CHAPTER-I

INTRODUCTION

1.1 Background of Study

Financial intermediaries are vital in the economic prosperity of the nation. There are different types of financial intermediaries or financial institutions such as commercial Banks, Development Banks, Finance Companies, Cooperatives, etc. Among all those institutions, the commercial banks are the key players in the economy of the country. Economic liberalization policy of Government has encouraged the establishment and Growth of financial institutions in Nepal.

Banks are the backbone of a country's economy. Commercial banks are the financial department stores that provide a number of services to the people. There are numerous services provided by commercial banks like accepting deposit, providing financial securities, granting loan, money exchanges, financial consultancy, fund transfer, etc. Among many task performed by commercial banks, commercial banks work as intermediaries between the two sectors of the economy; The Surplus sector and the deficit sector.

The Surplus sector includes the people who are middle and lower class people who save money that is not enough to invest or start a new business. Generally they are employees and labors. They generally do not want to take risk.

The Deficit sector comprises the business people who always seek money to invest in the business. They are investor rather than saver. They are risk taker.

The commercial banks collect money in small amount from the surplus sector and gives to the deficit sector. While collecting money from surplus sector bank gives the guarantee of repayment of money as well as a certain amount as interest. In the other hand while giving money to the deficit sector as a loan, it will charge certain percent as interest which is greater than that paid to saver.

The mushrooming growth of the banks has led them towards cutthroat competition. On the other hand economic condition of the country is not growing. The less opportunity for getting avenues for loan floatation has compelled the banks to finance without being choosy. Quality of the loans and advances could not be maintained to the desirable level if there is no choice whether to finance or not once the loan is given it is supposed that the repayment of interest or principal shall have to be served without any hindrance. The resources could not be considered utilized properly when the loans provided to the clients could not be regular and if there is cumulative overdue outstanding. There may be various reasons behind the loans that turn irregular from regular one. The main reason may be economic situation of the country which has global and far reaching impact. The smooth operation of the commercial banks is possible only when the economy of the country functions well. Satisfactory level of return on investment is the prerequisite for the financial sector to be groomed. The other contributing factors that turn the good loan into bad are the attitude of the burrower, types and quality of security taken and legal hurdles created by the burrower when the recovery action is started. Once the distributed loan is not returned timely by clients and becomes overdue than it is known as NPA for the banks. Reduction of NPA has always been a significant problem for every commercial banks and proper attention for the management of the NPA now under top priority. Due to various hurdles on way of management of NPA, commercial banks are now losing their profitability and struggling for their existence.

The operations of the banking institution has been regulated by the international norms, relevant acts, regulations, memorandum of Association (MOA), Article of Association(AOA), institution given at the time of getting intent and Directives issued by central Bank from time to time. Likewise the expectation of the stakeholder should also be taken into consideration. All banking institutions are supposed to confine their activities within that periphery.

1.2 Profile of selected Banks

In this study, six commercial banks are selected. Brief profile is presented below:

1.2.1 Nabil Bank Ltd.

Nabil bank is the first joint venture bank and it is one of the most successful banks in Nepal. It was established on 1984/07/16 with joint venture with United Arab Emirates Bank. It’s current share capital is Rs. 491,654,400 and Total Assets Rs. 27,253,393,008. It has 18 branches currently in operation.

1.2.2 Himalayan Bank Ltd.

Himalayan Bank Ltd was established on 1993/01/18 with joint venture of Habib Bank Ltd. of Pakistan. It is very aggressive in lending. Among private banks operating in Nepal, Himalayan Bank Limited has the highest Loan portfolio. It’s current share capital is Rs. 772,200,000 and Total Assets Rs. 29,460,389,672. It is currently supplying its services through 15 branches.

1.2.3 Bank of Kathmandu Ltd.

Bank of Kathmandu is one of the successful banks in Nepal among the non joint venture banks operating in Nepal. BoK is run by completely Nepali team. It was established on 1995/03/12. It’s current share capital is Rs. 463,580,900 and Total Assets Rs. 12,278,329,302. Bok is currently operating 13 branches.

