CHAPTER-I
INTRODUCTION

1. Introduction

A bank is a government–regulated, profit making business that operates in competition with other banks and financial institutions to serve the savings and credit needs of its customers. The primary business of banks is accepting deposits and lending money. Banks accept deposits from customers who want the safety and convenience of deposit services and the opportunity to earn interest on their excess funds, Banks put their depositors' funds to other-to individuals who need to finance major purchases, educational expenses, or medical bills; to businesses that need financing for new construction, for expansion, or for the purchase of inventory; and local government units that need financing for public projects such as schools, hospitals and highways.

1.1 General Background

Banks make direct loans to individuals and businesses as well as short-tern operating loans to municipalities. But when government units need to borrow long-term funds, they usually issue securities rather than borrow funds directly from banks. Thus, bank investments in government securities represent indirect loans to state or local governments. Investments can be a substantial part of a bank's total assets and total income. A sound investment portfolio allows a bank to realize earning on its assets and still maintain the necessary liquidity to provide funds to depositors and borrowers as needed. The safety and profitability of a bank depends on the effective management of a bank's assets and liability. A bank's total pool of funds shifts constantly as funds flow in and out of the bank. Funds management is planning and coordinating a bank's sources and uses of funds over time to achieve maximum profitability and yet

maintain adequate safety and liquidity consistent with banking regularities and community needs.

The evolution of the organized financial sector in Nepal has a more recent history compared to that in other developing South Asian countries. The financial structure which reflects the relative position of the financial system in comparison to the non-financial system has a bearing not only on the prosperity to save and inducement to invest but also on the conduct of monetary policy, for the financial institutions and instruments serve as the channels of the central bank in conducting monetary policy.

Bank is a financial institution, which deals on money. It collects money from different sectors, which are idle and scattered in our surroundings. It issues these deposits as a loan to those who need it. Those depositors can be individual or institutions. Duration of deposits depends upon the mutual agreement between bank and customer. Similarly, borrower of money can be individual as well as business firms or institutions. Terms and condition of depositing money and lending money depend on various factors like duration, volume or amount, purpose etc. For example bank provides high rate interest on long-term deposits. It allows some interests on deposits and charges some interest on loan. Interest on loan is comparatively higher than deposits. The difference in interest of deposits and loan is called spread rate and this is the main source of earning of a bank.

Commercial banks play an important role in affairs of the economy in various ways. The operations of commercial banks record the economic pulse of the economy. The size and composition of their transactions mirror the economic happening in their country. They are as essential instrument of accelerated growth in a developing economy. In fact, banks are the nerve center of economy and the barometer of economic prosperity. By mobilizing community savings and diverting then into productive channels, commercial banks expand

the tempo and appreciate the value of aggregate economic activity in the economy. In general banks are those financial institutions that offer the widest range of financial services especially credit, savings and payment services and perform the widest range of financial functions of any business firm in the economy. "Bank of Venice" which was established in Venice, Italy in 1157 was the first bank. Commercial banks grant loans in the form of cash credits, overdrafts, fixed term loans, retail lending like housing loans, hire purchase loans etc. Apart from financing, they also render services like collection of bills and cheque, safekeeping of the valuables, financial advising etc to their customers.

According to the American Institute of Banking 1972, "Commercial bank is a corporation which accepts demand deposits subjects to check and make short term loans to business enterprise regardless of the scope of its other services." *(American Institute of Banking, USA, 1972)*

In the Nepalese context, the Nepal Commercial Banks Act 2031 B. S. defines "A commercial bank as one, which exchanges money, deposits money, accepts deposits, grants loans and performs commercial banking function." *(Commercial Bank Act, 2031 B.S.)*

However, the bank in mobilizing its funds should be very careful while investing. The banks should have their own credit policies for the investments in business, projects or other sectors of the economy so that they can get the return from their investments smoothly and as expected without any difficulties. For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and in the trading book, and both on and off the balance sheet items. Thus, banks should develop and utilize internal risk rating systems in managing credit risk. The rating system should be consistent with the nature, size and complexity of a bank's activities. They must have information systems and analytical techniques that enable management to

measure the credit risk inherent in all on- and off-balance sheet activities. The management information system should provide adequate information on the composition of the credit portfolio, including identification of any concentrations of risk.

Banks must have in place a system for monitoring the overall composition and quality of the credit portfolio. They should take into consideration potential future changes in economic conditions when assessing individual credits and their credit portfolios, and should assess their credit risk exposures under stressful conditions. Since the government has taken initiative for the growth and development of the industrial sector, it has provided suitable environment to enable foreign and local investors to undertake joint venture operation with Nepalese investors. The government is consuming its efforts to encourage private participation in several infrastructure activities such as private airlines, hydro power, computer software, textiles, readymade garments and carpets, telecommunication, radio services, pharmaceutical, medical companies etc. So to enable to meet the needs of capital and resources, role of the joint venture and commercial banks has been emerging day by day.

1.2 Focus of the Study

Banking plays a significant role in the development of an economy. It provides an effective payments and credit system, which facilitates the channeling of funds from the surplus spending units (savers) to the deficit spending units (investors) in the economy. The basic task of the financial institutions is to mobilize the savings of the community and ensure efficient allocation of these savings to high yielding investment projects to offer attractive and secured returns to the different sectors of the economy according to plan priorities of the country, on the other. This process of the financial institutions gives rise to the money and other financial assets, which therefore have a central place in the development process of the economy. The created assets provide vital links between savings, investments and income.

Banks are the most important and essential financial institutions in any nation. Banks are differentiated from other financial institutions, as they can't create credit though they accept deposits, but the banks do so. An ordinary banking business consists of changing cash for bank deposits and bank deposits for cash; transferring bank deposits from one person or corporation to another; giving bank deposits in exchange for bills of exchange, government bonds, the secured or unsecured promises of businessmen to repay etc. However, during the course of its transactions, banks are facing credit risk regarding their investments. The main difficulty in the banking sector is the increasing non-performing assets and as a result they make huge provisions for it. For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank.

"Credit risk is most simply defined as the potential that a bank borrower or counter party will fail to meet its obligations in accordance with agreed terms. The goal of credit management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions. Banks should also consider the relationships between credit risk and other risks. The effective management of credit is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization." *(Basel Committee, Consultative Paper, 1999)*

Banks should establish overall credit limits at the level of individual borrowers and counter parties, and groups of connected counter parties that aggregate in a comparable and meaningful manner with different types of exposures, both in the banking and trading book and on and off the balance sheet. The credit risk strategy should give recognition to the goals of credit quality, earnings and growth. Every bank, regardless of size, is in business to be profitable and, consequently, must determine the acceptable risk/reward trade-off for its

activities, factoring in the cost of capital. A bank's board of directors should approve the bank's strategy for selecting risks and maximizing profits. The board should periodically review the financial results of the bank and, based on these results, determine if changes need to be made to the strategy. The board must also determine that the bank's capital level is adequate for the risks assumed throughout the entire organization.

The credit risk strategy of any bank should provide continuity in approach. Therefore, the strategy will need to take into account the cyclical aspects of any economy and the resulting shifts in the composition and quality of the overall credit portfolio. Although the strategy should be periodically assessed and amended, it should be viable in the long run and through various economic cycles.

1.3 Statement of the Problem

Before the inception of joint venture and other private owned commercial banks, the government banks were in operation namely Nepal Bank Ltd and Rastriya Banijya Bank. Due to the economic growth, liberalization and privatization policy of government, many banks came into existence from the private sector. The private owned commercial banks with the help of their quality and prompt services are becoming an indispensable part of the economy of Nepal. The evolution of the commercial bank shows a good sign of economy on one side but on other side due to such growth in number of banks and financial companies in a small economy, there might be an unhealthy competition between them.

In the present context, the major concern of most of the banks is regarding their NPA. As per NRB, the NPAs hover around 29% in the banking sector. Although most of the commercial banks increase their profit and market share, the NPA of the banks has been increasing and thus it has created problems to the banks. It has become a burden to the banks and as per NRB rules; banks

make provisions for such bad loans accordingly. Banks are increasingly facing credit risk (or counter party risk) in various financial instruments other than loans, including acceptances, inter bank transactions, financial futures, swaps, bonds, equities, options and in the extension of commitments and guarantees, and the settlement of transactions. Most major banks problems have been explicitly or indirectly caused by weakness in credit management. Severe credit losses in a banking system usually reflect simultaneous problems in several areas, such as concentrations, failures of due diligence and inadequate monitoring. Therefore, the banks should be very careful in making investments decisions and further should be able to cope with the changing economy and business environment. *(NRB Directives Manual, 2001)*

The study here is mostly concentrated within the credit management of NIC Bank Ltd and is focused mainly in the effectiveness of its credit management. It mainly focuses on the following aspects:

i) How is the strengths and weakness of the banks in terms of liquidity, profitability, leverage and other ratios?

ii) How is the effectiveness of its credit management in mobilizing its resources?

1.4 Objectives of the Study

In the present context, the commercial banks have groomed up well providing their customers with effective, reliable and prompt services. These banks are becoming popular and are covering wide area of Nepalese economy. The banks with the help of its prompt and reliable services are the need of the people and people are more inclined to these banks than they use to be in the past for the government owned banks. The main objective of this study is to analyze, examine and interpret the financial position and the effectiveness of credit policies and the management of NICBL, with the help of ratio analysis and other financial tools.

The objectives of the study can be summarized as follows:

i) evaluation of financial position of the banks

ii) credit management and its policies

iii) to analyze the financial strengths and weaknesses of the bank

iv) comments and recommendation for their effective and efficient performance regarding the credit risk and its management.

1.5 Importance of the Study

Commercial banks in developing countries like Nepal have the greatest responsibility towards the economic development of the country. "In the present day world in the developed and developing money economies, the vital processes of production and consumption are significantly affected by the aggregate money supply consisting of the currency, demand and time deposits with banks." *(Vaish, M.C., 1989:243)* In modern times, since credit or bank money constitutes bulk of the economy's aggregate money supply, it mostly changes the volume of bank money or credit rather than changes in the total supply of the high-powered money issued by the reserves held by banks against their deposit liabilities that account for changes in the aggregate money supply. Gone are the old days when commercial banks were regarded as merely purveyors of money. They are today not merely purveyors of money but are also the creators or manufacturers of money in the system. It is the bank that set the tempo of the aggregate economic activity in the system. The main goal of the bank as a commercial organization is to maximize the surplus by the efficient use of its funds and resources. In spite of being a commercial institution, it too has a responsibility/obligation to provide social service oriented contribution for the socio-economic upliftment of the country by providing specially considered loans and advances towards less privileged sector. In the present scenario, the banks are having difficulties in making investments, as the insurgency and government policy are unfavorable to the industries. As a result, the NPA of the banks is increasing every year.

The significance of this thesis is to help shareholders, equity investors and other creditors to identify the productivity of their funds in NICBL. Likewise other financial agencies e.g. stock exchange & stockbrokers are also interested in the performance of bank, as it has been listed in the stock exchange market. Besides these, the study will also help the management of the banks to analyze the effectiveness of its credit management and its policies of the bank in comparison to its competitors. The study is significantly helpful to the government and central bank to formulate the new credit policy, as there are certain loopholes as a result of which the non-performing asset has been regarded as the main problem of the commercial banks these days.

1.6 Limitation of the Study

This study attempts to evaluate the effectiveness of credit risk management of NIC Bank Ltd. However, it was difficult to receive any credit policy information as it was strictly prohibited. The study is purely based on the day-to-day activities of the staffs at NIC Bank and their work performances which are as per the credit polices and rules set by the higher management. Basically the study has following limitations:

1) The study is mostly concentrated in the credit management of NIC Bank Ltd whereby and would be mostly in descriptive form. The conclusion drawn may or may not be applicable to other various commercial banks because each of the banks has their own credit policies.
2) The study is based on secondary data, financial statements and financial reports. Secondary data itself are limiting factors.
3) This study covers the period of 7 years i.e. from Fiscal Year 2056/57 to 2062/63 only.
4) The study examines the portfolio management as well as the credit policy and its overall credit management of NIC Bank Ltd, which is based on the overall activities of the bank and the data relevant are collected from the staff from Kathmandu branch and are analyzed as needed. However, the

credit policies were restricted to be informed, as set by the rules of the bank so basically the credit polices are not mentioned in detail.

5) The report is mainly prepared to fulfill the requirement of MBS degree.

1.7 An Introduction of NIC Bank Ltd

Nepal Industrial & Commercial Bank Ltd. (NIC Bank) was incorporated on 30th May 1997 and commenced business on 21st July 1998. It is the first bank in the country to have the largest paid-up capital of Rs. 500 million. The Bank was promoted by some of the most renowned business houses in the country lead by Vishal Group along with Rastriya Banijya Bank. NIC Bank also has one of the largest numbers of shareholders among all banks. At the time of the IPO the number of shareholders was about 42,000 that have now reduced to around 38,000. *(Annual Report of NIC Bank, 2003/2004)*

With the start of the new fiscal year in 2002/03 the Board was on the lookout for a new Chief Executive Officer (CEO) to be entrusted with the responsibility of giving a new direction to the Bank and give its performance a fillip. Sashin Joshi, an experienced corporate banker working with Standard Chartered Bank, was identified to head NIC Bank in December 2002 and took over full control in January 2003.

Since taking over the reins in January 2003, the new CEO has embarked on a multi-pronged strategy of consolidation, administrative streamlining, HR management, cost control, focused NPA management, balance-sheet & treasury management, strengthening the credit culture and strategic marketing and sales. An NPA cell, separate from branches and credit, has been set up. A strong marketing and sales team has been formed with some high-level lateral entrants with proven track record from other banks. Within 8 years of commencement of business the Bank opened 8 branches: 3 in Kathmandu, and 1 each in Biratnagar, Birgunj, Janakpur, Dharan, Birtamod and Pokhara. Whilst the Bank has a plan to expand its operation to other towns it was put on hold

due to the unstable political situation and difficult business conditions. With a view to enhancing customer satisfaction, introducing new innovative products and improving internal efficiencies NIC bank is in the process of upgrading its system and network connectivity very shortly. On completion, all branches will be able to have on-line real-time transaction capability.

NIC bank is happy to announce the launch of “NIC Cash card” in association with Smart Choice Technologies (SCT). NIC Cash card is an electronic debit card that facilitates round the clock cash transactions through ATMs and Point of Sale (POS) machines located at merchant establishment including department stores.

NIC Bank's strategy going forward is to be cautiously aggressive in its target market, mainly through selective cherry picking in the corporate sector, non-credit risk institutional business, small business lending, consumer lending and transaction banking. The Bank will be launching a number of deposit, loan and transaction banking products in the current year.

The Bank believes in prudent self-regulation and has taken a number of steps this year to ensure that it remains healthy even in adverse situations. Most of the problem loans, even though recoverable, have been adequately provided for. The capital adequacy of the Bank at 20% is probably the highest among all the banks in Nepal. The Board Members and staff have committed to a strict code of ethics and corporate governance.

1.7.1 Management of NIC Bank Ltd.

Since its, inception, the bank has been run by the experience team of people having long experiences in banking sectors. Initially, it was headed by K.R. Iyer (Executive Director) who had banking experiences in State Bank of India for about 15 years and under his management higher-level staffs from various commercial banks like Grindlays Bank Ltd, Nabil Bank Ltd. joined the bank for better professionals so as to run the bank efficiently. However, the bank did

not run as expected under his management due to which most of the higher-level staffs left the bank including the ED. Presently the management of the bank is headed by Sashin Joshi who is considered as one of the most dynamic and experienced professional in banking sector. Before joining NIC Bank Sashin Joshi was working with Standard Chartered Bank Limited, where he was wearing multiple hats as a Director on the Board, Head of Corporate and Institutional Banking and Resident Representative at the Standard Chartered Bank Representative Office in Kathmandu. He joined the erstwhile Nepal Grindlays Bank Ltd. (taken over by Standard Chartered in August 2000) in June 1989 and rose up the ranks to become the first Nepali to be appointed on the Board of a bank by any foreign bank in Nepal. He was nominated on the Board by ANZ Bank, Melbourne and Standard Chartered Bank, London. He has also worked in ANZ Grindlays Bank, Calcutta and ANZ Bank, Melbourne in various capacities. Sashin Joshi started his banking career as a Credit Analyst with Nabil Bank Ltd. (then a JV with Emirates Bank International) before moving to Grindlays.

Under his leadership, the bank has made tremendous growth in every sector of banking transactions and services with innovative ideas and techniques. Similarly, there has been lateral recruitments at senior levels to bring in new skills, competencies and experiences in the organization to meet the requirements of growing business of the bank. Most of the high level staffs are from Standard Chartered Bank Nepal Ltd who has experiences in different departments of the bank with in depth knowledge of those departments. Further, the irrespective to the higher-level management, the bank has continuously, given great emphasis on enhancing employees' competencies to cope with the changing business environment and meeting customers' expectations. Accordingly, the majority of employees had been provided professional trainings organized internally and externally as per the need of the bank.

1.7.2 Portfolio and Credit Management of NICBL

The Bank's corporate governance policy is directed not only towards meeting the regulatory and legal requirements but also towards adherence to best business practices, transparency and disclosure to the stakeholders. The corporate governance framework in the Bank is based on an independent Board, which is not involved in executive management, and the constitution of different Board Committees with independent Directors to oversee critical areas. In order to identify, monitor and mitigate credit risk the Bank follows a dual appraisal with a centralized credit team analyzing the credit independent of the sales function. All credits are extended in strict compliance with the directives of NRB. High value exposures are approved by Board Management & Credit Committee (BMCC) and the Board on the recommendations of the management.

The present board of directors of the bank is as follows:

1. Jagdish Prasad Agrawal (Chairman, Promoter Group)
2. Lok Manya Golchha (Director, Promoter Group)
3. Tulsi Ram Agrawal (Director, Promoter Group)
4. Nirmal Kumar Agrawal (Director, Promoter Group)
5. Ashok Kumar Agrawal (Director, Promoter Group)
6. Ganesh Man Shrestha (Director, Representative RBB)
7. Rajendra Aryal (Director, Representative, Public Shareholders)
8. Birendra Kumar Sanghai (Director, Representative, Public Shareholder)

Similarly, the bank has a Management Committee (MANCOM) comprising of senior executives and headed by the CEO. The committee meets every week to discuss major business and strategic issues. Similarly, there is Asset Liability Committee (ALCO) that includes CEO, HBB, COO, MC-BB, MC-CB, MTF, MAC and other managerial position as required by CEO. The committee meets once in month to discuss on the bank's net interest margin, insulate the banks from interest rate sensitivity, maximize stockholders' long-term earnings, and

avoid any excessive default risk. Further, it also includes managing the acquisition and allocation of bank funds to ensure adequate liquidity, maximum profitability, and minimum risk. The management team of the bank is as follows:

1. Sashin Joshi (CEO)
2. Niraj Shrestha (HBB)
3. Laxman Risal (COO)
4. Bimal Daga (MC-BB)
5. Bhanu Dawadi (MC-CB)
6. Arun Parajuli (MTF)
7. Purna Man Napit (HAC)

Further, there is a treasury and finance department to handle the portfolio management. The TFD usually utilizes the surplus fund (if available) with the maximum return and manages fund in case of shortage. Further it utilizes the arbitrage opportunity, manages overall liquidity, monitors and maintains foreign currency accounts, foreign exchange rate movements etc. It maintains the liquidity of the bank through inter bank lending and borrowings. Similarly, it monitors the NOSTRO and VOSTO accounts by monitoring the account statements and reconciliation on regular basis. Further it maintains the cash management of the branches by purchase, sell, lending, borrowings, forward contracts, swap deals etc. It also reports to the NRB on regular basis as per the rule. On the other had there is central credit to monitor the overall credit portfolio of the bank. Each and every credit proposals are to be routed through central credit. The internal audit monitors the compliance of the NRB rules twice every year and reports the same to the higher management so that necessary steps are taken to mitigate such lapses. Thus, we can say that the credit management of the bank is satisfactory as it has good management to monitor its credit policy as well as portfolio management.

Similarly, the branch manger heads every branch of the bank and each has its team comprising of CST with RM and ARM, CSU in-charge, Marketing in-charge, operation in-charge, officer trade finance, officer customer service, officer administration department. All of them have their subordinates to support them in their daily routine work and each of these department heads report to branch manager for the necessary decisions. The workflow in the branch level is divided basically into two parts i.e. work related to credit & marketing department on one hand and the operation department on the other. The credit department routes its credit proposals along with ad-hoc proposals to central credit through branch manager. On the other hand, the operation department, which includes customer service, trade finance, and back office or account department report to treasury department so that the treasury department can manage its fund for its regular operation.

1.7.3 Credit and Marketing Department

The credit department comprises of credit sales team, marketing team & credit support team and it controls and monitors the total portfolio of the branch. The CST comprises of RM and ARM and it basically deals with its corporate credit of its regular and new customers to meet their requirement and review their performance yearly and recommends enhancements, reduction and fresh loans as per the requirement and satisfactory account conduct of the borrower. The marketing team basically is concentrated to small loans & retail lending and also makes marketing efforts for new loans, concentrate to increase the deposits and reviews/recommends the loans once a year as per the need of the management and reports to the CST for the corporate loans. The CSU looks after the credit documentation of both corporate credit and small loans and makes monitoring with the strict compliance of its documentation part as a whole of all the loans. After each and every loan approvals, the CSU prepares the documents as per the requirement of the loan upon the discussion and scrutiny from the legal advisor and then get it completed as per the credit policy of the bank. Similarly, it also makes disbursement as per the applications

forwarded by the customer if it is within the limit of the borrower. Further, it prepares necessary credit report on monthly basis as per the NRB rules and forward it to the central credit and audit team from the accumulated data are then compiled together and then reported to the central bank as per the rule.

