CHAPTER- I

INTRODUCTION

1.1 General Background

Banks and financial institutions are the institution that keeps on providing complete financial solutions to its valued customers in return for interest, fees and commission. Everyone is acquainted with the basic function of the banks and financial institution. They provide loans and advances in the form of various credit facilities to its customer and in return receive interest, fees and commission for the risk assumed thereon. Thus, in this process they assume various risks among which credit risk is the one that covers the significant portion, since, myriad of a bank deposits are invested in the form of loans. Banks and financial institutions are vulnerable to various risks because of poor credit appraisal of borrower, lack of credit standards, poor portfolio management and towards current political, legal, economic and social environments. These all leads to the deterioration in the credit standard of the bank thereby creating the credit risk. Thus a bank must be well acquainted to manage the risk associated with the credit. They must adequately examine borrowers character, capacity, collateral, creditworthiness before making any investment on them, this, however, does not make sure in the high credit standard and good loans. A borrower can default despite of his serious efforts in making payments because of other situation and risk associate with such as market risk. Thus, before making any decision on lending a bank must examine every situation and risks. Some of the risk a bank may encounter or witness may be market risk, operation risk, credit risk, interest rate risk, currency risk etc. Among them credit risk covers the significant risk since a bank's main function is to carry out lending which covers around 80% of the total deposits and capital of a bank. Thus, we need to know what actually a credit risk is and how does it affects the existence of a bank.

Credit risk is the major risk that banks are exposed to during the normal course of lending and credit underwriting. In other term, the risk associated for nonpayment of interest and principal for credit facilities extended to the clientele is credit risk. In general term, risk is deviation of what we expect to what actually happens. Banks and financial institution extend credit facilities (Loans and Advances) to its customers in a

return for Interest accrued thereon. Bank and financial institution grants loans and advances to different borrowers taking calculated risk. Pertaining to it, sometimes the calculated risk does fails and the borrower defaults. This is what we call credit risk.

To proceed with lets first discuss what literally a loan stands for. Loans and advances are the financial asset of a bank for a reasonable return in the form of interest, fees and commission; this is the overall income for any financial institutions.

Loan can take different form according to the requirements of borrower pertaining to the maturity of loans, purpose of loan etc. Following are some of them but not limited to its type.:

1. Consumer loans such are vehicle loan, equipment loan, home loan, credit loan, mortgage loan, margin lending, gold loan, and loan against fixed deposit etc.
2. Corporate loans such as overdraft, short term loans, demand loans, working capital loan, letter of credit, trust receipt loan etc.

1.1.1. Assessing Credit Risk

Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Another term for credit risk is default risk. Investor losses include lost principal and interest, decreased cash flow, and increased collection costs, which arise in a number of circumstances. Thus, banks and financial institutions deploy their maximum time in managing credit risk. The bank’s willingness to undertake or maintain credit risks is determined by the recognition, evaluation and weighing of all positive and negative factors of a proposal. The purpose of credit risk assessment is to determine the customer’s ability to meet his obligations to the Bank (and to other lenders and creditors) as they fall due.

Credit risk assessment thus involves:

1. Determining the Maximum Credit Risk

The following factors must be considered:

- Principal Risk: that the customer may not be able to repay indebtedness.
- Income Risk: that the customer may not be able to meet interest and fee payments as they fall due.

2. Analyzing Financial and Other Information

The financial and non financial information must be relevant and up to date in order to carry out meaningful credit risk assessment. Analysis of the information, evaluation and weighing of all positive and negative factors with a view of determining credit limits and associated terms and conditions is a matter of subjective judgment. Each officer in the credit approval process must be satisfied that he has sufficient information on which to make a recommendation or decision. Risk assessment will include, but not limited to an analysis of the following:

- Management strengths and weaknesses including the honesty, integrity and reliability of the customer and willingness to honor obligations.
- The customer's knowledge, management expertise and ability to implement strategies to ensure obligations are met.
- Financial strength, including its ability to repay loans and meet commitments based on historical and projected financial statements.
- Business environment and general business outlook.
- Current and future business prospects including external conditions affecting the customer such as economic and political trends, role and position in the industries in which the customer operates, position of the industries in the business cycle and vulnerability to technological change.
- The size and structure of the proposed facilities and their fit with customer needs
- Past performance of facilities
- Environmental risks.
- Revenue / Earnings for the Bank.
- The nature and value of security (to be given) to the Bank and to other lenders.

3. Assessing Safety

It must always be remembered that the longer the duration of exposure, the more difficult it is to assess a customer's creditworthiness.

If the customer is a member of a group, a safety assessment of both the borrowing entity and overall customer group is desirable.

The Bank does not normally undertake exposure to a customer simply because it is fully secured by attractive and high value real estate mortgages. It must be established

that the customer would have ability, and would be willing, to meet his financial commitments to the Bank, and it is highly unlikely that the Bank would have to enforce the security to recover its dues.

When the assessment has been completed, it may be decided that (additional) security is required to offset a weakness in the credit proposal, preclude other lenders or creditors from controlling the customer's assets and provide the Bank with a backup in case the customer fails.

Officers involved in the credit risk assessment must be satisfied that the positive factors outweigh the negative factors of the proposal.

In addition to it, significant resources and sophisticated programs are used to analyze and manage risk. Some companies run a credit risk department whose job is to assess the financial health of their customers, and extend credit (or not) accordingly. They may use in house programs to advice on avoiding, reducing and transferring risk. They also use third party provided intelligence. Companies like Standard & Poor's, Moody's Analytics, Fitch Ratings, and Dun and Bradstreet provide such information for a fee.

Most lenders employ their own models (credit scorecards) to rank potential and existing customers according to risk, and then apply appropriate strategies. With products such as unsecured personal loans or mortgages, lenders charge a higher price for higher risk customers and vice versa. With revolving products such as credit cards and overdrafts, risk is controlled through the setting of credit limits. Some products also require security, most commonly in the form of property.

Credit scoring models also form part of the framework used by banks or lending institutions grant credit to clients. For corporate and commercial borrowers, these models generally have qualitative and quantitative sections outlining various aspects of the risk including, but not limited to, operating experience, management expertise, asset quality, and leverage and liquidity ratios, respectively. Once this information has been fully reviewed by credit officers and credit committees, the lender provides the

funds subject to the terms and conditions presented within the contract (as outlined above).

Credit risk has been shown to be particularly large and particularly damaging for very large investment projects, so-called megaprojects. This is because such projects are especially prone to end up in what has been called the "debt trap," i.e., a situation where – due to cost overruns, schedule delays, etc. – the costs of servicing debt becomes larger than the revenues available to pay interest on and bring down the debt.

1.1.2. Mitigating Credit Risk

Lenders mitigate credit risk using several methods:

Risk-based Pricing

Lenders generally charge a higher interest rate to borrowers who are more likely to default, a practice called risk-based pricing. Lenders consider factors relating to the loan such as loan purpose, credit rating, and loan-to-value ratio and estimates the effect on yield (credit spread).

Covenants

Lenders may write stipulations on the borrower, called covenants, into loan agreements:

- Periodically report its financial condition
- Refrain from paying dividends, repurchasing shares, borrowing further, or other specific, voluntary actions that negatively affect the company's financial position
- Repay the loan in full, at the lender's request, in certain events such as changes in the borrower's debt-to-equity ratio or interest coverage ratio.

Credit Insurance and Credit Derivatives

Lenders and bond holders may hedge their credit risk by purchasing credit insurance orcredit derivatives. These contracts transfer the risk from the lender to the seller (insurer) in exchange for payment. The most common credit derivative is the credit default swap.

Tightening

Lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. For example, a distributor selling its products to a troubled retailer may attempt to lessen credit risk by reducing payment terms from *net 30* to *net 15*.

Diversification

Lenders to a small number of borrowers (or kinds of borrower) face a high degree of unsystematic credit risk, called concentration risk. Lenders reduce this risk by diversifying the borrower pool.

Deposit Insurance

Many governments establish deposit insurance to guarantee bank deposits of insolvent banks. Such protection discourages consumers from withdrawing money when a bank is becoming insolvent, to avoid a bank run, and encourages consumers to holding their savings in the banking system instead of in cash.

In addition to it, NRB has been constantly focusing on managing credit risk and applying its credit risk managing tools to govern every banks and financial institution to protect and act on behalf large depositors and shareholders. NRB being central bank plays a mentor and patron role in risk managing. The main tools applied by NRB to monitor and mitigate those risk are listed below but not limited to following:

1. Implementing BASSEL II (Capital Adequacy)

Institution	**Minimun Capital Reserve as per Risk Weighted Exposure**	
	Primary Capital	Supplementary Capital
"A" class	6%	10%
"B" & "C" Class	5.5%	11%
"D" Class	4%	8%

2. Loan loss provisioning
3. Single obligor limit and sector wise lending
4. Investment provisions
5. Consortium loan arrangements

6. Credit information and black listing
7. Merger and acquisition policy

All above tools including other as required by NRB are very effective tools that checks and monitors credit risk. Every banks and financial institution must comply with the terms and conditions stated on Unified NRB Directives 2068. Here, minimum standard threshold are stated below which the banks and financial institutions are obliged to comply. Mitigating credit risk is not a simple job, careful analysis and adequate time must be devoted. Despite of tremendous effort shown by NRB, many banks plays on loopholes and thus become problematic and helpless. Moreover, senior officials and even the chairman involvement in providing loans on nepotism basis and utilizing funds for personal use has created many serious problems that has degraded the banking position and its values. For instance, we have witnessed these problems in Nepal Share Markets and Finance Ltd., Gorkha Development Bank, Capital Merchant Bank, and even Vibor Bikas Bank Ltd. These are the lively examples of poor portfolio management and poor lending consequences.

NRB must envisage these and future problems and come up with more effective and accurate policies and guidelines in order to maintain good banking reputation in the eyes of the public and provide safer place for depositors. Though, we have been experiencing more and more tougher policies implemented by NRB under helm of governor Mr. Yuv Raj Khatiwada, tight rules and regulation are even sought on urgent basis to control threatening downsizing economy.

1.1.3. Banking System in Nepal

A bank is a financial institution that acts as a financial intermediary to privilege its clientele with complete financial solution and also a crucial means in accelerating the overall growth and development of economy. Commercial bank accepts deposits and pools those funds to provide credit, either directly by lending, or indirectly by investing through the capital markets. Within the global financial markets, these institutions connect market participants with capital deficits (borrowers) to market participants with capital surpluses (investors and lenders) by transferring funds from those parties who have surplus funds to invest (financial assets) to those parties who borrow funds to invest. Thus, a bank has a tremendous effort in development of trade

and industry. They act as a backbone for facilitation of any banking services required in execution and operation of trade and industry. This in turn leads trade balance ,higher gross domestic product, increase in exports and ultimately increasing per capita income of the citizens.

In Nepal, establishment of Nepal Bank Limited on Kartik 30,1994 Bikram Sambat (1937 A.D.) begin providing financial solutions to its customers.. This marked the beginning of an era of formal banking in Nepal. Until then all monetary transactions were carried out by private dealers and trading center. Nepal Rastra Bank, the central bank of Nepal was established in 1956 A.D to discharge the central banking responsibilities including guiding the development of the embryonic domestic financial sector followed by Rastriya Banijya Bank in 1966 A.D. As Nepalese government took liberal economic policy in 1980s, joint venture banks started to operate since 1984 A.D with the establishment of NABIL Bank Ltd. erstwhile known as Nepal Arab Bank Ltd.

However, the current market scenario of the Nepalese banking system is in the deteriorating state. NRB has been implementing its various strategies to tighten and control the banks and financial institutions. Rupee saving of even a small depositor has come into threat. NRB's control over the management of Nepal Bangladesh Bank followed by the latest liquidation of Nepal Bikas Bank to most recent problematic and risky Gorkha Development Bank, Nepal Share Markets and finance Ltd, Capital merchant finance , Vibor Bikas Bank, World Merchant banking and Finance has led the depositor to be skeptic about the whole banking industry. Depositor has even begun withdrawing their entire savings from these banks and other counterparts as well, which in turn has seriously affected the liquidity crisis. Banks are even unable to make payment of cheques.

Pertaining to it, NRB vide its circular is in process of providing special refinancing schemes to banks and financial institutions to avert this liquidity crisis in market. However, this facility shall be paid off within six months of time including subsidized interest accrued thereon.

Thus, NRB's interference in each and every activities of banking industry to tighten and monitor banks and financial institutions is mandatory in current situation. Various existing credit risk management policy are further intensified and tightened to smooth the whole banking industry.

Brief Introduction of Kumari Bank Ltd. (KBL)

Kumari Bank Limited, came into existence as the fifteenth commercial bank of Nepal by starting its banking operations from Chaitra 21, 2057 B.S (April 03, 2001) with an objective of providing competitive and modern banking services in the Nepalese financial market. The bank has paid up capital of Rs. 1,485,000,000 of which 70% is contributed from promoters and remaining from public.

Kumari Bank Ltd has been providing wide - range of modern banking services through 28 points of representations located in various urban and semi urban part of the country, 19 outside and 9 inside the valley. The bank is pioneer in providing some of the latest / lucrative banking services like E-Banking and SMS Banking services in Nepal. The bank always focus on building sound technology driven internal system to cater the changing needs of the customers that enhance high comfort and value. The adoption of modern Globus Software, developed by Temenos NV, Switzerland and arrangement of centralized data base system enables customer to make highly secured transactions in any branch regardless of having account with particular branch. Similarly the bank has been providing 365 days banking facilities, extended banking hours till 7 PM in the evening, Utility Bill Payment Services, Inward and Outward Remittance services, Online remit Services and various other banking services.

Visa Electron Debit Card, which is accessible in entire VISA linked ATMs (including 30 own ATMs) and POS (Point of Sale) terminals both in Nepal and India, has also added convenience to the customers. The bank has been able to get recognition as an innovative and fast growing institution striving to enhance customer value and satisfaction by backing transparent business practice, professional management, corporate governance and total quality management as the organizational mission.

The key focus of the bank is always center on serving unfulfilled needs of all classes of customers located in various parts of the country by offering modern and competitive banking products and services in their door step. The bank always prioritizes the priorities of the valued customers.

Mission Statement

Our mission is to deliver innovative products and services to our customers, use these innovative products to achieve financial inclusion, and do so by exemplifying good corporate governance, proactive risk management practices, and superior corporate social responsibility.

Vision Statement

Our vision is to be the preferred financial partner to our customers, a center of career growth to our employees, and to maximize our shareholders' value, while contributing to our nation's financial sector and to its economic welfare.

Brief Introduction of Machhapuchchhre Bank Ltd. (MBL)

Machhapuchchhre Bank Limited was registered in 1998 as the first regional commercial bank to start banking business from the western region of Nepal with its head office in Pokhara. Today, with a paid up capital of above 1,314 million rupees, it is one of the full fledged commercial bank operating in Nepal; and it ranks in the topmost among the private commercial banks.

Machhapuchchhre Bank Limited is striving to facilitate its customer needs by delivering the best of services in combination with the state of the art technologies and best international practices.

Machhapuchchhre Bank Limited is the pioneer in introducing the latest technology in the banking industry in the country. It is the first bank in Nepal to introduce centralized banking software named GLOBUS BANKING SYSTEM developed by Temenos NV, Switzerland.Currently it is using the latest version of GLOBUS,referred as T-24 Banking System**.** The bank provides modern banking facilities such as Any Branch Banking, Internet Banking and Mobile Banking to its valued customers.

The bank in the last few years have really opened up with branches spread all around the country. At this stage, it has its Corporate Office in Kathmandu and branch offices in other parts of Kathmandu, Damauli, Bhairahawa, Birgunj, Banepa, and different parts of Pokhara in addition to the Head Office in Naya Bazar, Pokhara. A full-fledged banking branch is in operation in Jomsom located high up in the mountains too. The bank aims to serve the people of both the urban and rural areas. The bank intends to open many more branches in the coming years and have planned to open more than 4 branches in the year 2009/10.

1.2 Statement of the Problem

Banking industry has always seemed a profitable, charming and glamorous in the eye of everyone (layman) since its inception. They are assumed to yield high rate on invested assets with the net profit of the whole commercial banking system of Rs. 7,330.72 million in Mid January 2011. However, unlike general perception, the industry is threatened with immense challenges and competition to sustain and outpace those within the industry, mainly due to rising competition among commercial banks in addition to weakening economic situation of the country, indicated by the GDP growth rate of 3.50% the fiscal year 2067/68 B.S.

