comparison low with interest paid to total assets .It is the favorable one from viewpoint of profitability, but it is not fair enough.Net profit earned in comparison to the total assets and total deposit is low. These two types of ratios average are negative. The bank has earned only 2.26% net on its total working fund or total assets fund during the study period. The researcher found that the EPS of the bank is not good; its average stands at Rs. -14.915 during the study period.

Pandey (2009), in his study titled *"Credit Management of Nepal Bank Ltd"* stated the objectives of his study as follows:

a. To analyze the lending system of the bank.
b. To examine the impact of growth in deposit on liquidity and lending practices.
c. To assess credit practice of the bank
d. To explore the relationship with loan and advances and net profit of the bank.
e. To provide suggestions and recommendations for the improvement based on the findings of this study.

In his study he has concluded as follows:

a. NBL has sufficient liquidity. It shows that bank has not got investment sectors to utilize their liquid money. Now, in Nepal, many banks and other financial institutions are functioning to collect deposits and invest money somewhere in invest able sectors. Therefore, monetization has been increased since liberalization policy taken by the government. Heavy remittance has also help to increase the amount of deposits in bank. On the other hand, due to political crisis, economic sectors have been fully damaged. Most of the projects have been withdrawn due to security problem. Therefore, bank has maximum liquidity due to lack of safety investment sectors.
b. Due to economic crisis in the country, credit takers are not getting good return from their investment sectors. On that situation, credit customers do not return money of the bank in the stipulated time period, therefore, the non-performing credit of the bank increases. As the non-performing credit increases, bank should increase its provision for credit loss.
c. Credit related financial indicators demonstrate the quite poor situation in Nepal Bank Limited. Therefore, Financial Sector Reform Program is below the level and still much needs to be done. It can also be concluded that there has been almost similar procedures and policies while granting the loan, not much change from its conventional methods.

Sigdel (2009), in his study titled *"Risk Management of Commercial Bank in Nepal: a comparative study between Nepal Credit & Commerce Bank Ltd and Machhapuchhre Bank Ltd"* stated the objectives of his study as follows:

1. To analyze different types of risks of the bank and management of such risks by the NCC Bank and MBL.
   a) Credit Risk
   b) Market Risk
      - Interest Rate Risk
      - Liquidity Risk
   c) Operational Risk
2. To analyze Nepal Rastra Bank's directives and measures on the risk management of commercial banks
3. To analyze the risk management system of NCC Bank and MBL in reference to NRB Guidelines.

In his study he has concluded as follows:

Nepalese government has started to liberalize the financial sector since 1980s to streamline the financial sector of the country. Prior to liberalization, there were 2 commercial banks, 1 central bank, and 2 development banks. After the adoption of financial sector liberalization policy, the financial sector widened with more banks and financial institutions. Commercial banking sectors have made a significant mark with the establishment of 26 commercial banks. Though banking sector developed rapidly in quantity, it has remained far behind in terms of quality compared to international banks. Commercial banks are established with an objective to maximize the shareholders value by performing the function of mobilizing the idle funds collected from the society to productive sector, which will help to achieve the economic development of a country. Bank needs proper handling of several problem and challenges. In current scenario, the major challenge of commercial banks is competition among 26 commercial banks.

Proper risk management is required to remain competitive in the market & achieve the goals. The major banking risks include credit risk, market risk (i.e. liquidity risk, interest risk, operation risk etc). Among these risks, credit risk has the major impact on banking (i.e. more than 60 %). Because of the credit risk, the Non Performing Loan (NPL) of bank will increase. With the increase in NPL, the loan loss provisioning will also increase simultaneously leading to decrease in profit. The decrease in profit results in low dividend to shareholder and bonus to employees.

Similarly, poor management of asset and liabilities having different maturity period is the main problem that results in other market risk such as liquidity risk, interest rate risk etc. The other component of market risk includes the interest rate risk.

Similarly, tactfully dealing with market interest movement by adjusting the interest sensitive asset and liabilities also remain challenge to these banks. To remain alert and prepare plans and policies to tackle unpredictable factors such as violence riots, natural disaster, technology and employees, fault and fraud of customers and outsiders are the challenges for these commercial banks.

For proper management of these risks, both banks have their own set of policies and practices, which is in consistence with NRB guidelines. For credit risk management, both banks have Credit Policies Guidelines (CPG). Similarly, NPL is regularly monitored by both the banks on regular basis and provisioning is done on quarterly basis by categorizing the loan as per NRB guidelines. Similarly, sector wise and security wise lending is being analyzed by these banks on monthly basis. Organization structure of these banks is frequently restructured for proper risk management.

Gap analysis is the major tool for managing the liquidity risk. The top management analyzes the gap between asset and liabilities and makes decision to make adjustment for it. Further, the top management decides how much liquid asset is needed to be kept in the bank. Treasury and finance depm1ment of these banks continuously manage the CRR in NRB to ensure that statutory requirement is met.

Gap analysis of both types of asset and liabilities (i.e. Rate Sensitive and Fixed Rate) is required for the interest rate risk management. Besides, analysis of cost of fund, yield on loan & spread is made continuously in these banks to ensure that banks have competitive interest rate, which is profitable for the banks.

In regard to operational risk, the major steps banks are taking to reduce it are preparing and implementing the different operational guidelines and policies & frequently monitoring their compliance. Most of these policies are prepared as per NRB guidelines. Similarly, employees' training is also the major tools for minimizing the operation risk in these banks.

For minimizing the loss arising due to occurrence of the above risks, capital and reserve have been maintained by these banks within the standard prescribed by NRB. However, the trend of Capital Adequacy ratio of these banks suggests that both the banks need to increase their capital fund, which is possible mainly by issuing shares, debentures or preference share.

Though both the banks have their own set of procedures for assessing various risks and their management, problems are still prevalent in these banks. In credit risk,

single sector loan concentration is the main problem in both the banks. In MBL the major problem is a high amount of lending in wholesaler and retailer sector, lending without collateral, nonperforming loan & organizational structure for handling credit risk. In NCC Bank, the major problem is a high amount of lending in manufacturing sector, non performing loan & organizational structure for handling credit risk. As the increase in total loan brings increase in NPL, proper adjustment is needed for managing the NPL. Similarly, asset liabilities mismatch is also the problem in both the banks. Both banks are in riskier position in the asset and liabilities of longer maturity period when the market price of asset liabilities decrease. Similarly, managing CRR to Statutory requirement is also one of the problems in these banks.

Adhikari (2009), in her study titled *"A case study on Accounting System Of Nepal Bank Ltd"* states the objective of her study as follows:

a. To identify the practices of accounting system and principles being present in Nepal Bank Limited.
b. To review the accounting system and policies being practiced in Nepal Bank Limited
c. To evaluate the contribution of accounting systems in the overall performance of the bank.
d. To explore the general environmental factors regarding the accounting system.
e. To provide the recommendations for the improvement of accounting system in Nepal Bank Limited.

In her study she has concluded as follows.

a. Nepalese Commercial Banks have determined the accounting policy clearly.
b. Computer software could not represent all accounting variables.
c. The poor relation in determine the accounting software between computer science engineer and specialists of accounting.
d. The maintaining and evaluation process of NRB is held once a year. It creates difficulties and problem to control.
e. Various commercial banks and departments are using accounting software.
f. Accounting software and manual accounting system covers all of accounting system of NBL but using both systems is may misunderstanding, creates difficulty in the operation of bank and inconsistent.

g. NBL follows all and every rules of NRB.
h. For proper development of accounting system, NBL don't have any unit or committee.
i. Lack of proper knowledge and training to the staff creates many problems in accounting system.

Acharya (2010), in his study titled "*The Study of Basel II Capital Accord: An Analysis of qualitative impact of NCAF over A class Banks*" stated the objectives of his Study as follows:

The main objective of this dissertation is to study the New Capital Adequacy norms developed by NRB based on Basel II and its qualitative effect over the Banks. Therefore this study is encompasses in the course of following objectives to acquire the research goal.

a. To test suitableness of the quantified level of Tier 1 capital,
b. To identify the appropriateness of CAR,
c. To analyze the NCAF,
d. To study the capability of NRB to enforce NCAF,
e. To study of the qualitative impact of NCAF in total financial system.

In his study he has concluded as follows:

In Nepal financial sector reform was started in 1980s with steps to deregulate the interest rate structure (NRB 1996). In 1984, financial sector opening up policies were pursued by allowing joint venture banks to operate in Nepal. Similarly the Finance Company Act was brought in to effect in 1985 to meet the rising demand of small borrowers. Removal of statutory liquidity ratio and introduction of auctioning of treasury bills were other reform measures implemented during the 1980s. From 1989, NRB also began to fix capital adequacy ratio. In the same year, NRB set up an upper limit on the amount of loan to be provided to a single borrower or group of borrowers by bank with the aim of minimizing the risk of over-concentration of loan in few big borrowers. Similarly, central bank also introduced open market operations as one of the monitory policy implementation tools in 1990.

A more intensive reform was started from early 1990s. Finance Company Act 1985 was amended; Development Bank Act 1995 and Financial Intermediary Institution Act 1998 were introduced to attract private sectors and NGOs in establishing financial institutions in the rural area. In response, large number of Development Banks, Gramin Bikash Banks, Financial Institutions, financial NGOs and Co-operatives came in to operation during the post reform period. Prudential norms were also gradually refined and strengthened. In 1995, the loan limit to a single and group borrower reduced to 35% and 50% respectively. Through the regulation 2001, the loan limits were further revised; 25% of core capital in case of fund based loans and 50% of core capital in case of non-fund based loan. The mandatory priority sector lending policy was introduced as early as 1974 which is continued in post-liberalization period also. The ratio was further revised to 12% in 1990 from 8% of 1984/85. In 1992, commercial banks were additionally directed to lend a certain percent of priority sector lending towards the small borrowers.

However, whatever reforms with the aim of raising the financial health of the banking system were pursued, they were found to be highly inadequate (World Bank 2002). The financial system was found entering in to deeper crisis. A study of KPMG revealed that state owned two commercial banks were technically insolvent with non performing assets reaching as high as 60% of total assets. As a result comprehensive Financial Sector Reform Program was introduced in 2002. The program aims to create a competitive, market friendly, well diversified and prudently managed system capable to lead the healthy growth of financial sector. As the part of the reform, NRB Act 2002 and Debt Recovery Act 2002 with the provision of Debt Recovery Tribunal were introduced. It also gives sufficient authority to the central bank in maintaining financial discipline and performing regulatory and supervisory role more effectively. As a part of the ongoing reform, the state owned commercial banks were given to outside management contract. An umbrella Act, Bank and Financial Act 2006 covering all bank and financial institution has been enacted with aim of bringing more reform in the financial sectors in more coordinated and unified way. Likewise NRB issued Prompt Corrective Action By-Law 2007 and New Capital Adequacy Framework 2007(revised in 2008) also enacted as the latest reform process.