The credit team as a whole monitors the entire portfolio and credit monitoring part so as to ensure the timely check and balance of the account as well prepares performance updates of the risky accounts and reports to the central credit via the branch manager who recommends it after the necessary corrections so as to get the effective and useful information from the higher management to tackle any sort of difficulties that arise on the risk assets investments. It usually routes every loan approval that includes fresh loans, annual review of the loan account and memo regarding the ad-hoc requests of the borrower beyond the approved limit as per the requirement of the borrower through BM who basically makes every possible efforts for the recommendations for such approvals. Thus, the loan proposals are then forwarded to central credit, which then routes through MC-BB who then recommends it to the HBB and then to the CEO who then approves it if it is within his limit. The high value exposures of risk assets are approved by BMCC and the Board on the recommendations of the management. Thus, we can conclude that each and every kind of loans is thoroughly scrutinized and then approved if found viable.

1.7.4 Operation Department

The operation department includes customer service department, administration department and trade finance department and these departments too report to the branch manger through operation in-charge. These departments usually report to the treasury and finance department every day so that TFD can make necessary arrangements for its surplus/deficit funds. These are the departments that set the service tempo of the bank and thus are considered the sensitive, as they are the one to entertain the customers. Therefore, if the operation area is

able to provide better and quick service to the customers then the bank is able to solicit more and more business that may ultimately increase the remittance income, high deposits, high volume of trade finance transactions like issuing of guarantees, opening of LC and collections of cheques etc.

1.7.4.1 Customer Service

The customer service includes both the cash and remittance departments and entertains the customers with the services like deposits and withdrawal of cash, issuance of drafts both in local and foreign currency, fax transfers, ABBS facility, opening of accounts, cash collection from NRB etc. All of the staffs relating to customer service department report to the head teller for any sort of valuable information and necessary feedbacks when needed. The head teller then report to the operation in-charge who at last reports to the BM.

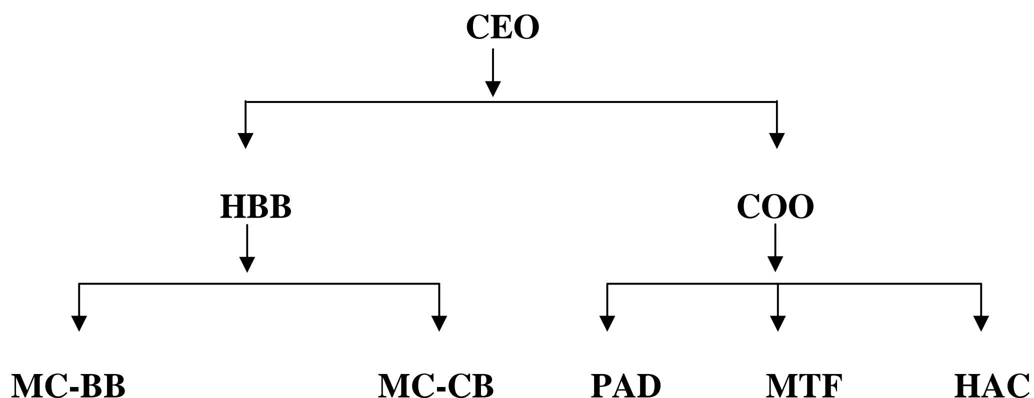
1.7.4.2 Administration Department

The administration department as the name suggest does all the administration of the branch as per the requirement of other departments and rule of the bank. It settles all the petty expenses, prepares all the monthly and daily report as needed. Further, it also functions the daily work of day start at the beginning of each day and day end after the closing of all the banking transactions and also prepares the necessary daily back up for precautions of the data of both the depositors and the borrowers. Similarly, it also handles the store-keeping department that includes the necessary requisitions of stationary items for the day-to-day work of each department. The department head reports to operation in-charge if problem arises that may include non-receivable of stationary items from the corporate office, problems related to breakdown of office materials etc who ultimately reports it to the branch manager. It also maintains the NRB balance and report it the operation in-charge about the surplus and deficit bank balance at NRB so as to make necessary arrangements of cash balance accordingly as per the need of the branch.

1.7.4.3 Trade Finance Department

The department includes the bills department and the foreign trade departments comprising of issuance of all types of bank guarantees and opening of all kinds of LC within the approve limit of the borrower or as per the approval set by the credit department. It also book the LC deals into TR with due dates as per the approval terms of the borrower after the arrival of documents and hands over the necessary documents to the borrower as per the NRB rules to release it from the custom office. Similarly, it also handles clearing of cheques and reports the administration department each day about the bank balance of clearing at NRB. It also purchases the bills of the borrower as per the limit and also does the collection of the bills upon the request of the borrower. Prior to issuance and opening of bank guarantees & LC respectively it also entertains the borrower in settlement of TR as per the borrower's request in the due dates. Further, it reports to the credit department if the request of the borrower crosses the approve limit so that the credit department put forward necessary memo to honor the request of the borrower beyond the approve limit. Thus, in way the trade finance is completely depended on the limits set by the credit department and should work only within the approve limit of the borrower and should inform the credit department if the borrower request is beyond the approve limit. In addition to that, the TF department also prepares necessary monthly reports and reports it to the accounts department.

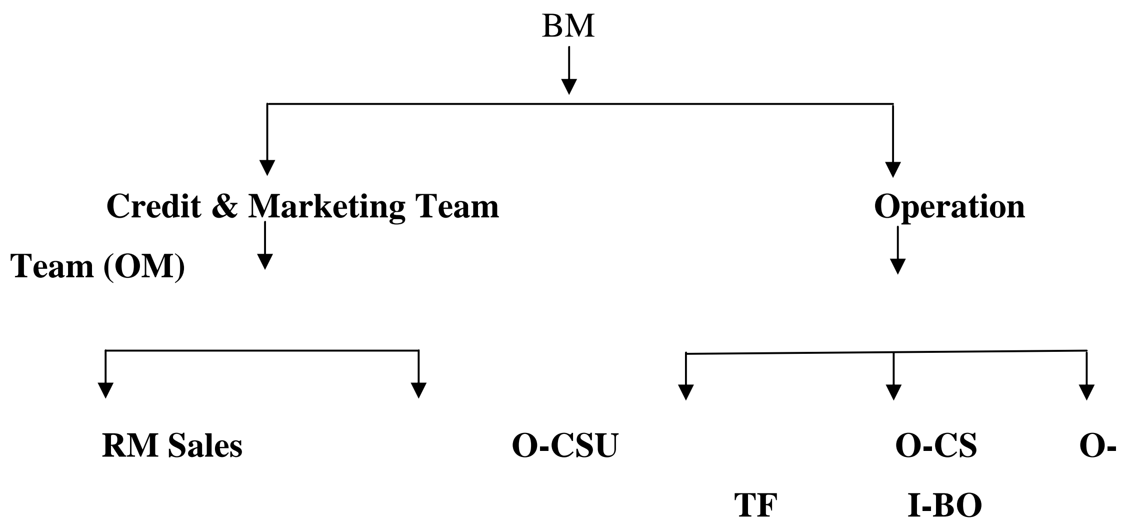
1.8 Organization Structure and its Work Flow



Note:

All the corporate credit loans proposals are handled by MC-BB, which is then reviewed by HBB and then approved by CEO as per the recommendations. Similarly, all the consumer loans (house loans, auto loans etc) are routed through MC-CB, which is forwarded to HBB and then to CEO for necessary approvals. While all the operations area and administration including audit compliance and treasury department is handled by COO which is then forwarded to CEO for necessary information and approvals.

Work Flow at Branch Level



Note:

In the branch, all the credit proposals are routed through BM and then forwarded to MC-BB/MC-CB for necessary approvals while all operations relating proposals are forwarded to COO via BM.

CHAPTER-II
REVIEW OF LITERATURE

2.1 **Introduction**

A commercial bank has been defined as an institution, which receives deposits of money or of credit and which seeks profits through the extension and sale of its own credit. According to the American Institute of Banking, "Commercial Bank is the corporation which accepts demand deposits subject to check and makes short-term loans to business enterprises regardless of the scope of its other sources". *(American Institute of Banking, USA, page. 345)*

Commercial bank is the corporation, which accepts demand deposits subject to check and makes short-term loans to business enterprises, regardless of the scope of its other services. (Principal of Bank Operations1997, American Institute of Banking)

The evolution of the organized financial sector in Nepal has a more recent history compared to that in other developing South Asian countries. Commercial Bank Act, 2031 B.S. of Nepal has defined commercial bank as, "An organization which exchanges money, deposits money, accepts deposits, grant loans and performs commercial banking functions and which is not a bank meant for co-operative, agriculture industries or for such specific purpose". The name of commercial banks was first used to indicate that the loans extended were short-term loans to businesses, though loans later were extended to consumers, governments, and other non-business institutions as well. In general, the assets of commercial banks tend to be more liquid and carry less risk than the assets held by other financial intermediaries.

"Commercial banks are the largest and most diversified intermediaries in range of assets held and liabilities issued. The salient feature of commercial banks lies, in fact, not in their assets, but in their liabilities". *(Garhwal, S, 1993, page13)*

There are various banking functions and no bank can discharge all of these functions. So, they specialize on only some of the functions such as foreign exchange, financing on industry, financing commerce, financing agricultural sector etc. On the basis of their specializations, bank can be classified as agriculture bank concentrates its function on the development of agricultural sector. It provides loan and other services for its developments. Similarly, industrial bank is related with industrial field. Generally this type of bank advances loan for long duration. Commercial banks play an important role in affairs of the economy in various ways. The operations of commercial banks record the economic pulse of the economy. The size and composition of their transactions mirror the economic happening in their country. They are as essential instrument of accelerated growth in a developing economy. In fat, banks are the nerve center of economy and the barometer of economic prosperity. By mobilizing community savings and diverting then into productive channels, commercial banks expand the tempo and appreciate the value of aggregate economic activity in the economy. A commercial bank has been defined as an institution, which receives deposits of money or of credit and which seeks profits through the extension and sale of its own credit. According to the American Institute of Banking, “Commercial Bank is the corporation which accepts demand deposits subject to check and makes short-term loans to business enterprises regardless of the scope of its other sources".

<u>Regulation relating to Commercial Bank in Nepal can be as below:</u>

Establishment

Commercial Banks are required to be registered under the company Act and Commercial Act in order to begin operation .The bank is registered under Company Act only if NRB gives a letter of intent for opening the bank and makes recommendation thereto.

Generally, minimum 30% shares should be sold to common public. This limit can be reduced to 20% only when foreign banks hold minimum 50% shares in

the bank. Foreign banks can hold maximum 67% stake in the bank. NRB allows the commercial banks to function under the given terms and conditions.

Minimum paid up capital required for a new commercial bank is as under:

(a) Rs.250 million to operate all over Nepal except Katmandu valley.

(b) Rs.1000 million to operate all over Nepal.

Existing banks were required to raise their capital fund to minimum Rs.1000 million by mid July 2009 through minimum 10% paid up capital increment every year.

Similarly there are other regulating activities relating to commercial bank in Nepal. Such as Reserves, Capital Adequacy Ratio, Branch and Counter Expansion, Cash Reserve Ratio, Single Borrower's Limit, Interest Spread, Interest Rate, Loan Classification and Provisioning, Sectoral Credit Limit, and Prohibition.

In case of directives credit, banks have to extend a certain percentage of loan and advances in the deprived and priority sector. Currently, deprived sector lending should be at least 0.25% to 3% depending on the banks and priority sector lending at least 12% inclusive of deprived sector lending to their total credit portfolio. However, monetary policy of FY 2059/2060 B.S announced by NRB has pledged to phase out priority sector credit programme in next five years but to continue with deprived sector credit programme. (A handbook to Banking, Bhuvan and Sarita Dahal page34-40)

2.2 Functions of Commercial Bank:

Commercial Banks perform different types of functions to attract more and more customer and they also use modern technology to facilitate its customers. Some of the functions are discussed below.

2.2.1 Accepting Deposits:

One of the most important functions of the bank is to collect the deposits from the customer who has little savings. Bank always collects those deposits, which

are scattered in our surrounding in a small volume but collectively large. They are also unaware about its profitable use. Bank collects deposits under different types of accounts.

(a) Fixed Deposit Account:

Depositors use this account to keep their money in bank for certain duration. Depositors can't withdraw their money before the expiry of stipulated time. Usually rate of interest on this account is always high. Longer the period, higher the interest will be. Fixed deposits can be classified as cumulative fixed deposit, unfixed deposits, and recurring fixed deposits.

(b) Current Deposits:

It is another heading under which banks collect deposits. Traders and businessmen generally maintain this type of accounts. Depositors have no limitation on withdrawal under this account. Because traders have to make payment more often, the bank does not provide interest on this heading.

(c) Savings Deposits:

The saving deposit bears some interest and is the most preferred ones among the people because it is easy to operate and the account opening balance ranges from NPR 1000 to NPR 5000 depending on the banks' strategy. Banks pay some interest on this account but the interest is lower compared to that of fixed deposits. Further, the bank may impose some restrictions on the withdrawal.

(d) Call Deposits:

This deposit scheme is for those depositors who deposit large volume of balance in their account. The bank provides higher interest rates as per the negotiation with the depositors. The interest is provided on the daily balance so as to attract huge deposits.

2.2.2 Advancing of Loans:

The other function of the bank is to provide the loans to business houses, people and traders. Bank in order to mobilize its deposits usually invest its deposits in those areas of the business field where the interest and the principal is secured to be obtained. For this, they charge interest, which is comparatively higher than the various deposit accounts. Thus, the bank is able to sustain with the income it earns from the interest of the loan provided. The loans provided have both short term and long-term durations depending upon the nature of the loans.

(a) Money at Call:

This type of loan is usually provided to another bank or financial institution for very short period and the bank can call its money back at a very short notice of one day to fourteen days.

(b) Cash Credit:

These loans are issued to the borrowers against their current assets like shares, stocks, bonds, etc. Bank opens an account depending upon the policy of the bank and credits the entire loan amount (as per the sanction limit) to the account. The borrower is allowed to with draw money as per his requirement from the limit provide to him. The bank charges the interest on the withdrawal amount.

(c) Overdraft:

These loans are provided to those that have high credibility in the business and depending upon their business volume and relationship

2.3 Credit Management

The word credit management is divided into two parts; credit and management. Credit means providing of overdraft, loans, discount of bills, issuance of letter of credit and guarantee, acceptance, investment on any financial instrument

(i.e. preference share, debentures etc) or any other action which create obligations or risk to the Bank's assets whether temporarily or permanently. Similarly, management is the process of efficiently getting activities completed with and through other people. The management process includes the planning, organizing, leading and controlling activities that take place to accomplish objectives. Management must include three common factors: goals, limited resources and people. Thus, credit management can be defined as the process of managing the credit effectively with a goal to achieve through the people. Here goal being the profit and effective use of sources of funds in viable projects where the income is expected to earn smoothly by the bank.

Credit always has some risk attached. Credit management is more than merely component of risk management; it constitutes the very foundation of effective risk management. If risk can be defined as uncertainty, risk management is the process of minimizing that uncertainty; and for that, bankers need to be aware of where their risks lie and what the nature and extent of such risks are. "Credit risk is most simply defined as the potential that a bank borrower or counter party will fail to meet its obligations in accordance with agreed terms. This failure of borrowers to carry out their financial obligations to their lenders as pledged by contract is called default. A borrower may be unable to perform up to expectations for a variety of reasons, many of which are not always predictable. For businesses, a slump in sales, a sudden increase in operating costs or in the cost of raw materials, stiff competition in the marketplace, labor problems or industry regulations all may cause default. Anything that affects the borrower's financial position may contribute to credit risk. Creditors may refrain from trying to enforce their claims in the hope that, given time, the defaulting borrower may recover from its financial difficulties." *(Basel Committee, Consultative Paper, 1999)*

The credit management of a bank includes both portfolio management and credit policy of a bank. The portfolio management is the complete management

of using the sources of funds to meet the liquidity of a bank and use the funds in a proper way so that profitable income generate smoothly. The credit policy on the other hand is a written document that a bank or financial institution designs to analyze, administer, monitor, recover and handle the credit operations. The basic objective of the Credit Policy Document (CPG) is to ensure consistency in credit operations.

2.3.1 Portfolio Management

Portfolio management aims at striking an optimum balance between the conflicting goals of liquidity, solvency and profitability. The bank has to solve the problem of portfolio management, i.e. it has to manage its assets and liabilities in such a way that maximum profits are secured without losing liquidity and solvency. According to Ranlett, "The objective of commercial banks' portfolio management is to achieve the pattern and contribution of assets and liabilities necessary to satisfy bank needs for liquidity, solvency and income. These needs are competitive because, for example, the assets that provide maximum liquidity generate little or no income." *(Paul, Dr. R.R., 1999:17-B)* There are three main objectives of portfolio management namely

1. Liquidity
2. Solvency and
3. Profitability

1. Liquidity

Liquidity means the ability of the bank to give cash on demand. In the words of Sayers, "Liquidity is the word that the banker uses to describe the ability to satisfy demand for cash in exchange for deposits." *(Sayers, R.S., 1967:75)* The business of the bank primarily depends upon the confidence of the depositors on the bank and the depositors feel confident when they are sure that they can demand their money back at any time. Thus, the bank must keep adequate

amount of liquid assets with them to meet the demand from the depositors. Liquid assets are assets either in the form of cash or in a form that can be easily turned into cash. The liquid assets of a bank are cash in hand, money at call or short notice, bills of exchange and treasury bills etc; etc. Thus, liquidity is necessary for maintaining public confidence. If a bank does not have sufficient liquidity, it loses public confidence and, in turn, destroys its own business.

The proportion of the total deposits to be kept in liquid or the amount of cash reserve to be maintained by the banks depends upon the following factors.

- Requisite Cash Reserve
- Banking Habits
- Structure of Banking
- Nature of Money Market
- Nature of Economy
- Nature of Business Condition
- Seasonal Requirements
- Type of Depositors
- Clearing House Arrangements

2. Solvency

Solvency (or security or safety) of a bank depends upon the, relationship between its liabilities and assets. It implies that assets are at least equal to liabilities. In the words of Chandler, "A bank is solvent when the value of its assets is at least great enough to cover all its liabilities except those to its owners; it is insolvent when the value of its assets is insufficient to cover all the non owner claims against it." *(Paul, Dr. R.R., 1999:18-B)* According to Meyers, "A bank is solvent if the amount of its assets exceeds the amount of its liabilities to all claimants."

Solvency is different from liquidity. Liquidity refers to the ability of the bank to easily turn its assets into cash without loss to meet the demands of the

depositors. Solvency means liabilities of the bank equal to or exceeding its assets. A bank may be solvent, but not liquid, if its assets, though equal to or exceed its liabilities, cannot be quickly exchanged for money to meet the demand of the depositors. Similarly, an insolvent bank may continue to operate without any liquidity problem, if its assets are at least equal to its liabilities but there is not much demand for payment from the depositors.

The problem of insolvency arises because of the fundamental reason that while the liabilities of the bank are fixed in terms of the monetary unit of the country, the assets of the bank are liable to change in value terms. A considerable fall in the realizable value of assets may lead to the insolvency of the bank. Some factors must be taken into consideration by the banks in portfolio management ensuring solvency. These factors are

- Misappropriation or Loss of Assets
- Risk of Default
- Change in Rate of Interest

3. Profitability

Bank is a business institution whose objective is to earn maximum profit or income. It must earn sufficient income to meet the cost of running the bank to make payments of interest on deposits and to yield a reasonable return for the owners. For this purpose, the bank should invest its funds in such a way that it earns maximum income with minimum variable cost. Income of the bank depends upon

(a) the receipts from an asset during the period it stays with the bank;

(b) the variable cost in owning the asset; and

(c) the cost of acquiring the assets.

To conclude, all the three objectives of portfolio management are not equally important. Liquidity and solvency are the primary and basic objectives. Profitability is secondary and less important objective. The secondary objective

should not be achieved at the cost of the primary objectives. In other words, liquidity and solvency of the bank must not be sacrificed in the endeavor to maximize profit.

2.3.2 Credit Policy

"A credit policy is a written document that a bank or financial institution designs to analyze, administer, monitor, recover and handle the credit operations. The basic objective of the Credit Policy Document (CPG) is to ensure consistency in credit operations. Generally, credit policy is formulated by the high level management of the bank or financial institution and approved by the board of directors. The policy once announced does not remain constant over time. It is reviewed and revised periodically to reflect the changes in banking policy requirements." *(Bhatta, Gopal Prasad, 2059B.S.:99)*

Credit is always a matter of judgement based on one's own experience and convictions. Ultimate result is the indicator of good or bad loan approval, and from such experience that one has to arrive at a proper credit policy. General principles of sound credit policy involve among other things to extend a most courteous and sympathetic service to all eligible and delivering borrowers, as a duty cast on the banker.