Presently, we are even witnessing many serious liquidity crises in the market and other credit related inefficiencies that has had seriously hit the market, even threatening the existence of those banks. Thus, NRB has recently announced a special refinancing scheme to banks and financial institutions to manage liquidity as per its circular no. 27 dated 2068/03/13 bearing reference no. 27/0387/068. However, these loans become due on six month from the date of refinance/interbank borrowing obtained and must be paid off with accrued interest thereon at 7% interest rate. Similarly, the banks and financial institution obtaining such loans are restricted to transact interbank borrowing and other similar facilities such as Credit Sale etc unless the earlier such transactions are settled.

Similarly, embracing liberalized policy on entrant of foreign banks to operate their branch in Nepal without joint venture of Nepalese investors has threatened existing indigenous banks and financial institution. This has resulted in increased pressure for Nepalese commercial banks to compete with foreign banks. Additionaly, commercial

banks are compelled to increase their paid up capital to Rs. 2 billion by Chaitra End 2068 has challenged most of the commercial banks in Nepal. Pertaining to it, few banks such as Bank of Asia, KIST bank, Sunrise Bank and Prime bank were not able to meet the ceiling and were in process to issue right share or auction their unsold shares and comply to regulating authority. Banks not complying it shall be penalized according the directive.

Major problem of the banking sector in Nepal is the Credit Risk. Poor lending practices, which are indicated by poor financial analysis of borrowers, inadequate or substandard collateral and poor portfolio analysis, poor tracking of credit and intention of borrowers to default and also involvement of banks directors and management to use fund for their own welfare and purpose have resulted in the high amount of Non Performing Loans of major commercial banks such as Rastriya Banijya Bank Ltd (RBBL), Agriculture Development Bank, and Nepal Bangladesh Bank Limited had the excess NPL to Total Loans ratio of 11.05%, 8.12% and 14.39% respectively in the mid January 2011. Because of the high amount of non-performing loan of these banks, these banks carries high amount of accumulated loss, which is indicated by the high amount of negative retained earnings and negative capital funds.

These huge negative capital funds of two big banks namely RBB and NBL have negative impact on capital base of the Nepalese banking system. The negative capital fund of Rs. 4498.35 million of Nepal Bank Limited and Rs. 10,363.70 million of Rastriya Banijya Bank in mid January 2011 had a serious impact on capital fund of overall commercial banks.

The Non Banking Asset (NBA) is also the major problem in banking industry. Out of the total Non Banking Assets, the share of NBL, RBB and Agriculture Development bank Ltd is almost 52%. Because of this phenomenon, the management of these banks has been handed over to the foreign experts. Likewise, Lumbini Bank Limited (LBL), because of its continuous poor performance, was taken over by NRB for few years however, the management of the bank was handed over to the private sectors.

Present challenges to the banking sector are to invest the money in productive as well as new sector and to manage the accumulated non-performing loan. The non-

performing loan for entire commercial banking industry is Rs. 15,834.28 million in mid July 2011 which is 3.15% of Total Gross Loan.

Further, the introduction of new Unified directives by the NRB in 2068 B.S. has also provided the commercial banks different measures related to credit risk, interest rate risk, foreign exchange risk, liquidity risk and operation risk coupled with maintaining adequate capital to safeguard the interest of investors, depositors and shareholders. The commercial banks need to comply with these prudential's, which have also provided the challenges to the commercial banks of Nepal. Among these, the loan loss provisioning and capital adequacy measures have been providing the major challenges to Nepalese commercial banks. As per NRB Unified Directive 2068 the capital adequacy ratio is 6% on Primary capital (Core Capital) and 10% on Total Capital (Primary+Supplementary).

Likewise, implementation of Basel II from 2007 in Nepal in parallel way has also been the challenge for Nepalese Commercial Banks. Basel II is mainly concerned with the management of various types of risks and the capital framework for providing enough cushions to absorb the risk faced by commercial banks. The Basel II has categorized Nepal as the high-risk country with ECA (Export Credit Rating Agencies) rating 7. This means that the Nepalese Commercial banks assets are rated risky up to 200%. (Basel, 2005).

Machhapuchhre Bank Ltd and Kumari Bank Ltd established as 14th and 15th commercial banks in Nepal respectively are not isolated with above mentioned challenges and problems faced by the entire banking industry. More specifically, the major problems related to these banks are proper compliance of NRB Directives and international measures. NRB had instructed to then Chairmen of Machhapuchhre Bank to step down from his position as chairman in 2002. The decision was taken after the central bank's Monitoring and Supervision Department found out that the chairman was Managing Director of another company that was blacklisted by the Credit Information Center (CIC). The researcher has selected Kumari Bank Ltd. (KBL) and Machhapuchhre Bank Limited (MBL) as the samples for the study. Since their date of establishment and the size of capital are also quiet similar, these two banks are chosen for study. Both the banks are in the growing stage, but in order to

achieve their expected growth target, these banks must be able to manage the various risks, especially, the credit risk.

Therefore, within this liberalized competitive market scenario, the stringent credit risk management, compliance of NRB's prudential and Basel II are the major problems and challenges for these banks to sustain and grow in the industry.

Thus this research particularly focuses on the problem faced by the commercial banks that connects with KBL and MBL. The research is focused on

- What is the total loans and advances to total deposit ratio of the sample banks?
- What is the capital adequacy ratio of the sample banks? Had they been able to maintain the adequate capital as per NRB?
- What is the non-performing loan to total loans and advances ratio?
- What is the loan loss provision to total loans and advances ratio?
- What is the security wise loan position of the sample banks?
- What is the real estate lending position of the sample banks?
- Identification, analysis and interpretation of different types of risk particularly on credit risk.
- Credit Risk that has seriously hit KBL and MBL along with other commercial banks and financial institutions.
- Measure to avert these risk and maintain good corporate governance.

1.3 Focus of the Study

The Study basically focuses on the major credit threats and the emerging credit risks that current banks and financial institutions are exposed to. It then, explains the various measures to acquaint with the emerging threat by strictly complying to the governing body i.e. NRB and bring standard and prudential performance in the industry. Pertaining to it, the study focuses on measurement and comparison of credit risks of the selected commercial banks i.e. MBL and KBL, analysis of Credit Risk Management systems and practice followed by the Nepalese Commercial Banks by taking KBL and MBL as the sample banks, the analysis of the directives of Nepal Rastra Bank issued to commercial banks and also is focused on finding out if the

banks have taken proper measures to be adequately compensated for the credit risk they are exposed to.

1.4 Objectives of the Study

The study aims at maintaining credit safety for every commercial bank and other financial institutions as well. For this, the credit threats are examined, analyze and interpreted to various concerned authority and corrective actions and measures are listed out and the most suitable one is opted to mitigate the risk. The major objectives of the study are listed out as below.

- To examine and analyze the total loans and advances to total deposit.
- To examine and analyze the capital adequacy ratio.
- To examine the non performing loan to total loans and advances.
- To examine and analyze loan loss provision to total loans and advances ratio.
- To examine and analyze security wise loans loan classification.
- To examine and analyze real estate lending.
- To examine the credit position of the sample banks.

1.5 Significance of the Study

From the very beginning of banking era, it is responsible for the overall growth and development of economy. It pools large borrower and saver together. It makes huge investment possible from the pooled funds. Thus, proper management of credit risk is mandatory in every organization. No organization can escape from ever changing environments such as Political, Economic, Social, and Technological that keeps on threatening. The success of any organization largely depends on how efficiently funds are being managed, its good portfolio and its ability to manage various risks. Banking sector involves several risks, which need to be handled promptly for the survival and growth. As this research focuses on analyzing credit risks and their management in reference to NRB directives and measures, it will provide valuable insight to different stakeholders about the major problems of banks and bank's action for its management. The research has its significant to various stakeholders as listed below.

- To banks and financial institutions licensed and governed by NRB. Their officials and higher management to take credit related decisions and correct their earlier mistakes. Also, this research highlights the major NRB guidelines related

to credit to mitigate risk. This in turn helps the banks and its officials to perform better and comply to guidelines provided by NRB.

- To various individuals who has direct or indirect relation or transaction with the banks and financial institution. Poor lending leads to failure, thus individuals are careful in depositing their life time savings to those institutions who have properly managed their portfolios and have minimal credit risk shown by minimal or no bad loans, adequate capital reserves and liquidity etc.
- To the governing body to tighten the existing guidelines to avoid loopholes that institutions keep on playing. Further, provide insight and envisage policymaker on emerging credit risk identification to smooth the current liquidity crisis and help problematic banks and financial institutions.
- To Investor, Creditor, depositor & borrower. The Investor, Creditor and depositor can collect, interpret and analyze data and make appropriate decision on whether to invest on particular organization or not. Depositor with these measures can make decision on depositing their lifelong saving on sound organization. Borrower can evaluate the organization and decide to borrow the funds from organization having lower cost of fund thereby minimizing their own cost itself.

1.6 Limitations of the Study

The study is based on sole research and analysis made by sole individual. Various journal and articles extracts has been the addendum. Thus the reliability of the research largely based upon the directives, journal, articles and newspapers. Management, resource mobilization and time constraints limit the in-depth study of all commercial banks operating except commercial banks under study.

- Primary data especially through personal interview, Financial disclosure and questionnaire. Moreover, the primary data are collected during the period of February 2011 to June 2011. Therefore, any changes in the general view, concepts and behavior of the people before and after the period are not included in the study. Therefore, the accuracy of results and conclusions highly depends on the reliability of these facts and the time and situation of data collection.

- The evaluation is made through the analysis of financial statement published and presented by the banks. Therefore generalization of the whole banking industry cannot be made.
- The secondary data of only five years are taken i.e. from 2008/09 to 2009/10. Inaccessibility of sufficient information also limit the conclusion drawn from study.

1.7 Organization of the Study

The study organized in following manner:

Chapter I is the introductory part of the study. This chapter describes the general background of the study, focus of the study, statement of the problem, objectives of study and limitations of the study.

Chapter II includes a discussion on the conceptual framework and review of the related and pertinent literature available. The conceptual considerations and review of related literature conducted in this chapter provides a framework with the help of which the study has been accomplished.

Chapter III describes the research methodology employed in the study. In this chapter, research design, nature and sources of data, methods of data collection and tools and techniques of data analysis are discussed.

Chapter IV consists of presentation and analysis of data, which deals with the empirical analysis of the study and the major findings of the study.

Chapter V is the summary, conclusion and recommendations of the study.

CHAPTER - II

REVIEW OF LITREATURE

The researcher has reviewed various related studies and NRB directives for the study. Firstly, the review on the concept the risk and credit risk management is briefly discussed as below:

2.1 Conceptual Review

2.1.1 Meaning of Risk

Risk is the potential that a chosen action or activity will lead to a loss (an undesirable outcome). The notion implies that a choice having an influence on the outcome exists (or existed). Potential losses themselves may also be called "risks". Almost any human endeavour carries some risk, but some are much more risky than others. In other words Risk is the difference for what we expect and what actually happens. In financial term, Risk can be defined as the possibility of deviation of actual return from the expected return. Kupper (2000) defines risk as the volatility of corporation's market value. Risk management, on the other hand, is the process of measuring or assessing risk and then developing strategies to manage risk. The strategies used can be transferring the risk to another party, avoiding the risk etc. It can also be defines as the attempt to minimize the possible losses that can occur.

2.1.2 Meaning of Credit

A contractual agreement in which a borrower receives something of value now and agrees to repay the lender at some date in the future, generally with interest. The term also refers to the borrowing capacity of an individual or company. In other words, The amount of money available to be borrowed by an individual or a company is referred to as credit because it must be paid back to the lender at some point in the future. For example, when you make a purchase at your local mall with your VISA card it is considered a form of credit because you are buying goods with the understanding that you'll need to pay for them later.

2.1.3 Risk Profile that Banks and Financial Institution are Exposed to

Banks and financial institution are exposed to different types of risks. According to Basell 2007, the risk banks and financial institutions are exposed to are basically Credit Risk, Operational Risk, Market Risk, Credit Concentration Risk, Liquidity Risk and Other Risk. Credit risk being one of the major risk hold significant review and analysis. The different risk is listed and discussed below.

A. Credit Risk

Credit risk is an investor's risk of loss arising from a borrower who does not make payments as promised. Such an event is called a default. Another term for credit risk is default risk.Investor losses include lost principal and interest, decreased cash flow, and increased collection costs, which arise in a number of circumstances. Credit risk is the major risk that banks are exposed to during the normal course of lending and credit underwriting. In other term, The risk associated for nonpayment of interest and principal for credit facilities extended to the clientele is CREDIT RISK. In general term, Risk is deviation of what we expect to what actually happens. Banks and financial institution extend credit facilities (Loans and Advances) to its customers in a return for Interest accrued thereon. Bank and financial institution grants loans and advances to different borrowers taking calculated risk. Pertaining to it, sometimes the calculated risk does fails and the borrower defaults. This is what we call credit risk.

B. Market Risk

- Market risk is defined as the risk of losses in on-balance sheet and off-balance sheet positions arising from adverse movements in market prices. The day-to-day potential for an investor to experience losses from fluctuations in securities prices. This risk cannot be diversified away. The major constituents of market risks are:
- The risks pertaining to interest rate related instruments;
- Foreign exchange risk (including gold positions) throughout the bank; and
- The risks pertaining to investment in equities and commodities.

i. Liquidity Risk

The risk stemming from the lack of marketability of an investment that cannot be bought or sold quickly enough to prevent or minimize a loss. In finance, liquidity risk is the risk that a given security or asset cannot be traded quickly enough in the

market to prevent a loss (or make the required profit). Liquidity risk arises from situations in which a party interested in trading an asset cannot do it because nobody in the market wants to trade that asset. Liquidity risk becomes particularly important to parties who are about to hold or currently hold an asset, since it affects their ability to trade.

ii. Interest Rate Risk

The risk that an investment's value will change due to a change in the absolute level of interest rates, in the spread between two rates, in the shape of the yield curve or in any other interest rate relationship. Such changes usually affect securities inversely and can be reduced by diversifying (investing in fixed-income securities with different durations) or hedging (e.g. through an interest rate swap). Interest rate risk affects the value of bonds more directly than stocks, and it is a major risk to all bondholders. As interest rates rise, bond prices fall and vice versa. The rationale is that as interest rates increase, the opportunity cost of holding a bond decreases since investors are able to realize greater yields by switching to other investments that reflect the higher interest rate. For example, a 5% bond is worth more if interest rates decrease since the bondholder receives a fixed rate of return relative to the market, which is offering a lower rate of return as a result of the decrease in rates.

iii. Foreign Exchange Risk

The risk of an investment's value changing due to changes in currency exchange rates. The risk that an investor will have to close out a long or short position in a foreign currency at a loss due to an adverse movement in exchange rates. Also known as "currency risk" or "exchange-rate risk". This risk usually affects businesses that export and/or import, but it can also affect investors making international investments. For example, if money must be converted to another currency to make a certain investment, then any changes in the currency exchange rate will cause that investment's value to either decrease or increase when the investment is sold and converted back

C. Operational Risk

2technology systems or events such as major fires or other disasters.

2.2 Review on Unified Directive 2068 Related to Credit Risk

The Unified Directive 2068 issued by NRB has great impact on every commercial banks and financial institutions. This unified directive brings every bank at par and complies to its rules and regulation. Besides this directive NRB keep on issuing circular for newer regulation and including addendum and replace of earlier directive. The directives issued over the time are the tools used by the central bank to control and monitor banks and financial institutions. This directive attempt to regularize prudential regulation on every banks and financial institutions and have proven an effective control mechanism for overall regulation. The credit related directive are discussed briefly below:

2.2.1 Directive No. 1-Capital Adequacy Ratio (Basel Implementation)

Capital Adequacy is to maintain sufficient capital fund or shareholders equity to make investment in risk weighted exposure or assets. Every "A", "B", "C" & "D" categorized banks and financial institutions must maintain certain percentage of their total risk weighted exposure as a capital requirement. This has been derived from the Basel. It is one of the most effective tools implemented by NRB in order to check and minimize risk. The total risk weighted asset, on the other hand, includes both on & off balance sheet items, which has been rated from 0% risk to 150% risk. Mathematically we obtain Capital Minimum capital fund by dividing Total Capital fund by Total Risk weighted exposure.