Our financial market is introducing those products which were introduced 30 year ago in US and other developed countries. Although today the world is converted in a small village because of IT development, technology transfer and globalization in economic sector. Every economy is inter-connected, mainly undeveloped and underdeveloped economy are interdependent with developed economy. The interdependency creates both opportunity and threat. Financial Crisis in one country could affect another country, likewise interest rate risk, exchange rate risk, HR consumption rate risk including other related risk have also chronological effect in each country. So financial policies and monitory policies of underdeveloped country like Nepal could not drive sovereignty. NRB seems always acknowledged and serious to enforce and adopt the international best practices in its history. Previously applied Basel I framework was not enough to measure all the risk except credit risk. To fulfill the drawback, Basel II was introduced which has developed different approaches to measure risks. NCAF prescribed Simplified Standardized Approach (SSA) to measure Credit Risk, Basic Indicator Approach (BIA) to measure the Operational Risk and Net Open Position Approach (NOPA) to measure the capital requirement for Market Risk. The respondents, who represent all the banks except Global Bank, viewed that NCAF was the desired, needed, feasible and suitable in our context. The customized version of Basel II has supported to adopt risk based price, in product identification and to quantify the associated risk. Likewise NCAF supported for inherent risk management practice, for safeguard of depositors interest, to manage the bank efficiently and confidently, to judge against competitor and for strengthening regularity capability of NRB which ultimately supported for financial stability of the nation. This study shows that NCAF also help to develop sound and safe financial system through maintaining sufficient amount of qualitative capital, enhancing risk management practice, maintaining portfolio investment, commensurate with risk associated activities and profiling the commercial banks and promoting public confidence in banking system.

Considering the aforementioned facts NRB must have to take initiation for full implementation of Basel II, continuous encouragement and on-site follow up also needed for adoption of BCP. Similarly sound practice for management of operational risk, adherence to high degree of corporate governance and direction for complete establishment of internal system including IT required to meet the advance approach

of Basel-II must be initiated. Policy amendment to establish Credit Rating Agency, initiation for benchmarking software for reporting, effective role of Central Information Bureau, accountable and trained manpower etc are the basic infrastructure for significant implementation of Basel II. It is found in an informal interaction with the respondents that Banks and FI are transparent among opaque. Obviously benefit of doubt should be acknowledged by NRB. So the cause behind lacking of transparency is the weaknesses of NRB in monitoring, supervising, controlling, directing and mobilizing the HR. Lacking of the provision of punishment to auditors in their disregard, influence of management in auditor appointment procedure, influence to the internal audit of NRB, influence of politics and retired (but engaged in private banks) officials are the main factors for the opaque.

Research Gap

Bank is the intermediates between the deficit and surplus sector of the economy. Surplus sector of the economy keeps their surplus money as deposits in the banks and hence banks can provide such funds to deficit sector in the form of loans and advances. In this way the well being and effective operation of a bank is important for the economy and surplus & deficit sector of the economy as well.

There are different types of rules, regulation, policy, principal and guide lines for the smooth operation of a bank and different monitoring & controlling authorities are also there to control the banking operation. Despite of existence of different control mechanism for the smooth operation of banks; poor performances of different banks have been noticed in banking industry. The quality of operation and financial strength of a bank can be tracked out with the help of the result of financial analysis. The result of financial analysis mere could not give any meaning regarding the financial strength and performance of a bank. In order to get the real meaning; these result need to be compare with pre determined standard and with the result of other banks and banking industry.

There are numerous studies regarding the evaluation of financial performance of Nepal Bank Limited. In these studies the results of financial analysis of NBL have been compared with other one or two banks of banking industry. But till the date there is no any study regarding the financial performance of NBL in comparison of banking

industry average and Basel II accord. This study is quite differ from all of the previous study regarding the financial performance of NBL as this study has compared the result of financial analysis of NBL with the result of banking industry average Basel II accord.

The major findings derived from this study are very serious and these are of great importance to the management of NBL and banking industry as well. The recommendations presented in this study are very practical and easy to understand & implement.

CHAPTER - III
RESEARCH METHODOLOGY

Research methodology is the way to solve systematically about the research problem *(Kothari;1994*). To evaluate, analyze and interpret on every subject and discipline a detailed research plan is required. Without gathering detail data and without applying different analytical tools it is impossible to confess anything about the related subject.

It is the time of liberalization & globalization and it is being realized that the economic growth/advancement of a country can be achieved only after the active involvement of banking sector in economic activities. In Nepal; role of government owned bank is not that much of effective what that was expected from them in the sector of economic development and at the same time joint venture banks are performing their role successfully and effectively. In order to track out the reason behind the weak performance of government owned bank; a detailed research is required and this thesis is concerned to explore the reason behind the weak performance of government owned bank.

The present study has its objective to analyze the financial performance of commercial bank. I have selected Nepal Bank Limited for the purpose of my research work. This research work requires an appropriate research methodology to follow for the finding of fact regarding the financial performance of Nepal Bank Limited. This chapter looks in to the research design, period covered, the nature and source of data, tools used, research variables and research questions.

3.1 Research Design

Research design is the plan structure and strategy of investigation convinced so as to obtain answer to research questions and to control variances. The plan is the overall scheme of program of the research. It includes an outline of what the investigator will do from writing the hypothesis and their operational implication to the financial analysis of data *(Wolf and Pant; 2005).*

This research design is a plan to obtain the answer of research questions through analysis of data. The research design of this study is an examination and evaluation of financial performance of Nepal Bank Limited. The study is closely related with the various & actual financial data of Nepal Bank Limited and banking industry average of Nepal. This study also comprises the standard determined by BASEL II regarding the financial indicator of bank and financial institution. These information are used to analyze and evaluate the financial performance of Nepal Bank Limited.

3.2 Period Covered

The study covers a period of five years from FY 2060/061 to 2064/65. Data are collected from Nepal Bank Limited and Nepal Rastra Bank along with other publication of World Bank and Asian Development Bank. In this study analysis is basically made on the basis of these data related with Nepal Bank Limited.

3.3 Nature and Source of Data

Data have been collected specially from the secondary sources. Beside this I have discussed informally with the staffs of Nepal Bank Limited in order to get needed information. In this way both primary and secondary data are used in this study. Secondary data are mainly taken from annual publications of Nepal Bank Limited and Bank and Financial Statistics published by Nepal Rastra Bank.

3.4 Method of Analysis

Specific financial and statistical tools are used in this research. The analysis of data is done according to the pattern of data available. The relationship between different variables related to study would be drawn out by using financial and statistical tools. The calculated result is tabulated under different headings for the easiness to read and they are compared with each other to interpret the results. To study the relationship between the variables; correlation is conducted.

3.5 Research Variables

Net interest margin, Net income, capital adequacy, Deposit lending ratio, Loan loss provisioning, Total NPA volume, and volume of deposit, volume of loan, Net worth

and volume of risk weighted assets are the main research variables of this research study.

3.6 Data Analysis Tools

For the purpose of analysis financial and statistical tools along with capital adequacy frame work of Basel II have been used.

3.6.1 Financial Tools

Financial tools are those which help to study the financial strength and weakness of the sample firms. The financial tools used in this study are briefly presented below:

i) Net Interest Margin (NIM)

NIM is a measure of the difference between the interest income generated by banks or other financial institutions and the amount of interest paid out to their lenders (for example, deposits), relative to the amount of their assets. It is similar to the gross margin of non-financial companies. It is usually expressed as a percentage of what the financial institution earns on loans in a time period and other assets minus the interest paid on borrowed funds divided by the average amount of the assets on which it earned income in that time period (the average earning assets). Net interest margin is similar in concept to net interest spread, but the net interest spread is the nominal average difference between the borrowing and the lending rates, without compensating for the fact that the earning assets and the borrowed funds may be different instruments and differ in volume. The net interest margin can therefore be higher (or occasionally lower) than the net interest spread.

NIM is calculated as a percentage of interest bearing assets. For example, a bank's average loan to customers was Rs. 100.00 in a year while it earned interest income of Rs. 6.00 and paid interest of Rs. 3.00. The NIM then is computed as (Rs. 6 – Rs. 3) / Rs. 100 or 3%. Net interest income equals the interest earned minus the interest paid out to customers. The net interest income of some banks is more sensitive to changes in interest rates than others. This can vary according to several factors, such as the type of assets and liabilities that are held. Banks with variable rate assets and liabilities will obviously be more vulnerable to changes in interest rates than those

with fixed-rate assets. Banks with liabilities that re-price more often or quicker than its assets will also be affected by interest rate changes.

$$\text{NIM} = \frac{\text{Interest Earned Z Interest Paid}}{\text{Average Earning Assets}} \text{X } 100$$

ii) CD Ratio

Credit Deposit ratio refers to the percentage of total advances divided by the total deposits of a Bank/ Branch. This signifies what proportion of total deposit is lent to borrowers. The proportion of loans generated by banks from the deposits received is known as CD ratio. CD ratio is an index of the health of banking system in terms of demand for credit in proportion to total deposit growth in the banking sector. A declining CD ratio implies that banking sector was flush with funds without any corresponding demand for credit affecting the bank's profitability in the long run as they have to pay interest to depositors without corresponding income from the credit outflow.

$$\text{CD Ratio} = \frac{\text{Total Loans}}{\text{Total Deposits}} \text{X } 100$$

iii) Earnings Ratios

Earnings ratios depict the bank's ability to earn profit. The following ratios will be calculated to analyze the NBL's earning capacity:

Table: 3.1

Earnings Ratios

1	Return on Assets	=	$\frac{\text{PAT}}{\text{Average Total Assets}} \times 100$
2	Interest Income to Total Assets	=	$\frac{\text{Interest Income}}{\text{Average Total Assets}} \times 100$
3	Interest Expenses to Total Assets	=	$\frac{\text{Interest Expense}}{\text{Average Total Assets}} \times 100$
4	Net Interest Margin	=	$\frac{\text{Net Interest Income}}{\text{Average Total Assets}} \times 100$
5	Non -interest Income to Total Assets	=	$\frac{\text{Non-Interest Income}}{\text{Average Total Assets}} \times 100$
6	PBPT to Total Assets	=	$\frac{\text{Profit before Provisions \& Tax}}{\text{Average Total Assets}} \times 100$
7	Cost Benefit Ratio	=	$\frac{\text{Cost}}{\text{Income}} \times 100$
8	Staff cost to Income Ratio	=	$\frac{\text{Staff Cost}}{\text{Income}} \times 100$
9	Staff cost to Total Operating Cost Ratio	=	$\frac{\text{Staff Cost}}{\text{Total Operating Cost}} \times 100$

iv) Liquidity and Resources Ratios

Liquidity management is important and crucial task in banking. Bank collects funds from the surplus sector in form of deposit and lends the collected amount in the deficit sector. Bank needs to hold adequate level of liquid assets in order to fulfill the needs of surplus and deficit sector of the economy. The following ratios will be calculated to analyze the liquidity and resource management of NBL:

Table: 3.2

Liquidity Ratios

1	Savings Deposits to Total deposits	=	$\frac{\text{Savings Deposits}}{\text{Total Deposits}} \times 100$
2	(Current + Savings Deposits) to Total Deposits	=	$\frac{\text{Current + Savings Deposits}}{\text{Total Deposits}} \times 100$
3	Time Deposits to Total Deposits	=	$\frac{\text{Time Deposits}}{\text{Total Deposits}} \times 100$
4	Total Deposits to Total Liabilities	=	$\frac{\text{Total Deposits}}{\text{Total Liabilities}} \times 100$
5	Net Loans to Total Assets	=	$\frac{\text{Net Loans}}{\text{Total Assets}} \times 100$
6	Gross Loans to Total Assets	=	$\frac{\text{Gross Loans}}{\text{Total Assets}} \times 100$
7	Net Loans to Total Deposits	=	$\frac{\text{Net Loans}}{\text{Total Deposits}} \times 100$

v) Asset Quality Ratios

The Asset Quality Ratio is a useful tool for assessing asset quality of bank. It provides a summary comparative view of asset quality of a bank with peer (similar) bank's as well as level and trend data of a bank's asset quality. The following ratios will be calculated to analyze the asset quality of NBL.

Table: 3.3

Assets Quality Ratio

1	% of Gross Bad Loan to Gross Total Loan	=	$\frac{\text{Gross NPA}}{\text{Gross Advances}} \times 100$
2	% of Net Bad Loan to Net Total Loan	=	$\frac{\text{Net NPA}}{\text{Net Advances}} \times 100$
3	% of Gross Bad Loan to Net total Loan	=	$\frac{\text{Gross NPA}}{\text{Net Advances}} \times 100$
4	% of Provision to Gross Bad Loan	=	$\frac{\text{Loan Loss Provisions}}{\text{Gross NPA}} \times 100$
5	% of Provision to Gross Total Loan	=	$\frac{\text{Provisions}}{\text{Gross Loans}} \times 100$

vi) Productivity Ratios

The productivity Ratio is a useful tool for assessing quality of employee and effectiveness of human resource policy. It provides a summary comparative view of employee quality of a bank with peer (similar) bank's as well as level and trend data of a bank's employee quality. The following ratios will be calculated to analyze the productivity of NBL.

Table: 3.4

Productivity Ratio

1	Headcount	=	Total No of Employee
2	Per employee business in Rs. Million	=	$\frac{\text{Business}}{\text{Employee}}$
3	Per employee profit in Rs. Million	=	$\frac{\text{Profit}}{\text{Employee}}$
4	Per employee income	=	$\frac{\text{Income}}{\text{Employee}}$
5	Net interest margin to staff expenses	=	$\frac{\text{Net Interest Margin}}{\text{Staff Expenses}} \times 100$

vii) Other Ratios

Apart from the ratios presented above extra other ratios are also been calculated to access the financial performance of NBL. These are as follows:

Table: 3.5

Other Ratios

1	Advance Interest to Pass Loan	=	$\frac{\text{Advance Interest}}{\text{Average Pass Loans}} \times 100$
2	Average Return on Investment	=	$\frac{\text{Interest on Investment}}{\text{Average Investments}} \times 100$
3	Total % of Cost of Funds	=	$\frac{\text{Cost of Funds}}{\text{Total Funds}} \times 100$
4	% of Cost of Deposits (Total)	=	$\frac{\text{Cost of Deposit}}{\text{Total Deposit}} \times 100$
5	% of Cost of Interest Bearing Deposits	=	$\frac{\text{Interest}}{\text{Interest Bearing Deposit}} \times 100$
6	Net interest income to Income	=	$\frac{\text{Net Interest Income}}{\text{Income}} \times 100$
7	Non-interest income to Income	=	$\frac{\text{Non-Interest Income}}{\text{Income}} \times 100$
8	DP ratio	=	$\frac{\text{DPS}}{\text{EPS}} \times 100$

3.6.2 Statistical Tools

Some of the statistical tools which show the highlight of Nepal Bank Limited are used to achieve objective of the study. The main statistical tools used in this research are as follows:

i. Arithmetic Mean

Arithmetic Mean has widely used in this study. It has been used as to calculate the average for 5 years. This tool has been used to calculate the single figure that can represent the whole data for the period. The Arithmetic Mean of loan, deposits, net profit, nonperforming loan, loan loss provision etc, has been calculated in this study. It is computed by sing following formula:

$$\text{Mean } (\overline{X}) = \frac{\Sigma x}{n}$$

Where,

$\overline{X}$ = Mean

ΣX = Sum of all the variable X

n = Variables involved

ii. Standard Deviation

Standard Deviation has been used wherever the mean is calculated to study the deviation of the data from the mean. Here, standard deviation is used as a measure of dispersion. It has also been used as a measure to identify the risk. Higher the deviation greater will be the risk and vice versa. Mathematically, it is defined as the positive square root of their arithmetic mean of squares of the deviation of the given observations from their arithmetic mean of a set of value. Here, it is denoted by the letter sigma (σ). It can be computed by using following formula.

$$\text{Standard Deviation } (\sigma) = \sqrt{\frac{1}{n}(\quad X\ Z\overline{X})^2}$$

Greater the magnitude of standard deviation, higher will be the fluctuation and vice versa.

3.6.3 Basel-II Capital Adequacy Framework

The Capital Adequacy Ratio (CAR) is calculated by dividing eligible regulatory capital by total risk weighted exposure. The total risk weighted exposure shall comprise of risk weights calculated in respect of bank's credit, operational and market risks.

$$\text{Tier 1 CAR} = \frac{\text{Eligible Tier 1 Capital Funds}}{\text{Credit Risk RWA + Market Risk RWA + Operational Risk RWA}}$$

$$\text{Total CAR} = \frac{\text{Eligible total capital funds}}{\text{Credit Risk RWA + Market Risk RWA + Operational Risk RWA}}$$

3.7 Limitation of the Methodology

The analysis on the secondary data is obtained from financial statement provided by NBL and through the web site of NRB. The financial analysis is based on the pooled data from the mentioned source. The reliability of the financial tools used and lack of experience is primary limitation of the research work. The computer operating system namely EXCELL has been used for financial calculation, therefore, technical error may exist with least chance.

CHAPTER - IV

DATA PRESENTATION AND ANALYSIS

To fulfill the objectives of the study mentioned in the introduction chapter several analytical tools and techniques have been presented in the research methodology chapter. All the tools and techniques mentioned in earlier chapter will become help full to achieve the basic objective of the study and so all the concerned tools and techniques have been used in this chapter. Actually, in this chapter, the effort has been made to analyze the financial performance of Nepal Bank Limited in comparison of Nepalese banking industry and Basel II. My analysis is highly supported by the practice of commercial banks to analyze the financial performance. That's why researcher has taken the data of Nepal Bank Limited and banking industry for elaboration, and to come to conclusion.

This chapter of data presentation and analysis of financial performance of Nepal Bank Limited begins with the financial tools i.e. Net interest margin, Net income, Deposit lending ratio, Loan loss provisioning, Total NPA volume, volume of deposit, volume of loan. These financial indicators of Nepal Bank Limited and banking industry are compared with the help of financial ratios viz. Earnings Ratios, Liquidity and Resources Ratios and Asset Quality Ratios; which are calculated and interpreted. In second phase, tools and data have been used to calculate capital adequacy ratio as per the specified format published by NRB. At last, some statistical tools i.e. mean and standard deviation has been used to analyze the risk level of NBL.

4.1 Financial Tools

4.1.1 Analysis of Net Interest Margin

Table: 4.1

Net Interest Margin

Year	Mid July of				
	2005	**2006**	**2007**	**2008**	**2009**
NBL	2.55	3.72	3.65	2.87	2.28
Industry Average	5.72	6.03	5.98	5.75	5.35

Source: Annual Report Published by NBL and Banking & Financial Statistics NRB

The data presented above shows that the net interest margin of NBL is significantly lower than of net interest margin of banking industry average of Nepal. It indicates the larger volume of interest expenses of NBL and the cause of larger volume interest expenses is the large volume of interest bearing deposit. On the other hand; the cause of lower level of net interest margin is lower level of interest income. Because of the lower CD ratio the interest income of NBL is comparatively lower than of industry average.

4.1.2 Analysis of Interest Spread

Interest spread is defined as:

$$\frac{\text{InterestEarned}}{\text{InterestBearingAssets}} \times 100 \; Z \; \frac{\text{InterestExpended}}{\text{InterestBearingLiabilities}} \times 100$$

Interest bearing assets include Money at call and short notice, Treasury Bills, Placements with banks, Development Bonds, Foreign assets, Debentures, Net Loans and Staff Loans and Advances. Whereas interest bearing liabilities include: Interest Bearing Deposits, Borrowings and Staff Funds.

Table: 4.2

Interest Spread

Year	Mid July of				
	2005	**2006**	**2007**	**2008**	**2009**
Interest Spread of NBL	5.03%	5.75%	5.53%	4.07%	3.29%
Industry Average	4.23%	4.57%	4.32%	3.75%	3.50%

Source: Annual Report Published by NBL and Banking & Financial Statistics NRB

As per the data presented above the interest spread of NBL is better than of industry average except on July 2009. It indicates the earning potentiality of NBL but due to the lower CD ratio the net interest margin of NBL is lower than of industry average. Higher interest spread along with lower net interest margin indicates that the NBL has hold large amount of interest bearing deposit idle. In order to improve the level of net interest margin NBL needs to improve the CD ratio for the enhancement of interest income by lending the idle amount of interest bearing deposit. On the other hand the net interest income and interest spread can further be improved by lowering the interest bearing deposit and enhancing the interest free deposit.