The basic purpose of a commercial bank is to maximize the shareholders' wealth by accepting deposits and granting loans in the society. In order to give maximum return to shareholders, the bank is required to invest most of its fund in loans and advances, risky assets. Consequently, a clear and sound loan credit policy is a must for the safety of depositors fund and adequate for the safety of depositors fund and adequate return to shareholders. "Credit policy can be defined as the decision made in advance about the management of credit." *(Bhuwan & Sarita Dahal, 2056 B.S.:66)*

Credit is the vital and most important activity in the Bank, next only to deposit mobilization. It is the activity that generates the main income stream for the Bank. The activity should therefore be pursued with the utmost professionalism, conservation and circumspection. To indulge in reckless credit disbursement, at any operating level, would be the ultimate sin, which must be prevented at all costs. It is therefore necessary to lay down a Credit Policy to instill and internalize certain discipline in the area of credit administration. Banks should develop and implement policies and procedures to ensure that the credit portfolio is adequately diversified given the bank's target markets and overall credit strategy. In particular, such mixes as well as set exposure limits on single counter parties and groups of connected counter parties, particular industries or economic sectors, geographic regions and specific products. Banks should ensure that their own internal exposure limits complies set by the banking supervisors. Credit policies establish the framework for lending and guide the credit-granting activities of the bank.

To meet the conflicting interest of depositors and shareholders, the established credit policy gives due regards to:

(a) Liquidity

Regular amortizing and self-liquidity loan, investment in marketable securities and placements.

(b) Profitability

Pricing in relation to cost of fund and risk. No concession in interest rate on the borrower's threat to shop around.

(c) Safety

Analysis of capital, character, capacity, condition and collateral.

- Marketability, transferability and validity of securities.
- Risk dispersion/diversification.

2.2.3.1 Factors affecting Credit Policy

(a) Statutory Directive

Credit flow as per central bank's directive:

- Loan to priority/deprived sector
- No loan to board of directors
- No loan to restricted areas
- One obligor limit etc.
- SLR and CRR.

(b) Deposit Mix

- Short-term loan if dominance of short term deposit.
- Long term loan if dominance of long term deposit.

(c) Competition

Credit policy should positively react to interest rate structure in the market. Flexibility required.

(d) Quality of Lending Officials

Experience, knowledge, adaptability of lending officers help to formulate the sound policy.

Considering all above facts, the credit policy should be carefully established, communicated properly to the lending officers and implemented effectively by the lending officers. The credit policy of the bank is established by the board of directors based on the recommendation of Chief Executive Officer or Senior Loan Officer.

2.2.3.2 Objectives of Sound Credit Policy

1. To have good assets

Loans are risky assets though a bank invests most of its resources in granting loans and advances. If loan assets of the bank are non-performing or bad, no

bank can survive. It is the very quality of assets that led bankruptcy of many banks in South East Asia. The objective of sound loan policy is to protect depositors' interest and maximize returns to the shareholders by striking a balance between liquidity and profitability.

2. To contribute to economic development

Sound credit policy is required to ensure that loans are given to the productive sector, which contributes to capital formulation and employment generation.

3. To give guidance to lending officials

A borrower should be assured that there would be no discrimination whether he deals with one officer or another. A sound credit policy is imperative to achieve a uniform standard procedure throughout the organization.

4. To establish a standard for control

Every policy requires periodic follow-up to ensure its proper implementation. A sound policy helps to determine the variance between actual performance and practices and to take corrective actions. A sound policy is always flexible and works as a guideline rather than a straitjacket. However, if the deviation between the practice and policy is observed, proper education to lending officer or amendment of the policy becomes inevitable.

2.2.4 Need of Credit Management in Commercial Banks

In bank funds management, the cost of handling is, of course, as important as the availability of funding. Competition, deregulation, economic conditions, and increased sophistication in money management on the part of retail and wholesale depositors have increased the cost of bank fund tremendously. After initial capitalization, a bank has three major sources of funds for its business operations: deposits purchased or borrower funds (issue of shares) and capital increases. Within these three basic categories are many funding instruments whose maturities, costs, and applications in liability management vary.

Liability management, in its broadest sense, is the coordination and control of all of a bank's sources of funds so that funds are available or obtainable as needed at reasonable cost. Effective liability management ensures that funds are available to meet reserve requirements and provide adequate liquidity over the short term, and to satisfy loan demand and provide investment earnings over the long term. Most of the commercial banks in the country provide lower interests in the deposits and charge higher interests on the loans provided. Thus, they make a better margin in their earnings. Bank funding sources and the nature of liability management have undergone profound changes in recent years, and continued change and challenge are still on the horizon. The deposit structures of most banks have been altered significantly due to marked declines in traditional demand deposits and rapid increases in the volume of time deposits. The sources of most bank funds are now interest sensitive and increasingly volatile. Competition for funds is intense, and effective management of a bank's liabilities now requires a much more aggressive approach to attracting and keeping funds. *(Paul, Dr.R.R, 1999:35)*

Making an unsecured loan involves taking a risk, and losses on some loans are to be expected. Commercial banks are facing increasingly credit risk (or counter party risk) risk in various financial instruments other than loans, including acceptances, inter bank transactions, trade financing, foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the settlement of transactions. Thus, the need of credit management is most as the banks should always try to mitigate the risk related to the loan provided. Steps that banks can take to limit loan losses include obtaining sufficient information on loans and borrowers and establishing an internal system of loan review in addition to the loan reviews of regulatory agencies. Banks can also affect or offset credit risk in their loan portfolios by watching the business cycle, varying loan rates against the degree of risk and recognizing risk in loan concentration. Although specific credit risk management practice may differ among banks depending upon the nature and complexity of their credit

activities, a comprehensive credit risk management program should address the following four areas:

1. Establishing an appropriate credit risk environment,
2. Operating under a sound credit granting process,
3. Maintaining an appropriate credit administration, measurement and monitoring process and
4. Ensuring adequate controls over credit risk.

Credit risk is a factor in all loans, but to varying degrees. Bank should recognize this variability by matching loan rates to risk. A bank that charges the same rates for many types of loans is not receiving adequate compensation for its riskier loans. In comparison a loan's total yield to its risk, a bank also should consider any supporting deposit balances required in conjunction with the loan and may also want to consider other profitability generated from the customer's relationship with the bank. *(Basel Committee, Consultative Paper, 1999)*

2.2.5 Credit Control

Credit control is the regulation of credit by the central bank for achieving some definite objectives. Modern economy is a credit economy because credit has come to play a major role in setting all kinds of monetary and business transactions in the modern economic system. Changes in the volume of credit influence the level of business activity and the price level in the economy. Unrestricted credit creation by the commercial banks, by causing wide fluctuations in the purchasing power of money, may pose a serious threat to the national economy. Hence, it becomes necessary for the central bank to keep the creation of credit under control in order to maintain stability in the economic system.

2.2.5.1 Objectives of Credit Control

The importance objectives of credit control are given below:

1. Price Stability

Violent price fluctuations cause disturbances and maladjustments in the economic system and have serious social consequences. Hence, price stability is an important objective of credit control policy. The central bank, by regulating the supply of credit in accordance with the commercial needs o the people, can bring about price stability in the country.

2. Economic Stability

Operation of the business cycle brings instability in a capitalist economy. The objective of the credit control policy of the central bank should be to eliminate cyclical fluctuations and entire economic stability in the economy.

3. Maximization of Employment

Unemployment is economically wasteful and socially undesirable. Therefore economic stability with full employment and high per capita income has been considered as an important objective of credit control policy of a country.

4. Economic Growth

The main objective of credit control policy in the underdeveloped countries should be the promotion of economic growth within the shortest possible time. These countries generally suffer from the deficiency of financial resources. Hence, the central banks in these countries should solve the problem of financial scarcity through planned expansion of bank credit.

5. Stabilization of Money Market

Another objective of the central bank's credit control policy is the stabilization of the money market so as to reduce the fluctuations in the interest rates to the minimum. Credit control should be exercised in such a way that the equilibrium in the demand and supply of money should be achieved at all times.

6. Exchange Rate Stability

Exchange rate stability can also be an objective of credit control policy. Instability in the exchange rates is harmful for the foreign trade of the country. Thus, the central bank in the countries largely dependent upon foreign trade should attempt to eliminate the fluctuations in the foreign exchange rates through its credit control policy.

2.2.5.2 Methods of Credit Control

The various methods or instruments of credit control used by the central bank can be broadly classified into two categories:

1. Quantitative or general methods, and
2. Qualitative or selective methods.

1. Quantitative or General Methods

The methods used by the central bank to influence the total volume of credit in the banking system, without any regard for the use to which it is put, are called quantitative or general methods of credit control. These methods regulate the lending ability of the financial sector of the whole economy and do not discriminate among the various sectors of the economy. The important quantitative methods of credit control are: (a) bank rate, (b) open market operations, and (c) cash-reserve ratio.

2. Qualitative or Selective Methods

The methods used by the central bank to regulate the flows of credit into particular directions of the economy are called qualitative or selective methods of credit control. Unlike the quantitative methods, which affect the total volume of credit, the qualitative methods affect the types of credit extended by the commercial banks; they affect the composition rather than the size of credit in the economy. The important qualitative or selective methods are; (a) marginal requirements, (b) regulation of consumer credit, (c) control through

directives, (d) credit rationing, (e) moral suasion and publicity, and (f) direct action.

2.2.5.3 Directives Relating To Loan Classification and Provisioning

2.2.5.3. A Classification of Loans and Advances

The Clause 2 of NRB Directive2 dated 2057.12.2 has classified loans and advances into 4 categories:

(a) Pass

The loans included in this category are those that have no recovery problems (principal and interest not past due) and principal and interest past due for a period of 3 months. These are defined as Performing Loans.

(b) Substandard

The loans and advances which are past due for a period of over 3 months to 6 months are considered to be Substandard Loans.

(c) Doubtful

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

(d) Loss

All loans and advances which are past due for a period of more than 1 year as well as advances which have least possibility of recovery or considered un-collectable and those having thin possibility of even partial recovery in future are included in this category.

Note:

(a) If it is appropriate in the views of the bank management, there is no restriction for classifying the loan and advances to lower category. For

instance, advances falling under substandard may be classified into doubtful or loss, but the same cannot be classified as Pass category.

(b) All loans and advances classified under substandard, doubtful and loss is categorized as Non-Performing Loan.

2.2.5.3. B Additional Arrangement in Respect of Pass Loan

The Clause 6 states that the loans and advances fully secured by gold, silver, fixed deposit receipts and HMG bonds are to be categorized under "Pass". However, where collateral of fixed deposit receipt or HMG bonds is placed as security against loan for other purposes, such loan to be classified on the basis of aging per Clause 1.

2.2.5.3. C Additional Arrangement In Respect Of "Loss Loan"

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

(a) No security at all or security that is not in accordance with the borrower's agreement with the borrower's agreement with the bank.
(b) The borrower has been declared bankrupt.
(c) The borrower cannot be found.
(d) Purchased or discounted bills are not realized within 90 days.
(e) The credit has not been used for the purpose originally intended.
(f) In the process of recovery, auctioning of collateral is initiated or is under litigation.
(g) Loans provided to the borrowers black-listed by CIB.

Note:

(a) Bills Purchased/Discounted are to be classified into Loss Loan where they are not realized within 90 days. This is departure from the normal classification rules applicable to other loans. Accordingly, it seems that Bills would have only two classifications viz. PASS and LOSS.

2.2.5.3. D Additional Arrangement In Respect Of Term Loan

The Clause 7 states that in respect of term loans, the classification is to be made against the entire outstanding loan on the basis of the past due period of overdue installment.

2.2.5.3. E Classification of Contingent Liabilities Converted Into Loan

The clause 8 states that in the event of conversion of contingent liabilities of the bank e.g. letters of credit, immature guarantees, into the liability of the bank, such amount become recoverable from the customers. Hence, such amounts shall also be classified as per the classification norms applicable to loans and advances and accordingly be provided with requisite provisioning.

2.2.5.3. F Prohibition To Recover Principal and Interest

The Clause 9 states that banks are prohibited from realizing interest on advances by debiting the customers' account that result in overdraft in such account or by utilizing/approving overdraft facilities of such customers.

2.2.5.3.G Loan Loss Provisioning

As per the Clause 10, the requisite loan loss provisioning on the basis of the loan classification of outstanding credit shall be as follows:

Classification of Loan	Loan Loss Provision
Pass	1 percent
Substandard	25 percent
Doubtful	50 percent
Loss	100 percent

Note:

(a) Loan loss provision set aside for Performing Loan is defined as "General Loan Loss Provision" and Loan loss Provision set aside for non-performing loan is defined as "Specific Loan Loss Provision".

2.2.5.3. H Provisioning Against Priority Sector Credit

Full provisioning as per Clause 10 is to be made against the un-insured priority and deprived sector loans. However, in respect of insured loans the requisite provisioning is 25% of the percentage stated under Clause 10. The required provisioning in the case of insured priority/deprived sector credit is follows:

Classification of Loan	Loan Loss Provision
Pass	0.25%
Substandard	5%
Doubtful	12.5%
Loss	25%

2.2.5.3. I Adjustments in Provisioning

Except in the following cases, banks are prohibited from making any adjustments in their loan loss provision amount:

(a) The loan has been completely written off.

(b) Outstanding principal and interest on the loan has been completely paid off by the borrower and the account has been closed.

(c) Loan has been classified and provision for loan loss is made.

2.2.5.3. I Actions To Be Taken In Cases Of Non-compliance

In cases where a bank has been found not complying the regulation in respect of loan classification and provisioning, NRB may ask for clarification. If the bank's response is unsatisfactory, NRB shall initiate the following action in exercise of its authority under section 23 (1) of NRB Act, 2012:

(a) Reclassify the loans and advances and require to adjust the appropriate provisioning within 3 months.

(b) If the banks continue to un-comply with the above directive, the following additional actions is initiated in exercise of the authority under Section 32 of NRB Act, 2012 (with amendment):

- Suspend the distribution of dividends.

- Suspend the extension of loans.
- Suspend the acceptance of deposits.

2.2.5.4 Directives Relating The Loans To Productive and Priority Sector (Including Deprived Sector):

Commercial banks are required to extend advances in the productive, priority and deprived sector as follows:

Of The Total Advances:

40% to Productive Sector,
12% to Priority Sector, including Deprived Sector.

Each bank is specified with the requisite amount for extension of advances to Deprived Sector. At present most of the banks as per the rule of NRB, has to extend 3 percent of the total loan outstanding in the deprived sector. Those banks whose deprived sector credit has not reached 3 percent, the requirement shall increase by 0.5 percentage point each year on previous year’s limit till it reaches 3 percent. Further, in the case of those banks whose limit has already reached and whose ceiling would reach 3 percent in the later years, the limit for each year shall remain to the same level (3 percent).

(a) Productive Sector

All advances made to the industries, including investments made in their shares and debentures are included under Productive Sector Lending. The other Productive Sector includes

- Pre-shipment Credit
- Export bill financing
- Advances for purchase of public transport means and agricultural/farm equipments
- Investments in shares and debentures of Government/semi-government or private sector or banking like companies.

(b) Priority Sector and Priority Sector Credit

"Priority Sector" is defined to include micro and small enterprises which help increase production, employment and income as prioritized under the national development plans with an objective to uplift the living standard of general public particularly the deprived and low income people by progressively reducing the prevalent unemployment, poverty, economic inequality and backwardness. Micro and Small Enterprises are classified into Agricultural enterprises, Cottage and Small Industries and Services. In addition, other businesses as specified by NRB from time to time are also included under Micro and Small Enterprises. All credits extended to priority sector up to the limit specified by NRB are termed as "Priority Sector Credit".

(c) Deprived Sector and Deprived Sector Credit

"Deprived Sector" includes low income and particularly socially backward women, tribes, lower caste, blind, hearing impaired and physically handicapped persons and squatters (SUKUMBASI) family. All credits extended for the operation of self-employment oriented micro-enterprises for the upliftment of economic and social status of deprived sector up to the limit specified by NRB is termed as "Deprived Sector Credit". "Deprived Sector Credit" is considered, as integral part of priority sector credit and this credit comprise micro-credit programs and projects also.

1. Priority sector lending is categorized in 4 major headings

- Agriculture and agric related enterprise
- Cottage and small industry (as defined by Industrial enterprise Act)
- Service Industry
- Other enterprises

2. Credit Limit

Banks are required to extend PS loans as prescribed by NRB from time to time. Following limits are applicable presently:

(a) Per project Rs. 2 million and Rs. 2.5 million for agriculture and services enterprise and industry respectively.

(b) In addition to above, enterprises, which are considered as national priority such as micro hydel projects generating upto 10 megawatts of electricity, tea estate development, production, processing/packaging. Cold storage, occupational and technical training institutes-development and extension, blending/production of chemical fertilizer, industrial pollution control equipment of Rs. 20 million remaining within single borrower limits. NRB have subsequently enhanced limit in hydro up to Rs. 100 million.

(c) Development/manufacturing of computer software and hardware, manufacturing and operation of non-polluting (safa) tempo &other vehicles, captive generator used for irrigation by industries, loans up to Rs. 10 million within single obligor limit.

3. Computation

1. Deprived Sector

Up to Rs. 30,000 per group member/family, investment in equity or loan investment in approved rural developments banks/micro-finance intermediaries.

2. Priority Sector

All loans and investments in deprived sector as per 3.1 above and as per 2 above (credit limit) will be counted as priority sector investment.

3. Method of Computation

On gross loans/advances of 6 months earlier, 12% should be in priority sector and 3% in deprived sector. However NRB has recently issued a circular reducing PS lending ceiling to 7%, which is being further reduced to 2% over a period of 5/6 years.

4. Penalty

If there is any shortfall in lending, penalty at the highest rate of interest charged by the bank will be levied.

2.2.5.5 Directives Relating To Single Borrowers Limit

As per the Clause 1 of NRB Directives No.3 Commercial banks may extend to a single borrower or group of related borrowers the amount of Fund Based loans and advances up to 25 percent of the core capital fund and Non Fund Based off-balance sheet facilities like letters of credit, guarantees, acceptances, commitments up to 50 percent of its core capital fund. The purpose of this directive is to avoid extension of credit to single borrower or group of interrelated borrowers and to mitigate concentration risk due to extension of loan to single/specific area of economy.

Limit:

Fund Based Credit = Up to 25% of Core Capital

Non-Fund Based Facilities = Up to 50% of Core Capital

2.2.5.5.1 Definition of Core Capital

The definition of Core capital is defined in the directives relating to Capital Fund. The Core capital includes the following:

- Paid up capital
- Share Premium
- Non-redeemable Preference Shares
- General reserve Fund
- Accumulated Profit and Loss Account

2.2.5.5.2 Limit Adjustment

Where a customer has once utilized the off-balance sheet facilities and such facilities has turned into fund based credit, directives relating to fund based credit limit shall be applied for fixation of limit to such customers.

2.2.5.5.3 Exemption Of Credit Limit

The exposure limits per clause 1 above is not applicable to:

(a) Credits and facilities extended against fixed deposit receipts, deposits placed with the bank, securities and bonds issued by HMG and NRB as well as against unconditional guarantees issued by multilateral institutions including the World Bank, Asian Development Bank, and International Finance Corporation.

(b) Advances/facilities to be used for the purpose of importing specified merchandise by the following public corporation:

Name of Corporation	Merchandise
Nepal Oil Corporation	Petrol, Diesel, Kerosene, and L.P. Gas
Agriculture Input Corporation	Fertilizer, seeds
Nepal Food Corporation	Cereal

2.2.5.5.4 When do different borrowers/companies fall under the same group?

1. If a unit/company owns 25% or more shares of another company-then both companies fall under the same group.
2. Directors of a company, shareholders/directors of a private limited company or family members living together or separately (being husband, wife, son, daughter-in-law, unmarried daughter, foster son, unmarried foster daughter, father, mother, step mother, brother and sister who are under care of concerned individual) and such persons themselves or their relatives as mentioned above owning 25% or more shares of another company, then all such companies come under the group.
3. Even if concerned shareholders/directors as per clause 2 above are owning less than 25% shares of another company but the person (director/partner) controls another company by:
   - Being chairman of the board of such company,

- Being chief executive, and
- By appointing 25% or more directors in the board.

4. If a borrower (individual or company) has provided cross guarantee to other borrower/company, then both will fall under single obligor.
5. Bank should submit one obligor exposure report on half- yearly basis to NRB.
6. Defined as different group

   If an institution, company is owned by HMG with 50% or more shares, it will not fall under single obligor.
7. Creation of capital charge to mitigate concentration risk

   Bank should bring an existing borrower availing higher limits prior to these norms within the single obligor limit within 6 months failing which bank should create additional capital charge by increasing primary capital within 6 months.
8. Banks should review their portfolio for concentration of credit (both funded and non-funded) to a single sector of economy. If necessary, NRB will direct banks to create capital charge as above to mitigate the risk.
9. Credit concentration will segregated in 2 levels as below:
   - Level 1: Loans of 50-100% of fund based limit to one sector
   - Level 2: Loans of 100% or more of fund based limit to one sector
10. Credit information and follow up for sectoral concentration of credit.
    - For Level 1: Bank should put in place its own MIS & Follow up procedure and review on quarterly basis.
    - For Level 2: Bank's board will have to approve such extensions, and NRB should be informed of its decision regarding maintaining exposure above 100% of primary capital.