Mathematically,

Minimum Capital Fund Required= $\frac{Total\ Capital\ Fund}{Total\ Risk\ Weighted\ Exposure}$

Table 2.1

Capital Fund Requirement

Institution	Minimun Capital Reserve as per Risk Weighted Exposure	
	Primary Capital	Supplementary Capital
"A" class	6%	10%
"B" & "C" Class	5.5%	11%
"D" Class	4%	8%

Source: NRB Directive

Now, Lets first Discuss what exactly a Capital Fund stands for and what are is constitutes. Capital Fund is the total capital invested by equity shareholders along with other long term capitals, reserves etc. The capital fund constitutes of sum of two types of capital consisting of:

C. Primary or Core Capital (Tier 1)

The key element of capital on which the main emphasis should be placed is the Tier 1 (core) capital, which comprises of equity capital and disclosed reserves. This key element of capital is the basis on which most market judgments of capital adequacy are made; and it has a crucial bearing on profit margins and a bank's ability to compete. The BCBS has therefore concluded that capital, for supervisory purposes, should be defined in two tiers in a way, which will have the effect of requiring at least 50% of a bank's capital base to consist of a core element comprised of equity capital and published reserves from post-tax retained earnings. In order to rank as Tier 1, capital must be fully paid up, have no fixed servicing or dividend costs attached to it and be freely available to absorb losses ahead of general creditors. Capital also needs to have a very high degree of permanence if it is to be treated as Tier 1.

It can be listed out as below:

Table 2.2

Primary Capital

1. Paid up Equity Capital
2. Irredeemable Preference Share
3. Share Premium
4. Proposed Bonus Equity Share
5. Statutory General Reserve
6. Retained Earnings available for distribution to shareholders
7. Un-audited current year cumulative profit, after all provisions including staff bonus and taxes
8. Capital Redemption Reserves
9. Capital Adjustment reserves
10. Dividend Equalization Reserves
11. Any other type of reserves notified by NRB from time to time for inclusion in Tier 1 capital

Source: NRB Directive

D. Supplementary Capital (Tier 2)

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

It can be listed out as below:

Table 2.3

Supplementary Capital

No.	Item
1.	Cumulative and/or redeemable preference shares with maturity of five years and above
2.	Subordinated term debt fully paid up with a maturity of more than 5 years
3.	Hybrid capital instruments
4.	General loan loss provision limited to a maximum of 1.25% of total Risk Weighted Exposures
5.	Exchange equalization reserves created by banks
6.	Investment adjustment reserves
7.	Revaluation reserves
8.	Any other type of reserves notified by NRB from time to time for inclusion in Tier 2 capital

E. Risk Weighted Exposure

Every lending made by banks and financial institutions carry certain portion of risk according to the type of the borrower. Thus, the borrower are categorized and weighted according to the type of lending. Hence, total lending having provided certain weight of risk is the total risk weighted exposure. The risk weight ranges from zero to 150.

The risk weight is based on following criteria.

I. **Claims on government & central bank**

i. All claims on Government of Nepal and Nepal Rastra Bank shall be risk weighed at 0 %.

ii. Claims on foreign government and their central banks shall be risk-weighted on the basis of the consensus country risk scores as follows:

ECA risk score	**0-1**	**2**	**3**	**4 to 6**	**7**
Risk Weight	0%	20%	50%	100%	150%

II. **Claims on other official entities**

i. Claims on the Bank for International Settlements, the International Monetary Fund, the European Central Bank and the European Community will receive a 0% risk weight.

ii. Following Multilateral Development Banks (MDBs) will be eligible for a 0% risk weight. World Bank Group, comprised of the International Bank for Reconstruction and Development (IBRD) and the International Finance Corporation (IFC), Asian development Bank (ADB), African Development Bank (AfDB), European Bank for Reconstruction and Development (EBRD), Inter-American Development Bank (IADB), European Investment Bank (EIB), European Investment Fund (EIF), Nordic Investment Bank (NIB), Caribbean Development Bank (CDB), Islamic Development Bank (IDB), and Council of Europe Development Bank (CEDB).

iii. The standard risk weight for claims on other Multilateral Development Banks will be 100%

iv. Claims on public sector entities (PSEs) 4 will be risk-weighed as per the ECA country risk scores.

ECA risk score	**0-1**	**2**	**3-6**	**7**
Risk Weight	0%	50%	100%	150%

III. Claims on Banks

i. All claims, irrespective of currency, excluding investment in equity shares and other instruments eligible for capital funds, on domestic banks/financial institutions that fulfill Capital Adequacy Requirements will be risk weighed at 20% while for the rest, it will be 100%. Banks should make use of the publicly available information of the immediately preceding quarter of the respective banks to gauge their status on capital adequacy.

ii. Claims on a foreign bank excluding investment in equity shares and other instruments eligible for capital funds shall be risk weighed as per the ECA

Country risk score subject to the floor of 20%. The primary basis for applying the ECA Country Risk score shall be the country of incorporation of the bank. Where the bank is a branch office, the ECA score of the country where the corporate office is located shall be used while in the case of a subsidiary the basis shall be the country where the subsidiary is incorporated.

ECA risk score	**0-1**	**2**	**3-6**	**7**
Risk Weight	20%	50%	100%	150%

IV. Claims on corporate & securities firms

i. The risk weight for claims on domestic corporate, including claims on insurance companies and securities firm will be 100%. The domestic corporate includes all firms and companies incorporated in Nepal as per prevailing Acts and regulations.

ii. The claims on foreign corporate shall be risk weighed as per the ECA Country risk score subject to the floor of 20% as follows:

ECA risk score	**0-1**	**2**	**3**	**4 to 6**	**7**
Risk Weight	20%	50%	100%	100%	150%

V. Claims on regulatory retail portfolio

i. Claims that qualify all criteria listed below may be considered as regulatory retail portfolio and risk weighed at 75%, except for past due loans. Such claims however, have to be in strict compliance with the Product paper developed by the bank and approved by their respective board of directors.

Criteria:

Orientation Criteria

exposure is to an individual person or persons or to a small business. Bank should obtain written declaration from the borrower to the effect that their indebtedness is within the threshold across all banks and FIs.

Product Criteria

The exposure takes the form of any of the following:

- Revolving credits and lines of credit, (including overdraft, hypothecation etc.)

- Term loans and leases (e.g. hire purchase, auto loans and leases, student and educational loans6) and,
- Small business facilities and commitments,
- Deprived sector loans upto a threshold of Rs.10 million (Ten Million only)

Granularity Criteria

NRB must be satisfied that the regulatory retail portfolio is sufficiently diversified to a degree that reduces the risks in the portfolio, warranting the 75% risk weight. No aggregate exposure7 to one counterpart can exceed 0.5 % of the overall regulatory retail portfolio.

Low value Individual Criteria

The total aggregated exposure to one counterpart8 cannot exceed an absolute threshold of Rs.10 million (Nepalese Rupees Ten Million only)

VI. Claims Secured by Residential Properties

i. Lending to individuals meant for acquiring or developing residential property which are fully secured by mortgages on residential property, that is or will be occupied by the borrower or that is rented, will be risk-weighed at 60%. However, banks should ensure the existence of adequate margin of security over the amount of loan based on strict valuation rules. Banks have to develop product paper and get it approved from the board of directors to regulate this kind of lending. The claims in order to be eligible for this category have to be in strict compliance with this product paper
ii. Where the loan is not fully secured, such claims have to risk weighed at 150%
iii. When claims secured by residential properties are or have been past due**9** at any point of time during the last two years, they shall be risk-weighed at 100**%,** net of specific provisions.

VII. Claims Secured by Commercial Real Estate

i. Claims secured by mortgages on commercial real estate, except past due, shall be risk weighed at 100%. Commercial real estate hereby refers to mortgage of Office buildings, retail space, multi-purpose commercial premises, multi-family

residential buildings, multitenanted commercial premises, industrial or warehouse space, hotels, land acquisition, development and construction etc.

VIII. Past Due Claims

i. Any loan, except for claim secured by residential property, which is or has been past due at any point of time during the last two years, will be risk-weighted at 150% net of specific provision.

IX. High Risk Claims

i. 150% risk weight shall be applied for venture capital and private equity investments.

ii. Exposures on Personal loan in excess of the threshold of regulatory retail portfolio and lending against securities (bonds and shares) shall attract a risk weight of 150%. Similarly, exposures on credit card shall also warrant a risk weight of 150%.

iii. Investments in the equity and other capital instruments of institutions, which are not listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk weighed at 150% net of provisions.

iv. Investments in the equity and other capital instruments of institutions, which are listed in the stock exchange and have not been deducted from Tier 1 capital, shall be risk weighed at 100% net of provisions.

v. The claims which are not fully secured or are only backed up by personal guarantee shall attract 150% risk weight.

vi. Where loan cannot be segregated/or identified as regulatory retail portfolio or qualifying residential mortgage loan or under other categories, it shall be risk weighed at 150%.

X. Other Assets

i. With regard to other assets, following provisions have been made;

- Interest receivable/claim on government securities will be risk-weighted at 0%.
- Investments in equity or regulatory capital instruments issued by securities firms will be risk-weighted at 100%.

- Cash in transit and other cash items in the process of collection will be risk-weighted at 20%. For this purpose, cash items shall include Cheque, Draft, and Travellers Cheques.
- Fictitious assets that have not been deducted from Tier 1 capital shall be risk weighed at 100%.
- All Other assets will be risk-weighted at 100% net of specific provision.

XI. Off Balance Sheet Items

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

Table 2.4

Off Balance Sheet Exposure

Off Balance Sheet Exposure	Risk Weight
Any commitments those are unconditionally cancelable at any time by the bank without prior notice, or that effectively provide for automatic cancellation due to deterioration in a borrower's creditworthiness (for example bills under collection)	0%
Forward exchange contracts.	10%
Short Term Trade-related contingencies	20%
Undertaking to provide a commitment on an off-balance sheet items	20%
Unsettled10 securities and foreign exchange transactions between bank to bank and between bank and customer	20%
Long Term Trade-related contingencies	50%
Performance-related contingencies	50%
Long term irrevocable Credit Commitments	50%
Short term irrevocable Credit Commitments	20%
Repurchase agreements, securities lending, securities borrowing, reverse repurchase agreements and equivalent transactions	100%
Direct credit substitutes	100%
Unpaid portion of partly paid shares and securities	100%
Other Contingent Liabilities	100%

2.2.2 Directive No. 2-Classification of Loans and Advances and Loan Loss Provision

Each Loan is different. Thus Loans and Advances are classified according to the due period. A due period is a period when a borrower fails to pay his promised obligation to the banks and financial institutions. A borrower failing to pay his/her obligation for

a period more than 3 months falls under this category. The basic logic behind this is, the provisioning of specific percentage of entire loan outstanding upon failure of borrower to exercise his/her obligations. The provision amount is deducted from the profit so that the bank can utilized this sum if the borrower does not exercise his obligation and goes bankrupt. This measure or tool of NRB is very effective since certain portion of the profit is secured for contingency.

1. Classification of Loans and Advances:

a. Pass Loan

All Loan and Advances whose principal and interest payment is regular i.e. not due or if due but has not crossed 90 days falls under this category. This category requires 1% provision on outstanding balance of loans and advances.

b. Substandard Loan

Loans and Advances whose either principal or interest payment is due for more than 3 months but has not crossed 6 months falls under this category. This category requires 25% provision on outstanding balance of loans and advances.

c. Doubtful Loan

Loans and Advances whose either principal or interest payment is due for more than 6 months but has not crossed 1 year falls under this category. This category requires 50% provision on outstanding balance of loans and advances.

d. Bad Loan

Loans and Advances whose either principal or interest payment is due for more than 1 Year falls under this category. This category requires 100% provision on outstanding balance of loans and advances.

- Pass Loans and advances are called Performing loans whereas Substandard, Doubtful and Bad loans are called non-performing loans and advances.

2. Additional arrangement for Pass Loan

I. Following Loans and advances can be considered as Pass Loan

a. Loans and advances that are fully secured by bullions (Gold, Silver).
b. Loans and advances that are fully secured by Fixed Deposit Receipt.

c. Loans and advances that are secured by government securities or NRB issued Bonds.

But, if the government securities and NRB issued Bonds are pledged as secondary collateral those loans and advances must be provisioned on the basis of ageing as shown above 1

II. Working Capital Loans having maturity of one year can be classified under pass category if renewed. If interest is due on those loans then it must be categorised on the basis of due days of interest.

3. Additional arrangement for Bad Loan

Even if the loan is not past due, loans and advances showing following characteristics are considered as Bad Loan

a. Market value of collateral insufficient to cover loan amount.
b. Declared Bankrupt of Borrower.
c. Borrower missing or absconding
d. Non-funded facilities including bills purchased converted into funded facilities but not yet recovered within 90 days.
e. Misuse of Loans
f. If Non recovery of loan succeeded by auction process exceeds 6 months or recovery of loans under litigation process.
g. Loans and advances extended to Black listed borrowers.
h. Project and business under threat of operation.
i. Exceed of 90 days for credit card loan.
j. Overdue Trust Receipt Loan

4. Additional Arrangement for Term Loan

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

5. Principal and Interest cannot be recovered by overdrawing the account of the customer

6. Rescheduling and Restructuring of Loan

Banks may reschedule or restructure such loans upon receipt of the written plan of action from the borrower citing the following reasons.

i. Evidence of adequate collateral and documentation regarding Loans.
ii. An evaluation of the borrower/ enterprise's management with particular emphasis on efficiency, commitment and high standards of business ethics.

To reschedule or restructure the loans, it is mandatory that at least 25% of past due interest up to rescheduled or restructured date should be paid by the borrower. If all interests have been recovered before renewal of loans, it can be categorized into Pass Loan.

2.2.2.1 Loan Loss Provisioning

1. The following are the provision percentage.

Table 2.5

Loan Loss Provisioning

Pass Loan	1%
Substandard	25%
Doubtful	50%
Bad	100%

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. Loan Loss Provisioning in respect of reschedule, restructured or swapped loan.
   a. For rescheduled/restructured loan, loan loss provision should be at least 12.5%.
   b. In case of rescheduling or restructuring or swapping of insured or guaranteed priority sector credit, the loan loss provisioning shall be provided at one fourth of the percentage mentioned in clause (a)
   c. If interest and principal of rescheduled/restructured loans have been served regularly for two years, such loans can be converted into "Pass Loan" Category.

2.2.3 Directive No. 3 (Single Obligor Limit and Sector wise Lending)

1. Single Obligor Limit

This tool of NRB is effective in checking the credit concentration risk of the banks and financial institutions. Single Obligor refers to the credit facility being extended to single person, firm, company or a group of the borrowers, meaning that banks and financial institutions are provided certain threshold to extend credit facilities. Banks and financial institutions and extend credit facilities including fund based and non fund based facility to the tune of 25% of the Primary Capital.

2. Credit facility extended to Hydropower, Transmission Line and Cable car operation

The single obligor limit, however, does not hold 25% threshold in sector like Hydropower development, transmission line and cable car operation. Banks and financial institutions can extend credit facilities including fund based and non fund based facility to the tune of 50% of the Primary Capital.

3. Exception on Limit of Credit Facility

Banks and financial institution need not comply to above mentioned threshold in following circumstances.

a. Loans and advances extended by fully securing it by Fixed deposit receipt, government securities and government bonds, guarantee provided by multilateral banks, International Monetary fund and
b. Loans and advances extended to Nepal Oil Corporation, Nepal Food Corporation.

4. Interrelation between borrowers shall be kept under same group.

a. If a company or a person holds 25% of more share of another company comes under same group.
b. Member of Same group, firm
c. Personal guarantee provided by a person, company to another person or company.
d. Credit facility extended to different borrower from same collateral.

5. **Sector wise Lending**

This tool of NRB checks sector concentration risk. If banks and financial institutions keeps on extending credit facilities to same sector and if unfortunately the sector has no profitable future, then a bank and financial institutions existence comes into threat. Thus this risk must be checked.