4.1.3 Gross Credit Deposit (C/D) Ratio

Table: 4.3

Credit Deposit Ratio

Year	**Mid July of**				
	2005	**2006**	**2007**	**2008**	**2009**
NBL CD Ratio	50.20%	46.94%	34.72%	35.26%	39.88%
Industry Average	71.41%	74.21%	70.02%	75.46%	79.83%

Source: Annual Report Published by NBL Banking and Financial Statistics Published by NRB

The CD Ratio indicates the amount lend by the bank from the total deposit amount held by it. The CD ratio of NBL is quite lower than of industry average. NRB has instructed to maintain CD ratio to the maximum of 80%. But the CD ratio of NBL is just about to 50% of NRB's instruction. NBL has to improve the CD ratio by lending its deposit aggressively for the improvement of its net interest margin.

Individual analysis of net interest margin, interest spread and CD ratio could not give any clear meaning regarding the financial performance of banks and financial institution. While analyzing the financial performance of a bank; integrated analysis of these three indicators is needed. These indicators are dependent with each other. The higher level of interest spread of NBL indicates that NBL has good earning potentiality if it lends its deposit amount to the high. But the position of CD ratio indicates that NBL is become unable to lend the deposited amount properly and it has

idle amount in its hand. Because of the lower CD ratio the net interest margin of NBL is also lower and unsatisfactory.

4.1.4 Earnings Ratios

Banks are the financial institutions established with profit/earning motive. Earning is needed to survive the institution and to give return to its owner. In this way earning is essential for every bank. Here, effort has been made to analyze the earning of NBL. In order to ascertain the clear picture of earning, different types of earnings have been compared with other data:

Table: 4.4

Earnings Ratios

	Types of Ratios	Mid July of				
		2005	**2006**	**2007**	**2008**	**2009**
1	Return on assets (%)	2.27	5.19	3.45	0.60	-0.46
2	Interest Income to Total Assets (%)	5.83	5.96	5.86	4.92	4.12
3	Interest Expenses to Total Assets (%)	3.27	2.25	2.21	2.06	1.84
4	Net interest margin (%)	2.55	3.72	3.65	2.87	2.28
5	Non -interest Income to Total Assets (%)	3.36	5.33	1.32	1.89	1.15
6	PBPT to Total Assets (%)	4.93	5.92	3.79	0.79	-0.23
7	Cost Benefit Ratio (%)	44.02	29.35	53.59	55.89	78.18
8	Staff cost to Income ratio (%)	33.31	22.50	38.18	41.42	60.29
9	Staff cost to Operating cost ratio (%)	75.68	76.67	71.26	74.11	77.12

Source: Annual Report Published by NBL

) Return on Assets

Return on assets ratio at the beginning and at the ending of the analysis period is relatively uncomfortable as they are at negative value. After the holding of bank management by ICCMT, the ratio has been improved to some extent but in 2008 and 2009, when the ICCMT left the bank, the ratio decreased to its worse. Improvement on the return on assets ratio in rest of the year is just because of bad loan recovery as ICCMT focused on recovery of bad loan. This ratio indicates that the NBL is unable to expand the volume of good quality assets (Good loan).

) Net Interest Margin

It is the difference between the ratio of interest income to total assets and interest expenses to total assets. Positive value of this ratio indicates that the bank has been

earning enough amounts in form of interest income to pay interest expenses. Lower amount of net interest margin leads to lower profitability as the interest income is main revenue source to the bank. NBL has been facing lower level of net interest margin. During the tenure of ICCMT, the ratio was little bit satisfactory.

⁾ Non-interest Income to Total Assets

This ratio indicates the capacity of bank to earn non-interest income (Commission, charges, fees etc.) by using available capacity with bank. Lower value of this ratio indicates the bank's inability to grasp the opportunity of commission business (Guarantees, L/Cs & Remittance). Commission businesses generally are of non-funded in nature and comparatively less risky than of funded one. Commission business helps to improve the profitability of a bank as these kinds of business does not need to use any funds. Non-interest income to total assets ratio of the NBL is highly unsatisfactory. During the tenure of ICCMT, the ratio was little bit satisfactory.

⁾ Cost Benefit Ratio

This ratio compares the total cost with total revenue of the bank. CB ratio 95.53% means the total cost of bank is 95.53% of total revenue. In other word, NBL needs to spend Rs. 95.53 for earning each 100 Rupees. In another way this data can be expressed as NBL has earned Re. 1.05 by spending every 1 Rupee in year 2005. The position of CB ratio had little bit been improved on wards to year 2006 but the ratio is further worsen on 2009. NBL has extremely worse CB ratio because of high level of interest expenses and other overhead expenses including employee expenses. During the tenure of ICCMT, the ratio was little bit satisfactory.

⁾ Staff Cost to Income Ratio

This ratio compares the total employee expenses with total revenue. Since the ratio is extremely high; it can be concluded that the bank has been paying most of its revenue to employee as salary and benefit. Staff cost to income ratio in industry average is 20% but in some of the year it is up to 80% in NBL. The position of this ratio indicates that the NBL has over and unproductive staff and which has adversely affect the earning and profitability of the bank. During the tenure of ICCMT, the ratio was little bit satisfactory as the regular staff expenses was decrease by the effect of VRS

(Voluntary Retirement Scheme) and the total revenue was increase because of bad loan recovery.

⟩ Staff Cost to Total Operating Cost Ratio

Here, it has been tried to track out the reason behind the lower level of earnings of NBL. It has already been discussed about some of the reasons for lower level of earnings of NBL i.e. high volume of interest expenses, high level of CB ratio and high level of staff cost to income ratio. With the help of staff cost to operating cost ratio it is clear that how the staff expenses have adversely affects on the earning of NBL as the staff cost constitute the major portion on total operating cost. In some of year it is up to 83% of total operating cost.

4.1.5 Liquidity and Resource Ratios

Key financial ratios measuring a bank's application of interest-earning deposit liabilities to fund loan growth, expressed as a percentage. There are four primary liquidity ratios: cash and unpledged marketable securities divided by total assets; total deposits divided by borrowed funds; volatile funds divided by liquid assets; and total loans divided by total deposits (most commonly used). A low ratio of loans to deposits indicates excess liquidity, and potentially low profits, compared to other banks. A high loan-to-deposit ratio presents the risk that some loans may have to be sold at a loss to meet depositors' claims. In order to analyze the liquidity and resource ratio of NBL the following ratios have been calculated:

Table: 4.5

Liquidity & Resource Ratio

	Types of Ratios	**Mid July of**				
		2005	**2006**	**2007**	**2008**	**2009**
1	Savings to Total deposits (%)	62.14	65.37	67.33	67.74	69.15
2	*C+S Deposit to Total deposits (%)	77.63	82.06	84.18	85.08	85.72
3	Time to Total deposits (%)	22.76	18.16	14.64	14.65	14.15
4	Total Deposit to Total liabilities (%)	109.52	105.67	99.75	99.62	100.87
5	Net loans to Total assets (%)	31.12	28.06	30.82	31.59	36.65
6	Gross loans to Total assets (%)	54.97	49.60	34.64	35.13	40.23
7	Net loans to Total deposits (%)	24.85	22.87	27.23	28.34	32.97

Source: Annual Report Published by NBL

**C+S Deposit: Current + Saving Deposit*

⁾ Deposit Mix

Saving deposit is interest bearing deposit and timely bank has to pay certain amount as interest on saving deposit. The volume of saving deposit has been increasing every year. Increase on saving deposit adversely affect on bank's profitability. Every bank prefers to get current deposit as it is interest free deposit. But in case of NBL data presented above indicates that the percentage of current deposit in deposit mix has been decreasing every year. Government units and business organization, generally, deposit their amount on current deposit and decreasing trend of current deposit indicates that NBL became unable to grow and even to retain the government and other institutional deposit client. On the other hand, the volume of time deposit has also been decreasing every year. Although the time deposit is expensive source of fund but it helps bank to manage liquidity when excess cash outflow is happen. Generally, retired people and other who do not want to take any risk on their saving amount prefer to keep their amount on time deposit. Decreasing the volume of time deposit indicates that the NBL has been losing the faith of general public.

⁾ Loan Volume

Total Net loan equals to Total Gross loan minus loan loss provision. The position of Net loan to total assets indicates that NBL has low level of loan assets in its balance sheet. Loan is earning assets and other is none earning. High volume of none earning assets in assets mix leads to poor profitability and even to operating loss. The position of net loan to total deposit indicates that NBL has strong liquidity position and it has huge volume of idle liquid assets either in form of cash or in form of security investment. One thing to remember here that cash is none earning assets and security investment is least earning assets. Higher volume of loan assets in total assets mix leads to higher profitability.

4.1.6 Assets Quality Ratio

When a bank fails, it is usually a result of poor asset quality, so paying attention to assets is pretty important. The buzzwords here are nonperforming assets (NPAs), which are basically loans that are no longer earning interest or are more than 90 days past due. The absolute level of NPAs is less important than how large NPAs are as a percentage of equity or assets.

Most bankers and examiners will agree that the single greatest risk in banking is the risk of loan losses. This is because loans typically comprise a majority of the assets in banks. It's not hard to imagine an entire year's worth of earnings being completely eliminated because of one or two large loans being charged off. Because the exposure is so vast, examiners spend a significant amount of time assessing asset quality, primarily loan quality, at almost every examination. Of course, given the size of the exposure, we think the directorate should spend a significant amount of time assessing this risk as well, in formulating loan policies, attending loan committee meetings, reading credit reviews, and reviewing various management reports on the condition of the loan portfolio. The ratios presented below will examine the assets quality of NBL:

Table: 4.6

Assets Quality Ratio

Types of Ratios		**Mid July of**				
		2005	**2006**	**2007**	**2008**	**2009**
1	% of Gross NPA to Gross Total Loan	53.74	49.64	18.18	13.49	10.58
2	% of Net NPA to Net Total Loan	6.58	-3.3	-4.34	-7.61	-8.16
3	% of Gross NPA to Net total Loan	108.54	101.86	23.19	16.78	12.80
4	% of Provision to Gross Bad Loan	93.94	103.29	118.11	145.37	163.74
5	% of Provision to Gross Total Loan	92.22	100.59	92.77	104.73	114.76

Source: Annual Report Published by NBL

) Gross NPA to Gross Total Loan

This ratio tries to examine the loan quality (Assets Quality) of NBL by ascertaining the percentage of NPA (Past due loan or Bad loan) out from total loan volume. During the year 2005 Gross NPA percentage was 53.74% and it was decrease to 10.58% on 2009. After the holding of bank management by ICCMT, the ratio has been improved to some extent as the ICCMT primarily focused on the recovery of Bad Loan. In international practice, generally, the single digit percentage of NPA is acceptable. As per this view NBL has to effort even more to lower the level of NPA.