2.2.6 Restriction on Providing Credit Facility

Directive on Corporate Good Governance (NRB Directive No 6, Ref: BBP 71/058, Dated 2058/5/29 with amendments)

NRB has brought these directives with a view to discourage the practice or tendency whereby banks may lend to directors/their family members without proper evaluation

of the loan proposal/project which causes great loss to the banks. The purpose of these directives is to restrict such practices, which take place due to favours/pressure tactics, applied by bank's directors/their family members. It encourages banks to follow the rules, regulations and develop professionalism in decision-making.

Bank can extend credit facility to:

- Promoter, shareholders of promoting group, or shareholders owning more than 1% shares of the bank and to bank's employees,
- To a firm or company in which bank's shareholder or employee owning more than 1% of its shares has financial interest, is a partner or guarantor,
- To a firm or company in which Bank's shareholders and employees own more than 10% shares and have voting rights-other than those cases where NRB has permitted the same,
- To a person for whom guarantee has been provided by Bank's employee or by shareholder holding more than 1% share,
- By pledging the property owned by bank's director, his/her family member.

Bank cannot extend credit facility to

- Bank's director and member of his/her family,
- An institution/enterprise in which the director or family member has direct financial interest or is a manager, partner, agent or guarantor of such unit.
- A firm or company in which a director and his/her family member hold more than 10% shares.
- A firm or company on behalf of which a director or his/her family member is guarantor.

But this will not restrict the loans against FDR or NRB Bond paper owned by director/family.

Note:

Family member means concerned individuals husband, wife, son, daughter-in-law, unmarried daughter, foster son, unmarried foster daughter, father, mother, step mother, brother and sister who are under his/her care.

Exception:

Investments made by banks in the share capital of rural development banks and development banks doing micro-finance activities as part of priority/deprived sector lending do not come under the above (restrictions).

2.2.7 Major Concerns of Banks in Nepal

In the present scenario, Nepal banking system is evolving itself as a powerful instrument of planning and economic growth of all the developed and underdeveloped sectors. The scope and scale of banking too have undergone substantial change in response to the saving and credit needs of people. After the restoration of democracy, Nepal had adopted more liberal and open economic policies. The process of economic liberalization and reforms in the financial sector introduced in the early 1980s has led to significant changes in the banking industry. The open and liberal policy of the government in the financial sector has helped in establishing many banks and financial institutions in the country. These banks have contributed towards introducing new technology, new banking systems and efficient service delivery in the country. These banks have been contributing in line with the thrust of economic liberalization and financial sector reform, i.e. making the financial system more competitive, efficient and profitable. Like other organization, the main objective of the banking industries is profit maximization and wealth maximization. However, the banks are responsible for safeguarding the interest of the depositors, the shareholders and the society they are serving. A sound banking system is important because of the key roles it plays in the economy: intermediation, maturity transformation, facilitating payment flows, credit allocation and maintaining financial discipline among borrowers.

At present, large numbers of banks are operating in Nepal. Naturally, they are residing a wide range services. They are keeping up with the changes taking place in the world. Though the changes are towards advancement and right direction, the banking today is not hale and hearty. Both the government and private sector banks are facing difficulties. The major concern of the banks is about the NPA, which is led by the circumstances led by the government

regulations regarding the trade treaty, continuous transportation disruptions, macroeconomic conditions, poor management of the industries, Maoist insurgency etc. These conditions have affected the industrial sector mostly and thus many industries have shut down. The banks too are having difficulties in recovering the investments from these sectors. Thus, the NPA has been increasing every year. Apart from that, there are other reasons that have increased the NPA of the banks both in private and government owned banks. The main reason is the poor credit management in these banks which has led increment in NPA continuously rather to recover those bad loans. The recent rumor of some private sector banks manipulating their audited and un-audited has led the banking sectors in the speculation and thus NRB has come forward to penalize those banks if found guilty.

Although Nepal has not experienced a major banking crisis, a number of serious issues exist in the system. A study of the Nepalese financial sector conducted by the World Bank has revealed four major weaknesses in the system-excessive government ownership, weak central bank, poor banking environment and inadequate banking services for the poor. Excessive government ownership has led to poor internal governance, weak management, fragile financial health and unhealthy politicization of state owned institutions. The central bank has not been able to supervise and regulate the system effectively due to lack of autonomy and excessive number of poorly trained staffs. Weak legal framework, weak corporate governance, lack of competition, poor banking culture, information asymmetry and corruption have been reported as the major facts responsible for creating poor banking environment in the system. Though the government has emphasized the social dimension of banking by establishing state-dominated rural development banks, these banks have failed to produce the intended results. *(Paudel, Narayan Prasad, 2059 B.S.:85)*

CHAPTER-III
RESEARCH METHODOLOGY

3.1 Introduction

Research methodology may be defined as a systematic process that is adapted by the researcher in studying a problem with certain objective in view. In other words, research methodology describes the methods and process applied in the entire aspect of the study. It is a broader concept, which consist of tools and techniques use to analyze the data.

The basic objective of this study is to evaluate the overall performance of Credit Management of NIC Bank mostly regarding the portfolio management and credit policy of the bank. In order to evaluate the performance and effectiveness of Credit Management, an appropriate methodology has to be followed. Thus, in this chapter, the focuses have been made on research design, population and sample, nature and sources of data and collection procedures etc. such that it will help to draw a meaningful interpretation so that recommendation can be made.

3.2 Research Design

Research is a theory building activities. Theory is a relationship between two or more facts. The research design refers to the conceptual structure within which the research is conducted. "A research design is the arrangement of conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure." *(Kothari, C.R. 1962:2)* In other words it is strategy specifying which approach will be used for collecting and analyzing the data.

"A good design is often characterized by adjectives like flexible, appropriate, efficient, economical and so on. Generally, the design, which minimizes bias and maximizes the reliability of the data collected and analyzed, is considered a

good design that gives the smallest experimental error is supposed to be the best design in many investigations. The first step of the study is to collect the necessary information and data for the evaluation of Credit Management of NIC Bank, which comprises of portfolio and risk management. The research is conducted on the basis of secondary data collected in published journals, NRB Directives, annual report and from the websites regarding credit management. For this study, two different research designs are used to meet the objectives of the study. These designs are analytical and descriptive.

Analytical, descriptive and exploratory research design is conducted so as to evaluate the overall performance of credit management since its inception on the basis of presented data and facts. The data are carefully studied and analyzed under specific major headings so as to meet the objective of the study. In order to carry out the study, both financial and statistical analysis has been conducted.

3.3 Population and Sample

Population is the group of individuals under which study is carried out. Here all commercial banks are population and NIC Bank has been taken as sample. NIC Bank has completed 8 years, hence the financial statements, viz, Balance sheet and Profit and Loss account published till date are considered as the population of the study. The data are collected from the annual report and from the website of Nepal Stock Exchange.

"The sampling is a sub-group chosen, which is believed to be the representative of the population. It is a tool, which enables us to draw conclusion about the characteristics of the population after studying the items in the sample" *(Woolf and Pant, 2000:75)* The sample of the study comprises of Balance Sheet and Profit & Loss Account from fiscal year 2001/02 to fiscal year 2007/08.

3.4 Nature and Sources of Data

The data collection activities consists of taking ordered information from

reality and transferring it into some recording system so that it can later be examined and analyzed for patterns. Without any data, nothing can be studied. The structure of the financial analysis, statistical analysis and the decision-making depends upon the data. If the data collected are reliable, correct decisions can be obtained. Hence, collection of relevant data is essential for correct and important decisions.

The data collected in order to carry out this thesis are basically secondary. The data are mostly taken from the published journals, NRB Directives, annual report of NIC Bank, articles published in newspapers and the website of Nepal Stock Exchange. The study mainly focuses on the Credit Management of NIC Bank and therefore is more concentrated on the analysis of the overall performance of the bank. The study analyses the balance sheet and profit & loss account. There are no primary data as the study is mostly based on the secondary data.

3.5 Data Collection Techniques

In this study, the data are mostly extracted from the annual reports of NIC Bank of seven years. Similarly the other information relating to NRB and Credit management are collected and extracted from NRB Directives and published journals. The annual reports were collected from the accounts department by personal effort while the other information was collected from the journals and respective websites.

The data collected are mostly secondary. The data are classified into different heads like risk assets, deposits, profit, bills payable, interest etc. The classification of data helps to change the voluminous heterogeneous data into homogeneous groups so that its important characteristics can easily be grouped. It also makes the data more useful for further processing such as tabulation, analysis and interpretation of data.

3.6 Data Analysis Tools

In the course of analysis and interpretation various financial and statistical tools are used in the study. The percentage trend methods, simple arithmetic mean, Karl Pearson's co-efficient of correlation, probable error and different types of financial ratios are applied to analyze and interpret the data. Thus, the analysis of the study is focused on

3.6.1 Financial Tools and

3.6.2 Statistical Tools

3.6.1 Financial Tools

Financial analysis is the starting point for making plans, before using any sophisticated forecasting and planning procedures. Understanding the past is a prerequisite for anticipating the future. Management should be particularly interested in knowing financial strengths of the firm to make their best use and to be able to spot out financial weaknesses of the firm to take suitable corrective actions. The future plans of the firm should be laid down in view of the firm's financial strengths and weaknesses.

Financial analysis is the process of identifying the financial strengths and weaknesses of the firm by properly establishing relationships between the items of the balance sheet and the profit & loss account. To carry out the financial analysis, different financial tools are used.

Ratio Analysis is a powerful tool of financial analysis. A ratio is defined as "the indicated quotient of two mathematical expressions" and as "the relationship between two or more things." *(Pandey, I.M., 1999:125)* In financial analysis, a ratio is used as a benchmark for evaluating the financial position and performance of a firm. Ratio helps to summarize large quantities of judgement about the firm's financial performance. The point to note is that a

ratio reflecting quantitative relationships helps to form a qualitative judgement. Such is the nature of all financial ratios.

Types of Ratios

Several ratios, calculated from the accounting data, can be grouped into various classes according to financial activity or functions to be evaluated. As the study work is mainly focussed on the Credit Management and its overall performance, the study is analysed by analyzing four different ratios.

Liquidity Ratio

Activity Ratio

Profitability Ratio

Liquidity Ratio

It is extremely essential for a firm to be able to meet its obligations as they become due. Liquidity ratios measure the ability of the firm to meet its current obligations. The failure of a company to meet its obligations due to lack of sufficient liquidity will result in a poor creditworthiness, loss of creditors', confidence, or even in legal tangles resulting in the closure of the company. A very high degree of liquidity is also bad, idle assets earn nothing. The firm's funds will be unnecessarily tied up in current assets. Therefore, it is necessary to strike a proper balance between high liquidity and lack of liquidity. *(Pandey, I.M. 1999:127)*

There are different liquidity ratios, however only following liquidity ratios are carried out for the study.

(a) Current Ratio

(b) Cash and Bank Balance to Current Assets

(c) Fixed Deposit to Total Deposit

(d) Savings Deposit to Total Deposit

(e) Total Risk Assets to Current Assets

Activity Ratio

Funds of creditors and owners are invested in various assets to generate revenues and profits. The better the management of assets, the larger the amount of income. Activity ratios are employed to evaluate the efficiency with which the firm manages and utilizes its assets. Though, there are several activity ratios to judge the effectiveness of asset utilization, only the following ratios are analyzed:

(a) Risk Assets to Total Deposits

(b) Risk Assets to Saving, Fixed, Call and Short Deposits

(c) Staff Costs to Total Operating Costs

(d) Total Costs to Gross Income

(e) Total Shareholders' Equity to Total Risk Assets

Profitability Ratio

Profits are essential but it would be wrong to assume that every action initiated by management of a firm/institution should be aimed at maximizing profits, irrespective of social consequences. Profit is the ultimate 'Output' of a firm, and it will have no future if it fails to make sufficient profits. Thus, the profitability ratios are calculated to measure the operating efficiency of the firm. Profitability ratios indicate the degree of success in achieving desired profit. Various profitability ratios are calculated to measure the operating efficiency of business enterprises.

Thus, the profitability ratio enables the lenders and investors to decide whether to invest in a particular business or not. Some of the important profitability ratios used are as follows:

(a) Return on Risk Assets (RORA)

(b) Return on Total Assets (ROTA)

(c) Return on Equity (ROE)

(d) Earning Per Share (EPS)

(e) Total Interest Earnings to Total Risk Assets

(f) Price Earning Ratio (P/E Ratio)

(g) Interest Earning to Total Assets

3.6.2 Statistical Tools

"By Statistics", we mean aggregates of facts affected to a marked extent by multiplicity of causes, numerically expressed, enumerated or estimated according to reasonable standards of accuracy, collected in a systematic manner for a pre-determined purpose and placed in relation to each other. Statistics helps in formulating policies regarding the business with valid forecasts about the future with the help of tendencies based on past records. *(Bajracharya, Dr. B.C., 2057B.S.:7)*

Unless the figures are compared with other figures with the same kind, they are meaningless. Statistical methods such as averages, ratios, percentages, coefficients etc. offer the best way of comparison between two phenomena, which will enable to draw valid conclusion. There are different statistical tools, however only four methods are used to analyze the study.

1. Average (Mean)

The averages are the measures, which condense a huge mass of data into single value representing the whole data. Averages are the typical values around which most of the data tend to cluster. These are the values, which lie between two extreme observations of the entire data and give us the idea about the concentration of the values in the central part of the distribution.

In the study, simple arithmetic mean is used. Arithmetic mean (A.M.) or simply a 'mean' is a sum of set of observations divided by the number of observations. The purpose of computing average is to get the single value that describes the characteristics of the entire group and facilitate the comparison. If X_1, X_2, $X_3 \ldots X_n$ are the given observations, then their A.M. is usually denoted by $\overline{X}$ is given by:

$$\overline{X} = \frac{X_1 + X_2 + X_3 ... X_n}{n} = \frac{\Sigma X}{n}$$

2. Range

The simplest method of studying the variation in the distribution is the range. Range is defined as the difference between the largest item and the smallest item in the set of observations. If L is the largest item and S, the smallest item, then the range is defined by:

Range = L – S.

It is not a superior method to measure the dispersion of the data. Even though this method is used here because of its simplicity. In this study, range of ratios will be calculated to measure the dispersion. *(Bajracharya, Dr.B.C, 2057B.S.:171)*

3. Trend-Percentage Method

Trend percentage method shows the changes over a period of time. This method is very important for analyst because it indicates the direction of change of any balance sheet item such as deposit, investment, operating profit etc. Suppose, if we want to find the percentage change on a particular item say investment, a base year is selected as 100 (in this research, the base year is FY 2001/02). Then the amounts of subsequent years are divided by the base year to know the change pattern. It is expressed in percentage.

4. Correlation

The measure of correlation called the 'correlation co-efficient' summarizes in one figure, the degree and direction of movement. Correlation analysis is used here to find out the degree of relationship between two variables.

The theoretical explanation of correlation of coefficient is that when there is a change in volume of one variable (say deposits) there will be a change in

another variable (say investment). The important thing to be noted here is that determining the extent to which the two variables are correlated but it does not tell us about cause and effect relationship. Correlation may be positive & negative, linear and non-linear and simple, multiple and partial. In this research study, the Karl Pearson's Correlation coefficient is taken to analyze the relationship between different variables like deposits and investments, income and profit etc.

The correlation coefficient is defined as the ratio of explained variance to the total variance.

$$\text{Correlation Coefficient } (r_{xy}) = \frac{\sum xy}{\sqrt{\sum x^2}\ \sqrt{\sum y^2}}$$

Where, $x = X - \bar{X}$ and $y = Y - \bar{Y}$.

5. Probable error

Probable error of the correlation denoted by P.E. is the measure of testing the reliability of the calculated value of r. If r be the calculated value of correlation from a sample of n pair of observations, then P.E. is defined by

$$\text{P.E.} = 0.6745 \times \frac{1-r^2}{\sqrt{n}}$$

It is used in interpretation whether calculated value of r is significant or not.

(a) If $r <$ P.E., it is insignificant. So, perhaps there is no evidence of correlation.

(b) If $r >$ 6 P.E., it is significant.

In other cases, nothing can be concluded.

6. Other statical tools such as Z-test, F-test, X-test etc.

3.7 Credit Policy

Credit is always a matter of judgement based on one's own experience and convictions. The management of the bank therefore is always cautious, as every loan should be scrutinized before making any investments. A cornerstone of safe and sound banking is the design and implementation of written policies and procedures related to identifying, measuring, monitoring and controlling credit risk. *(Vaidya, Shakespeare, 2001:107)* Credit policies establish the framework for lending and guide the credit-granting activities of the bank. Credit policies should address such topics as target markets, portfolio mix, price and non-price terms, the structure of limits, approval authorities, exception reporting etc. Such policies should be clearly defined, consistent with prudent banking practices and relevant regulatory requirements, and adequate for the nature and complexity of the bank's activities. Some of the basic principles of credit policies of the bank are:

- The policies should be designed and implemented within the context of internal and external factors such as bank's market position, trade area, staff capabilities and technology. Policies and procedures that are properly developed and implemented enable the bank to:
  (a) maintain sound credit-granting standards;
  (b) monitor and control risk;
  (c) properly evaluate new business opportunities; and
  (d) identify and administer problem credits.
- Banks must operate under sound, well-defined credit granting criteria. These criteria should include a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment.
- Establishing sound, well-defined credit granting criteria is essential to approving credit in a safe and sound manner. The criteria should be set out who is eligible for credit and for how much, what types of credit are

available, and under what terms and conditions the credits should be granted.

- Banks must receive sufficient information to enable a comprehensive assessment of the true risk profile of the borrower or counterparty. At a minimum, the factors to be considered and documented in approving credits must include:

(a) the purpose of the credit and the source of repayment;
(b) the integrity and reputation of the borrower or counterparty;
(c) the current risk profile (including the nature and aggregate amounts of risks) of the borrower or counterparty and its sensitivity to economic and market developments;
(d) the borrower's repayment history and current capacity to repay, based on historical financial trends and cash flow projections;
(e) a forward-looking analysis of the capacity to repay based on various scenarios;
(f) the legal capacity of the borrower or counterparty to assume the liability;
(g) for commercial credits, the borrower's business expertise and the status of the borrower's economic sector and its position within that sector;
(h) the proposed terms and conditions of the credit, including covenants designed to limit changes in the future risk profile of the borrower; and
(i) where applicable, the adequacy and enforceability of collateral or guarantees, including under various scenarios.

Once credit-granting criteria have been established, it is essential for the bank to ensure that the information it receives is sufficient to make proper credit-granting decisions. Thus, information will also serve as the basis for rating the credit under the bank's internal rating system. In this study, we shall basically focus in the above mentioned principles of credit policies and shall analyze whether the bank granting the credit within its policies or not. Further, we shall also look into the monitoring of its investments in the branch level.

3.8 Limitations of Methodology

To carry out the research work various financial and statistical tools are used. Similarly, the descriptive analysis of credit policies and its management has also been carried out. However, these tools and techniques have some limitations.

Basically, the seven-year data are used in analyzing the financials and statistical tools, which may mislead the research work, as it is not sufficient to make projections for future regarding the performance of the bank. As far as the statistical tools are concerned, only trend analysis and correlation have been carried out to know the relationship between two variables. Similarly, in the banking practices there are various financial tools to measure the financial performances of the bank however, only liquidity, profitability and activity are used to measure the performance of the bank. Similarly, during the analysis of credit policies of the bank the staff of the bank did not provide the detail policies of the bank due to certain restrictions laid by the rule of the bank. Thus, the analysis was basically focused on the day-to-day activities on the credit department regarding the monitoring and loan approval process of retail banking and corporate credit business. Though, there were certain limitations during the research work, they are not so crucial that it can weaken the basic findings of the study. Nevertheless, such limitations prevent to explore more in the subject matter and also lead to find the major loopholes in the management of NIC bank.

CHAPTER-IV

DATA PRESENTATION AND ANALYSIS

4. Introduction

The purpose of the study is to analyze the performance of the credit management of the bank. The study is focused on both the portfolio management as well as credit policies of the bank. After collecting the necessary data, this section of the study attempts to analyze, interpret and present the data so that some conclusions can be drawn for the objective of this study. The descriptive analysis of credit policies and monitoring has also been carried to know the performance of the credit management of the bank.

In this study, the data relating to profit, deposits, loan loss provisions, NPA, NPAT, RA, NW, current ration etc. are presented in various tables throughout the section of this study and similarly the relationship between them are also carried out. The important calculations regarding profitability, liquidity and activity are carried out in the financial analysis while trend analysis while trend analysis and correlation between total deposits and RA, NPA and Loan Loss Provisions, interest income and RA, NW and Net Profit, interest expenses and total borrowings and deposits, Net profit and RA etc. are carried out in statistical tools to study the performance of the bank. In order to carry out the study various figures and tables were prepared so as to make the study clear, simple and understandable.