6. **Arrangement for Real Estate Lending**

This tool of NRB has proven to be one of the best tools. We have been witnessing a serious problem in real estate sector form past few years. The real estate sector were booming and the price hike was everywhere by brokers and investors investing in it. NRB according to its circular have made below mentioned provisions under real estate lending.

a. Loans and advances extended to this sector can lend only 60% of fair market value of the properties mortgage in favor of the bank to avail credit facilities.
b. Following threshold is defined and shall be maintained within the prescribed date.

Table 2.6

Real Estate Arrangement

<table>
<tr><th>Topic</th><th>Asadh 2068</th><th>Asadh 2069</th></tr>
<tr><td>(a) Residential Real Estate</td><td rowspan="3">Maximum of 30% of Total Loans and advances</td><td rowspan="3">Maximum of 25% of Total Loans and advances</td></tr>
<tr><td>(b) Commercial Complex & Residential Apartment Construction Loan</td></tr>
<tr><td>(c) Construction Completed & Revenue Generating Commercial Complex</td></tr>
<tr><td>(d) Other Real Estate</td><td rowspan="4">Maximum of 15% of Total Loans and advances</td><td rowspan="4">Maximum of 10% of Total Loans and advances</td></tr>
<tr><td>1. Land Purchase & Plotting Loan</td></tr>
<tr><td>2. Loan of NPR 5.00 million and above without specified Reason (personal Loan, Mortgage Loan, Flexi Loan)</td></tr>
<tr><td>3. Others</td></tr>
<tr><td>Total (a+b+c+d)</td><td>Maximum of 30% of Total Loans and advances</td><td>Maximum of 25% of Total Loans and advances</td></tr>
</table>

2.2.4 Directive No. 17 (Deprived Sector Lending)

NRB has created provisions for every banks and financial institutions to create deprived sector lending so as to promote deprived sectors. Banks and financial

institutions are penalized if not met minimum criterion/threshold on this lending. The minimum criterion/threshold set for various licensed institutions are as below:

Licensed Institutions	Required % of Out. Loans and Advances
"A" Class Licensed Institutions.	3%
"B" Class Licensed Institutions.	2.5%
"C" Class Licensed Institutions.	2%

For this purpose, NRB has defined deprived sector as less earning Individuals, socially deprived womens, Dalits, Blinds, Deafs, Differently able people etc..

This minimum criterion/threshold shall be met by banks and financial institution after successful operation of 1 year.

Following direct investment made on loans and advances are eligible for contribution on deprived sector.

a. Deprived or less earning individuals, micro finance etc.
b. Micro Hydropower Project producing less than 50KW electricity, Solar Home System, Solar Cooker, Solar Dyer, Solar Pump, Biogas, Improved Water Mill, Improved Cook Stoves and wind energy.
c. Lending under tri-party arrangement involving manpower agency, foreign employment seeking individuals and banks for threshold up to 150,000.00
d. Reserve created by NRB on Youth and small entrepreneurship.
e. Other small and micro finance projects.

Following indirect investment made on loans and advances are eligible for contribution on deprived sector.

a. Lending made to "D" class licensed institutions and other small credit co-operatives in an understanding to flow the sum lended to various deprived sectors as defined by NRB.
b. Lending made to small Farmer Co-operatives in an understanding to make small lending to various units.

2.2.5 Directive No. 11 (Consortium Loan Financing)

a. Definition: Loans and advances availed to a borrower, Firm, Company or Project under consensus agreement between participating licensed banks and financial institution is called Consortium Loan Financing.

b. About Consortium: Borrower, Firm, Company or Project can only make banking transaction from Lead or participating bank to use the consortium loan. The same is applicable to Loose consortium.

   A Project financed by two or more banks without forming consortium group/bank under paripasu collateral arrangement is called Loose Consortium.

c. Required Conditions/Covenants:

   i. Banks and Financial institutions licensed by NRB can only participate as a consortium banks and financial institutions.

But, Provident Fund, Citizen investment trust and Insurance companies can also participate or become a lead bank under consortium loan arrangement.

   iii. If any institutions are participated beside one stated in section "c", NRB must be notified .

d. Other Institution granting loan and open account:

   i. No additional loans and advances shall be granted to the borrower by non participating banks and financial institution. However, in case of urgency or contingency such loans that add up to existing consortium loan is allowed.

   ii. The borrower, firm, company and project is not allowed to open accounts on non participating banks and financial institutions. However, in case of urgency or contingency such account operation is allowed.

e. Disbursement of Loans and Timing: Once the application for consortium loan is filed and consortium banks are formed, the consortium banks and financial institutions must decide whether the applied loans and advances shall be availed or not by within 90 days.

f. Selection of Consortium Banks: The selection of Consortium banks can be made by the borrower itself and the lead bank where borrower has applied consortium loan for.

   But, once the consortium banks are formed, no new participating bank can entry without approval from existing consortium bank's decision.

g. Selection of Lead Bank: Bank or financial institution granting highest share in loans and advances among the participating bank, experience in handling consortium loans can have long relationship with the client/borrower is selected as the lead bank.
h. Disbursement of Loans and advances must be carried out via lead bank. Same is applicable in settlement issues. If settlement is possible in partial basis then the settlement is carried on proportionate basis.
i. Duties and Responsibilities of Lead Bank.
   - Act as an agent for consortium participating banks.
   - Co-ordinate between consortium banks and act as correspondent.
   - Call Consortium meeting at least once in every three months.
   - Call consortium meeting in contingency or urgency within 15 days.
   - Meet short term need of the borrower.
   - Collect and proceed for required documents for extending credit to borrower.
   - Make arrangement for required collateral mortgages.
   - Safe Keeping of all security documents obtained from borrower.
   - Collect, interpret and disseminate all information, financials obtained from borrower to consortium participating banks.
   - Make effort in any litigation issues.
   - Collect information from Credit information centre.
   - Act according to the NRB guidelines in this issues.
j. Decision of Majority shall be respected.
k. Duties and Responsibilities of Participating Bank
   - Provide consent letter for processing of consortium Loans.
   - Participate in consortium meeting.
   - Act as per the covenants of consortium decision.
   - Provide timely transfer of funds after disbursement of participating banks portion.
   - Implement decision led by consortium meeting.
   - Provide services according to consortium facility agreement to borrower.
l. Provide additional loans and advances to borrower with agreed covenants and according to decision of consortium meeting.

m. Withdrawing share from Consortium Banks: No banks and financial institution can withdraw their share from the agreed share before the successful operation of the project. If any participating banks and financial institutions desires to take share of the withdrawing bank after successful operation of project, then the withdrawing bank can exit from the consortium group.
n. Appointment of Auditor and Consultant: Consortium banks and financial institutions can appoint an auditor and consultant in favor of them. The fees shall be paid proportionate to loans and advances extended to the borrower.
o. Provide Reports to regulatory authority in timely manner.

2.3 Review of Related Studies

2.3.1 Review of Articles and Journals

Now, Let's discuss and review the various articles and Journals form various pioneers, firms, committee and organization. Santomero (1997) has analyzed the various risk faced by commercial banks. According to him, the major risk of commercial bank included credit, market risk, interest rate risk, counterparty risk and liquidity risk. He has categorized this risk into following categories:

i. Risk that can be eliminated by simple business practices.
ii. Risk that must be actively managed at the firm level
iii. Risk that can be transferred to other participants

According to Basel Committee of Bank Supervision banks and financial institutions are exposed to multitude of risk in their regular process of lending, where credit risk is the one of the most important part and needs to be look after. Basel II recognizes that banks can face a multitude of risks, ranging from the traditional risks associated with financial intermediation to the day-to-day risks of operating a business as well as the risks associated with the ups and downs of the local and international economies. As a result, the new framework more explicitly associates capital requirements with the particular categories of major risks that banks face. The Basel Committees on Banking Supervision's (BCBS) recommendations on capital accord are important guiding framework for the regulatory capital requirement to the banking industry all over the world and Nepal is no exception. Realizing the significance of capital for ensuring the safety and soundness of the banks and the banking system, at large, Nepal Rastra Bank (NRB) has developed and enforced capital adequacy requirement

based on international practices with appropriate level of customization based on domestic state of market developments. The existing regulatory capital is largely based on the Basel committee's 1988 recommendations.

Sharma (2002) states that NRB has instructed to then Chairman of Machhapuchchhre Bank to step down from his position, as chairman. The decision was taken after the central bank's Monitoring and Supervision Department found out that the chairman was the Managing Director of another Company that was blacklisted by the Credit Information Center Ltd (CIC). The decision goes by the latest directives of the central bank, which clearly states that no person involved in the firms blacklisted by the CIC, will be allowed to hold a sensitive and responsible post in the Board of Directors of Financial Institutions.

Irony to this action of NRB, the then chairman claims that the blacklisting of the said company was done only in 1998 and he was associated with that company only until 1996. Hence, he opined that he need not step down of his position as chairman and that NRB was wrong in instructing to him to do so.

NRB guidelines in some cases are found vague. These vagueness and ambiguous policy has been manipulated in different terms by banks and financial institution to take decision in their favor. Thus, NRB must attempt to bring more strict guidelines and policy to effectively control. Here, this article failed to give a clear picture on what exactly happened after the instruction of NRB. This article highlights the importance of compliance with the directives issued by NRB.

Lawrence (2nd Quarter, 2006) has taken Basel II as a big opportunity for risk management. There are three stages in the credit process: the first is the simple risk control of the business avoiding being over concentrated in any one sector, estimating the probability of defaulting and assessing recovery, In emerging markets, such as China, collection and recovery processes have to be better understood. The legal governance structure of liens has to be improved and this will come in time with the new legal regulations being legislated. However, banks cannot afford to count on the legal system as has been painfully learnt from the Netting cases or the sovereign jurisprudence. These are operational risks that must be taken care of.

The second phase is the link between economic capital and return. Clearly banks would like to set minimum rates of return they expect to earn on their portfolios after provisioning. The link between economic profit and risk is the next stage in advancing the practice of credit risk management.

Finally, the third stage is when risk management is used as a strategic management tool to align Risk Adjusted Return on Economic Capital (RAROC) with ROE.

In most emerging markets, where many commercial banks have been protected from foreign banking invasion, the landscape is now changing. In Malaysia, new legislation will allow regional banks to bank locally and in China, the new foreign bank regulations will allow investment banks, commercial banks and fund managers to enter the market, putting stress on the current "big four" oligopolistic structure. It is precisely in emerging markets where Basel II is an invaluable tool to go through the three stages set out above. This regulation is thus an important catalyst to implement all processes including analytic modeling-this includes better predictability of probability of default, exposure at default and loss given default-the business architecture that goes with it including the right corporate governance, the organization, the risk monitoring and reporting.

Banks that fail to have deep understanding of credit risk management will continue being caught in the time warp of the old banking paradigm and be targets for acquisitions by larger banks that have stronger risk management policies in place. The only key to survival and sustainable success is to reengineer and reform the risk strategy that maximizes shareholder value. It would thus be fallacious for the CEO to think of Basel II as just a compliance issue but he should rather use it as an opportunity to really get on top of using risk management as a cornerstone of strategic decision making.

2.4 Review of Thesis

Dhakal (2011) has written dissertation on "*A study on Credit Risk Management of Standard Chartered Bank (SCB) and Rastriya Banijya Bank (RBB) "*. This thesis has some practical implication because she has attempted to compare a private sector bank and government sector bank and its performance. Standard Chartered Bank has

been able to manage its credit risk and is the number one bank in Nepal. Non-Performing Loans of almost 0% has shown its mastery in managing credit risk. The other counterpart, Rastriya Banijya Bank Ltd, on the other hand has 9.81% of Non-Performing Loans to total Loans, this indicated that the government sector bank is not doing well in minimizing credit risk mitigation. The basic findings of this study is, SCB being one of the most prudently and well managed commercial banks in Nepal, this bank has adopted and complied each and every policies and guidelines issued by the central bank. It has its own lending policies and practices which keeps itself far better than other commercial banks in Nepal. Her major objectives of the study are:

- To find the status of growth of non-performing loan, total loan and loan loss provisioning of the respective banks.
- To analyze the lending portfolio i.e. concentration and sector wise lending
- To find out the portfolio of investment in government sector.
- To find out the risky and low risk weighted asset of the bank.
- To find out relationship between total deposits and total lending

Her major finding of the study are:

- The researcher has conducted with objective spirit of analyzing credit risk management of Standard chartered Bank Nepal Ltd and Rastriya Banijya Bank Ltd with respect of analysis of NPL, Portfolio management (Sectorwise lendign) position of risk weighted assets, investment in government securities and status of Margin lending
- Although both bank has decreasing trend of NPL, RBB has higher NPR as compared to SCBNL which has affected its capital base.
- Both Sector has high percentage of lending in other sector. This means they have not invested in sector as explicitly listed by NRB, meaning that the fund has not been mobilized in economy booming sectors.
- Capital adequacy of SCBNL is comparatively good than that of RBB.

Maharjan (2010) has written thesis on "*Core Risk in Banking", CRM*. According to her credit has been the major source in developing economy and has substantial risk, thus needs to be controlled in time.

Her major objectives of the study are:

- To evaluate better policy and procedural guidelines that the bank should follow to lessen the credit risk
- To collect the opinion for effective credit management of BOK and NIC.
- To analyze and interpret guidelines and policies issued by NRB in line with controlling the credit lending of banks and financial institution.

Her major finding of the study are:

- Credit has been the major use of total fund of both th banks. In average BOK has mobilized 67.01% of its Total Assets to that of NIC having utilized 71.89% of total asset.
- The Non performing credit in total credit amount is in decreasing trend in both the banks. The non performing credit has occupied 2.67% of the total credit in BOK & 1.85% in NIC on an average.
- In average the substandard credit, doubtful credit and credit loss has covered 28.38%, 13.53%, 58.09% of the total credit respectively in BOK while 8.55%, 14.15% & 77.17%. of the total credit has been occupied by substandard, doubtful and loss respectively by NIC.
- Credit risk of BOK seems higher than that of NIC as a result of BOK keepin credit loan loss provision higher than NIC in respect to total credit.
- BOK has been more dependent in single borrower than NIC. The average exposure to single borrower to total credit of BOK is 2.85% and that of NIC is 2.33%.
- The pace of decrease in doubtful credit will be higher than other in the forth coming fiscal years in BOK.

Khadgi (2010) has written thesis on *"A Study on Credit Risk Management of Nepal Investment Bank Ltd"*. She has also attempted in describing the various risk involved in the banking operation and credit risk being one of the most important one.

Her major objectives of the study are:

- To analyze the credit procedures of the banks and recovery status and control over the credit portfolio.
- To find out credit quality portfolio faced by the banks.

- To provide suitable recommendation & suggest additional measures for improvement of credit risk management.

Her major findings of the study are:

- Liquidity Ratio: The cash and bank balance to total deposit of NIBL is fluctuation during the study period. The mean ration is 0.093 times in the study period.
- Asset Management Ration: Loans and advances to fixed deposit ratio are increasing trend in overall. The mean ratio is 2.9432 time at the research period. The total loan & advances to total deposit ratio of NIBL is in increasing trend. The average mean ratio of NIBL is 0.718 times in the study period.
- Leverage Ratio: The debt to equity ratio of NIBL is in increasing trend during the thesis period. The average mean ratio is 14.24 times.
- Profitability Ratio: The total net profit of NIBL is in increasing trend
- Lending Efficiency ratio: The loan loss provision to total loans and advances ratio of NIBL is in decreasing trend. The highest ratio is 3.11% in year 2004/5 and lowest in 2007/8 with 1.93%. The mean ratio of the study period is 2.73%

Regmi (2009) Central Department of Economics) have written thesis on "*the Credit risk",* he attempted to describe, analyze, interpret various credit risk associated with banks and financial institutions. He also described the various other risks involved in operating banks and financial institutions. His thesis to some extent had a broader concept and aspects than other the researcher looked at. He also attempted to coincide the then directives issued by the NRB in monitoring and managing the credit risks of the banks.

He emphasized that, the banks and financial institutions must strictly comply to the directives and policies issued by the NRB. However, the policy and directives issued by the NRB are itself vague and ambiguous which do not give a clear picture and thus provides room for manipulation. The major findings of the study are:

- The major problems in credit risk are related to the broad areas of concentrations, credit processing and market and liquidity sensitive credit exposures. From his analysis on primary data, it is found that the majority of the

banks have emphasized on lending. Hence, too much concentration on lending has degraded and eliminated other functions of commercial banks and hence complimented on poor lending practices.