) Net NPA to Net Total Loan

Here, Net NPA equals to Total NPA minus loan loss provision for NPA and Net Total loan equals to Total loan minus loan loss provision for total loan. Positive figure in year 2005 and 2006 indicates the inadequate amount of loan loss provision for NPA

and negative figure in rest of year indicates the excess amount of loan loss provision than of actual NPA volume. Negative value of NPA to Net Total Loan ratio depict the position that NBL has set sufficient amount aside from total operating revenue to cover the losses occurred due to bad loan.

- **Loan Loss Provision to Gross Bad Loan**

Gross bad loan means bad loan before deducting provision. During the year 2005 and 2006 there was inadequate amount of loan loss provision to cover the losses of bad loan as the percentage was less than 100. But from the year 2007, the amount of loan loss provision have been sufficient to cover the bad loan as the percentage of loan loss provision is excess than 100% of bad loan.

- **Loan Loss Provision to Gross Total Loan**

Gross total loan equals to gross bad loan (NPA) plus gross good loan. It is to be noted here that as per the instruction of NRB every banks should have to maintain 1% loan loss provision for good loan, 25% for substandard loan, 50% for doubtful loan and 100% for bad loan. On the basis of figure presented above we can conclude that there is sufficient amount of loan loss provision to cover losses arise due to bad loan.

The different ratios calculated to analyze the quality of assets indicates that during the year 2005 and 2006 the assets quality of NBL was worse as there was inadequate amount of loan loss provision to cover the volume of bad loan and even the percentage of bad loan out from total loan was extremely high. As per the international banking practice; even of banks having lower double digit NPA volume considered as problematic bank and eligible for liquidation. In the case of NBL even after having 60% NPA level it was not considered for liquidation. After the holding of bank management by ICCMT, the ratio has been improved to some extent as the ICCMT primarily focused on the recovery of Bad Loan. Still the assets quality of NBL is not that much of better that it could be ranked as of healthy and sound bank.

4.1.7 Productivity Ratios

Productivity is defined as the ratio of Output to Input. In manufacturing organizations the value added or net output is taken as the output measure. In the service sector it is

difficult to quantify the output because it is intangible. Hence, different proxy indicators are used for measuring productivity of service organizations. The indicators commonly used for assessing productivity of banks are Business per employee/ Branch, advances per employee/Branch, number of accounts per employee/branch etc. the results obtained by different factors need not be the same and may often be contradictory. In our study we have used revenue (Total Income) per employee, profit per employee, Business per as indicators of productivity of banks.

Table: 4.7

Productivity Ratio

Types of Ratios		**Mid July of**				
		2005	**2006**	**2007**	**2008**	**2009**
1	Headcount	3,818	2,912	2,960	2,937	2,912
2	Per employee business in Rs. Million	11.26	15.32	14.92	15.52	17.20
3	Per employee profit in Rs. Million	0.19	0.59	0.41	0.08	-0.06
4	Per employee income	0.48	1.04	0.59	0.61	0.46
5	Net interest income to staff expenses	77%	55%	52%	69%	63%

Source: Annual Report Published by NBL

The indication of productivity ratio of NBL is not satisfactory. Over staffing is noted in head count. All over the Nepal NBL has 100 branches on its network and head count indicates that each branch has 30 employees on an average. Because of high volume of staff the ratio of per employee business, per employee income and per employee profit is going down and down. But at the same time NBL has to spent huge volume (More than 50%) of net interest income as staff expenses. If we consider the industry average the Net interest income to staff expenses ratio is just 21%.

4.1.8 Other Ratios

Table: 4.8

Other Ratios

Types of Ratios		Mid July of				
		2005	**2006**	**2007**	**2008**	**2009**
1	Advance interest to pass loan (%)	13.89	15.68	12.14	14.27	11.14
2	Average return on investment (%)	6.71	5.65	6.53	5.75	5.69
3	Cost of funds (%)	4.22	3.05	3.09	2.96	2.65
4	Cost of deposits (%)	3.99	3.00	3.13	3.04	2.70
5	Cost of interest bearing deposits (%)	4.94	3.67	3.85	3.71	3.27
6	Net interest income to Income	43.21	41.08	73.37	60.29	66.43
7	Non-interest income to Income	56.79	58.92	26.63	39.71	33.5
8	DP ratio	0.00	0.00	0.00	0.00	0.00

Source: Annual Report Published by NBL

Other ratios have also been presented above in 4.8 to analyze the financial performance of NBL. Average return on investment is highly unsatisfactory as it is lower than average bank rate. The income composition has been changing drastically and it indicates that NBL has been losing non-interest income sector of business. Dividend payout ratio is zero in all study year because of Negative net-worth.

4.2 Capital Adequacy Ratio under Basel – II Concept

The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability.

4.2.1 RWE for Credit Risk

Credit risk is the major risk that banks are exposed to during the normal course of

lending and credit underwriting. Within Basel, there are two approaches for credit risk measurement: the standardized approach and the internal ratings based (IRB) approach. Due to various inherent constraints of the Nepalese banking system, the standardized approach in its simplified form, Simplified Standardized Approach (SSA), has been prescribed in the initial phase.

Under this approach commercial banks are required to assign a risk weight to their balance sheet and off-balance sheet exposures. These risk weights are based on a fixed weight that is broadly aligned with the likelihood of a counterparty default.

Table: 4.9

Risk Weighted Exposure for Credit Risk

(Mid July 2009)

A. Balance Sheet Exposures	**Book Value**	**Specific Provision**	**Eligible CRM**	**Net Value**	**RW**	**RW Exposures**
	a	**b**	**c**	**d=a-b-c**	**e**	**f=d*e**
Cash Balance	1,498,624			1,498,624	0%	-
Balance With Nepal Rastra Bank	6,619,700			6,619,700	0%	-
Gold					0%	
Investment in Nepalese Government Securities	9,059,240			9,059,240	0%	-
All other Claims on Government of Nepal	583,654			583,654	0%	-
Investment in Nepal Rastra Bank securities	1,538,700			1,538,700	0%	-
Claims on domestic banks that meet capital adequacy requirements	365,500		-	365,500	20%	73,100
Claims on domestic banks that do not meet capital adequacy requirements	452,292		-	452,292	100%	452,292
Claims on Foreign Banks (ECA Rating 0-1)	2,631,604		460,441	2,171,162	20%	434,232
Claims on Foreign Banks (ECA Rating 2)			-	-	50%	-
Claims on Foreign Banks (ECA Rating 3-6)	185,429		107,579	77,850	100%	77,850
Claims secured by residential properties	3,807,071		-	3,807,071	60%	2,284,242
High Risk claims	15,675,174		1,634,558	14,040,616	150%	21,060,924
Other Assets	11,109,206	4,654,367	-	6,454,839	100%	6,454,839
Total (A)	**53,526,194**	**4,654,367**	**2,202,578.15**	**46,669,249**		**30,837,480**
B. Off Balance Sheet Exposures	**Book Value**	**Specific Provision**	**Eligible CRM**	**Net Value**	**RW**	**RW Exposures**
	a	**b**	**c**	**d=a-b-c**	**e**	**f=d*e**
Revocable Commitments				-	0%	-
Bills Under Collection	301,999			301,999	0%	-
foreign counterparty (ECA Rating 3-6)	628,662		51,522.85	577,139	100%	577,139
foreign counterparty (ECA Rating 3-6)	71,246		5,839.07	65,407	100%	65,407
Bid Bond and Performance Bond and Counter guarantee domestic counterparty	368,519		30,202.48	338,317	50%	169,158
Advance Payment Guarantee	202,440		16,591.20	185,848	100%	185,848
Financial Guarantee	3,090		253.25	2,837	100%	2,837
Acceptances and Endorsements	131,128		-	131,128	100%	131,128
Other Contingent Liabilities	255,430		-	255,430	100%	255,430
Total (B)	**1,962,515**	**-**	**104,408.86**	**1,858,106**		**1,386,948**
Total RWE for Credit Risk (A) + (B)	**55,488,709**	**4,654,367**	**2,306,987**	**48,527,355**	**-**	**32,224,428**

Source: Annual Report Published by NBL

4.2.2 Specific Provision made for Credit Risk

Table: 4.10

Specific Provision (July 2009)

S. N.	Assets	Gross Amount	Specific Provision	Net Balance
1	Cash and Cash Items in Transit	374,081		374,081
3	Fixed Assets	233,934		233,934
4	Interest Receivable on Other Investment	195,983		195,983
5	Interest Receivable on Loan	4,044,155	4,044,155	-
6	Non Banking Assets	604,071	604,071	-
8	Draft Paid Without Notice	2,323,056	-	2,323,056
9	Sundry Debtors	325,586	6,141	319,445
10	Advance payment and Deposits	731,439		731,439
11	Staff Advance	1,733,735		1,733,735
12	Stationery	19,947		19,947
13	Other	897,298		897,298
Total:		**11,109,206**	**4,654,367**	**6,454,839**

Source: Annual Report Published by NBL

4.2.3 RWE for Operational Risk

"Operational risk is the risk of loss resulting from inadequate internal processes, people, and systems, or from external events. Operational risk itself is not a new concept, and well run banks have been addressing it in their internal controls and corporate governance structures. However, applying an explicit regulatory capital charge against operational risk is a relatively new and evolving idea. Basel II requires banks to hold capital against the risk of unexpected loss that could arise from the failure of operational systems" *(http://www.nrb.org.np/Basel_II).* Banks must hold capital for operational risk equal to the average over the previous three years of a fixed percentage (denoted alpha) of positive annual gross income.

Table: 4.11

Risk Weighted Exposure For Operational Risk (Mid July 2009)

Particulars	**Year 1**	**Year 2**	**Year 3**
Net Interest Income	1,274,921	1,075,968	1,322,249
Commission and Discount Income	177,784	181,020	229,724
Other Operating Income	140,955	126,504	157,432
Exchange Fluctuation Income	1,368.80	-	119,407
Additional Interest Suspense during the period*	889,536	(139,714)	259,521
Gross income (a)	**2,484,565**	**1,243,778**	**2,088,333**
Alfa (b)	15%	15%	15%
Fixed Percentage of Gross Income {c=(axb)}	372,685	186,567	313,250
Capital Requirement for operational risk (d)	290,834		
Risk Weight in times (e)	10		
Equivalent Risk Weight Exposure {F=(dxe)}	**2,908,338**		

Source: Annual Report Published by NBL

4.2.4 RWE for Market Risk

Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from adverse movements in market prices. The major constituents of market risks are: The risks pertaining to interest rate related instruments, Foreign exchange risk (including gold positions) throughout the bank and the risks pertaining to investment in equities and commodities.