4.1 Liquidity Ratio

Liquidity refers to that state of position of the bank, which pronounces its capacity to meet all its cash obligations. In other words, it refers to the capacity of the bank to pay cash against the deposits. As we know that a large part of a bank's deposits are withdrawn on demand and hence the bank must be prepared with sufficient degree of liquidity of its assets. The liquidity position of a bank is such an important factor that it must be able to meet its cash requirement

either by its cash vault or by the help of converting its assets into cash in case of demand for its customers. However, it is a known fact that all the deposits are not withdrawn at a time. Moreover, everyday people come to deposit as well. Thus, the demand of liquidity is normally offset by their supply *(Dahal, Bhuvan and Sarita, 2056 B.S.:63).*

The following are the ratios to analyze the liquidity position of the bank.

4.1.1 Current Ratio:

Current Ratio is a measure of the firm's short-term solvency. It indicates the availability of current assets in rupees for every one rupee of current liability. A ratio of greater than 1 means that the firm has more current assets than current claims against them. The standard current ratio is 2:1, however, for a bank the ratio between 1to2 is considered satisfactory, as we know that all the deposits are not withdrawn at a time from the bank. The current ratio is computed as follows:

$$\text{Current Ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

Table 1.1 Current Ratio

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Current Assests	2518.65	4117.78	3632.21	3902.13	5358.27	7063.77	9611.60
Current Liabilities	2072.86	3728.08	3236.55	3485.41	5309.64	6814.11	9502.53
Ratio	**1.22**	**1.10**	**1.12**	**1.12**	**1.01**	**1.04**	**1.01**

If we see table no 1.1, we find that 1.22 is the highest and 1.01 is the lowest among all the ratios. As a conventional rule, a current ratio of 2:1 or more is considered satisfactory. However, as mentioned above, we know that the depositors do not withdraw their at a time and hence, the ratio though below the standard level is considered satisfactory.

- During FY 2002/03, the current assets have not increased compared to that of current liabilities due to which the current ratio has decreased compared to that of FY 2001/02. This is because, the deposits of the bank have increased whereas the investments have not increased drastically.

- Similarly, during FY 2003/04 & FY 2004/05, the ratio is at the similar level. This is because the current assets and the current liabilities of the bank have increased with the same rate and thus the ratio is same.

- During 2005/06, the current ratio is 1.01, which is one of the lowest among all the ratios and this indicates that the bank has higher deposits compared to its investments. Further, it indicates that the deposits of the bank has drastically increased which can be considered satisfactory from the bank's point of view because without its funds the bank is unable to make investments and ultimately it is unable to earn profit. From the shareholders' point of view the ratio is still satisfactory because, the bank has enough current assets to meet its obligations.

- During FY 2007/08, the current assets have not increased compared to that of current liabilities due to which the current ratio has decreased compared to that of FY 2006/07. This is because the lower increment in the investments and greater increment in the deposits of the bank.

The fluctuation observed in current ratio during the seven years period, however it has still enough assets to meet its liabilities. Hence, it can be considered satisfactory.

4.1.2 Cash and Bank Balance to Current Assets

The cash & bank balance refers to total cash and balance of the bank at different banks to meet its obligations regarding contingent liabilities and other liquidity position of the bank. The ratio of cash & bank balance to current assets measures the percentage of cash & bank balance to total current assets. The formula for computing the ratio is as follows:

$$\text{Cash \& Bank Balance to Current Assets} = \frac{\text{Cash \& Bank Balance}}{\text{Current Assets}}$$

Table 1.2 Cash & Bank Balance to Current Assets Ratio

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Cash and Bank Balance	234.39	539.45	559.53	318.06	319.3	1010.39	749.14
Current Assets	2518.65	4117.78	3632.21	3902.13	5358.27	7063.77	9611.60
Ration in %	**9.31**	**13.10**	**15.40**	**8.15**	**5.96**	**14.30**	**7.79**

From table no 1.2, we can figure out that 15.40% is the highest and 5.96% is the lowest among all. It indicates that the cash and bank balance of the bank has been decreasing during these years however the current assets have been increasing continuously. It reflects that the fund management of the bank is poor and thus it has tight balance to meet its contingent liabilities and other short-term obligations.

- During FY 2003/04, the cash and bank balance of the bank had increased whereas the current assets that comprises of investments, money at short call, cash and bank balance had decreased compared to that of previous year due to which the percentage of cash & bank balance has increased.

- Similarly, during FY 2005/06, the cash & bank balance of the bank has decreased drastically compared to that of previous years while the current

assets of the bank have increased indicating that the investments of the bank has increased and also its earnings.

- During FY 2007/08, the ratio has significantly decreased indicating the lower cash and bank balance as compared to current assets. The ratio has reached in the second lowest position during the periods.

From the above, we can conclude that due to low cash & bank balance, the bank might be having difficulties in meeting its current obligations. Thus, the bank has to focus on its earnings and then maintain sufficient amount in cash & bank balance both in NOSTRO and NRB accounts so that it may save its interest on borrowings and also be able to meet its current obligations when need arises.

4.1.3 Fixed Deposits to Total Deposits

A fixed deposit is one where a customer is required to keep a fixed amount with bank for a specific period generally by those who do not need money for stipulated period. The bank pays a higher interest on such deposits. The ratio of fixed deposit to total deposits measures the percentage of fixed deposits in total deposits of the bank. It is calculated as follows:

$$\text{Fixed Deposit to Total Deposit} = \frac{\text{Fixed Deposit}}{\text{Total Deposit}}$$

Table 1.3 Fixed Deposits to Total Deposits

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Fixed Deposits	1174.18	1958.06	1347.09	1143.04	2083.06	2930.62	4064.50
Total Deposits	2025.50	3575.83	3165.32	3144.32	5146.46	6241.38	8765.95
Ratio in %	**57.97**	**54.76**	**42.56**	**36.35**	**40.48**	**46.95**	**46.37**

From the above table no.1.3, we can see that during its early years of establishment, the bank had huge amount of fixed deposits because of high interest rates compared to others as the bank wanted to accumulate funds. The percentage of 57.97% & 36.35% are the highest and lowest among all.

- As mentioned earlier, the bank had huge amounts in its fixed deposits, which is almost to 56% of total deposits on average during FY 2001/02 & 2002/03. It further indicates that the bank's interest expenses in its deposits were high because of the high interest rates in fixed deposits.

- However, the fixed deposits continuously started to drop below the 50% till 2004/05 marks because of reduction in interest rates on fixed deposits, which was a trend among all the banks in Nepal because of high liquidity in the market. However during FY 2005/06, the percentage has increased again as this indicates that the fixed deposit of the bank has increased.
- During FY 2006/07 and 2007/08, the fixed deposit has gradually increased and has been able to maintain at constant level of 46%. This is due to the favorable interest rate provided by the bank on fixed deposits.

In conclusion, we can figure out that the bank is going as per the market trend and making continuous reduction in interest rates in its deposits. However, the bank should have enough deposits so that it can make investments smoothly and for this it is better to have fixed deposits than savings though the interest is comparatively high to other deposits because of time restrictions to the depositors.

4.1.4 Savings Deposits to Total Deposits

The saving deposit is one of the deposits collected from small depositors and low-income depositors. The bank usually pays small interest to the depositors against their deposits. The ratio measures the percentage of savings in total deposits. The ratio is computed as

$$\text{Savings Deposits to Total Deposits} = \frac{\text{Savings Deposits}}{\text{Total Deposits}}$$

Table 1.4 Savings Deposits to Total Deposits

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Savings Deposits	356.29	525.97	576.19	734.09	1280.47	2024.26	2797.42
Total Deposits	2025.50	3575.83	3165.32	3144.32	5146.46	6241.38	8765.95
Ratio in %	**17.59**	**14.71**	**18.20**	**23.35**	**24.88**	**32.43**	**31.91**

From the above table 1.4, we can find out that the percentage of savings deposit has increased continuously if we exclude the FY 2002/03 where it has dropped to 3% below the previous year. The purpose of savings deposits is to encourage the habit of saving among the common people and institutions. Savings deposits attract interest, which is normally less than that of long-term deposit but more than that of short-term deposit.

- During FY 2002/03, the percentage of savings deposits to total deposits has decreased due to increase in other deposits despite increase in savings deposits.
- If we see the figures of consecutive years then after FY 2002/03, the savings deposits have continuously increased whereas the total deposit has decreased during FY 2004/05 and increase in FY 2005/06. It also indicates that the total deposit, which comprises of interest bearing and non-bearing interest deposits is increasing continuously despite the reduction in interest, which is considered good because the bank is utilizing its low cost fund.
- Analyzing the pattern of deposits, the total deposits seem to have increased with the increase in savings deposits, however, the total deposits consists of interest bearing and non-interest bearing deposits. The other deposits rather than saving deposits contribute more to increase the total deposits resulting the lower ratio as in the fiscal year 2007/08.

Hence, it can be concluded that the bank is increasing its low cost fund continuously and thus its interest expenses have decreased. Similarly, the total deposit is in increasing trend and it may be due to non interest bearing accounts in margin accounts of LC and guarantee.

4.1.5 Total Risk Assets to Total Current Assets

The total risk assets comprises of total lending of the bank either in short term or long term lending excluding the investment made on common shares & government securities. Similarly, the current assets of the bank include cash & bank balance, money at call & short notice, risk assets, investments, interest receivables within 30 days. The ratio measures the percentage of risk assets in the current assets of the bank.

The ratio is computed as follows:

$$\text{Total Risk Assets to Total Current Assets} = \frac{\text{Total Risk Assets}}{\text{Total Current Assets}}$$

Table 1.5 Total Risk Assets to Total Current Assets

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Total Risk Assets	1655.51	2617.76	2279.00	2419.52	3561.14	4711.71	6655.96
Total Current Assets	2518.65	4117.78	3632.21	3902.13	5358.27	7063.77	9611.60
Ratio in %	**65.73**	**63.57**	**62.74**	**62.01**	**66.46**	**66.70**	**69.25**

From above table no. 1.5, we can see that the percentage of risk assets in total current assets is less fluctuating during all the fiscal years. The total risk assets and current assets of the bank are at increasing trend since 2003/04. The total risk assets include cash credit, overdrafts, bills discounted and purchase while the current assets includes risk assets, cash & bank balance, money at call & short notice, interest receivables within 30 days etc. Higher the ratio better is the management of its current assets and vice-versa.

- During FY 2002/03, the ratio has decreased which is due to higher increment in current assets compared to increase in risk assets.
- Then after till FY 2007/08, the ratio has improved indicating that the bank has smooth investments in risk assets, which have high percentage in total income of the bank because the risk assets have high lending interest rates, and thus the return is high.

Thus, we can conclude that the bank's risk asset is increasing which can be considered a good sign regarding the earning but the care has to be taken by the management to make investments in good loans and monitor the investments in an efficient ways through its staff such that the loan do not turn into non performing assets.

4.2 Profitability Ratio

The profitability ratios are calculated to measure the operating efficiency of the firm. Creditors want to get interest and repayment of principal regularly. Owners' want to get a required rate of return on their investment. *(Pandey, I.M., 1999:130)* This is possible only when the firm earns enough profits. Generally, two major types of profitability ratios are calculated:
Profitability in relation to sales
Profitability in relation to investment.

However, only profitability in relation to investment is only analyzed in this research work. Following are the ratios in relation to investment in banking sector:
(a) Return on Risk Assets
(b) Return on Equity (ROE)
(c) Earning Per Share (EPS)
(d) Price Earning Ratio (P/E ratio)
(e) Return on Total Assets
(f) Interest earned on Total Assets

4.2.1 Return on Risk Assets

The term risk assets refers to bank's investments on cash credit, short term & long term loan, retail lending etc. The ratio of return on risk assets is useful in measuring the profitability of all financial resources invested in the banks risk assets. The formula to measure the ratio is as follows:

$$\text{Return on Risk Assets} = \frac{\text{Net Profit After Tax (NPAT)}}{\text{Total Risk Assets}}$$

Table 2.1 Return on Risk Assets

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
NPAT	24.30	48.29	6.82	26.06	68.23	113.76	96.59
Total RA	1655.51	2617.76	2279.00	2419.52	3561.14	4711.71	6655.96
Return on RA	**1.47**	**1.84**	**0.30**	**1.08**	**1.92**	**2.41**	**1.45**

From the above table no. 2.1, we can see that the percentage of return on risk assets had been nominal during FY 2003/04. Besides, the bank has been able to make net income in increasing trend. The net profit has increased to 77% compared to that of FY 2004/05 indicating the effective use of sources in good loans and reduction in operating expenses. The total risk assets of the bank are in increasing trend and similarly, the net profit has also increased efficiently. The total risk assets include cash credit, overdrafts, bills discounted and purchase.

- Higher ratio indicates more investments on risk assets from the financial resources available.
- Lower ratio indicates less investment on risk assets from the financial resources available.

- The net profit of the bank has decreased during FY 2003/04 because of the loan loss provision, which was amended during this year. As per the NRB regulations the time period of the NPA was also shortened due to which the bank had to make huge provisions from operating profit accordingly.
- The excess loan loss provision has decreased the net profit in FY 2007/08 and accordingly has decreased the return on risk assets.

4.2.2 Return on Equity (ROE)

Common shareholders are entitled to the residual profits. The rate of dividend is not fixed; the earnings may be distributed to shareholders or retained in the business. Nevertheless, the net profit after tax represent the return. A return on shareholder's equity is calculated to see the profitability of owners' investments. The shareholder's equity or net worth will include paid-up share capital, share premium and reserves and surplus less accumulated loss. *(Horne, Van, 2002:361)* The return on shareholders' equity is net profit after taxes divided by shareholders' equity.

$$ROE = \frac{NPAT}{\text{Net Worth}}$$

Table 2.2 Return on Equity

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
NPAT	24.30	48.29	6.82	26.06	68.23	113.76	96.59
Net Worth	511.71	519.13	526.09	552.09	570.4	584.2	706.46
ROE	**4.75**	**9.30**	**1.30**	**4.72**	**11.96**	**19.47**	**13.67**

ROE indicates how well the firm has used the resources of owners. In fact, this ratio is one of the most important relationships in financial analysis. This ratio is, thus, of great interest to the present as well as the prospective shareholders

and also of great concern to the management, which has the responsibility of maximizing the owner's welfare.

- From the above table 2.2, we can see that the net profit of the bank has reduced once during FY 2003/04 due to restructure and amendment on the NRB regulations regarding the loan loss provisions.
- However, the bank is able to earn net profit then after in increasing trend indicating the effective use or funds and cost reduction in operating and other expenses.
- Similarly, the net worth of the bank is increasing every year indicating the shareholders' wealth maximization. However, the bank has distributed 10% dividend only once since its establishment because it has retained earnings for its future course of actions like opening of branch, to increase its capital etc.
- The ROE is seen the highest in the FY 2006/07 as the NPAT has increased significantly and the Net Worth has increased slightly.
- During the FY 2007/08, ROE has dropped to 13.67% which indicates the significant decrease in NPAT and significant increase in Net worth. During this fiscal year, the issue of bonus shares results the following outcome.

Hence, it can be concluded that the net worth of the bank is satisfactory and that the shareholder wealth is also maximizing despite there is no dividend distributed to the shareholder's regularly. Since, the bank is in the progressing path every year with increasing profit, the management of the bank distribute dividend in coming years so that the shareholder's need not to worry about their part of income as the MPS is also increasing which can be considered satisfactory.

4.2.3 Earning Per Share (EPS)

EPS indicates whether or not the firm's earnings on per share basis have changed over that period. EPS simply shows the profitability of the firm on a

per share basis; it does not reflect how much is paid as dividend and how much is retained in the business.

$$EPS = \frac{\text{Profit After Tax (PAT)}}{\text{No. of shares outstanding}}$$

Table 2.3 Earning Per Share

(NPR in Million)

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
NPAT	24.30	48.29	6.82	26.06	68.23	113.76	96.59
No. of Shares	4.92	4.997	4.998	4.999	4.999	5.00	6.00
EPS	**4.94**	**9.66**	**1.36**	**5.21**	**13.65**	**22.75**	**16.10**

Higher the ratio better is the EPS, which is a good sign both from investors' point of view and the management's point of view as it adds some value to the organization if it continues to rise upward and vice versa.

- If we see the above table 2.3, we can see that the no. of shareholders has increased and further the EPS too has increased which is due to the increase in PAT.
- During FY 2001/02 and 2002/03, the PAT has increased with the increase in risk assets as the major source of the income comes from the interest on its RA.
- But during FY 2003/04, due to NRB regulations regarding NPA and loan loss provision, the PAT has decreased and thus there was reduction in the ratio.
- However, the EPS has started to increase since FY 2004/05 with greater income despite the increase in number of shareholders.
- The high NPAT with the constant equity holder results the best EPS in the FY 2006/07. It shows the best profitability position along with the maximization of shareholders fund.

- The issue of bonus shares in the FY 2007/08 increases the equity holder claims on NPAT and thus results the lower EPS as compared to FY 2006/07.

Thus, it can be concluded that despite the cutthroat competition between the commercial banks to retain the business, the EPS of the bank has been increasing. Though the bank has not distributed the dividend regularly, at least from shareholder's point of view the EPS has been increasing year after year thus indicating the effective use of deposit portfolio in the risk assets and its return.

4.2.4 Price Earnings Ratio (P/E Ratio)

The price earnings ratio is widely used by the security analysis to value the firm's performance as expected by investors. It indicates investors' judgment or expectations about the firm's performance. Management is also interested in this market appraisal of the firm's performance and will like to find the causes if the P/E ratio declines. P/E ratio reflects investors' expectations about the growth in the firm's earnings.

The reciprocal of the earnings yield is called the price-earnings (P/E) ratio. Thus,

$$\text{P/E Ratio} = \frac{\text{Market Value Per Share}}{\text{Earning Per Share}}$$

Table 2.4 Price Earnings Ratio

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Market Value Per Share	550.00	399.00	245.00	220.00	218.00	390.00	496.00
EPS	4.94	9.66	1.36	5.21	13.65	22.75	16.10
P/E RATIO	**111.34**	**41.30**	**180.15**	**42.23**	**15.97**	**17.14**	**30.81**

From the above table 2.4, we can see that there has been fluctuation in the P/E ratio, which indicates that the investors are hesitating to buy or hold the shares, as the MVPS is reducing every year.

- During FY 2001/02, the share market was doing well because the trend on investments on shares of the company and more or less every firm were doing well. Thus, as soon as the bank floated its shares in the market, the price went up which ultimately increased its P/E ratio.
- Then after from FY 2002/03 to 2005/06, the ratio continuously decreased thus alarming the management of the bank to trace out the reasons behind. However, due to primitive stage of stock market, most of the investors were unaware of its movement and thus the shares of most companies started to fall which also affected the MVPS of the bank.
- P/E Ratio has been gradually increasing from the FY 2005/06 onwards. It shows the positive signaling effect in the stock market.

Though the MVPS of the bank has been decreasing, the EPS of the firm has been increasing which is a positive sign for the investors but the management should be aware of the fact and should concentrate to increase the MVPS. This will make investors positive towards the organization as a result of which the bank shall able to solicit more business from the market, which ultimately results in greater earning of the bank.

Thus, the management of the bank should be careful on the P/E ratio and should take necessary steps for making better lending prospects, as this would create greater profit margin and high MVPS in the years to come.

4.2.5 Return on Total Assets

The ratio of return on total assets measures the success and failure to utilize the total assets. This ratio judges effectiveness in using the pool of funds, which is useful to measure the profitability of all the financial resources, invested in the

firm's assets. Higher the ratio, better is the financing position. It is computed by using the following formula:

$$\text{Return on Total Assets} = \frac{\text{NPAT}}{\text{Total Assets}}$$

Table 2.5 Return on Total Assets

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
NPAT	24.30	48.29	6.82	26.06	68.23	113.76	96.59
Total Assets	2584.57	4247.77	3768.66	4037.50	5930.09	7510.40	10383.60
Return on Total Assets	**0.94**	**1.14**	**0.18**	**0.65**	**1.15**	**1.51**	**0.93**

From the above table 2.5, we can figure out that the ratio of return on total assets is satisfactory during FY 2002/03 and 2005/06 as compared to others. Higher the ratio better is use of its sources and vice-versa.

- During FY 2002/03, both the NPAT and TA of the bank have increased compared to the previous year due to which the ratio has increased to 1.14.
- However, during FY 2003/04 due to change in loan loss provisions as per the NRB regulations, the NPAT of the firm decreased which resulted in the decline of the ratio.
- But from FY 2004/05, the NPAT and TA of the bank has again started increasing. Thus, it resulted in the higher ratio of the firm indicating the effective use of the total assets.
- In the FY 2006/07 the ROTA of 1.51% is the highest than all other Fiscal years. On the other, it has decreased significantly and dropped by 0.58% in the FY 2007/08. In the FY 2007/08, the NPAT has decreased due to high NPA and higher loan loss provision. It reflects the poor management of earning assets.

Hence, we can conclude that higher the ration the better is the earning of the bank and the effective use of its sources of the funds. Thus, the management should be careful to make prospective investments on total assets that include risk assets, current assets, fixed assets and investments on securities.