- Similarly, lack of systematic and thorough credit processing is also the major source of credit risk in these banks. The problems in credit processing include lack of thorough credit assessment, absence of testing and validation of new lending techniques, subjective decision-making by senior management, lack of effective credit review process, failure to monitor borrowers or collateral values, and failure of banks to take sufficient account of business cycle effects.

However, the thesis has serious problems as well. The researcher has attempted to write thesis on credit risk mitigation and hence discussed various tools as advised by NRB vide its directive, 2068. But the researcher has failed where actually a problem is and what are the measures to control and correct them. Only directives, issued by the NRB is not sufficient to control and monitor credit risk. The banks and financial institutions itself create some lending policies and risk management departments that constantly monitors total and marginal credit risk from each new lending.

Tiwari (2006) has written thesis on "*A Study on Credit Management of Himalayan Bank Ltd*." emphasizing credit risk as one of the significant risk. The basic objective of the study is to have insight into the credit management aspects of the HBL. This aim to examine the efficiency, effectiveness in lending policy.
His major objectives of the study are:

- To examine the impact of deposit in liquidity
- To analyze the portfolio behaviour of lending and measuring the ratio of loans and advances made in different sector
- To examine the asset management effectively.
- To analyze the lending effectively of the bank.

His major findings of the study are:
Though the optimal standard of current ratio should be 2:1 for convention measure of liquidity it is not appraisable on banking . The credit to private sector to the credit rate shows the high intensity of bank investment in private sector. Investment to total

loans and advance & investment ratio shows the better practice of HBL in investment to safe asset to that on risky assets. The interest income to total income ratio shows the dependency ratio. The interest income to interest expenses ratio is higher i.e. mean 2.0484. The lending seems consistent and seems effective. The considerable decrease in loan loss provision shows.

CHAPTER – III

RESEARCH METHODOLOGY

3.1 Introduction

Research is the process of a systematic and in-depth study or search of any particular topic, subject or area of investigation backed by the collection, complication, presentation and interpretation of the relevant details or data. It is a careful search or inquiry into any subject matter, which is an endeavourer to discover or find out valuable facts, which will be use full for further application or utilization. The research that involved the discovery of new techniques, a modification of old concepts or a knocking off an existing theories, concepts and techniques. It may develop a hypothesis and test it by establishing relationship between different variables and identify the means for problem solving.

Research methodology describes the methods and process applied in the entire aspect of the study. The main objective of this research is to measure the credit risk of the selected commercial banks and to study the various management techniques and principles used by the Nepalese commercial banks to manage credit risk. Thus, this chapter consists of the research methodology applied in the study for the fulfillment of the stated objectives. Thus the overall approach to the research is presented in this chapter. This chapter consists of research design, sample size and selection process, data collection procedure and data procession and presentation techniques and tools.

3.2 Research Design

Research design means defining procedures and techniques which guide to study and propound ways for research work. It is an analytical as well as descriptive approach to achieve the objectives. It is the arrangement of condition for collection and analysis of data relevance to the study purpose with economy in procedure. In order to make type of research, this fulfills the objectives of the study.

The study is the blend of descriptive and analytical type of research. Historical data are used to identify and analyze the credit risk of a bank in the past period. Similarly,

management system, organizational structure and policies for mitigating the credit risk and the credit risk management procedures have been presented in descriptive form so as to identify the current status from which pitfalls can be identifies, From collection of past data and information from key informants, the credit risk management system has been analyzed and recommendations have been made for improving the credit risk management of banks, Since only two banks have been selected for the study, thesis study is a comparative study between these two banks in credit risk and their management system.

3.3 Research Population and Sample

The large group about which the generalization is made is called the population under study, or the universe and small portion on which the study is made is called the sample of the study.

Research population would be all banks and financial institutions of Nepal. Due to various circumstances it would not be possible to attempt all the number of research population regarding in this dissertation. To, convenient the research, only Kumari Bank Ltd and Machhapuchchhre Bank Ltd has been taken and a comparative study is made and considered for the research purpose. Being KBL and MBL a same entrant banks and possess a similar characteristics, I chose to put forward my research on these banks. Also, these both banks are facing similar credit risk problems and have been under pressure to continuously increasing its credit standard. Hence, these banks has been chosen as a sample to better examine where the problem is and the measures to overcome those lax in credit standards. Hence, Random sampling technique is used.

3.4 Source and Type of Data

Data and information are the foundation of any study. Data may be obtained from several sources; it is not easy to list them in detail. Each research project has its own data needs and data sources. For this study, Secondary data have been taken mainly from personal interview, annual reports, auditor's reports, balance sheet, P/L account, cost detail sheet, previous thesis and other relevant published and unpublished documents related to Kumari Bank Ltd. and Machhapuchchhre Bank Ltd. For further information informal interviews were conducted with the concern authority.

3.5 Data Processing and Presentation

3.6 Method of Analysis & Presentation

Analysis and presentation of the data is the core of each and every research work. In order to get the concrete results from this research, data are analyzed by using different types of tools. Basically, following two techniques are used to explain the collected data.

Statistical Tools

The relationship between two or more variables can be measured by using statistical tools. In this study the following statistical tools are used.

Bar Diagram:

Bar diagram are one of the easiest and the most commonly used methods of presenting the numerical data. They present the data by means of bars, or rectangles of equal width. The length of the bars represents the given figures and the width may be of any size.

Mean:

The sum of all the observations divided by the number of observations is called Mean. In such cases all the items are equally important. It is usually devoted by X. It is defined by the following formula:

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

Where,

$\sum X =$ the sum of observations

N = no. of observation

Standard Deviation (S.D.)

The standard deviation is defined as the positive root of the mean of the squared deviations from their mean of a set of values. It is also known as Root Mean Square Deviation. It is usually devoted by the Greek letter δ (Small Sigma). The SD is calculated by the following formula:

SD= $\sqrt{\frac{\sum X^2}{N} - \left(\frac{\sum X}{N}\right)^2}$

Coefficient of Variation (CV):

The relative measure of dispersion based on SD is called coefficient of SD. Thus,

Coefficient of SD. $= \frac{\delta}{\bar{X}}$

100 times coefficient of SD is called coefficient of variation. It is denoted by C.V. thus,

CV = $\frac{\delta}{\bar{X}} \times 100$

Ratio Analysis

In this study, various ratios have been used as per requirement. The major ratios used in this study includes:

- Loans and advances to Total Risk Weighted Assets Ratio
- Non-Performing Loan to Total Loans and advances Ratio
- Loan Loss Provision to Non Performing Loan Ration
- Loan Loss Provision to Total Loans and Advances
- Core Capital to Total Risk Weighted Asset (RWA)
- Supplementary Capital to Total Risk Weighted Asset
- Capital Fund to Total Risk Weighted Asset (RWA)

CHAPTER- IV
PRESENTATION AND ANALYSIS OF DATA

4.1 Introduction

This chapter represents the data collected from various sources and also presents and analyzes them to measure the various dimensions of the problems of the study. This is the section where, the filtered data are presented and analyzed. This is one of the major chapters of this study because it includes detail analysis and interpretation of data from which concrete result can be obtained. This chapter consists of various calculation made for the analysis of credit risks of the sample banks. To make our study effective, precise and easily understandable, this chapter is categorized in three parts: presentation analysis and interpretation.

4.2. Ratio Analysis

4.2.1 Total Loans & Advances to Total Deposit. (Credit to Deposit Ratio)

As we are witnessing a very large lending made by banks in past few years that has created substantial liquidity crisis in market, NRB has been implementing CD Ratio to check this. As per NRB this ratio must be kept 80% or below. Many banks and financial institutions were lending above their deposit base that created serous liquidity problems in the market.

Table 4.1

Total Loans & Advances to Total Deposit. (Credit to Deposit Ratio)

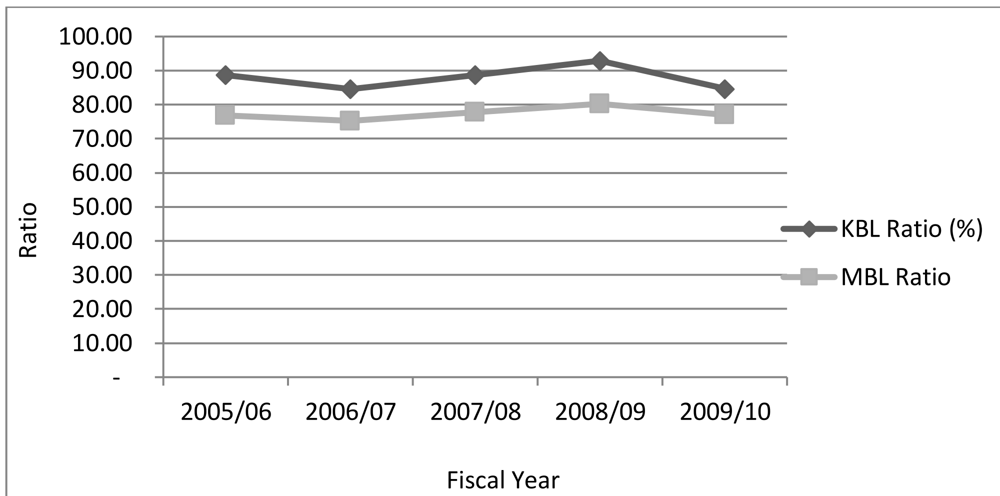
(Rs. In Million)

Fiscal Year	KBL			MBL		
	Total Loans & Advances	Total Deposits	Ratio (%)	Total Loans & Advances	Total Deposits	Ratio
2005/06	6,891.86	7,768.96	88.71	6,068.43	7,893.30	76.88
2006/07	8,929.01	10,557.42	84.58	7,129.89	9,475.45	75.25
2007/08	11,335.09	12,774.28	88.73	8,642.32	11,102.24	77.84
2008/09	14,593.35	15,710.40	92.89	12,516.01	15,596.79	80.25
2009/10	14,765.91	17,432.25	84.70	14,289.79	18,535.92	77.09
		Mean	**87.92**			**77.46**
		S.D.	**3.45**			**1.82**

Source: Annual Reports

Figure 4.1

Total Loans & Advances to Total Deposit. (Credit to Deposit Ratio)



As per the above table and figure we can see that MBL has better maintain the CD ration. But it should be noted that while calculating CD ratio Shareholders equity is added to deposit to yield true CD ratio as per the directive of NRB 2068. From above figure we can see MBL has maintain better liquidity position to that of KBL but if we consider Shareholders equity then MBL will have excess liquidity which has substantial effect on its profitability. Thus, from above we can say that MBL has maintained high liquidity and KBL has made efficient use of available resources.

4.2.2 Capital Adequacy Ratio (Basel II)

Capital Adequacy is to maintain sufficient capital fund in consideration with Total risk weighted Exposure. We know,

$$\text{Minimum Capital Fund Required} = \frac{Total\ Capital\ Fund}{Total\ Risk\ Weighted\ Exposure}$$

Table 4.2

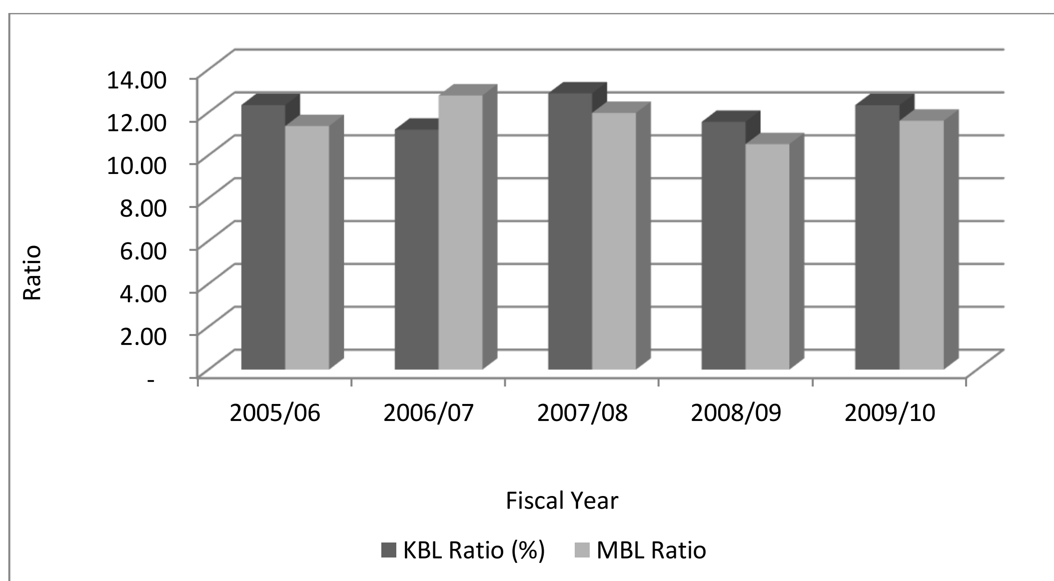
Capital Adequacy Ratio

Fiscal Year	KBL			MBL		
	Total Risk Weighted Exposure	**Total Capital Fund**	**Ratio (%)**	**Total Risk Weighted Exposure**	**Total Capital Fund**	**Ratio**
2005/06	7,625.05	940.98	12.34	6,063.13	688.84	11.36
2006/07	9,959.91	1,115.21	11.20	7,632.00	976.07	12.79
2007/08	14,418.71	1,858.21	12.89	9,200.66	1,101.73	11.97
2008/09	17,743.24	2,050.91	11.56	11,435.20	1,202.74	10.52
2009/10	17,220.69	2,124.63	12.34	15,308.32	1,777.48	11.61
		Mean	**12.06**			**11.65**
		S.D.	**0.68**			**0.83**

Source: Annual Reports

Figure 4.2

Capital Adequacy Ratio



From above table, it is obvious that both banks have been meeting minimum required capital Adequacy. However, as we discussed earlier that banks and financial institutions are only meeting minimum standards, if they truly want to minimize risk and have sound financials then they have to go beyond the expectations of the NRB. In above figure, we can see both banks ratio are hovering around the required minimum criteria posed by NRB i.e. 10%. KBL seems to have maintained pretty good ratio throughout the period than that of MBL. It has 1234% in fiscal year 2005/06 to that of 11.36 of MBL. Similarly, it has maintained 12.34% in fiscal year 2009/10 to that of 11.61% of MBL. This shows that both banks have been adequately safeguarding their investments. However, this does not confirm because the banks and

financial institutions may put more risky investments to the lesser one. The average ratio maintained by KBL is 12.06 and its s.d is 0.68. On the other hand, the average ratio maintained by MBL is 11.65 with s.d of 0.83. The lesser standard deviation of 0.68 in KBL shows that the capital adequacy ratio maintained by KBL is less volatile to that of MBL.