Out of the various forms of market risk, foreign exchange risk is the predominant one in our country. The effects of other forms of market risk are negligible. Thus, a net open position approach has devised to measure the capital requirement for market risk. As evidenced by its name, this approach only addresses the risk of loss arising out of adverse movements in exchange rates. This approach will be consolidated over time to incorporate other forms of market risks as they start to gain prominence. The designated Net Open Position approach requires banks to allocate a fixed proportion of capital in terms of its net open position. The banks should allocate 5 percentages of their net open positions as capital charge for market risk.

Table: 4.12

Risk Weighted Exposure for Market Risk (Mid July 2009)

S.N.	Currency	Open Position (FCY)	Open Position (NPR)	Relevant Open Position
1	INR	80,696	129,114	129,114
2	USD*	(11,992)	(933,595)	933,595
3	GBP	1,185	150,411	150,411
4	EURO	8,016	872,867	872,867
5	SFR	-	-	-
6	JPY	416,209	347,951	347,951
7	SGD	87	4,648	4,648
8	AUD	408	25,016	25,016
9	CAD	824	55,993	55,993
Total Open Position (a)				**2,519,594**
Fixed Percentage (b)				**5%**
Capital Charge for Market Risk {c=(axb)}				**125,980**
Risk Weight in times (d)				**10**
Equivalent Risk Weight Exposure {e=(cxd)}				**1,259,797**

Source: Annual Report Published by NBL

4.2.5 Calculation of Capital Adequacy Ratio

The Capital Adequacy Ratio (CAR) is calculated by dividing eligible regulatory capital by total risk weighted exposure. The total risk weighted exposure shall comprise of risk weights calculated in respect of bank's credit, operational and market risks.

$$\text{Tier 1 CAR} = \frac{\text{Eligible Tier 1 Capital Funds}}{\text{Credit Risk RWA + Market Risk RWA + Operational Risk RWA}}$$

$$\text{Total CAR} = \frac{\text{Eligible Total Capital Funds}}{\text{Credit Risk RWA + Market Risk RWA + Operational Risk RWA}}$$

Table: 4.13

Calculation of Capital Adequacy Ratio

1.1	**RISK WEIGHTED EXPOSURES**	**July 2009**	**July 2008**
a	Risk Weighted Exposure for Credit Risk	32,224,428	31,632,058
b	Risk Weighted Exposure for Operational Risk	2,908,338	2,908,338
c	Risk Weighted Exposure for market Risk	1,259,797	1,838,529
Total Risk Weighted Exposures (a+ b + c)		**36,392,563**	**36,378,925**
1.2	**CAPITAL**	**July 2009**	**July 2008**
	Core Capital (Tier 1)	**(5,404,013)**	**(5,146,803)**
a	Paid up equity Share Capital	380,383	380,383
b	Statutory General Reserves	1,380,000	1,380,000
c	Retained Earnings	(8,023,440)	(8,023,440)
d	Un-audited current year cumulative profit	794,463	1,051,674
e	Capital Adjustment Reserve	190,191	190,191
f	Dividend Equalization Reserves	7,486	7,486
g	Other Free Reserves	6,063	6,063
h	Less: Investment in equity of institutions in excess of limit	(139,159)	(139,159)
	Supplementary Capital (Tier 2)	**508,427**	**425,870**
a	General loan loss provision	454,907	372,350
b	Investment Adjustment Reserve	2,504	2,504
c	Exchange Equalization Reserve	51,017	51,017
Total Capital Fund (Tier 1 and Tier 2)		**(4,895,586)**	**(4,720,933)**
1.3	**CAPITAL ADEQUACY RATIOS**	**July 2009**	**July 2008**
	Tier 1 Capital to Total Risk Weighted Exposures	-14.85%	-14.15%
	Tier 1 and Tier 2 Capital to Total Risk Weighted Exposures	-13.45%	-12.98%
	Required Capital in % of RWA	10%	10%
	Shortfall (Tire 1 + Tire 2 Capital)	-23.45%	-22.98%

Source: Annual Report Published by NBL

The figure presented above regarding the CAR of NBL indicates the worst financial position of NBL as the required CAR as per Basel – II is 10% (Under total capital) but it has negative CAR i.e. - 13.45%. In this way the total short fall in CAR comes to – 23.45% in July 15, 2009. In order to manage the capital short fall and to reach the Basel – II standard; NBL needs to borrow additional capital of Rs. 8,534,056,024/- i.e (36,392,563,000 x 23.45%) immediately.

4.2.6 Share holders Fund (Net-worth Position)

Table: 4.14

Net-worth Position

(In Rs million)

Particulars	**Jul-05**	**Jul-06**	**Jul-07**	**Jul-08**	**Jul-09**
Share Capital	380.38	380.38	380.38	380.38	380.38
General Reserve + Capital Adjustment Fund	805.50	1,128.49	1,286.77	1,332.16	1,332.16
Reserves	131.66	89.63	153.40	191.44	191.44
Retained Earnings	(10,332.07)	(9,024.04)	(8,122.00)	(8,151.49)	(8,241.99)
Share holders' Funds	**(9,014.53)**	**(7,425.54)**	**(6,301.45)**	**(6,247.52)**	**(6,338.01)**
Increase over previous year	816.61	1,588.98	1,124.09	53.94	(90.50)

Source: Annual Report Published by NBL

The Net Worth position (Position of Shareholders Fund) of NBL is highly unsatisfactory as it is in negative. However, the position has been improving every coming year by the effect of yearly net profit. Because of the negative net worth position; the capital adequacy ratio of NBL is also negative.

4.3 Statistical Tools

Two statistical tools namely Mean and Standard Deviation have been used to analyze the data.

4.3.1 Loan & Advances to 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 carry 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 lower ratio is indicative of lower proportion of income generating asset and high degree of safety in liquidity and vice versa.

Table: 4.15

Loan to Total Assets

Year	Loan & Advance	Total Assets	Ratio
2005	17752	32629	54.40559012
2006	16812	34006	49.43833441
2007	12423	35919	34.58615218
2008	13743	39163	35.09179583
2009	15922	39632	40.17460638
Mean	**15330.40**	**36269.80**	**42.73929578**
SD	-	**-**	**8.839049441**

The mean of Loan and Advance to Total Assets Ratio is 42.74, which is quite low than of industry average. However, low level of this ratio indicates the sound liquidity position but it adversely affect on profitability of NBL. The value of SD indicates the possibility of fluctuation on mean value.

4.3.2 Loan & Advances to Total Deposit

The core banking function is to mobilize the funds obtained from the depositors to borrowers and earn profit and loan and advances to total deposit ratio, often called Credit Deposit Ratio (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 purposes 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% ratio is considered as appropriate. This ratio is calculated by dividing total credit by total deposits.

Table: 4.16

Loan to Total Deposit

Year	Loan & Advance	Total Deposit	Ratio
2005	17752	35735	49.67678746
2006	16812	35934	46.78577392
2007	12423	35829	34.67303023
2008	13743	39014	35.22581637
2009	15922	39977	39.82790000
Mean	**15330.40**	**37297.80**	**41.23786181**
SD	-	**-**	**6.768022022**

The mean of Loan and Advance to Total Deposit Ratio is 41.24, which is relatively low than of standard determined by NRB i.e. 80%. However, low level of this ratio also indicates the sound liquidity position but it adversely affect on profitability of NBL. The value of SD indicates the possibility of fluctuation on mean value.

4.3.3 NPL to Total Loan and Advances

This ratio determines the proportion of non-performing loans (NPL) in the total loan portfolio. As per Nepal Rastra Bank directives the loans falling under category of substandard, doubtful and bad loan are regarded as non-performing loan. Higher the ratio implies the bad quality of assets of banks in the form of loans and advances. Hence the lower NPL to total credit ratio is preferred.

Table: 4.17

NPL to Total Loan

Year	NPL	Total Loan	Ratio
2005	9640	17752	54.30374042
2006	8372	16812	49.7977635
2007	2262	12423	18.20816228
2008	1856	13743	13.50505712
2009	1687	15922	10.59540259
Mean	**4763.40**	**15330.40**	**29.28202518**
SD	-	-	**21.02210014**

The mean of NPL to Total Loan Ratio is 29.28, which is excessive high than of industry average. In general practice a single digit of this ratio is preferred but despite of drastic improvement NBL could not lower it to single digit. The value of SD indicates the possibility of fluctuation on mean value.

4.3.4 Loan Loss Provision to NPL

This ratio determines the proportion of provision held to non-performing loan of bank. This ratio measures up to what extent of risk innate in NPL is covered by total loan loss provision. Higher the ratio, the better cushion that the bank provides for recovering from loss caused by NPL. Hence higher ratio signifies the better financial position of bank.

Table: 4.18

Loan Loss Provision to NPL

Year	LLP	NPL	Ratio
2005	9055	9640	93.93153527
2006	8647	8372	103.2847587
2007	2685	2262	118.7002653
2008	2698	1856	145.3663793
2009	2762	1687	163.7225845
Mean	**5169.40**	**4763.40**	**125.0011046**
SD	-	-	**29.11492663**

The mean of LLP to NPL Ratio is 125, which is better than of industry average. In general practice 100% of this ratio is preferred but NBL has better position than of that. The value of SD indicates the possibility of fluctuation on mean value.

4.3.5 Loan Loss Provision to Total Loan

This ratio indicates the amount of Loan Loss Provision, a cushion for the possibility of default, to total loans and advances of a bank. Higher provision for non performing loan 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 and makes efforts to cope with provable loan loss. Higher ratio implies that the bank has the higher proposition of NPL in bank loan portfolio.

Table: 4.19

Loan Loss Provision to Total Loan

Year	LLP	Total Loan	Ratio
2005	9055	17752	51.00833709
2006	8647	16812	51.43349988
2007	2685	12423	21.61313692
2008	2698	13743	19.63181256
2009	2762	15922	17.3470670
Mean	**5169.40**	**15330.40**	**32.20677068**
SD	-	-	**17.42362949**

The mean of LLP to Total Loan Ratio is 32.21, which is higher than of industry average. The higher value of this ratio indicates the high proportion of NPL in total loan portfolio. The value of SD indicates the possibility of fluctuation on mean value.