4.2.6 Interest Earnings on Total Assets

The ratio of total interest earned to total assets measures the earning capacity of NIC from the investment on total assets. The total assets comprise of current assets, fixed assets and investments in common shares & government securities. This ratio measure s the interest earnings on its total investments and shows the effectiveness of the bank management in using its sources of funds in profitable and reliable ventures. It is computed as follows:

$$\text{Interest Earning on Total Assets} = \frac{\text{Interest Earnings}}{\text{Total Assets}}$$

Table 2.6 Interest Earnings on Total Assets

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Interest Earnings	155.36	294.22	297.76	291.14	363.04	457.61	579.98
Total Assets	2584.57	4247.77	3768.66	4037.50	5930.09	7510.40	10383.60
Ratio in %	**6.01**	**6.93**	**7.90**	**7.21**	**6.12**	**6.09**	**5.59**

From the above table 2.6, we can see that the ratio of the bank is between 6% to 7% during all the years indicating that the earnings and the total assets of the bank has increased/decreased in the similar ratio. However, higher ratio indicates proper utilization of its financial resources on risk assets while lower ratio indicates poor utilization of its resources on higher profitable assets.

- The interest earnings of the bank depend on investments on the risk assets and the interest rates on those risk assets. The earning has been increasing every year if we exclude the FY 2004/05, where the earning has decreased with a nominal margin otherwise the interest earning has always increased.
- Similarly, if we see the total assets figure, there has been decline during FY 2002/03 to FY 2004/05, which resulted in the higher ratio as the interest earning was increasing during these years.
- The decline in the total assets figure is due to the decrease in the value of fixed assets, current assets and reduction in the investments of risk assets as the management focused its lending in less risky assets and concentrated to recover its bad loans.
- Increase in loan loss provision in the FY 2007/08 results the lower NPAT in comparison to 2006/07. More loan loss provision depicts the turning of loans into NPA which certainly earns low interest.

Hence, it can be concluded that the ratio is a bit steady compared to other ratios thus indicating the effective use of sources of funds and the return on the investments is smooth.

4.3 Activity Ratios

Activity ratios are employed to evaluate the efficiency with which the bank manages and utilizes its assets. The fund of depositors and owners are invested in various assets to generate profits. The better the management of assets, the higher the amount of profits. These ratios are also called turnover ratios because they indicate the speed with which assets are being converted or turned over into income.

Though, there are several activity ratios to judge the effectiveness of asset utilization, only the following ratios are analyzed:

(a) Risk Assets to Total Deposits

(b) Risk Assets to Savings, Fixed and Call & Short Deposits

(c) Staff Costs to Total Operating Costs

(d) Total Costs to Gross Income

(e) Total Shareholder's Equity to Total Risk Assets

4.3.1 Risk Assets to Total Deposits

The ratio of risk assets to total deposits measures the extent to which the bank is successfully utilizing the outsiders' funds for the profit generating purpose. In other words, the ratio measures the bank's ability to utilize the deposits that includes interest bearing and non-interest bearing accounts in making investment in risk assets. This ratio is calculated as follows:

$$\text{Risk assets to total deposits} = \frac{\text{Risk Assets}}{\text{Total Deposits}}$$

Table 3.1 Risk Assets to Total Deposits

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Risk Assets	1655.51	2617.76	2279	2419.52	3561.14	4711.71	6655.96
Total Deposits	2025.5	3575.83	3165.32	3144.32	5146.46	6241.38	8765.95
Ratio in times	**0.82**	**0.73**	**0.72**	**0.77**	**0.69**	**0.75**	**0.76**

From the above table 3.1, we can see that the risk assets have been increased smoothly excluding the FY 2003/04 where RA has reduced which may be due to swapping of loans by other banks or settlement of NPA.

- The ratio during all the seven years from FY 2001/02 to FY 2007/08 is comparatively at similar level thus indicating that the total deposits and the RA of the bank has gone similar level of change. The higher ratio indicates that use of most of the funds from its deposits in risk assets.

- With the average ratio of 0.75 in the fiscal years, the bank is attempting to maintain its lending in risk assets. However, the NPA is increasing with more loan loss provisions.

During FY 2005/06, the ratio is lowest of all, which is due to the high percentage increase in the total deposits to lower percentage increase in RA. The total deposits rose because of the recent launching of the NIC Life Savings Premium Account with 5% interest rate, however, the bank has not been able to utilize the deposits in the risk assets properly. The lower ratio indicates the non-utilization of its funds in risk assets.

Hence, it can be concluded that the bank is utilizing its sources of funds mostly from the deposits and that the bank is able to make its investments smoothly. So, the bank should be able to increase its deposits in coming years and similarly increase its investments.

4.3.2 Risk Assets to Savings, Fixed, Call and Short Deposits

The ratio of risk assets to savings, fixed, call & short deposits measures the efficiency of NIC on its investments out of interest bearing sources of funds. It measures the ability of the bank management to invest in risk assets, which generally should exceed 60%. This ratio indicates about what proportion of these deposits is utilized to invest in risk assets. Since the deposits are interest bearing, the bank should able to utilize these funds in higher return investments so that it is able to cover its interest expenses on such deposits. This ratio is calculated as follows:

$$\text{Risk Assets to Savings, Fixed, Call \& Short Deposits} = \frac{\text{Risk Assets}}{\text{Savings, Fixed, Call \& Short Deposits}}$$

Table 3.2 Risk Assets to Savings, Fixed, Call & Short Deposits

(NPR in Million)

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Risk Assets	1655.51	2617.76	2279	2419.52	3561.14	4711.71	6655.96
Savings, Fixed and Call	1749.98	3281.15	2866.16	2843.19	4779.77	5944.79	8321.14
Ratio in times	**0.95**	**0.80**	**0.80**	**0.85**	**0.75**	**0.79**	**0.80**

From the above table 3.2, we can see that the ratio is between 0.75 to 0.95. The risk assets depends upon the funds of the bank and the bank accumulates those funds from the customers to whom it facilitates with different deposit accounts like savings, fixed, call and short deposits to its depositors with different interest rates.

- Since in FY 2002/03, the deposits in savings, fixed, call and short deposits have increased because of the higher interest in those accounts compared to others in order to accumulate the high volume of deposits. However, the RA of the bank has not increased with similar level to that of deposits and thus the ratio has decreased. The lowest ratio means the management hesitated to invest its fund on risk assets, rather it preferred to invest in non-risk assets i.e. governments securities and other bonds.
- The ratio of 0.95 is the highest among all as during this year the bank was able to use its sources of funds mostly in the risk assets compared the business prospects was good and mostly the bank tried to solicit more business from the market with lower interest rates. The highest ratio means the management has invested most of its fund available from interest bearing deposits on risk yielding higher return investments.
- The bank is retaining its ratio in its previous levels' ratio during FY 206/07-FY 2007/08. The management takes the significant step by increasing its investment in risk assets. However, it should be noted that the NPA should not increase as it is seen in the bank’s annual financial reports.

Hence, from the above we can conclude that despite the increase in deposits, the bank was not able to invest its funds in risk assets. Therefore, the bank should be able it use its sources of funds such that investments provide high return which is the ultimate target of the management.

4.3.3 Staff Costs to Total Operating Costs

The ratio of staff costs to total operating costs measures the proportion of expenses made by bank on its staff out of its operating costs. The ratio is calculated by applying following formula:

$$\text{Staff Costs to Total Operating Costs} = \frac{\text{Staff Costs}}{\text{Total Operating Costs}}$$

Table 3.3 Staff Costs to Total Operating Costs

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Staff Costs	18.78	29.15	27.93	38.52	45.98	57.30	59.23
Total Costs	147.54	266.72	321.36	278.37	313.02	346.12	508.19
Ratio in Times	**0.13**	**0.11**	**0.09**	**0.14**	**0.15**	**0.17**	**0.12**

There is no doubt that no management can run without its staff and for this the management has to motivate to get the work done with extra incentives, yearly trainings, performance bonus, promotions etc. For this the bank makes huge costs because without its staff, the management is not able to get the expected return, as they are the one to carry out the orders and get the work completed as expected by higher management. The above table 3.3, shows the ratio of staff costs and total costs. The total costs include interest on total deposits and borrowings, salaries and allowances to the staff including bonus, other general expenses, deprecation etc.

- Since FY 2001/02, the total costs includes both operating and other expenses of the bank and it has been continuously increasing except in FY 2004/05 where it has reduced by 13.37% to that of FY 2003/04. The reason for continuous increase in total costs is because of growing number of staff, yearly increase in interest expenses because of deposits and borrowings and other general expenses.
- Similarly, the staff costs has also been continuously increasing except in FY 2003/04 where it has reduced by 4.18%, which is due to reduction in profit, which ultimately reduced the balance of yearly bonus and welfare of the staff. However, the ratio has been increasing yearly indicating the rise in staff costs that includes rise in salaries, allowances, bonus and welfare. Thus, we can conclude that the management of the bank has been able to motivate the staff and has been able to build a good team to reach its target with a team effort.
- The ratio of staff cost to total cost is seen the highest in FY 2006/07 while the staff costs is the highest in the FY 2007/08. The higher staff cost ratio satisfies the higher NPAT and well team work in the FY 2006/07.

Hence, it can be concluded that the staff costs of the bank is increasing every year thus indicating that the management is making a regular expenses for the staff that includes training, incentives, allowances etc. If the bank is able to motivate and train its staff, then there is no doubt that it can achieve its target.

4.3.4 Total Costs to Gross Income

The ratio of total costs to gross income measures the cost control capacity of NIC from its gross income. In other words, the ratio indicates that the lower the ratio, the higher effective of cost control. The ratio is calculated as follows:

$$\text{Total Costs to Gross Income} = \frac{\text{Total Costs}}{\text{Gross Income}}$$

Table 3.4 Total Costs to Gross Income

(NPR in Million)

Fiscal Year	2001/02	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08
Total Costs	147.54	266.72	321.36	278.37	313.02	346.12	508.19
Gross Income	40.49	77.47	15.89	49.39	103.68	172.38	146.87
Ratio in times	**3.64**	**3.44**	**20.22**	**5.64**	**3.02**	**2.01**	**3.46**

The gross income of the bank depends upon the total costs of the bank because if the bank is not able to minimize its total costs then the bank is sure to gain lower profit. The total costs include the interest expenses in deposits and borrowings, staff costs and other general expenses of the bank. So, if the bank is able to minimize its costs then it is able to earn more net profit, which is the ultimate target of the bank. The above table 3.4 gives clear view of the ratio between total costs and gross income.

- The ratio has decreased in FY 2002/03 while it has increased during FY 2003/04 compared to previous year's figure. Then after it has started to decrease thus indicating the effective cost control by the management.
- The ratio of 3.02 is the lowest among all and thus the gross income of the bank has increased compared to the previous of 49.39 million. The lower ratio indicates the cost of control of the management and thus increases in gross profit of the bank.
- During FY 2003/04 and FY 2007/08, the bank had to make loan loss provisions, which reduced the gross profit, while there was increment in the total costs of the bank. The higher the ratio indicates the ineffectiveness of the management on its cost alarming the management of the bank shall be able to control the cost and thus increase its gross profit margin.

From the above table, the higher the ratio indicates the effectiveness of the management and vice versa. The management should be able to control the cost so as to earn higher profit margin. However, it is expected that the management of the bank shall be able to control the cost and thus increase its gross profit margin in coming years.

4.3.5 Total Shareholder's equity to Total Risk Assets

The ratio of total shareholder's equity to total assets measures the contribution of shareholders' equity on risk assets. In other words, this ratio helps to examine the percentage of shareholder's equity invested on risk assets. It is calculated as follows:

$$\text{Total Shareholder's equity to Total Risk Assets} = \frac{\text{Total Shareholder's Equity}}{\text{Total Risk Assets}}$$

Table 3.5 Total Shareholder's Equity to Total Risk Assets

(NPR in Million)

Fiscal Year	**2001/02**	**2002/03**	**2003/04**	**2004/05**	**2005/06**	**2006/07**	**2007/08**
Shareholder's Equity	511.18	517.3	523.4	549.42	566.79	580.15	701.78
Total Risk Assets	1655.51	2617.76	2279	2419.52	3561.14	4711.71	6655.96
Ratio in times	**0.31**	**0.20**	**0.23**	**0.23**	**0.16**	**0.12**	**0.11**

The shareholders are the one that the bank is liable to pay the dividend as return on their investments made in the bank. It depends on the earning of the bank and the earning depends upon the investments made by the bank. Thus, we can say that in order to increase the shareholder's equity the bank has to increase its investment is risk assets. From the above table 3.5, we can see that 0.11 is the lowest and 0.31is the highest ratio between total shareholders' equity to total risk assets.

- In the initial years, one of the main sources of the fund was paid up share capital, share premium that is a part of shareholder's equity. The bank utilizes this source in the risk assets investments and thus during FY 2001/02, the ratio is the highest among all indicating the higher use of the shareholder's equity compared to the other years.
- Then after from FY 2003/04 till 2007/08, the ratio has been decreasing thus indicating that the bank has been utilizing lower part of the shareholder's equity in risk assets. However, both the figures have been increasing

indicating the effective use of sources in risk assets on one hand and on the other, the rise in shareholders' equity indicates that the management is aware of increasing the shareholders wealth which ultimately increases EPS and MVPS of the bank.

Thus, we can conclude that despite the proportionate rise in both risk assets and shareholders' equity, the bank has not been utilizing the shareholders' equity as it is focused on the wealth maximization of the shareholder, which can be considered satisfactory.

4.4 Correlation Analysis

The correlation of coefficient shows the degree of closeness of two figures. It shows the effect of one variable on the other. Thus, the correlation is that statistical device, which helps in analyzing the co-variation of two or more variables. In this study, the correlation of different financial data relating to profit and RA, total deposits and RA etc. have been studied and conclusions have been drawn. Similarly, the projections are also been drawn based on the result of the relationship between the data.

4.4.1 Correlation between Total Deposits and Total Investment

A bank's primary function is to make investment and without its fund it is totally impossible to make such investments either it is loans and advances or investments in any other government securities/ shares etc. Here, the total deposit is assumed to be an independent variable whereas the total investment is considered as dependent variable.

The correlation between total deposits & total investment = r

Here,

X = Total deposits

Y = Total Investment

N = no. of observations

r = Correlation coefficient

Table 4.1 Correlation between Total Deposits and Total Investments

(NPR in Million)

Fiscal Year	Total Deposits (X)	Total Investment (Y)	$x = X - \overline{X}$	x^2	$y = Y - \overline{Y}$	y^2	xy
2001/02	2025.5	302.28	-2558.18	6544284.91	-924.86	855366.02	2365958.35
2002/03	3575.83	567.08	-1007.85	1015761.62	-660.06	435679.20	665241.47
2003/04	3165.32	753.81	-1418.36	2011745.09	-473.33	224041.29	671352.34
2004/05	3165.32	1153.25	-1418.36	2011745.09	-73.89	5459.73	104802.62
2005/06	5146.46	1760.72	562.78	316721.33	533.58	284707.62	300288.15
2006/07	6241.38	1572.9	1657.7	2747969.29	345.76	119549.98	573166.35
2007/08	8765.95	2479.91	4182.27	17491382.35	1252.77	1569432.67	5239422.39
	X=32085.76	**Y=8589.95**		**x^2=32139609.69**		**y^2=3494236.51**	**xy= 9920231.68**

$$\overline{X} = \frac{\Sigma X}{n} = \frac{32085.76}{7} = 4583.68$$

$$\overline{Y} = \frac{\Sigma Y}{n} = \frac{8589.95}{7} = 1227.135714$$

$$r = \frac{\Sigma xy}{\sqrt{\Sigma x^2} \times \sqrt{\Sigma y^2}} = \frac{9920231.68}{\sqrt{32139609.69} \times \sqrt{3494236.51}} = 0.936106729$$

Hence, from above calculation, we can conclude that the two variables are highly positive correlated indicating that the change in one variable positively affects the other and vice- versa.

Similarly, Probable error (P.E) = $0.6745 \times \frac{1 - r^2}{\sqrt{n}} = 0.03153678$

$$\because 6 \times P.E. = 6 \times 0.03153678 = 0.18922068\,1$$

$\therefore$ r > 6 P.E, the calculated value of r is significant and it indicates that the bank's investment depends upon its deposits. So, the bank has to have more and more deposits if it has to make investments.

4.4.2 Correlation between Total Deposits and Total Risk Assets

Bank is a financial institution whose primary function is to make investment. The total deposit of the bank includes both interest bearing and non-interest bearing accounts. Here, total deposit is assumed to be an independent variable. The risk assets also known as loan and advances include investments made on cash credit, long & short-term loan, bills purchase, retail lending etc .The total risk assets is assumed to be a dependent variable.

The correlation between total deposits & total risk assets = r

Here,

X = Total deposits

Y = Total risk assets

N = no. of observations

r = Correlation coefficient

Table 4.2 Correlation between Total Deposits and Total Risk Assets

(NPR in Million)

Fiscal Year	Total Deposits (X)	Total Risk Assets (Y)	$x = X - \overline{X}$	x^2	$y = Y - \overline{Y}$	y^2	xy
2001/02	2025.5	1655.51	-2558.18	6544284.91	-1758.86	3093588.50	4499480.47
2002/03	3575.83	2617.76	-1007.85	1015761.62	-796.61	634587.49	802863.39
2003/04	3165.32	2279	-1418.36	2011745.09	-1135.37	1289065.04	1610363.39
2004/05	3165.32	2419.52	-1418.36	2011745.09	-994.85	989726.52	1411055.45
2005/06	5146.46	3561.14	562.78	316721.33	146.77	21541.43	82599.22
2006/07	6241.38	4711.71	1657.7	2747969.29	1297.34	1683091.08	2150600.52
2007/08	8765.95	6655.96	4182.27	17491382.35	3241.59	10507905.73	13557204.61
	X=32085.76	**Y=23900.60**		**x^2=32139609.69**		**y^2=18219505.79**	**xy= 24114167.05**

$$\overline{X} = \frac{\Sigma X}{n} = \frac{32085.76}{7} = 4583.68$$

$$\overline{Y} = \frac{\Sigma Y}{n} = \frac{23900.60}{7} = 3414.371429$$

$$r = \frac{\Sigma xy}{\sqrt{\Sigma x^2} \times \sqrt{\Sigma y^2}} = \frac{24114167.05}{\sqrt{32139609.69} \times \sqrt{18219505.79}} = 0.996514609$$

Hence, from above calculation, we can conclude that the two variables are almost perfectly positive correlated indicating that the change in one variable positively affects the other and vice- versa.

Similarly, Probable Error (P.E.) $= 0.6745 \times \frac{1-r^2}{\sqrt{n}} = 0.001774014$

$$\because 6 \times P.E. = 6 \times 0.001774014 = 0.010644081$$

$\therefore$ r > 6 P.E, the calculated value of r is significant and it indicates that the total risk assets depend upon its deposits. So, the bank has to have more and more deposits if it has to make investments on risk assets.

4.4.3 Correlation between NPA and Loan Loss Provisions

The bank has to make loan loss provisions for its NPA either it is pass, substandard, doubtful or loss. The NPA comprises of those loans that are not paid (interest as well as principal as stipulated by the bank) for three to 12 months and for that all the above-mentioned loans, the bank has to make provisions to cover these loans from their profit as per the NRB rules. Thus, NPA is considered independent while loan loss provision is assumed to be dependent variable.

The correlation between total loan loss provisions to total risk assets = r

Here,

X = Loan loss provisions

Y = Total NPA

N = no. of observations

r = Correlation coefficient

Table 4.3 Correlation between NPA and Loan Loss Provisions

(NPR in Million)

Fiscal Year	Loan Loss Provisions (X)	Total NPA (Y)	$x = X - \overline{X}$	x^2	$y = Y - \overline{Y}$	y^2	xy
2001/02	18.82	74.16	-111.19	12363.22	-80.42	6467.38	8941.90
2002/03	32.34	132.36	-97.67	9539.43	-22.22	493.73	2170.23
2003/04	89.85	193.25	-40.16	1612.83	38.67	1495.37	-1552.99
2004/05	143.34	170.69	13.33	177.69	16.11	259.53	214.75
2005/06	181.95	146.59	51.94	2697.76	-7.99	63.84	-415.00
2006/07	197.64	185.43	67.63	4573.82	30.85	951.72	2086.39
2007/08	246.16	179.55	116.15	13490.82	24.97	623.50	2900.27
	X=910.1	**Y=1082.03**		**x^2=44455.56**		**y^2=10355.07**	**xy= 14345.54**

$$\overline{X} = \frac{\Sigma X}{n} = \frac{910.1}{7} = 130.01$$

$$\overline{Y} = \frac{\Sigma Y}{n} = \frac{1082.03}{7} = 154.58$$

$$r = \frac{\Sigma xy}{\sqrt{\Sigma x^2} \times \sqrt{\Sigma y^2}} = \frac{14345.54}{\sqrt{44455.56} \times \sqrt{10355.07}} = 0.668616733$$

Hence, from above calculation, we can conclude that the two variables have less relation are positively correlated indicating that the change in one variable positively affects the other and vice- versa.

Similarly, Probable error (P.E) = $0.6745 \times \frac{1 - r^2}{\sqrt{n}} = 0.140967859$

$$\because 6 \times P.E. = 6 \times 0.140967859 = 0.845807154$$

∴ r < 6 P.E, the calculated value of r is not significant and it indicates that the bank's loan loss provision has no such relation to NPA.

4.4.4 Correlation between Interest Income to Risk Assets

The major income of the bank comes from the interest earned on its total lending. If the bank is able to make huge investments in its risk assets, then the possibility of the bank to earn more interest income is certain if its loans are good and the borrowers pay their interest within the time period. So, interest is a dependent of risk assets.