The total risk weighted exposure is calculated as below:

Calculation of Capital Adquacy.		
Risk weighted exposures under each 11 categories of Credit Risk		
S.No.	**Particulars**	**Risk Weight**
1	Claims on government and central bank	0 to 150%
2	Claims on other official entities	0 to 150%
3	Claims on banks	20-150%
4	Claims on Corporate and securities firms	20-150%
5	Regulatory Retail Portfolio	75%
6	Claims secured by residential properties	60%
7	Claims secured by Commercial real estate	100%
8	Past due claims	150%
9	High Risk claims	150%
10	Other Assets	0 to 100%
11	Off Balance Sheet Exposures	0 to 100%
	Total	**Sum(1:11)**

Total Risk Weighted Exposure Calculation Table		
1	Risk Weighted Exposure for Credit Risk	-
2	Risk Weighted Exposure for Operational Risk	-
3	Risk Weighted Exposure for Market Risk	-
4	**Total Risk Weighted Exposures**	**Sum (1+2+3)**
a	Add: 3% of the total RWE due to non compliance to Disclosure Requirement	-
b	Addition to RWE as per supervisiory review (3%)	-
c	Add: ...% of Total Deposit due to Insufficient Liquid Assets -	-
5	**Total Risk Weighted Exposures**	Sum(4+a+b+c)
6	**Total Capital Fund**	**-**
7	**Capital Fund to Risk Weighted Exposure**	**Divide-(6/5)**
	**Three Years Bassel Classification Shown in Appendix*	

4.2.3 Non-Performing Loan to Total Loans and Advances Ratio

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

Table 4.3

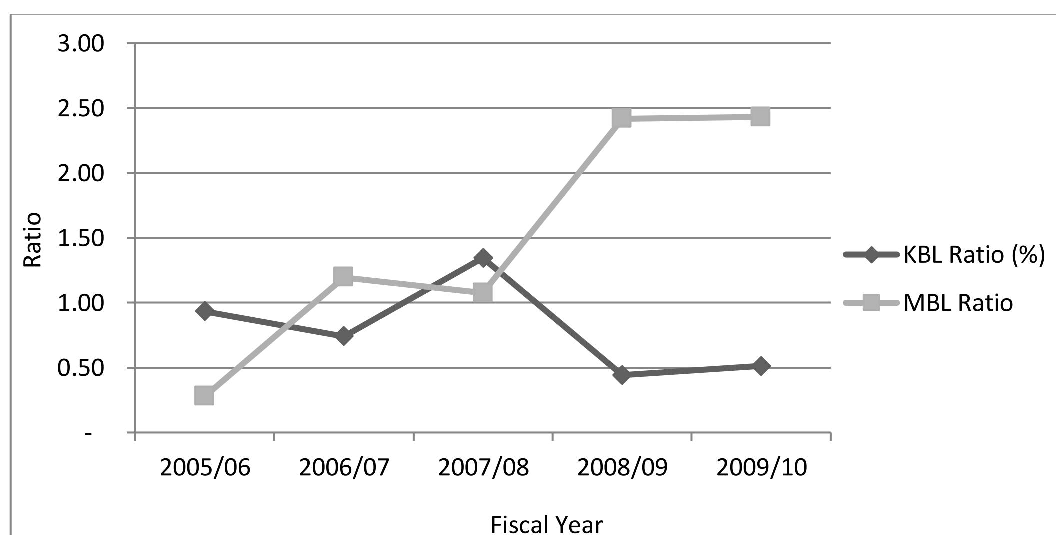
Non-Performing Loan to Total Loans and Advances Ratio

Fiscal Year	KBL			MBL		
	NPL	Total Loans & Advances	Ratio (%)	NPL	Total Loans & Advances	Ratio
2005/06	64.35	6,891.86	0.93	16.92	6,068.43	0.28
2006/07	66.12	8,929.01	0.74	85.17	7,129.89	1.19
2007/08	152.48	11,335.09	1.35	92.92	8,642.32	1.08
2008/09	64.54	14,593.35	0.44	302.84	12,516.01	2.42
2009/10	75.51	14,765.91	0.51	347.58	14,289.79	2.43
		Mean	**0.79**			**1.48**
		S.D.	**0.36**			**0.93**

Source: Annual Reports

Figure 4.3

Non-Performing Loan to Total Loans and Advances Ratio



From above figure and table it is clear that the Non Performing Loan to Total Loans and advances ratio of MBL is increasing every year besides 2007/08. This shows that performance of MBL is degrading each year. From above data it is clear that the borrowers of MBL have been defaulting each year. NPL of MBL has increased from 16.92 million in year 2005/06 to 85.17 in year 2006/07. In fiscal year 2008/09 this NPL has increased by approximately 210 million. This has serious problem of non-payment by the defaulter which in turn reduces the overall profitability of the bank. In turn general people will have negative impact of it and compel them to withdraw their deposit from the bank and creating liquidity problem in MBL.

On the other hand, KBL has been decreasing its NPL over the years. It faced serious problem in year 2007/08 where it had NPL of 152.48 million. However, this NPL was reduced in succeeding year 2008/09. This might have been possible either regularized payment by the borrower or settlement of the NPL.

From this data, we can also assume that MBL is not quite proactive in lending and able to recover the NPL whereas KBL seems to be very good at handling these situations.

4.2.4 Loan Loss Provision to Total Loans and Advances Ratio

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

Table 4.4

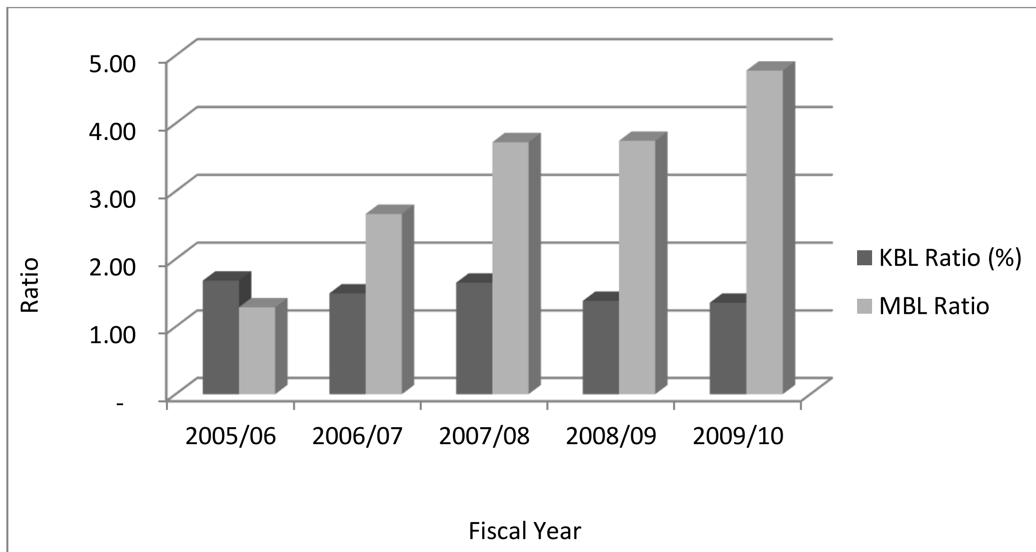
Loan Loss Provision to Total Loans and Advances Ratio

Fiscal Year	KBL			MBL		
	Provision for Loan Losses	Total Loans & Advances	Ratio (%)	Provision for Loan Losses	Total Loans & Advances	Ratio
2005/06	115.93	6,891.86	1.68	78.15	6,068.43	1.29
2006/07	133.42	8,929.01	1.49	190.05	7,129.89	2.67
2007/08	187.29	11,335.09	1.65	321.75	8,642.32	3.72
2008/09	201.91	14,593.35	1.38	468.45	12,516.01	3.74
2009/10	200.17	14,765.91	1.36	682.74	14,289.79	4.78
		Mean	**1.51**			**3.24**
		S.D.	**0.15**			**1.32**

Source: Annual Reports

Figure 4.4

Non-Performing Loan to Total Loans and Advances Ratio



From the above table and figure, we can see that MBL has been maintaining high provision for possible loan losses to that of Kumari bank Ltd. This does not mean that MBL is maintaining additional cushion for the possible losses, this argument is supported by the higher NPL in table 4.3. MBL is maintaining only required reserves made mandatory by NRB, no additional provision is made for future losses. Similar case is also for KBL. We can notice that MBL has its provision increasing over the years with due cushion for additional NPL. It had made provision of 78.15 million in year 2005/06 and hence increased over the years to 682.74 in year 2009/10.

As we discussed earlier that all banks and financial institutions only meet the minimum criteria to make arrangement as directed by NRB directive 2068. Here if provision for possible loan loss had been made by keeping enough cushion then the banks would have been safer for next period and fiscal years but they do not do so, because if they make additional provision then their profit would be lessen. We are witnessing every banks and financial institutions are attempting to make larger profits by only meeting the minimum requirements. We even are witnessing the fact that even banks and financial institutions are providing additional loans to the borrower simply to avoid the required provision. This can create higher profit for that particular period but the profit is not sustainable one. Because one day the same customer is

going to default and then the bank may suffer great loss. This situation is found in every banks and financial institutions.

4.2.5 Security wise Loan Classification

This analysis will help to identify the various types of securities on the basis of which loans have been provided by KBL. This also assists to analyze the credit risk of a bank. As more liquid the collateral, low credit risk to the bank. Here, security wise lending includes 12 types of securities, including collateral less lending.

Table 4.5

Security wise Loan Classification of KBL

Particulars	2005/06	2006/07	2007/08	2008/09	2009/10	Mean
A. Secured	**7,007.79**	**9,062.43**	**11,522.38**	**14,795.26**	**14,966.08**	**11,470.79**
1. Against Security of Movable/Immovable Assets	5,564.31	7,463.68	10,565.02	13,444.86	14,152.77	10,238.13
2. Against Guarantee of Local Licensed Institutions	137.49		-	-	-	34.37
3. Against Government Guarantee	-		-	-	-	-
4. Against Guarantee of Internationally Rated Bank	-		-	-	-	-
5. Against Security of Export Documents	102.83	12.25	-	1.82	2.32	23.85
6. Against Security of Fixed Deposit Receipts (a+b)	85.44	106.89	112.95	55.36	53.26	82.78
a. Own FDR	21.56	21.95	6.96	2.79	53.26	21.30
b. FDR of Other Licensed Institutions	63.88	84.94	105.99	52.57	-	61.48
7. Against Security of Government Bonds	0.60		-	-	6.81	1.85
8. Against Counter Guarantee	-		-	-	-	-
9. Against Personal Guarantee	17.88		-	-	-	4.47
10. Against Other Securities	1,099.23	1,479.61	844.41	1,293.23	750.92	1,093.48
B. Unsecured	**-**		**-**	**-**	**-**	-
Total	**7,007.79**	**9,062.43**	**11,522.38**	**14,795.26**	**14,966.08**	**11,470.79**

Source: Annual Report

Figure 4.5

Security wise Loan Classification of KBL

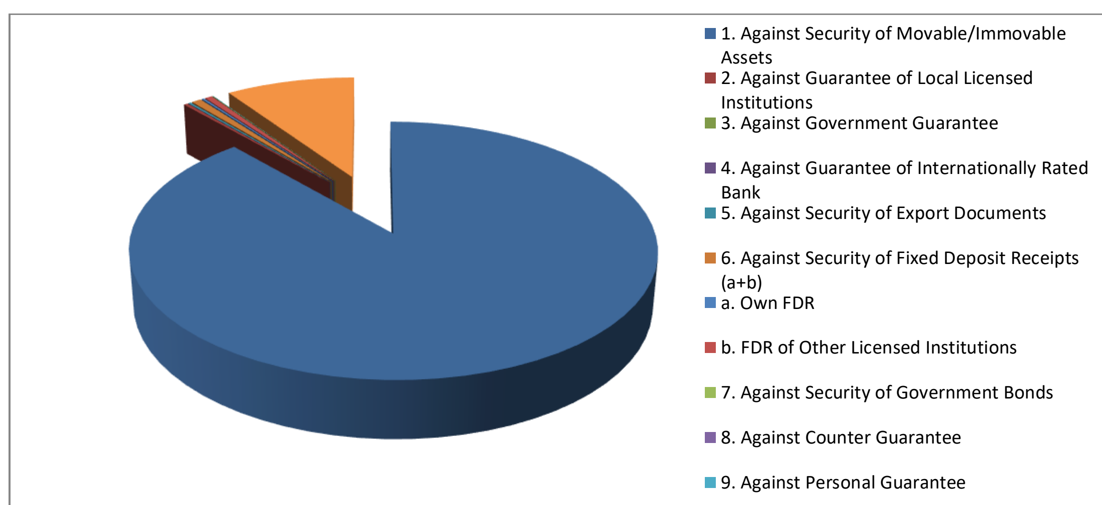


Table 4.6

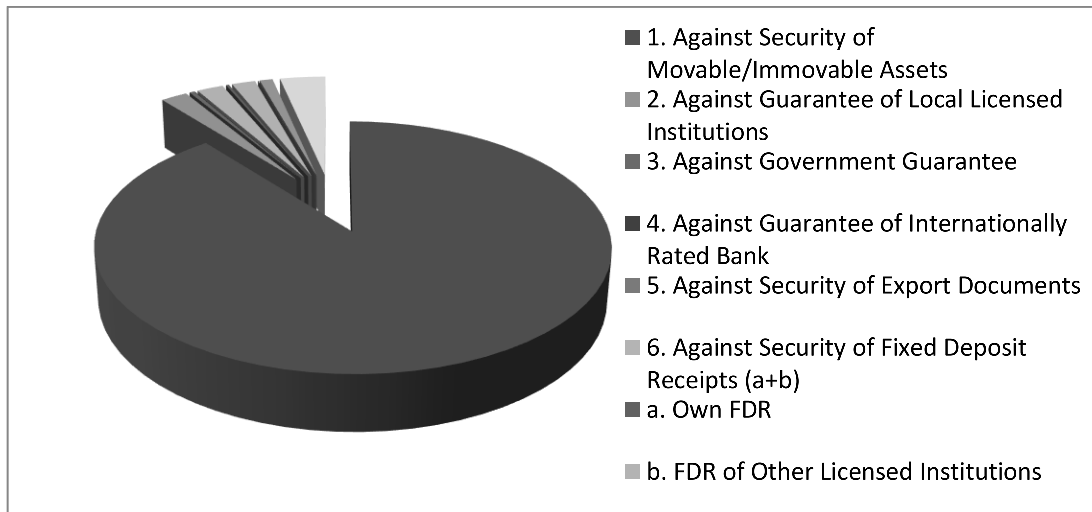
Security wise Loan Classification of MBL

Particulars	2005/06	2006/07	2007/08	2008/09	2009/10	Mean
A. Secured	**6,146.57**	**7,326.01**	**8,964.06**	**12,984.46**	**14,972.53**	**10,078.73**
1. Against Security of Movable/Immovable Assets	5,151.20	6,510.13	7,880.16	12,174.98	14,215.57	9,186.41
2. Against Guarantee of Local Licensed Institutions	159.17	378.30	57.22	188.12	235.62	203.69
3. Against Government Guarantee	-	-	-	52.21	129.84	36.41
4. Against Guarantee of Internationally Rated Bank	-	-	-	-	-	-
5. Against Security of Export Documents	-	-	-	-	-	-
6. Against Security of Fixed Deposit Receipts (a+b)	123.83	229.98	242.33	285.34	133.19	202.93
a. Own FDR	40.37	18.77	4.44	18.83	27.74	22.03
b. FDR of Other Licensed Institutions	83.46	211.20	237.89	266.51	105.45	180.90
7. Against Security of Government Bonds	2.46	-	-	-	-	0.49
8. Against Counter Guarantee	-	-	-	-	-	-
9. Against Personal Guarantee	-	184.60	98.24	99.39	118.80	100.21
10. Against Other Securities	709.90	23.00	686.12	184.41	139.51	348.59
B. Unsecured	**-**		**-**	**-**	**-**	-
Total	**6,146.57**	**7,326.01**	**8,964.06**	**12,984.46**	**14,972.53**	**10,078.73**

Source: Annual Report

Figure 4.6

Security wise Loan Classification of MBL



From above table 4.5 & 4.6 and figure 4.5 & 4.6, we can see KBL & MBL has extended its majority of loans and advances by keeping security of movable and immovable properties of mean Rs. 10,238.13 million and 9,186.41 million respectively. This indicates that both banks have given considerable concentration on adequately safeguarding the loans and advances extended by collateral. But this not mean that the loans and advances extended shall perform well, this is only a collateral part, a borrower can default despite of adequate and quality collateral. Moreover, the collateral may be unqualified and inadequate since only figure cannot summarize whole scenario. In addition to it, if a borrower fail to pay the interest and principal amount then pledged collateral must be auctioned, this may take plenty of time and non sellable of collateral still exists.

Lending against FDR has no risk and requires 0% risk according to the Basel II. Both bank has extended credit facility in this category. KBL has mean average lending of 82.78 million to that of 209.93 of MBL. This portfolio shows better management of risk and mitigation of credit risk as well, since, no risk weight is assigned to this category. However, at current situation we can see many banks and financial institutions have very high liquidity problems. Thus, lending against security of FDR has witnessed threat as well. This problem has been seen with FDR of World Merchant Banking and finance ltd., Vibor bikas bank ltd, gorkha development bank ltd. and Nepal share markets and finance ltd.

Lending against sole personal guarantee is witnessed more in MBL. This has high risk since it does not assure on payment of accrued interest and principal on timely basis. Since, lending has been made on the basis of personal relationship and without pledging of collateral there is high chances of borrower defaulting. Hence, these loans must be timely monitored and controlled. From this point of view, MBL seems to have made very risky lending. Rs. 118.80 million (Year 2009/10) falls under threat and necessary provisioning arrangement is required.