4.4 Major Findings

The following have been found while analyzing the data:

1. Net interest margin of NBL is comparatively lower than the net interest margin of banking industry average. The main cause behind the lower net interest margin of NBL is lower CD ratio.
2. Interest spread of NBL is better than of banking industry average and it indicates the earning potentiality of NBL but due to the lower CD Ratio the net interest margin of NBL is lower than of banking industry average.
3. The CD Ratio of NBL is quite lower than of banking industry average. NRB has instructed to maintain CD Ratio to the maximum of 80% but the CD Ratio of NBL is just about 40%.
4. Return on assets ratio at the beginning and at the ending of the analysis period is relatively uncomfortable as they are at negative value. After the holding of bank management by ICCMT, the ratio has been improved to some extent but in 2008 and 2009, when the ICCMT left the bank, the ratio decreased to its worse.
5. Non-interest income to total assets ratio of the NBL is highly unsatisfactory. During the tenure of ICCMT, the ratio was little bit satisfactory.
6. NBL has extremely worse CB ratio because of high level of interest expenses and other overhead expenses including employee expenses. During the tenure of ICCMT, the ratio was little bit satisfactory.
7. Staff cost to income ratio of NBL is extremely high; it can be concluded that the bank has been paying most of its revenue to employee as salary and benefit. Staff cost to income ratio in industry average is 20% but in some of the year it is up to 80% in NBL.
8. Staff cost to operating cost ratio of NBL is extremely high as the staff cost constitute the major portion on total operating cost. In some of year it is up to 83% of total operating cost.
9. Deposit mix of NBL is dominated by interest bearing deposit as it is up to 85% of total deposit.
10. The position of Net loan to total assets indicates that NBL has low level of loan assets in its balance sheet. Loan is earning assets and other is none earning. High volume of none earning assets in assets mix leads to poor profitability and even to operating loss.

11. During the year 2005 Gross NPA percentage was 53.74% and it was decrease to 10.58% on 2009. After the holding of bank management by ICCMT, the ratio has been improved to some extent as the ICCMT primarily focused on the recovery of Bad Loan.
12. Negative value of NPA to Net Total Loan ratio depict the position that NBL has set sufficient amount aside from total operating revenue to cover the losses occurred due to bad loan.
13. From the year 2007, the amount of loan loss provision have been sufficient to cover the bad loan as the percentage of loan loss provision is excess than 100% of bad loan.
14. Productivity ratio of NBL is highly unsatisfactory as it has high number unproductive staff, per employee business is low, per employ income and per employ profit has been decreasing every year and major portion of net interest income has been spending for staff expenses.
15. Average return on investment of NBL is around 6% which is lower than average bank rate determined by NRB.
16. Cost of fund of NBL is highly satisfactory as it is 3% on average but the industry average cost of fund is > 5%.
17. Portion of net interest income on net income has been increasing every year and it is a symptom that NBL has been losing commission business.
18. DP ratio is zero.
19. Capital Adequacy Ratio (CAR) of NBL indicates the worst financial position. The required CAR as per Basel – II is 10% (Under total capital) but NBL has negative CAR i.e. - 13.45%. In this way the total short fall in CAR comes to – 23.45% in July 15, 2009. In order to manage the capital short fall and to reach the Basel – II standard; NBL needs to borrow additional capital of Rs. 8,534,056,024/-
20. The Net Worth position (Position of Shareholders Fund) of NBL is highly unsatisfactory as it is in negative. However, the position has been improving every coming year by the effect of yearly net profit. Because of the negative net worth position; the capital adequacy ratio of NBL is also negative.
21. High value of Standard Deviation (SD) between the relation of loan and total assets, loan and total deposit, NPL and total loan, loan loss provision and NPL,

loan loss provision and total loan indicates the inconsistency and high level of risk in NBL's banking business.

22. It has been found that the financial performance of NBL was improved during the period of ICCMT.

CHAPTER - V

SUMMARY, CONCLUSION AND RECOMMENDATION

5.1 Summary

Economic development is not possible without the proper development of banking sector in a country, as banks are the real facilitator for mobilizing the resources. Banks are the institutions, which collect the scattered small savings from the public and invest them into productive sector that ultimately contributes to economic development of a country. Besides providing the services for economic development, they are established to earn profit. In the context of current competitive scenario, banks need to face challenges from all around. One of the major challenges for Nepalese commercial banks is sound financial performance. Considering the importance of sound financial performance of commercial banks, this research aimed at studying the financial performance of selected commercial bank. For this purpose, descriptive cum analytical research design was adopted. Out of total population of 26 commercial banks, one bank was taken as sample using judgmental sampling method.

NBL has been taken for comparative study. Both primary and secondary data have been used in this study. Primary data has been collected mainly from personal interview with key position staff and telephonic interview. Annual reports and other publication of these banks and NRB are the basis of secondary data. The data collection from various sources are recorded systematically & presented. Appropriate statistical and financial tools have been applied to analyze the date. The data of five consecutive years of the bank have been analyzed to meet the objective of the study.

The major risk in NBL is associated with credit decision as the proportion of credit risk on total risk is high. The average loan and advances to total asset ratio of NBL is 42.73%. This means that loan and advances hold major portion in total asset. Similarly, the mobilization of deposit in credit, which is indicated by Credit Deposit ratio, also suggests that major portion of deposit is invested on loan and advances. The average CD ratio of NBL is 41.24%. Similarly, the interest income holds 79% of

total income in NBL. This figure indicates that credit risk has covered significant ground in NBL.

The credit risk of bank mainly arises due to non-payment of loan by borrower, poor appraisal of borrower's financial condition and substandard collateral. Poor tracking of borrowers and improper diversification of lending across industries also result in higher credit risk in commercial banks. The major problems in credit risk can be categorized into three areas of concentrations; credit processing, and market and liquidity-sensitive credit exposures. The main indicators of loan default (i.e. non-performing loan) indicate that average NPL of NBL is 29.21% and the loan loss provision is 125%.

Improper portfolio management also remains one of the significant problems in credit management of commercial bank. Average interest spread of NBL is 4.50% and this figure is better than of industry average.

The net interest margin of NBL is significantly lower than of net interest margin of banking industry average of Nepal. It indicates the larger volume of interest expenses of NBL and the cause of larger volume interest expenses is the large volume of interest bearing deposit. On the other hand; the cause of lower level of net interest margin is lower level of interest income. Because of the lower CD ratio the interest income of NBL is comparatively lower than of industry average. The interest spread of NBL is better than of industry average. It indicates the earning potentiality of NBL but due to the lower CD ratio the net interest margin of NBL is lower than of industry average. The CD ratio of NBL is quite lower than of industry average. NRB has instructed to maintain CD ratio to the maximum of 80%. But the CD ratio of NBL is just about to 50% of NRB's instruction.

Return on assets ratio at the beginning and at the ending of the analysis period is quit uncomfortable as they are at negative value. After the holding of bank management by ICCMT, the ratio has been improved to some extent but in 2008 and 2009, when the ICCMT left the bank, the ratio decreased to its worse.

Lower value of non-interest income to total assets ratio indicates the bank's inability to grasp the opportunity of commission business (Guarantees, L/Cs & Remittance).

Commission businesses generally are of non-funded in nature and comparatively less risky than of funded one. Commission business helps to improve the profitability of a bank as these kinds of business does not need to use any funds. Non-interest income to total assets ratio of the NBL is highly unsatisfactory. The position of CB ratio had little bit been improved on wards to year 2005 but the ratio is further worsen on 2008. NBL has extremely worse CB ratio because of high level of interest expenses and other overhead expenses including employee expenses. During the tenure of ICCMT, the ratio was little bit satisfactory.

Since the staff cost to income ratio is extremely high; it can be concluded that the bank has been paying most of its revenue to employee as salary and benefit. Staff cost to income ratio in industry average is 20% but in some of the year it is up to 80% in NBL. The position of this ratio indicates that the NBL has over and unproductive staff and which has adversely affect the earning and profitability of the bank. During the tenure of ICCMT, the ratio was little bit satisfactory as the regular staff expenses was decrease by the effect of VRS (Voluntary Retirement Scheme) and the total revenue was increase because of bad loan recovery. Staff cost to total operating cost ratio of NBL is also high. With the help of staff cost to operating cost ratio it can be concluded that how adversely the staff expenses have affects on the earning of NBL as the staff cost constitute the major portion on total operating cost. In some of year it is up to 83% of total operating cost.

The volume of saving deposit has been increasing every year. Increase on saving deposit adversely affect on bank's profitability. Every bank prefers to get current deposit as it is interest free deposit. But in case of NBL data presented above indicates that the percentage of current deposit in deposit mix has been decreasing every year. Government units and business organization, generally, deposit their amount on current deposit and decreasing trend of current deposit indicates that NBL became unable to grow and even to retain the government and other institutional deposit client. On the other hand, the volume of time deposit has also been decreasing every year. Although the time deposit is expensive source of fund but it helps bank to manage liquidity when excess cash outflow is happen. Generally, retired people and other who do not want to take any risk on their saving amount prefer to keep their

amount on time deposit. Decreasing the volume of time deposit indicates that the NBL has been losing the faith of general public.

The indication of productivity ratio of NBL is not satisfactory. Over staffing is noted in head count. All over the Nepal NBL has 100 branches on its network and head count indicates that each branch has 30 employees on an average. Because of high volume of staff the ratio of per employee business, per employee income and per employee profit is going down and down. But at the same time NBL has to spent huge volume (More than 50%) of net interest income as staff expenses. If we consider the industry average the Net interest income to staff expenses ratio is just 21%.

The purpose of Basel II is to create an international standard that banking regulators can use when creating regulations about how much capital banks need to put aside to guard against the types of financial and operational risks banks face. Advocates of Basel II believe that such an international standard can help protect the international financial system from the types of problems that might arise should a major bank or a series of banks collapse. In practice, Basel II attempts to accomplish this by setting up rigorous risk and capital management requirements designed to ensure that a bank holds capital reserves appropriate to the risk the bank exposes itself to through its lending and investment practices. Generally speaking, these rules mean that the greater risk to which the bank is exposed, the greater the amount of capital the bank needs to hold to safeguard its solvency and overall economic stability. The figure CAR of NBL indicates the worst financial position of NBL as the required CAR as per Basel – II is 10% (Under total capital) but it has negative CAR i.e. - 13.45%. In this way the total short fall in CAR comes to – 23.45% in July 15, 2009. In order to manage the capital short fall and to reach the Basel – II standard; NBL needs to borrow additional capital of Rs. 8,534,056,024/- i.e (36,392,563,000 x 23.45%) immediately.