The correlation between Interest Income to Risk Assets = r

Here,

X = Interest Income

Y = Total risk assets

N = no. of observations

r = Correlation coefficient

Table 4.4 Correlation between Interest Income to Risk Assets

(NPR in Million)

Fiscal Year	Interest Income (X)	Total Risk Assets(Y)	$x = X - \overline{X}$	x^2	$y = Y - \overline{Y}$	y^2	xy
2001/02	155.36	1655.51	-193.08	37279.89	-1758.86	3093588.50	339600.69
2002/03	294.22	2617.76	-54.22	2939.81	-796.61	634587.49	43192.19
2003/04	297.76	2279	-50.68	2568.46	-1135.37	1289065.04	57540.55
2004/05	291.14	2419.52	-57.3	3283.29	-994.85	989726.52	57004.91
2005/06	363.04	3561.14	14.6	213.16	146.77	21541.43	2142.84
2006/07	457.61	4711.71	109.17	11918.09	1297.34	1683091.08	141630.61
2007/08	579.98	6655.96	231.54	53610.77	3241.59	10507905.73	750557.75
	X=2439.11	**Y=23900.6**		**x^2=111813.47**		**y^2=18219505.79**	**xy= 1391669.54**

$$\overline{X} = \frac{\Sigma X}{n} = \frac{2439.11}{7} = 348.4442857$$

$$\overline{Y} = \frac{\Sigma Y}{n} = \frac{23900.6}{7} = 3414.371429$$

$$r = \frac{\Sigma xy}{\sqrt{\Sigma x^2} \times \sqrt{\Sigma y^2}} = \frac{1391669.54}{\sqrt{111813.47} \times \sqrt{18219505.79}} = 0.97503626$$

Hence, from above calculation, we can conclude that the two variables are highly positive correlated indicating that higher the investments in RA, higher will be the interest income and vice- versa.

Similarly, Probable error (P.E) = $0.6745 \times \frac{1-r^2}{\sqrt{n}} = 0.01256949$

$\because 6 \times P.E. = 6 \times 0.01256949 = 0.07541694$

$\therefore$ r > 6 P.E, the calculated value of r is significant and it indicates that the major earning of the bank comes from interest, which depends upon the investments made on the RA. So, in order to have more earning the bank has to have more and more investments in RA.

4.4.5 Correlation between Net worth and Net Profit

The net worth or shareholder's equity includes paid up share capital, share premium and reserves and surplus less accumulated loss. The shareholders always want more return on their investments. This is possible if the firm earns high profit and the profit is only possible if the bank is able to cut its expenses and have enough investments. Here, the net worth is a dependable variable while, the net profit is undependable variable.

The correlation between net worth to net profit = r

Here,
X = Net worth

Y = Net Profit

N = no. of observations

r = Correlation coefficient

Table 4.5 Correlation between Net worth and Net Profit

(NPR in Million)

Fiscal Year	Net Worth (X)	Net Profit (Y)	$x = X - \overline{X}$	x^2	$y = Y - \overline{Y}$	y^2	xy
2001/02	511.71	24.3	-55.44	3073.59	-30.56	933.91	1694.25
2002/03	519.13	48.29	-48.02	2305.92	-6.57	43.16	315.49
2003/04	526.09	6.82	-41.06	1685.92	-48.04	2307.84	1972.52
2004/05	552.09	26.06	-15.06	226.80	-28.8	829.44	433.73
2005/06	570.4	68.23	3.25	10.56	13.37	178.76	43.45
2006/07	584.2	113.76	17.05	290.70	58.9	3469.21	1004.25
2007/08	706.46	96.59	139.31	19407.28	41.73	1741.39	5813.41
	X=3970.08	Y=384.05		x^2=27000.78		y^2=9503.72	xy= 11277.09

$$\overline{X} = \frac{\Sigma X}{n} = \frac{3970.08}{7} = 567.1542857$$

$$\overline{Y} = \frac{\Sigma Y}{n} = \frac{384.05}{7} = 54.86428571$$

$$r = \frac{\Sigma xy}{\sqrt{\Sigma x^2} \times \sqrt{\Sigma y^2}} = \frac{11277.09}{\sqrt{27000.78} \times \sqrt{9503.72}} = 0.703982942$$

Hence, from above calculation, we can conclude that the two variables are positively correlated indicating that the change in one variable positively affects the other and vice- versa.

Similarly, Probable error (P.E) = $0.6745 \times \frac{1-r^2}{\sqrt{n}} = 0.128592286$

$\because 6 \times P.E. = 6 \times 0.128592286 = 0.771553713$

$\therefore$ r < 6 P.E, the calculated value of r is not significant and it indicates that the bank's net worth does not depend upon its NPAT.

4.5 Trend Analysis

Trend Analysis is another tool used in the course of financial analysis. In financial analysis the direction of change over a period of time is of crucial importance. It is a statistical measure, which shows the changes, or a group related variables with respect to time, geographical location or other characteristics. In order to carry out this research work, the trend analysis in respect to time is taken and for that seven year period is taken i.e. from FY 2001/02 to FY 2007/08. The trend analysis of different data relating to deposits, profit, RA, interest income, NPA and loan loss provisions are taken to study the performance of the bank and similarly the conclusions and projections are drawn.

4.5.1 Trend Analysis of Interest Expenses and Total Deposits and Borrowings

From the below figure 4.1, we can see that both curves have not been steady. The total deposit curve had increased during FY 2002/03 and then had gone down during FY 2003/04 and 2004/05. Thereafter, it has gone upward indicating that the total deposits and borrowings of the bank have been increased again.

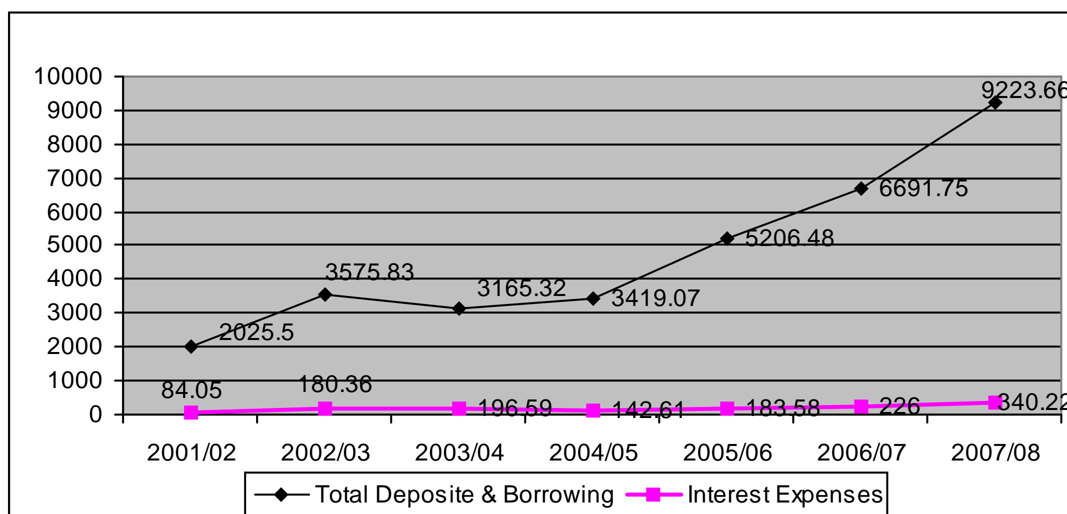


Figure 4.1 Trend Analysis between Interest Expenses and Total Deposits and Borrowings

Similarly, the interest expenses curve is more or less steady compared to total deposits and borrowings. Since, the interest expenses depend on the total deposits and borrowings, the curve had also gone upward during FY 2002/03 and then after it had lowered till FY 2004/05. During these years the deposits (both interest bearing and non-bearing) have gone down due to which it resulted in downward slope. However, both the curves have started to climb upwards thus indicating the growth in deposits and interest expenses as interest depends on the interest bearing deposits and borrowings. The interest expenses depend on interest bearing deposits like saving, fixed, call account and short-term borrowings. Thus, the bank should have low cost deposits and if possible it has to have deposits in current account and margin accounts as these are non interest bearing accounts, which lowers the interest expenses of the bank.

The interest expenses depend on the total deposits of a bank because the bank provides interest to its depositors under different heads like savings, fixed, call amount etc. On the other hand, the total deposits comprises of short-term deposits, call deposits, margin deposits etc. which are considered as the liabilities of the bank. The bank has to increase its funds and it is rather impossible for the management to have deposits without any expenses. But as far as possible the bank has to maintain the non-interest bearing deposits as this lowers the interest expenses.

4.5.2 Trend Analysis of Interest Income and Risk Assets

From the below figure 4.2, we can see that both the lines had moved upward during FY 2002/03 due to aggressive lending, however, compared to the risk assets line the interest income line has not moved upward which is because of interest rate. During initial years, the bank made huge investments with lower offered rated compared to the other banks so as to retain the business in the market. But, then after it started making its investments carefully and this it started focusing more or less risky investments due to which both the lines lowered till FY 2004/05. Despite the competition between the banks, the bank is able to

sizeable growth in both interest incomes and risk assets and thus the lines have started to move upward indicating the effective use of sources by the management.

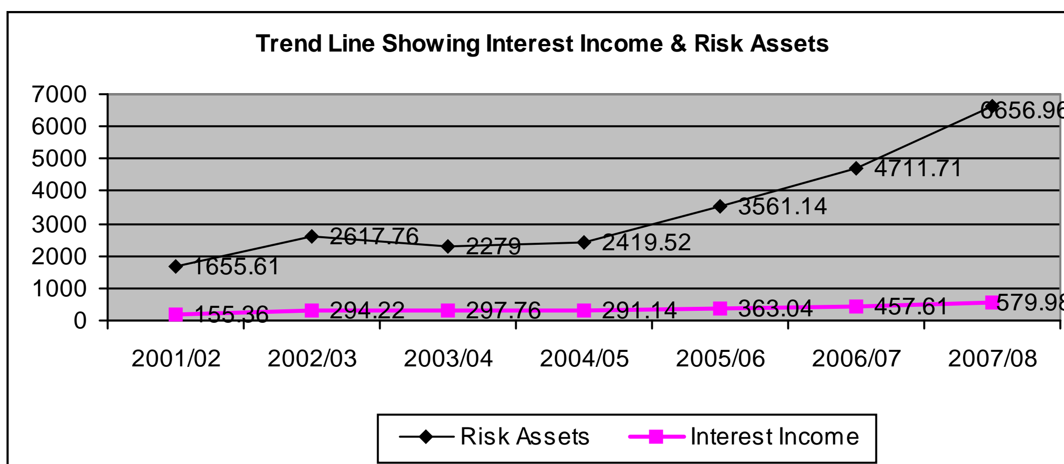


Figure: 4.2 Trend Analysis of Interest Income and Risk Assets

The interest income depends on the total assets of a bank because the bank charges interest to its borrowers for the lent amount. The risk assets comprise of both short term and long term investments, however, it does not include investments on government securities and shares of other firms and company. Thus, the bank has to increase its risk assets so as to earn higher interest income.

4.5.3 Trend Analysis of Net Profit and Risk Assets

From the figure below 4.3, we can see that risk assets had gone upward which is comparatively higher than the net profit. This is because the bank made its lending flexible and aggressive during initial years of its establishment so as to retain the business from the market. Then after, the management of the bank started to sort out the total loan portfolio and started making less risky investments due to which the investments and net profit of the bank started moving downward till FY 2003/04. Then after, it has started to move upwards indicating the efficient lending of the bank in the risky assets and cost reduction. But in FY 2007/08, more NPA and Loan Loss Provision has decreased the net profit.

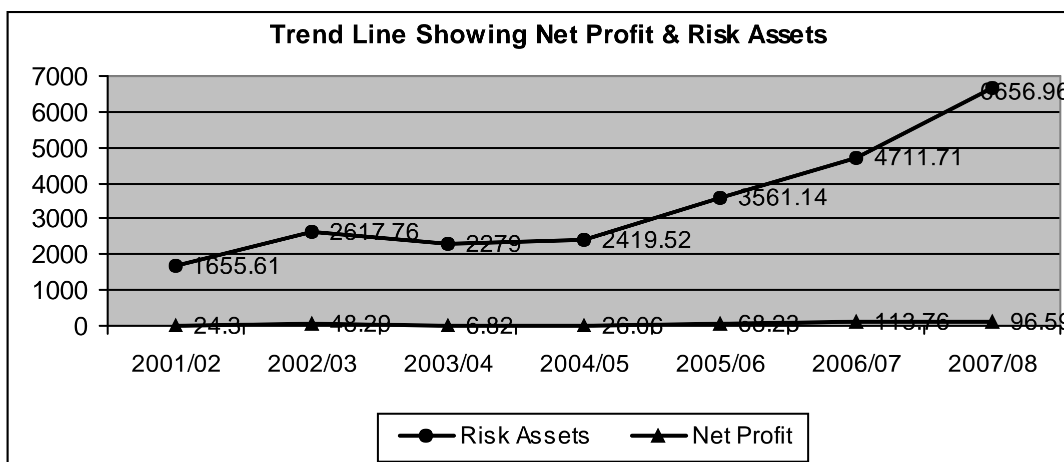


Figure: 4.3 Trend Analysis of Net Profit and Risk Assets

We know that the net profit depends upon the interest income and its total cost. However, the bank is able to earn higher profit only when it makes investments and this is only possible after it starts to make investments in risk assets. Thus, net profit is reciprocating to the risk assets of the bank because these risk assets in return earn some interest income to the bank which is the foremost source of income of the bank.

4.5.4 Trend Analysis of Total Risk Assets and Total Deposits

If we see the figure below 4.4, we notice that the risk assets and total deposits have moved simultaneously with the same speed during the initial years because the bank provided higher interests on the deposits while the investments on risk assets was flexible and aggressive so as to solicit the business from the market. However, there is a gap between RA line and total deposit line because a bank cannot invest whatever it holds in its deposits. It has to maintain enough liquidity to carry out its day-to-day transactions that include withdrawal of deposits by the borrowers and to meet its short-term obligations and expenses. However, both the lines have started moving upward steadily indicating the efficient use of sources in its risk assets.

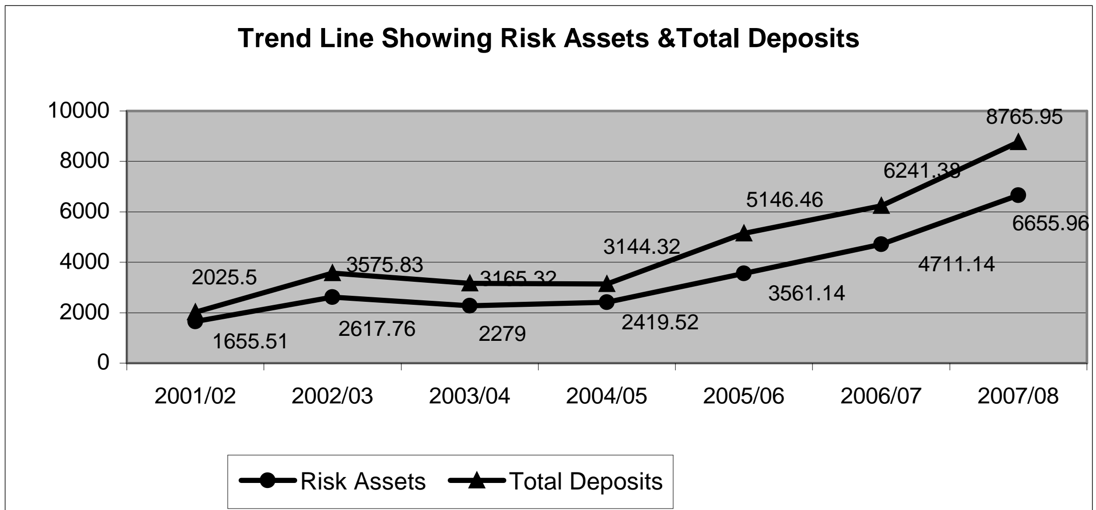


Figure: 4.4 Trend Analysis of Total Risk Assets and Total Deposits

The main source of funds of banks is their deposits. Similarly, the risk assets depend upon its sources without which the bank is unable to make its investment and future plans. So, a bank has enough deposits to carry out its banking transactions that include day-to-day cash transactions and investments. However, the ultimate target of the bank is to make investments in risk assets, which in return earns interest income for the bank.

4.5.5 Trend Analysis of NPA and Loan Loss Provision

From the figure below, we can see that during its initial years, the loan loss provision had increased slowly with increase in non-performing loans. After the amendment of loan loss provisions on FY2003/04, both the curves increased rapidly with the increase of loan loss provisions compared to FY2002/03 because there were no bad loans as all loans were under good and substandard loans in the initial phase. However, these loans converted into doubtful and bad loans in the due course of time and due to poor monitoring of the business of the borrower availing these loans. Though the bank has credit unit to monitor its risk assets portfolio, the credit team was not able to monitor its loan effectively. However, its been able to recover its bad loans to some extent and is also able to reschedule the loans as per the NRB rules, the NPA has started decreasing but the total loan loss provision has increased which is because of 1% provisioning in the pass category loan, which hold major part of

the risk assets. In FY 2007/08, NPA seems increasing whereas loan loss provision moves inversely.

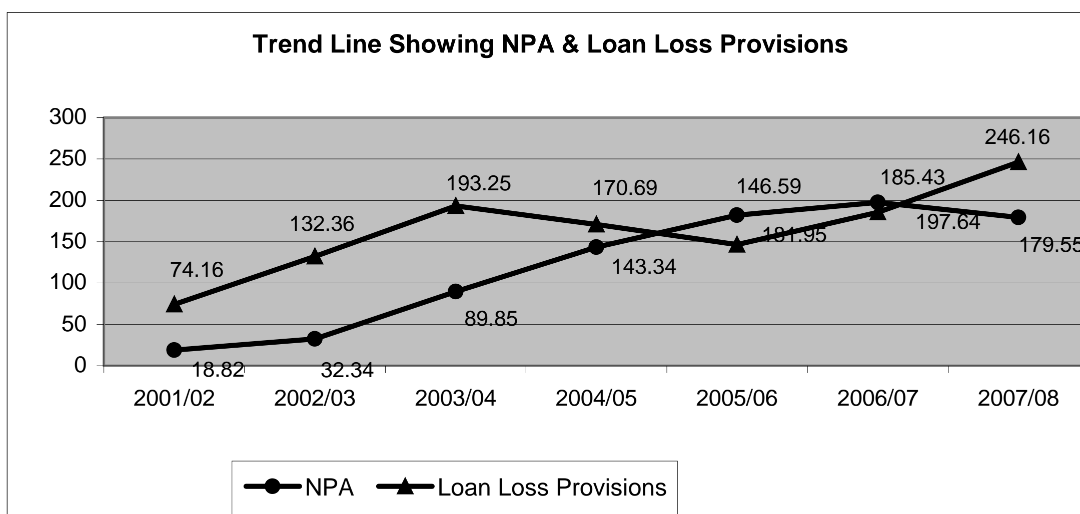


Figure: 4.5 Trend Analysis of NPA and Loan Loss Provisions

The non-performing loans consist of sub-standard, doubtful & bad loans and the bank has to make loan loss provisions as per the NRB regulations i.e. 25%, 50% and 100% respectively for each of these loans. However, the bank has to make 1% provision for its pass loans as well. Thus, the bank should monitor its risk assets so that its loan loss provisions shall be low to the possible extent.

4.6 Analysis of Portfolio Management and Credit Policy and its Monitoring Process

4.6.1 Portfolio Management

Effective bank management requires understanding how banks are influenced by monetary and fiscal policy, by changes in business cycles, by changes in business cycles, by interest rate movements, and by local community characteristics, bank structure, and management style.

Bank profitability depends on how successfully management can spread earnings between the interest a bank pays for funds and the interest it earns on funds. A bank's balance sheet and income statement show how effectively the

bank manages its assets and liabilities. The balance sheet indicates how the bank manages its assets and liabilities. The balance sheet indicates the nature and extent of management decision-making in each of the bank's functional areas as of a given date. The income statement shows the degree of profitability resulting from management decisions over a given time period. These financial statements provide a framework for analyzing the bank's financial condition and for planning the bank's future course of action; changes in the bank's portfolios of assets and liabilities-changes that may lead to increased profitability.

Banks are major investors in country and local government securities. These investments can be a substantial part of a bank's total assets and can provide a significant percentage of the bank's total income. A bank's investment allows it to realize earnings on its assets and yet maintain the ability to liquidate funds, which are needed to grant loans and cover deposit outflows. The bank has different committee to monitor its portfolio management. The higher level management of the bank heads these committees, which meet more often to discuss on the fund management and other necessary issues as per the requirements. There are two committees that mostly discuss on the portfolio management of the bank:
(a) Assets Liabilities Committee (ALCO) and
(b) Management Committee (MANCOM)

(a) Assets Liabilities Committee (ALCO)

The active and effective management of a bank's assets and liabilities has assumed increasing importance and greater complexity in recent years. One use of asset and liability management is for planning to meet liquidity purposes. But this is only one part of the process. Maximizing bank profitability and minimizing the bank's exposure to risk are equally important concerns. The bank's asset and liability portfolios must be maintained and coordinated to

enhance profitability and control risk. This can be accomplished through effective decision making regarding the volume, mix and pricing of earning assets and the liabilities that fund them. The ALCO of NICBL is headed by CEO and includes HBB, MC-BB, COO, MC-CB, MTF and other senior heads as per the need. It usually meets once a month to discuss on the portfolio management of the bank.