Lending against other securities consists of shares pledged as security. As we are very much aware that investment is security is very risky. Hence, lending made on its basis is risky, proper timely monitoring pertaining to the changing prices in shares must be monitored and margin call shall be made accordingly. This claims high risk since market value of underlying assets can clash at any point of time. Thus these lending carries 150% weightage as per Basel II.

4.2.6 Real Estate Lending

We have been witnessing a serious problem in real estate sector form past few years. The real estate sector were booming and the price hike was everywhere by brokers and investors investing in it. Now, with this decision made by NRB many banks and financial institutions existence has come into threat. Thus, NRB has been controlling lending into these sector and thus provided ceiling to meet within the stipulated time and this sector segregation has been made compulsion in banks financial reports.

Table 4.7

Real Estate Lending of KBL

Topic	Asadh 2068	Asadh 2069	13/04/2011	Ratio %	16/07/2010	Ratio %
(a) Residential Real Estate	30% or less	25% or less	332.95	2.20	1,171.52	8.11
(b) Commercial Complex & Residential Apartment Construction Loan			478.63	3.17	490.45	3.39
(c) Construction Completed & Revenue Generating Commercial Complex			-	-	-	-
(d) Other Real Estate (Personal Loan above 5 mil, Land Purchase & Plotting	15% or Less	10% or Less	**2,498.80**	16.53	**2,813.59**	19.47
Total (a+b+c+d)	**30% or less**	**25% or less**	**3,310.38**	21.90	**4,475.56**	30.97
Total Loans and Advances			**15,113.71**		**14,451.76**	

Source: Annual Reports

Table 4.8
Real Estate Lending of MBL

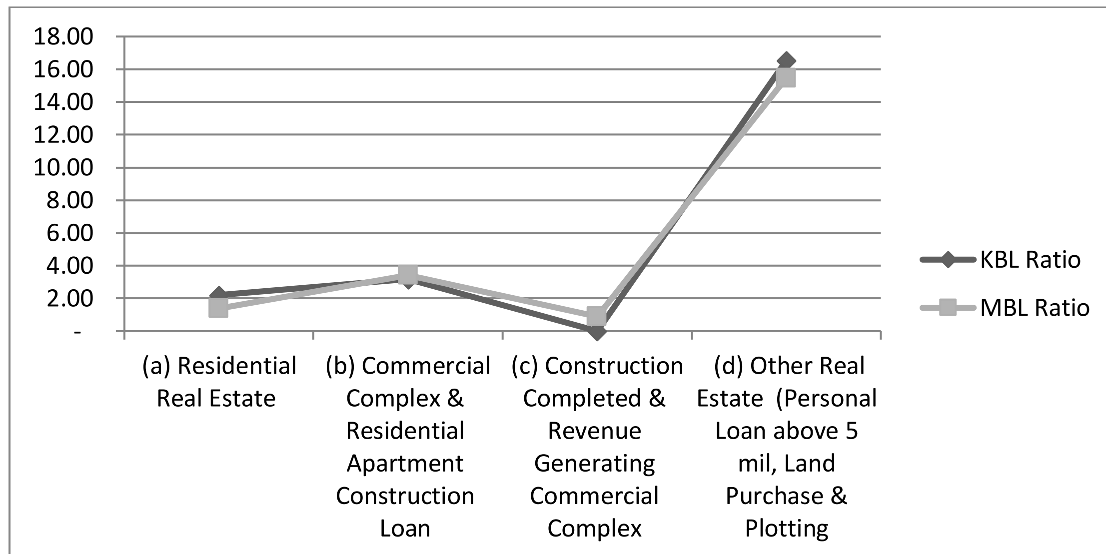
Topic	Asadh 2068	Asadh 2069	13/04/2011	Ratio %	16/07/2010	Ratio %
(a) Residential Real Estate	30% or less	25% or less	217.74	1.39	779.27	5.20
(b) Commercial Complex & Residential Apartment Construction Loan			535.27	3.43	485.21	3.24
(c) Construction Completed & Revenue Generating Commercial Complex			138.42	0.89	-	-
(d) Other Real Estate (Personal Loan above 5 mil, Land Purchase & Plotting	15% or Less	10% or Less	**2,415.49**	15.47	**3,038.97**	20.30
Total (a+b+c+d)	**30% or less**	**25% or less**	**3,306.92**	21.17	**4,303.44**	28.74
Total Loans and Advances			**15,618.28**		**14,972.53**	

Source: Annual Reports

Above table represents the real estate lendings made my KBL and MBL in last 3rd quarter ending 13/04/2011 & fiscal year 2066/67. The data was available for only those period since this segregation in real estate has come into effect recently. As per NRB Circular, banks and financial institutions must downsize their real estate lending on other real estate sector including personal lending and for land purchase and plotting in 15% or less. This threshold has not been met by both banks in 3rd quarter and fiscal year 2066/67. KBL has 16.53% in 3rd quarter and 19.47% in f/y 2066/67. MBL has 15.47% and 20.30%. Now, both banks must downsize this ratio to 15% or less within f/y 2067/68 and total real estate lending to 30% or less. However, both banks have met total real estate lending threshold of 30%. Now let's compare both banks real estate in a graph.

Figure 4.7

Real Estate Lending Comparison of KBL & MBL



From above figure 4.7 it is obvious that both banks has similar exposure in real estate. Both banks seem to have comfortable position for lending on real estate. They even meet 25% of total exposure that must be downsized within Asadh 2069. However, this does not mean they do not possess credit risk. As we are witnessing a serious downfall in real estate lending, many real estate players are being unable to pay their accrued interest. This shall continue unless a new regulation in favor of real estate sector is made. Thus, until then there is a high risk in real estate lending. This means the total exposure of around 22% of both bank has come into threat. This threat must be minimized by making additional provisioning for possible losses.

4.3 Major Findings of the Study

From the above analysis of credit risks, following major findings have been obtained:

1. Credit risk is one of the most important risk that a manager should deal on. Dealing with it requires extensive knowledge and experiences. Lack of systematic and thorough credit processing is also the major source of credit risk in these banks. The problems in credit processing include lack of through credit assessment, absence of testing and validation of new lending techniques, subjective decision making by senior management, lack of effective credit review process, failure to monitor borrowers or collateral values, and failure of banks to take sufficient accounts of business cycle effects etc. Likewise the market sensitive and liquidity sensitive

exposures also increase the credit risk of these banks. Similarly, it is found that both banks have their own rating system of the credit client and the sectors. Bothe banks have ranked 1st to the manufacturing sector where as the agriculture sector has been ranked the last on the basis of priority. KBL has chosen others sector and real estate business in 2nd and 3rd position respectively, where as the MBL has just opposite preference in these sectors.

1. From the analysis from Credit to deposit ratio MBL seems to have maintain better liquidity position to that of KBL but if we consider Shareholders equity to deposit side to calculate CD ratio as per NRB directive then MBL will have excess liquidity which has substantial effect on its profitability. This problem is looked after in KBL. Thus, from above we can say that MBL has maintained high liquidity that may possess adverse effect in its profitability and KBL has made efficient use of available resources.
2. Capital Adequacy ratio is one of the major tool implemented by Basel II and same has been implemented here by NRB in order to minimize the possible credit risks. Both banks maintained required minimum ratios. They have only met the minimum criteria as prescribed by the NRB. Higher the capital adequacy ratio, higher comfortable zone is obtained for the banks and financial institutions.
3. Higher non performing loan of MBL indicates lower credibility of the borrowers. This means, there has been some inefficiency in lending, which has resulted in non-payment of interest and principal by the borrower. If this continues, survival of MBL comes into threat. In contrast to it, KBL's performance is found satisfactory since it has lower NPL as compared to MBL. Standard Chartered Bank, Nabil Bank has NPL of almost zero. This shows their high credit standard performance.
4. Both banks has maintained required minimum provision as per the category of their lendings. No additional provisions is created to mitigate future credit risk. Prudentially both banks has maintained sufficient provisions but we cannot make sure that the recovery of accrued interest and principal has been made by the cash deposit of the borrower, since we have been witnessing these settlements by additional loans provided to the customers. This is done to avoid accumulation of NPL and create additional provision that directly reduces the profitability of banks. Hence, they provide additional loans and settle past dues.

5. Most of the Loans and advances of both banks has been secured with movable and immovable securities. This does not make sure in timely payment of accrued interest and principals. The basic rule in extending credit to borrower is the repayment capability. Lending against personal guarantee is observed in MBL which shows high risk lending arrangement. However, this is nil in most recent year of KBL, MBL has extended credit to the tune of 118.8 million in this category. This makes MBL more risky to that of KBL.
6. Real estate lending was a very lucrative business until NRB regulated this sector with a very tight regulations. Every banks and financial institutions were extending credit to these real estate players which is one of the most non productive sector. A huge exposure of many banks and financial institutions was seen. This is observed in KBL and MBL as well with 21.90% & 21.17% respectively. This ratio meets the minimum criteria as prescribed by NRB, however, lending to single sector for more than 20% is itself a threatening situation.

CHAPTER - V

SUMMARY, CONCLUSION AND RECOMMENDATION

In this chapter we examine the processed data to come into summary, conclusions on the performance of the bank on an individual basis and put some recommendation for the subject bank in order to improve its weaknesses. This chapter is divided into summary, conclusions and recommendations.

5.1 Summary

As we all are aware that, banks and financial institutions are responsible for the overall development of the country. Banks and financial institutions, which collect the scattered small-small saving from nook and corner of the country and invest them to the needy one in productive sector thereby multiplying the economic reform. Credit risk being one of the major risk in banking sectors requires plenty of consciousness and proactiveness in lending. Thus, to make a comparative analysis of banking sector, 2 banks were taken as sample using judgemental sampling method. KBL and MBL have been taken for comparative study because of their similarities in terms of business size, date of establishment, capital size etc. Both primary and secondary data have been used in this study.

Various credit risk mitigating and arising factors were studied. Appropriate statistical and financial tools have been applied to analyze the collected data. The data of five consecutive years of the two banks have been analyzed to meet the objective of the study. The major risk in KBL and MBL is associated with credit decision as the proportion of credit risk on total risk is high. The credit risk of these banks mainly arises due to non-payment of loan by borrowers, poor appraisal of borrower's financial condition and substandard collateral. Poor tracking of borrowers and improper diversification of lending across industries also result in higher credit risk in commercial banks. The major problems in credit risk can be categorized into three areas of concentration; credit processing, and market and liquidity-sensitive credit exposures.

Both banks has developed their own CPG (Credit Policy Guidelines) that direct their credit officers to comply as per the banks policy. This brings uniformity and standard in the lending policy. In addition to it, they have separate risk management department, which constantly keeps on exercising to mitigate credit risk. However, these policy has been only transcribed in paper, had these been implemented in full capacity and understanding, there would not have been such major credit lax. This has been observed by the non performing to total loans and advances ratio of 0.51% and 2.41% of KBL and MBL respectively. Increasing trend of this ratio on MBL has posed threat to the depositors of the bank.

Increasing cost of fund has pressurized both banks to increase their interest rate on lending, this in turn have adverse effect on repayment capability of the banks and financial institutions. Every banks and financial institution have been vying for the same deposits, which created constant increase in the interest rate, this in turn increases the inflation of the nation. Moreover, both banks has been observed to have utilized the collected deposits on loans and advances only. Though, lending is the basic function of the banks, it is not the only function. We have witnessed investment in treasury and other debt instruments floated by government of Nepal. This is basically seen in Standard Chartered Bank. Almost investment and loans and advances are equal in this bank.

Concentration of both bank on single sector has also pose threat to depositors and investors of banks. Almost 21% of total lending to real estate sector, one of the most unproductive sector, has created high risk, since these players are unable to pay at least interest accrued.

5.2 Conclusion

A better decision can lead a business towards a path of sustainable growth and success. A better management team with properly addressed duties and responsibilities to each departments and its head can better perform and add up to a better decision. A company's shareholders must be separated with management team, since indulgement of a shareholder can harass sound and judgmental decision.

Majority of banks and financial institutions are now facing problems due to involvement of Executive chairman, one who is also a shareholder and a holder of top position, favoring nepotism in granting loans and advances has created a serious issues in present banking era.

Commercial banks are established with an objective to maximize the shareholders' value by performing the function of mobilizing the idle funds collected from the society to productive sector, which will help to achieve the economic development of a country.

Proper risk management is required to remain competitive in the market to achieve the goals. With the increase in NPL, the loan loss provisioning will also increase simultaneously leading to decrease in profit. Thus banks and financial institutions must prepare for the worst scenario and maintain sufficient provision exceeding the required minimum criteria. This not only helps in hard time but also reduces the tax liability for the period.

Thus, For minimizing the loss arising due to occurrence of the credit risks, capital adequacy have been maintained by these banks within the standard prescribed by NRB. However, the trend of Capital Adequacy ratio of these banks suggests that both the banks need to increase their capital fund.

Major lending to single sector is found in both banks, however, this is seriously ill for the health of banks and financial sectors. Other problems related to insufficient collateral, borrower's negative character and mis-utilization of credit must be frequently checked.

5.3 Recommendation

Based on the findings in chapter four and above conclusions the following recommendations have been put forward.

1. Firstly, Credit risk management is not a simple process. Thus, both banks, KBL and MBL, must update and maintain proper credit/lending policy. This must be prepared by professional bankers and scholars with substantial knowledge and experience in this field. The policy must be prudently and strictly followed by

all the lending staffs. The policy must be reviewed and analyzed periodically. Addendums and amendments must be made over the time.

2. Following the normal guidelines of NRB and acting upon this also reduces many of the credit risk arising from borrower's defaulter, lack of proper credit appraisals, black listed borrowers, and willful defaulters. The over confidence in commercial banks regarding credit appraisal efficiency and negligence in taking information from Credit Information Bureau has caused many bad debts in the bank. Hence, the bank is recommended to follow the directives of NRB strictly and be more cautious and realistic while granting loans and advances. The major solution of reducing the risk is to avoid lending in the more risky area until the bank is fully satisfied regarding the future viability of the project. Although the government has established an office named 'Debt Recovery Tribunal' in order to help the banks for recovery of bad debts. An additional effort for establishment of 'Assets Management Company', which helps the banks in collecting their debts and improving their credit rating efficiency, should be initiated
3. Both banks must initiate to put forward their plans to invest in rural areas. This can be led by SME lending. These loans are relatively small in portfolio but have less risk of default. Hence these sectors must be given special priority by both banks and shall also be promoted by government and NRB to flow credit in the rural economy.
4. The increasing non performing loan of MBL must be checked in time so that the bank can recover from being insolvent. Both positive and negative strategy must be initiated. Decreasing interest rate and providing subsidy on interest due can somehow facilitate and entice borrower to pay his loans. On the other hand taking action regarding recovery of loan such as auctioning and taking a sincere harsh step to recover loans must be taken soon.

   As compared to MBL, KBL has considerably low Non performing loans. If the bank has followed prudent banking practice this is a very good sign. But if not, this must be checked in time, because this can hamper the sustainability in the long run.

   Additional extra provisions must be created to that of required minimum criteria as required by NRB. This can help in upcoming difficult situation of both banks.

5. Both banks must try to tap the untapped areas to accelerate the economic growth of that areas. This not only facilitates the new area, it also adds to the net profit of the banks. The rural economy has always been realizing the credit needs; the dominancy of non-organized moneylender in this area has been prevailing. To compromise between the liquidity and credit need of rural economy, the bank is highly recommended to expand its credit in this area. This helps minimizing idle fund in business and at the same time contribute to the national economy.
6. Both banks are recommended to reduce their lending in Real Estate sector, since, this sector is one of the most unproductive sector. We have noticed a galloping demand for Flats and Housing in Kathmandu Valley. This is due to the availability of infrastructure, better employment opportunities, educational opportunities, access to better health and sanitations. The increasing population to urban and sub urban areas and demand for the additional land and building can be met by newly constructed Flats and housing colonies. Hence, banks and FI's with proper examination and possible future prospects should only invest to these sectors. We have witnessed lending to these sector without proper analysis and forecast future prospects. Every new players in this sectors were enjoying credit facilities from different banks and FI's just in as sake of lucrative returns. This in turn led to the galloping rise in prices of land and building. Now this sector has been demoralized by the NRB and hence the creditors are being unable to repay the interest along with the principal. Thus, the life time saving of depositors has come into threat.
7. The regulatory authority must come up with new and additional regulating circulars that binds the banks and FI's regarding credit risks and safeguard the hard earning of deposit holders.
8. Being an investor and depositors one should must analyze the bank and FI's past transactions, financial before depositing. We are aware that every deposit holder are attractive towards lucrative investment giving them higher return. But as an active investor and citizen we must analyze various issues and consequences of this. As a result of higher cost of fund, the banks and FI's are compelled to invest collected high cost deposit into lending at high rate and risky assets. This in turn exposes threat to the deposit of the depositors. In addition to it, the high rate on lending in turn increases inflation and this burden is ultimately going to be borne by the individual citizen (Depositors). Hence, we must check the

credibility, financials, management teams etc. before depositing funds. Banks and FI's having low cost of fund, experienced and professional management teams can better safeguard our life time savings.