The Net Worth position (Position of Shareholders Fund) of NBL is highly unsatisfactory as it is in negative. However, the position has been improving every coming year by the effect of yearly net profit. Because of the negative net worth position; the capital adequacy ratio of NBL is also negative.

5.2 Conclusion

Nepalese government has started to liberalize the financial sector since 1980s to streamline the financial sector of the country. Prior to liberalization, there were 2 commercial banks, 1 central bank, and 2 development banks. After the adoption of financial sector liberalization policy, the financial sector widened with more banks and financial institutions. Commercial banking sectors have made a significant mark with the establishment of 26 commercial banks. Though banking sector developed rapidly in quantity, it has remained far behind in terms of quality compared to international banks. Commercial banks are established with an objective to maximize the shareholders value by performing the function of mobilizing the idle funds collected from the society to productive sector, which will help to achieve the economic development of a country. Bank needs proper handling of several problem and challenges. In current scenario, the major challenge of commercial banks is competition among 26 commercial banks.

Proper risk management is required to remain competitive in the market & achieve the goals. The major banking risks include credit risk, market risk (i.e. liquidity risk, interest risk, operation risk etc). Among these risks, credit risk has the major impact on banking (i.e. more than 60 %). Because of the credit risk, the Non Performing Loan (NPL) of bank will increase. With the increase in NPL, the loan loss provisioning will also increase simultaneously leading to decrease in profit or even loss. The decrease in profit results in low dividend to shareholder and bonus to employees.

Similarly, poor management of asset and liabilities having different maturity period is the main problem that results in other market risk such as liquidity risk, interest rate risk etc. The other component of market risk includes the interest rate risk.

Similarly, tactfully dealing with market interest movement by adjusting the interest sensitive asset and liabilities also remain challenge to these banks. To remain alert and prepare plans and policies to tackle unpredictable factors such as violence riots, natural disaster, technology and employees, fault and fraud of customers and outsiders are the challenges for commercial banks.

For proper management of these risks, NBL has its own set of policies and practices, which is in consistence with NRB guidelines. For credit risk management, NBL has Credit Policies Guidelines (CPG). Similarly, NPL is regularly monitored by the banks on regular basis and provisioning is done on quarterly basis by categorizing the loan as per NRB guidelines. Similarly, sector wise and security wise lending is being analyzed by these banks on monthly basis.

Gap analysis is the major tool for managing the liquidity risk. The top management analyzes the gap between asset and liabilities and makes decision to make adjustment for it. Further, the top management decides how much liquid asset is needed to be kept in the bank. Treasury and finance department of the banks continuously manage the CRR in NRB to ensure that statutory requirement is met.

Gap analysis of both types of asset and liabilities (i.e. Rate Sensitive and Fixed Rate) is required for the interest rate risk management. Besides, analysis of cost of fund, yield on loan & spread is made continuously in NBL to ensure that banks have competitive interest rate, which is profitable for the banks.

In regard to operational risk, the major steps NBL is taking to reduce it are preparing and implementing the different operational guidelines and policies & frequently monitoring their compliance. Most of these policies are prepared as per NRB guidelines. Similarly, employees' training is also the major tools for minimizing the operation risk in these banks.

For minimizing the loss arising due to occurrence of the above risks, capital and reserve need to be maintained by NBL within the standard prescribed by NRB. However, the trend of Capital Adequacy ratio suggests that NBL need to increase its capital fund, which is possible mainly by issuing shares or getting equity injection from government.

Despite of pursuing and adopting various measures of performance improvement; the financial performance of NBL is extremely poor. The capital adequacy ratio of NBL is negative; the net worth position is also negative and the position of Net interest

margin, CD ratio, Earnings ratios, Liquidity and resource ratio, Assets quality ratio and productivity are not satisfactory. On the basis of facts presented above, we can conclude that the financial performance of NBL is below than the average.

5.3 Recommendation

From the above analysis of the financial performance and capital adequacy, the following recommendations are made to NBL, NRB and Nepal government in respect to improve the financial performance of NBL:

5.3.1 General Recommendation

Following general recommendations can be made to NBL regarding the improvement of financial performance.

- **Old Techniques no longer work**

In the current context, NBL has been applying old techniques for managing the bank. These techniques should be changed with changes in the environmental forces. For the improvement of financial performance and management of risk associated with asset and liabilities management, banks need to adopt new methods such as Simulation Method and Value at Risk (VAR) Method etc.

- **Identify and deal with new changes in banking business**

NBL seems conservative in terms of dealing with new changes and development in banking business. NBL needs to give high priority to manage credit risk, operational risk and market risk. To remain competent in the market NBL needs to identify and deal with new risks that arise with changes in environmental forces.

- **Upgrade System**

NBL needs to upgrade the system with the changes in both level and pace of technological changes in external environment.

- **Training and Development**

NBL is recommended to initiate training and development program for the employees to make them efficient and professional in terms of managing various aspect of banking business.

⁾ System of check and balance

NBL should give focus in the system of check and balance, which helps to reduce mistake and fraud committed during the operation of bank.

⁾ Proper adherence of NRB directives

Following the directives of NRB and acting upon it helps to improve the financial performance and reduces bank's risk. Therefore, NBL is recommended to adhere to the directives and come up with a stronger internal audit and compliance to ensure that the directives are properly followed up.

⁾ Preventive Measures

It is often said, “Prevention is better than cure". Hence it is recommended for NBL to take preventive measures before the problems occur and will suffer loss. NBL is also recommended to develop an information system to gather all the possible information and activities to take timely precaution.

5.3.2 Specific Recommendation

Specific recommendations are especially made for particular organization for specific issue and to the different stakeholders of bank i.e. NRB and Nepal Government.

⁾ Recommendation to NBL

The recommendations suggested to NBL are as follows:

- In order to reduce the volume of Risk Weighted Assets, NBL need to extend its credit up on the adequate collateral back-up
- Lending and investment portfolio need to be diversified in order to avoid the concentration risk.
- NBL need to enhance the amount of loan and advances in total assets.
- NBL need to improve its CD Ratio.
- NBL need to change the organizational structure and follow following principles for proper credit risk management.
  a. Establishing an appropriate credit risk monitoring and assessment environment.
  b. Operating under a sound credit granting process

c. Maintaining an appropriate credit administration, measurement and monitoring process
d. Ensuring adequate controls over credit risk

- Asset Liabilities mismatch needs to be given higher priority in NBL. NBL has high mismatch amount, which needs to be frequently revised and brought under control.
- NBL needs to set up policy for the maximum mismatch amount between asset and liabilities.
- Interest income has major portion in total income of NBL. As there is change in interest rate, it will have huge impact on total income. So NBL needs to increase its fees and commission based income to minimize income concentration risk.
- NBL should maintain a tight grip on business practice. This includes proper implementation of internal and NRB policies, keeping eyes on new risks that could arise due to changing market condition, new regulatory requirements and intensifying competitive pressures.
- NBL should constantly evaluate its internal principles and policies related to day-to-day operation. Those policies need to be evaluated periodically to ensure policies are time relevant.
- Even if banks have the appropriate control; mitigation and managerial backstops of place, their culture does not allow them to follow the appropriate control mechanism. NBL needs to stop a tendency to say one thing but do another.
- NBL is required to focus on its supplementary capital as the proportion of supplementary capital on total capital fund is very low.
- NBL is unable to meet the statutory requirement on Capital Adequacy ratio. NBL can only meet the requirement either by decreasing the risk weighted asset or by increasing capital. As with the decrease in asset the profit of bank also decrease, NBL has only option of increasing its capital fund which is possible mainly by issuing share, debenture and preference share etc.
- In total risk weighted asset NBL has lesser amount of off balance sheet fee based income generating asset such as Letter of Credit, Guarantee etc. So NBL need to increase the portion of off-balance sheet asset both to diversify the risk as well as return.
- The position of Return on assets ratio, Net interest margin ratio, Non-interest income to total assets ratio and Cost benefit ratio is highly unsatisfactory. In

order to improve the indication of these ratios NBL needs to improve its assets quality.

- Staff cost to income ratio and staff cost to total operating cost ratio indicates the high volume of staff cost. NBL needs to lower the staff related cost by reducing the number of unproductive staff.
- The composition of deposit mix indicates that NBL has higher volume of interest bearing deposit and every year NBL pays significant amount as interest to its depositors. In order to improve its profitability, NBL needs to improve the volume of non-interest bearing deposit.
- The position of assets quality ratio is highly unsatisfactory. The volume of loss / bad quality assets is significantly high. The impact of bad quality assets can be noticed in profitability, volume of risk weighted assets and in whole bank performance. NBL needs to give its first priority to improve the assets quality.
- Employee productivity of NBL in terms of per employee revenue and per employee profit is too low. The prime reason behind the low productivity of the bank is large number of unproductive staff. NBL needs to plan properly for reducing the number of unproductive staff.
- Standard Deviation of Loan and advances to total assets ratio, loan and advances to total deposit ratio, NPL to total loan and advances ratio, loan loss provision to NPL ratio and loan loss provision to total loan ratio indicates that there is unpredictable deviation in these value. High level of deviation means high level of uncertainty and high level of risk. In order to minimize the risk and uncertainty on performance; NBL needs to operate on planned way rather to leave it on devils hand.
- Now days the management of NBL is taken over by NRB and the performance of the bank has been degrading slowly and slowly. The performance of NBL was improved to its best during the tenure of ICCMT. This fact indicates that NBL needs a professional management team to improve its performance rather operating it by NRB team under ad-hoc basis.

) Recommendations to Nepal Government

- Nepal Government should draft and implement all the required policy and guideline to ensure the smooth operation of commercial banks.

- From 2009/10, Nepal Government has allowed to establish banks in Nepal by foreigners without joint venture of Nepalese investors. This will certainly provide threat to Nepalese banks which are already established. So Nepal Government should provide some incentives to the local banks and banks that are already established to face the intense competition of foreign banks.
- Nepal Government should provide adequate measures for taking action against the willful defaulters.

) Recommendation to NRB

- NRB, in addition to imposing directives, needs to provide training for commercial banks to apply new methods and system.
- NRB should make a clear cut policies related to banking supervision. Confusing policies need to be removed.
- Regarding to the Asset and Liabilities gap analysis, NRB should specify the maximum amount of gap a bank can maintain on asset and liabilities of different maturity period.
- NRB has been mainly focusing on credit risk of the banks. Therefore, NRB needs to focus on other risks like market and operation risk as well.
- NRB needs to establish a separate credit rating organization, which will help to minimize bank's credit and operation risk.
- In the case of NBL, NRB needs to hand over the management of the bank to a professional team rather to managing it by NRB itself.

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