The Asset/liability management coordinates the bank's portfolio of assets and liabilities in order to maximize bank profitability and stockholder earnings over the long term, consistent with safety and liquidity needs. The objectives interest in asset/liability management include planning to meet liquidity needs, planning the maturities of assets and paid and liabilities in order to maintain or maximize the spread between interest costs and invest income –all of which must be accomplished without exposing the bank to excessive risk of default. Liquidity is a key concern in the construction of the asset and liability portfolios. Liquidity is the asset portfolio is maintained by structuring assets so that fluctuations in deposit levels can be covered and demands for credit can be met by holding liquid assets that will be sold or that will mature to meet liquidity needs. Thus, asset management is concerned with adjustments in the price and availability of credit and in the bank's holdings of liquid assets in relation to deposit and loan patterns. To maximize the net interest margin, ALCO must establish and implement policies and strategies affecting overall asset acquisition and funding within the constraints, and the dictates of the bank's marketplace. *(Paul, Dr.R.R. 1999:341)*

Responsibilities of ALCO

The objectives of the asset/liquidity management committee are to improve the bank's net interest margin, insulate the banks from interest rate sensitivity, maximize stockholders' long-term earnings, and avoid any excessive default risk. The ALCO's responsibilities generally include managing the acquisition and allocation of bank funds to ensure adequate liquidity, maximum

profitability, and minimum risk. This includes reviewing the recent past performance of the bank's loan and investment portfolios, assessing funding strategies and costs, and monitoring the bank's distribution of assets and liabilities in terms of rate, volume and mix. The ALCO also reviews budgets and earnings forecasts, and implements asset/ liability management strategies such as spread management, gap management and interest sensitivity analysis.

Asset/Liability Management Strategies

There are three strategies approaches to asset/liability management:

- Spread management focuses on maintaining an adequate spread between a bank's interest expense on liabilities and its interest income on assets.
- Gap management focuses on identifying and matching rate-sensitive assets and liabilities to achieve maximum profits over the course of interest rate cycles.
- Interest sensitivity analysis focuses on improving interest spread by testing the effects of possible changes in the rates, volume, and mix of assets and liabilities, given alternative movements in interest rates.

These strategies attempt to closely coordinate bank asset and liability management so that bank earnings are less vulnerable to changes in interest rates.

(b) Management Committee (MANCOM)

The management committee is also headed by CEO and comprises of senior executives of the bank. The committee also meets every week to discuss the different issues regarding the major business and strategic issues. Similarly, it also emphasizes and focus on different issues like credit policies, branches performances, operating expenses of the bank.

The committee makes necessary recommendations regarding the business and strategic issues to the branches through circular to the branches. The branch

level staffs follow the strategy set by the MANCOM and focus on their business so as to achieve the target set by the higher management.

4.6.2 Credit Policies and Its Monitoring Process

The bank has been operated under sound and well-defined credit-granting criteria. These criteria should include a thorough understanding of the borrower or counterparty, as well as the purpose and structure of the credit, and its source of repayment. Credit is the vital and most important activity in the Bank, next only to deposit mobilization. It is the activity that generates the main income stream for the Bank. The activity should therefore be pursued with the utmost professionalism, conservation and circumspection. To indulge in reckless credit disbursement, at any operating level, would be the ultimate sin, which must be prevented at all costs. The bank has therefore laid down a sound Credit Policy to internalize certain discipline in the area of credit administration. It has developed and implemented policies and procedures to ensure that the credit portfolio is adequately diversified given the bank's target markets and overall credit strategy. In particular, such mix has set exposure limits on single counter parties and groups of connected counter parties, particular industries or economic sectors, geographic regions and specific products. Banks has ensured that their credit policies have been strictly followed by lower level management at all branches and that all the credit teams have been monitoring the accounts properly.

Credit policies establish the framework for lending and guide the credit-granting activities of the bank. The credit policy of the bank is satisfactory as it thoroughly checks all its credit proposals whether it is corporate credit or retail lending. Every single proposal is routed through right channel and then it is either approved or declined by the higher management with certain recommendations wherever needed. Similarly, the documentation process are also scrutinize from the legal advisor. However, the major analysis regarding the credit policies of the bank is as follows:

- The credit department in all branches is divided into three division mainly sales team, marketing & retail lending and credit support unit.
- The sales team reviews the credit proposals of all the corporate credit business under its relationship and put forward ad-hoc requests of the borrower upon the requirement of the borrower. In addition to that it also solicits the new business if it is viable project/business.
- The main responsibility of the marketing team is to look after the retail banking and go on marketing the new products of the bank. Similarly, it looks after the small size business and also focus to increase the deposits of the bank.
- The credit support team executes the necessary credit documentation as per the requirement of the loans approved or as recommended by the sales team/MC-BB. Similarly, it also monitors the stock position of the borrowers' bi-monthly/quarterly and prepares the drawing power of the borrower. It also ensures that the insurance of the stocks is in place and informs the borrower about the expiry of the insurance and reduction of the drawing power of the borrower if the stock position of the borrower is deficit as per the condition laid down by the bank (i.e. 70% of stocks plus account receivables less account payables).
- The CSU unit also prepares reporting regarding the LLP, sector wise lending reports, account monitoring report of the borrowers etc and informs it to the central credit at the end of every month.
- Each and every proposal including ad-hoc requests of the borrower are put forward to the central credit which evaluates its requirements and makes approval based on the recommendations of the branch manager and sales team.
- Further, it accumulates monthly reports sent by the branches and prepares the consolidated report and then submits it to the NRB as per the rule.
- Besides, it recommends every branches to monitor the loan portfolio of the branches so as to ensure that every investments made turn to be good loans.
- The bank had BCMC, which approves the high exposure loans if it feels comfortable for the investments.

- Similarly, the board meeting is held every month so as to inform the board members about the performance of the bank and also the monthly achievements of the bank. On the other hand, the board members amend the credit policies as per the need of the bank so as to have effective monitoring policies for its investments.
- The bank has internal auditors who make inspections of the branches twice every year on the overall documentations of every department including credit departments. They make necessary recommendations to the branch level at the end so that external auditors headed by NRB staffs may not find the loopholes of the bank.

Hence, it can be concluded that the overall credit management of the bank is at comfortable position and is always focused to implement the rules of NRB. Similarly, it is also focused on the credit policies of NRB and till date it has been able to implement the NRB regulations smoothly. Further, the bank is able to provide the efficient service to its customers from its branches situated at 8 different cities of the country. The higher-level management is able to meet the targeted profit with investments on risk assets by the continuous efforts of the staffs at different levels. Thus, the credit management of the bank as a whole can be considered satisfactory.

CHAPTER-V
SUMMARY, MAJOR FINDINGS AND RECOMMENDATIONS

5.1 Summary

Bank is a financial institution, which deals on money. It collects money from different sectors, which are idle and scattered in our surroundings. It issues these deposits as a loan to those who need it. Those depositors can be individual or institutions. Duration of deposits depends upon the mutual agreement between bank and customer. Similarly, borrower of money can be individual as well as business firms or institutions. Terms and condition of depositing money and lending money depend on various factors like duration, volume or amount, purpose etc. For example bank provides high rate interest on long-term deposits. It allows some interests on deposits and charges some interest on loan. Interest on loan is comparatively higher than deposits. The difference in interest of deposits and loan is called spread rate and this is the main source of earning of a bank.

Commercial banks play an important role in affairs of the economy in various ways. The operations of commercial banks record the economic pulse of the economy. The size and composition of their transactions mirror the economic happening in their country. They are as essential instrument of accelerated growth in a developing economy. In fact, banks are the nerve center of economy and the barometer of economic prosperity. By mobilizing community savings and diverting then into productive channels, commercial banks expand the tempo and appreciate the value of aggregate economic activity in the economy. In general banks are those financial institutions that offer the widest range of financial services especially credit, savings and payment services and perform the widest range of financial functions of any business firm in the economy

The financial system is the channel through which mobilization and allocation of savings is carried out in the economy. As such the financial system facilitates the transfer of financial resources from savers to borrowers. The financial system constitutes financial institutions, instruments and market as its component. The Nepalese financial system is small, but rapidly changing. Today in developing economies, regional balance or reduction in regional disparities with regard to the levels and the rate of development amongst the different regions has along been one of the principal objectives of planned economic development. In this objective, commercial bank can play a very vital role. Banking helps to mobilize the small savings collectively to the huge capital investment. Though the banking is considered as the platform of money market and capital markets, commercial banks basically help to promote money market.

After initial capitalization, a bank has three major sources of funds for its business operations: deposits, purchased or borrowed funds, and capital increases. Within these three basic categories are many funding instruments whose maturities, costs, and applications in liability management vary. Liability management, in its broadest sense, is the co-ordination and control of all of a bank’s sources of funds so that funds are available or obtainable as needed at reasonable cost. Effective liability management ensures that funds are available to meet reserve requirements and provide adequate liquidity over the short term, and to satisfy loan demand and provide investment earnings over the long term.

Bank funding sources and the nature of liability management have undergone profound changes in recent years and continued change and challenges are still on the horizon. The deposit structures of most banks have been altered significantly due to marked declines in traditional demand deposits and rapid increases in the volume of time deposits. The sources of most banks are now interest sensitive and increasingly volatile on the one hand, while on the other

there is a tough competition between the banks in their investments with lower offer rates to the customers to retain more businesses from the market. Competition for funds and investments are intense, so an effective credit management is required for aggressive approach to attract the funds and then invest those funds in safe but profitable earning assets. *(Hatler, O. Gerald, 2001:761)*

Banks are important institutions for any economy. They can mobilize resources; provide financing for commercial enterprises and basic financial services to a broad segment of the population. Banking sector plays vital role in the development of the country through facilitating the intermediary process in between capital surplus and deficit sector. They transfer the liabilities and diversified the risk efficiently in such a way that they earn some margin. The importance of banks to national economies is under scored by the fact that banks have access to government safety net. It is of crucial importance therefore that banks should have strong corporate governance. For the efficiency of the banking system, all banks to be prudent and have commercial orientation in their activities. A sound system of corporate governance is much demanded for the maintenance and development of a well-managed banking system. *(Neupane, Hem Prasad, 2060:335)*

Apart from the resource mobilization and collection of sources of funds, the banks should have good credit policy to monitor its loan portfolio, analyze & analyze the loan process and handle the credit operations so that the investments made provide them smooth return and get the return even if the business fails in future. Thus, though each bank has its own credit policies, the management should be aware that the credit policies should be mandatory and followed strictly with compliance by the staffs within.

This study has been carried out to find out with a view to analyze the credit management of NIC Bank Ltd studying the credit polices and portfolio

management of the bank. There are five chapters in this study viz: Introduction, Review of Literature, Research Methodology, Data Presentation & Analysis and Summary, Major Findings & Recommendation.

The first chapter deals with the general background, focus of the study, statement of the problem, objective of the study, significance of the study and limitations of the study.

In the second chapter, the relevant and pertinent literature on the subject is reviewed with a view to understand the functions and business of banking, number of commercial banks, the role of central bank, present scenario of the banking sector, credit management and its need in the bank and the introduction of NIC Bank Ltd and its credit management.

The third chapter explains about the research methodology, that explains how the about the research analyzing process was carried out. This chapter includes research design, population and sample, nature & sources of data, data collection techniques, data analysis tools and limitations of the methodology.

The fourth chapter deals with the presentation of data and analysis by using various financial and statistical tools. Various tables and graphs are used in this chapter so that presentations can be made easy to understand. Besides, it also includes the descriptive analysis of credit policies of the bank.

The last chapter is the summary, major findings and recommendation of the study. It presents the summary, conclusion by point and has made recommendations so that the higher management considers it as valuable tips in making certain changes in the portfolio management and credit policies of the bank.

5.2 Major Findings

The major findings of the study are as follows:

1. The bank has been able to maintain satisfactory portfolio management and credit policies to monitor its risk assets. Similarly, the bank is able to meet all the NRB regulations as per the rules set by NRB.
2. The liquidity ratios are not as per the standard level of 2:1, however the CR of the bank is still enough to meet its current liabilities.
3. The ratio of cash & bank balance is in fluctuating trend indicating the variable percentage of cash and bank balance in CA.
4. The percentage of FD to TD is in decreasing trend upto FY 2005/06, which indicates reduction in interest expenses in fixed deposits. But in two successive fiscal years, the ratio remains constant at 46.66%. During these two fiscal years, FD has increased with the increase in interest rate as compared to preceeding fiscal years.
5. The ratio of savings deposits to TD is increasing which can be considered satisfactory because of lower cost deposits compared to fixed and call deposits.
6. The ratio of total RA to CA has started to increase thus indicating the increment in investments in RA, which is the ultimate source of interest earning and the goal of the management.
7. The ratio of NPAT to RA is increasing since FY 2003/04 and is considered satisfactory, as the increase in NPAT is the other main target of the bank. However, the NPAT has decreased in FY 2007/08.
8. The ratio of NPAT to NW is also in increasing trend is considered satisfactory as its adds value to the wealth maximization of the shareholder. However, the ROE has decreased due to issue of Bonus shares in FY 2007/08.
9. The EPS of the bank decreased during FY 2003/04, because of the reduction in

NPAT. But then it started increasing after FY 2004/05. In fact, the EPS in FY 2007/08 has increased at diminishing rate due to issue of Bonus shares in the same year.

10. The P/E ratio has not been satisfactory because of the reduction in MVPS, which has made the management aware of its share price.
11. The ratio of NPAT to TA has been fluctuating over seven years. Thus, the bank should be cut off its unnecessary operating expenses and other general expenses so as to increase the NPAT.
12. Despite the tough competition, the bank is able to maintain continuous growth in its interest earning till FY 2004/05 but has decreased in the following fiscal years due to NPA.
13. The investments depend on total deposits because without its sources of funds the bank is unable to make the investments in RA. The ratio has been fluctuating with 0.08 coefficient of range. The greater proportion of TD has been employed to RA which can be signified by the ratio observed in FY 2006/07 and FY 2007/08.
14. The ratio of RA to savings, fixed and call & short deposits is decreasing from FY 2001/02 as it indicates that the management is unable to utilize its sources effectively. However, the bank is able to maintain the ratio at the level of 0.82 on average. The ratios in the FY 2006/07 and FY 2007/08 are both nearer to its average.
15. The ratio of staff costs to total costs has decreased during FY 2002/03 & FY 2003/04 while it has increased during next three years. However, in FY 2007/08 the staff costs has decreased along with staff bonus due to heavy loan loss provisions in the same year.
16. The ratio of total costs to gross income had increased during FY 2003/04 but then it started to decrease continuously.
17. The proportion of shareholders' equity in risk assets has been decreasing indicating that the bank has been utilizing the other sources of funds for the investments.

18. Similarly, the correlations between TD and TI, TD and TRA, NPA and LLP, Interest Income and RA, and NW and NP were positively correlated.
19. Further, the Correlation is greater than 6 times of P.E. in all the cases except in the correlation between NPAT and Net Worth, indicating that all the correlated data were significantly having positive correlation.
20. The trend analysis between TRA & TD showed that the RA is dependent on TD.
21. The trend analysis of interest expenses and total deposits & borrowings showed that the interest expenses increased simultaneously with the increase in deposits and borrowings.
22. The trend analysis of net profit and RA concluded that they were positively correlated and that they two move simultaneously.
23. However, though the NPA of the bank has decreased, the loan loss provision increased because of the increase in risk assets and the provisioning even in the pass categories loans.
24. The portfolio management of the bank can be considered satisfactory as it is monitored by TF and also has different committees to monitor on the assets and liabilities of the bank. The committee includes ALCO and MANCOM that meet each month and discusses on various business and strategic issues of the bank.
25. The credit policy of the bank is monitored by the central credit in the country level and credit departments in the branch level. The staffs of credit department are highly qualified and motivated towards their work.
26. Besides, there is an audit committee and accounts department to monitor the documentation and reporting works of NICBL, which has effectively doing their works till date.

5.3 Recommendations

Though the credit management of the bank is satisfactory, there are certain regions where the management has to make necessary steps to overcome such difficulties. Thus, following recommendations are offered by the study:

1. The business market of Nepal is small and almost saturated. Most of the commercial banks are making investments aggressively with lower interests. In the present context, the possibility of foreign banks to enter in Nepal in coming days is high. The management of the bank therefore should update themselves with the latest technologies and also be ready to make necessary changes to overcome difficulties regarding technologies, credit policies, efficient customer service etc. in coming days.
2. In order to be more competitive, the bank should always be prompt and reliable service to provide for the customers. Similarly, they should have qualified and trained staffs. Though the staffs are trained on regular basis however, only few staffs get the opportunity for such trainings. The bank therefore should conduct in house training on monthly or quarterly basis as possible so as to train the staffs at every level and make them understand each and every rules set by the management and NRB.
3. Though the net profit of the bank has been increasing, the bank can still earn more with effective marketing strategies and new loan schemes.
4. The bank has recently launch home loans with new interest rates and at present market, it is the lowest rate provided to the customers. With such schemes, it is expected that the risk assets of the bank shall rise in coming years. Similarly, it is expected that the bank shall launch such retail services to its customers with innovative schemes so that it can increase its market share.
5. Like every commercial bank, the main goal of the management is to earn higher profit and for that the management should make investments in risk assets and similarly lower its operating and other expenses.
6. Although the total deposits of the bank have been increasing every year, it still has high cost deposits. The bank provides 5% interest on NLS scheme, which is one of the highest interest rates in savings account and similarly provides higher interest in fixed and call deposits compared to other commercial banks. Therefore, if possible the bank should make continuous efforts to have low cost deposits.

7. In order to hold better position in the financial market, the bank should provide dividends to its shareholders and it is possible only if it makes higher profit. Thus the management should be aware of EPS and MVPS and should make necessary steps to increase the value of EPS and MVPS as they are considered to be the rationale indicator of credit management of the bank.
8. Apart from above, the credit management should be aware of its NPA and should monitor such loans carefully. Further, it should take necessary steps to recover its bad loans and if possible reschedule such loans so that the borrowers can repay it on time.
9. Recently the bank has launched ABBS, ATM and Debit card facilities for its customers in order to provide better service, however, the bank has focused ATM facilities on the core markets like Biratnagar and Kathmandu only. But the ABBS facility is provided in all 8 branches of the bank. Though there are certain limitations within the management, it is expected that the bank shall launch its ATM machines at Birgunj and Pokhara due to potential market.
10. During the verbal discussions with the staffs of the Biratnagar branch and corporate office, they mostly focused on the inadequacy of the staffs at central credit which can be regarded as the brain of the whole management because as per the proposals sent are usually approved in a week time. Thus, if possible the management should recruit the staffs or place the staffs from other departments if there is budget constraint.
11. The management should circulate internal credit policies and NRB credit policies to all the branches timely so that the staffs are updated abut such rules and regulations.
12. As far as routing the proposals are concerned, the central credit has been monitoring the total loan proposals sent from all branches, which is ultimately approved by CEO or board committee where needed. If possible the management should provide credit approval discretions to all credit management staffs including HBB, MCBB, MCCB and all branch

managers so that the credit decisions are made promptly within their responsibility.

13. The CSU unit mostly forwards the mortgaged deed of every borrower to the legal advisor at Corporate Office, which takes about 3 to 4 days time to get it approved after necessary corrections. If the management is able to place a standard format of mortgage deed for every kind of loans, then it would be easy for CSU to execute the legal documents to the customers.
14. As far as fund management is concerned, the bank has to maintain CRR of 5% from Sunday to Friday as per the new NRB rule. Thus, the bank has to maintain enough liquidity within the branches and therefore has to focus in increasing the deposits.
15. The treasury department should be able to maintain enough bank balances on its NOSTRO accounts both in local as well as foreign currencies such that no problem arises regarding the remittance and payments of LCs.
16. There are no such standard credit documents set by the bank for its borrowers. Mostly, CSU prepares similar kind of documents whether it is small size loans or corporate credit loans. Thus, the central credit should prepare standard formats for each kind of loan.
17. Although the board of directors and senior management bear the ultimate responsibility for an effective system of credit risk management, supervisors should, as part of their ongoing supervisory activities, assess the system in place at individual banks to identify, measure, monitor and control credit risk.
18. Supervisors should review the results of any independent internal reviews of the credit-granting and credit administration functions and further should make use of any reviews conducted by the bank's external auditors, where available.
19. Supervisors should also take particular note of whether bank management recognizes problem credit at an early stage and take the appropriate actions.

20. Supervisors should monitor trends within a bank's overall credit portfolio and discuss with senior management any marked deterioration. They should also assess whether the capital of the bank, in addition to its provisions and reserves, is adequate related to the level of credit risk inherent in the bank's various on and off balance sheet activities.
21. Lastly, the bank should focus on retail banking though it has recently launched new home loan schemes. In coming days, the bank has to introduce new loans in retail lending, like education loans, auto loans, travel loans and other small size loans. Because it leads to less risky investments on one hand and on the other the risk assets increases leading to profit increase of the bank due to lower loan loss provisions and operating expenses. However, the bank should also venture new corporate loans and if possible should open new branches at other business market of the country.

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