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Website

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www.machbank.com,

www.worldbank.org:

APPENDIXES

Schedule 4.31

KUMARI BANK LIMITED
PRINCIPAL INDICATORS
(For Previous 6 years)

Particulars	Indicators	F/Y 2003/04	F/Y 2004/05	F/Y 2005/06	F/Y 2006/07	F/Y 2007/08	F/Y 2008/09	F/Y 2009/10
1. Net Profit/Gross Income	%	14.20%	16.26%	15.52%	19.61%	16.18%	16.54%	15.32%
2. Earnings Per Share	Rs.	9.74	17.58	16.59	22.70	16.35	22.04	24.24
3. Market Value Per Share	Rs.	-	369.00	443	830	1,005	700	468
4. Price Earning Ratio	Ratio	-	20.99	26.71	36.56	61.47	31.76	19.31
5. Dividend (including Bonus) on Share Capital	%	-	-	21.05%	21.05%	10.53%	10.58%	12.00%
6. Cash Dividend on Share Capital	%	-	-	1.05%	1.05%	0.53%	0.55%	12.00%
7. Interest Income/Loans & Advances	%	8.39%	8.33%	5.89%	7.63%	7.61%	8.34%	11.58%
8. Employee Expenses/Total Operating Expenses	%	11.48%	11.96%	12.32%	17.22%	15.66%	10.37%	9.24%
9. Interest Expenses on Total Deposit and Borrowings	%	3.41%	4.48%	4.20%	3.69%	3.87%	5.10%	6.51%
10. Exchange Fluctuation Gain/Gross Income	%	4.20%	2.77%	3.95%	2.34%	3.87%	3.73%	1.84%
11. Staff Bonus/Total Employee Expenses	%	26.88%	34.24%	24.59%	25.08%	22.32%	24.04%	31.93%
12. Net Profit/Loans & Advances	%	1.32%	1.55%	1.48%	1.88%	1.52%	1.77%	2.12%
13. Net Profit/Total Assets	%	0.89%	1.13%	1.15%	1.43%	1.16%	1.41%	1.59%
14. Total Credit/Deposit	%	76.91%	90.62%	90.20%	85.84%	90.20%	94.17%	79.45%
15. Total Operating Expenses/Total Assets	%	4.53%	4.76%	5.39%	4.83%	4.90%	6.03%	7.55%
16. Adequacy of Capital Fund on Risk Weightage Assets								
a. Core Capital	%	12.50%	10.20%	11.28%	10.26%	10.40%	9.08%	10.29%
b. Supplementary Capital	%	0.91%	1.01%	1.08%	0.96%	4.01%	2.47%	2.05%
c. Total Capital Fund	%	13.41%	11.21%	12.36%	11.22%	14.41%	11.56%	12.34%
17. Liquidity (CRR)	Ratio	11.02%	3.44%	2.71%	3.65%	1.91%	7.13%	8.02%
18. Non Performing Loans/Total Loans	%	0.76%	0.95%	0.92%	0.73%	1.32%	0.44%	0.50%
19. Weighted Average Interest Rate Spread	%	3.82%	3.85%	4.58%	4.67%	4.30%	4.17%	3.28%
20. Book Net Worth Per Share	Rs.	114	141	149	137	128	137	136.73
21. Total Shares	Number	5,000,000	5,000,000	6,250,000	7,500,000	10,700,000	11,860,992	13,060,159
22. Total Employees	Number	115	143	177	212	256	260	364
23. Others		-	-	-	-	-	-	-

प्रमुख सूचकाङ्क
कम्तिमा विगत ५ वर्षको परिसूचकहरू

विवरण	सूचकाङ्क	आ. ब. २०६२/२०६३	आ. ब. २०६३/२०६४	आ. ब. २०६४/२०६५	आ. ब. २०६५/२०६६	आ. ब. २०६६/२०६७
१. खुद नाफा/कूल आम्दानी प्रतिशत	प्रतिशत	२०.८०	८.६६	८.१५	९.४३	३.७४
२. प्रति शेयर आम्दानी	रू	१८.७४	९.०२	१०.३५	८.३३	४.९६
३. प्रति शेयर बजार मूल्य	रू	३२०.००	६२०.००	१,२८५.००	४२०.००	२८२.००
४. मूल्य आम्दानी अनुपात (PE Ratio)	अनुपात	१७.०८	६८.७४	१२४.१९	५०.४१	५६.९०
५. शेयर पूँजीमा नगद लाभांश (वोनस सहित)	प्रतिशत	१५.७९	-	२१.०५	-	१०.००
६. शेयर पूँजीमा नगद लाभांश भुक्तानी	प्रतिशत	०.७९	-	१.०५	-	-
७. व्याज आम्दानी/कर्जा तथा सापट	प्रतिशत	८.८०	९.४९	८.८९	०.०८	०.११
८. कर्मचारी खर्च/कूल सञ्चालन खर्च	प्रतिशत	१०.३९	९.७७	११.८३	०.११	०.१०
९. कूल निक्षेप तथा सापटीमा व्याज खर्च	प्रतिशत	३.६०	४.१०	३.६५	३.७२	६.१३
१०. सटही घटबढ आम्दानी/कूल आम्दानी	प्रतिशत	५.२९	(०.२२)	५.०३	५.००	२.३१
११. कर्मचारी बोनस/कूल कर्मचारी खर्च	प्रतिशत	३०.७०	२०.९८	२२.२९	१९.३७	६.८२
१२. खुद नाफा/कर्जा सापट	प्रतिशत	२.१८	१.०१	०.९५	०.९५	०.४९
१३. खुद नाफा/कूल सम्पत्ति	अनुपात	१.४८	०.६९	०.६८	०.७०	०.३५
१४. कूल कर्जा/निक्षेप	प्रतिशत	७७.८७	७७.२५	८०.७४	८३.२५	८०.७८
१५. कुल सञ्चालन खर्च/कूल सम्पत्ति	प्रतिशत	४.६१	५.१६	४.८३	४.८८	७.३५
१६. जोखिम भारित सम्पत्तिमा पूँजीकोषको पर्याप्तता						
(क) प्राथमिक पूँजी कोष	प्रतिशत	११.९४	१०.६८	१०.९७	१०.९६	९.९४
(ख) पूरक पूँजी कोष	प्रतिशत	०.८५	१.३०	१.३१	०.८८	१३०.२२
(ग) कूल पूँजी कोष	प्रतिशत	१२.७९	११.९७	१२.२९	११.८४	११.२५
१७. तरलता (CRR)	अनुपात	५.१८	८.२९	८.०५	१२.३३	५.८९
१८. निष्कृय कर्जा/कूल कर्जा	प्रतिशत	०.२८	१.१६	१.०४	२.३३	२.३२
१९. व्याज दर अन्तर (Weighted Average Interest Rate Spread)	प्रतिशत	३.४०	३.३८	३.९६	३.६०	३.४०
२०. बुक नेटवर्थ	रू	९३१,०९१,३५७	१,०००,२६४,६३५	१,१६३,३४६,९५८	१,७००,१९८,०९६	१,७७३,५१०,८९५
२१. कूल शेयर	संख्या	७,१५०,०००	८,२१६,५१३	८,२१६,५१३	१४,७९२,६९६	१,६२७,१९६,५.६०
२२. कूल कर्मचारी	संख्या	१९६	२३४	३१३	४३९	४९२
२३. प्रति कर्मचारी उत्पादकत्व	रू हजारमा	६८३.६६	३१६.६१	२७१.६२	-	१४९.०१
२४. प्रति शेयर किताबी मुल्य	रू	१३०.२२	१२१.७४	१४१.५९	११४.९३	१.०९
२५. तरल सम्पती/निक्षेप	प्रतिशत	२५.२९	२८.०८	२२.८९	२२.६८	२६.४७

KUMARI BANK LTD

5 YEARS BALANCE SHEET

Rs. In Million

Capital and Liabilities	2009/10	2008/09	2007/08	2006/07	2005/06
1. Share Capital	1,306.02	1,304.94	1,070.00	750.00	625.00
2. Reserve and Funds	479.74	320.02	294.89	275.63	238.85
3. Debenture and Bonds	400.00	400.00	400.00	-	-
4. Borrowing Outstandings	429.74	293.42	100.00	212.97	251.40
5. Deposit Liabilities	17,432.25	15,710.39	12,774.28	10,557.42	7,768.96
6. Bills Payable	42.31	70.09	65.30	16.55	11.92
7. Proposed Dividend Payable	156.82	6.53	-	-	6.58
8. Income Tax Liability	-	0.23	(9.65)	11.01	0.30
9. Other Liability	275.59	432.89	331.79	94.73	107.27
Total Capital and Liabilities	**20,522.46**	**18,538.51**	**15,026.60**	**11,918.31**	**9,010.27**

Assets	2009/10	2008/09	2007/08	2006/07	2005/06
1. Cash Balance	574.07	549.11	565.64	190.75	135.79
2. Balance with Nepal Rastra Bank	1,664.00	1,120.76	244.58	384.84	210.55
3. Balance with Banks/Financial Institutions	485.77	106.43	123.62	96.52	43.28
4. Money at Call and Short Notice	120.00	30.00	55.36	372.22	145.00
5. Investments	2,296.87	1,510.83	2,138.80	1,678.42	1,394.95
6. Loans and Advances	14,765.91	14,593.35	11,335.09	8,929.01	6,891.86
7. Fixed Assets	285.64	247.83	222.00	189.32	91.93
8. Non Banking Assets	-	-	3.14	2.39	3.59
9. Other Assets	330.22	380.26	338.37	74.83	93.32
Total Capital and Liabilities	**20,522.47**	**18,538.56**	**15,026.60**	**11,918.31**	**9,010.27**

MACHHAPUCHCHHRE BANK LTD

5 YEARS BALANCE SHEET

Capital and Liabilities	2009/10	2008/09	2007/08	2006/07	2005/06
1. Share Capital	1,627.20	1,479.27	901.34	821.65	715.00
2. Reserve and Funds	146.31	220.93	262.01	178.61	216.09
3. Debenture and Bonds	-	-	-	-	-
4. Borrowing Outstandings	150.00	-	88.51	228.50	131.68
5. Deposit Liabilities	18,535.92	15,596.79	11,102.24	9,475.45	7,893.30
6. Bills Payable	15.40	24.44	10.31	21.48	11.37
7. Proposed Dividend Payable	-	-	8.65	4.31	5.64
8. Income Tax Liability	-	11.76	3.04	7.37	10.46
9. Other Liability	203.96	157.58	122.45	70.23	86.29
Total Capital and Liabilities	**20,678.79**	**17,490.78**	**12,498.55**	**10,807.61**	**9,069.83**

Assets	2009/10	2008/09	2007/08	2006/07	2005/06
1. Cash Balance	1,049.33	743.20	560.32	385.94	280.42
2. Balance with Nepal Rastra Bank	1,094.66	1,755.98	893.30	785.69	489.09
3. Balance with Banks/Financial Institutions	315.73	267.47	134.95	112.45	44.41
4. Money at Call and Short Notice	661.56	-	70.00	694.00	718.47
5. Investments	2,096.79	1,246.16	1,443.55	1,278.47	1,190.83
6. Loans and Advances	14,289.79	12,516.01	8,642.32	7,129.89	6,068.43
7. Fixed Assets	732.29	664.16	535.89	259.53	104.94
8. Non Banking Assets	-	4.50	-	3.39	12.53
9. Other Assets	438.63	293.30	218.22	158.25	160.70
Total Capital and Liabilities	**20,678.79**	**17,490.78**	**12,498.55**	**10,807.61**	**9,069.83**

KUMARI BANK LTD				
Risk weighted exposures under each 11 categories of Credit Risk:				
S.No.	**Particulars**	**2008/09**	**2009/10**	**2010/11**
1	Claims on government and central bank	-	-	-
2	Claims on other official entities	151.31	89.94	25.48
3	Claims on banks	114.01	258.41	280.67
4	Claims on Corporate and securities firms	6,385.25	7,036.56	7,668.63
5	Regulatory Retail Portfolio	1,389.81	1,381.80	1,476.93
6	Claims secured by residential properties	646.72	690.38	776.14
7	Claims secured by Commercial real estate	2,152.68	3,636.38	2,614.68
8	Past due claims	237.17	89.72	399.74
9	High Risk claims	4,543.77	1,477.98	1,131.35
10	Other Assets	633.79	578.81	581.47
11	Off Balance Sheet Exposures	798.39	1,017.88	1,197.19
12	**Total**	**17,052.89**	**16,257.86**	**16,152.28**

Total Risk Weighted Exposure Calculation Table				
1	Risk Weighted Exposure for Credit Risk	17,052.89	16,257.86	16,152.28
2	Risk	713.92	909.51	1,099.01
3	Risk Weighted Exposure for Market Risk	49.81	53.88	92.29
4	**Total Risk Weighted Exposures**	**17,816.63**	**17,221.25**	**17,343.58**
	Add: 3% of the total RWE due to non compliance to Disclosure Requirement	-	-	-
	Addition to RWE as per supervisiory review (3%)	-	-	520.31
	Add: ...% of Total Deposit due to Insufficient Liquid Assets -	-	-	-
	Total Risk Weighted Exposures	17,816.63	17,221.25	**17,863.89**
5	**Total Capital Fund**	**2,060.80**	**2,376.94**	**2,580.56**
6	**Capital Fund to Risk Weighted Exposure**	**11.57**	**13.80**	**14.45**

MACHHAPUCHCHHRE BANK LTD				
Risk weighted exposures under each 11 categories of Credit Risk:				
S.No.	**Particulars**	**2008/09**	**2009/10**	**2010/11**
1	Claims on government and central bank	-	-	-
2	Claims on other official entities	130.31	130.31	151.91
3	Claims on banks	279.83	279.83	237.38
4	Claims on Corporate and securities firms	7,014.32	7,014.32	6,643.13
5	Regulatory Retail Portfolio	2,530.75	2,530.75	2,596.20
6	Claims secured by residential properties	457.10	457.10	462.08
7	Claims secured by Commercial real estate	1,325.14	1,325.14	2,380.08
8	Past due claims	179.82	179.82	563.85
9	High Risk claims	2,407.73	2,407.73	83.63
10	Other Assets	1,062.11	1,062.11	1,145.46
11	Off Balance Sheet Exposures	1,325.19	1,325.19	1,026.77
	Total	**16,712.30**	**16,712.30**	**15,290.87**

Total Risk Weighted Exposure Calculation Table				
1	Risk Weighted Exposure for Credit Risk	16,712.30	16,712.30	15,290.87
2	Risk Weighted Exposure for Operational Risk	788.11	788.11	934.80
3	Risk Weighted Exposure for Market Risk	47.39	47.39	31.25
4	**Total Risk Weighted Exposures**	**17,547.81**	**17,547.80**	**16,256.92**
	Add: 3% of the total RWE due to non compliance to Disclosure Requirement	-	-	-
	Addition to RWE as per supervisiory review (3%)	-	-	325.14
	Add: ...% of Total Deposit due to Insufficient Liquid Assets -	-	-	820.57
	Total Risk Weighted Exposures	17,547.81	17,547.80	**17,402.63**
5	**Total Capital Fund**	**1,961.90**	**1,979.55**	**1,899.91**
6	**Capital Fund to Risk Weighted Exposure**	**11.18**	**11.28**	**10.92**