1.2.4 Nepal Industrial and Commercial Bank Ltd.

Nepal industrial and commercial bank commenced its operation on the year 1998/07/28 A.D. The bank was promoted by some of the prominent business houses of the county. NIC is the first bank of Nepal to be ISO 1901:2000 certified for quality management. It's current share capital is Rs. 600,000,000 and total assets Rs. 10,383,601,708. It is currently providing services through 10 branches.

1.2.5 Machhapuchhre Bank Ltd.

Machhapuchhre Bank Ltd is one of the youngest banks. It was established on 2000/10/03 A.D in the tourist city of Pokhara. It is one of the effective banks that have the lowest Non Performing Asset level. It shows it efficiency in managing the loan and advances. It's current share capital is Rs. 715,000,000 and total assets Rs. 6,069,830,401. It has currently 12 branches.

1.2.6 Nepal Bangladesh Bank Ltd.

Nepal Bangladesh Bank is established on 1993/06/05, a joint venture with IFIC Bank Ltd of Bangladesh. Currently the performance of the bank is not satisfactory due to which Nepal Rastra Bank has taken over the control of the management. NRB team currently has achieved significant success in the management of the Bank. It's current share capital is Rs. 719,852,000 and total Assets Rs. 13,277,150,678. It has 17 branches operating of NBBL.

1.3 Focus of Study

An asset which ceases to generate income of the bank is called non-performing asset. The past due amount remaining uncovered for the two quarter consequently the amount would be classified as NPA for the whole year. It includes borrowers' defaults or delays in interest or principal repayment

NPA may be defined broadly as the *Bad Debt*. However NPA in terms of banking sector consists of those loans and advances which are not performing well and likely to be turn as bad loan. NPA as per current directives of Nepal Rastra Bank (NRB) has been categorized as classified loans and Advances. NPA has severe impacts on the financial institution. On the one hand the investment becomes worthless as expected return cannot be realizable and on the other, due to the provisioning required for the risk mitigation the profitability is directly affected. The existence of the bank can be questioned on this situation. Thus interest along with principal has to be recovered timely and without and obstacles.

NPA as categorized by NRB are classified loans and Advances. For the probable loss on lending that can not be recovered even after liquidation of security held with banks. NRB has directed to maintain loan loss provisioning according to aging basis for risk mitigation. The loan loss provision is to be maintained by debiting profit account. Thus as the quality of loan degrades the ratio of loan loss provision is increased affecting the profitability of the banks. This study will have effort to find out the relationship of NPA on Profitability of Commercial banks.

Management of NPA has led the banks towards the rigorous recovery action which ultimately may cause auctioning of the security held with banks custody. Due to adverse economic situation of the country and perception build up among the people that the properties under auction are always over evaluated there is less participation of the bidder during auction. Such situation compels the bank to accept the security on its own name. Continuous acceptance of the ownership has now created another problem by piling up the volume of Non Banking Assets (NBA). As the major chunk of NBA are fixed in nature the fund supposed to be rolled over are being tied up on fixed assets which is heating the liquidity of the Banks.

1.4 Statement of Problem

The commercial banks give loans to the deprived sectors and the loan receiver is entitled to pay the interest and the Principal amount on time. But in practice all loans are not recovered as per the sanction or within the expiry of repayment period. The study has identified the following research questions.

a. Is the NPA level of commercial banks lies within the international standard?
b. Is there any significant difference between the NPAs of commercial banks of Nepal?
c. What are the causes of NPA?
d. What is the trend of NPA of commercial banks?
e. What is the overall impact of NPA on the profitability of the Bank?
f. What are the methods to control NPA?

1.5 Objectives of the Study

The general objective of this research is to analyze the NPA and the loan and advances of the commercial banks of Nepal. The specific objectives of this research are as follows:

- To study the trend and level of Non Performing Assets of the Commercial banks of Nepal.
- To study the relationship between the ratios of Income and the Non Performing Assets to the Loan and Advances.
- To analyze the impacts of Non Performing Assets to the bank.
- To study the general reasons for assets become Non Performing Assets and make suggestions to overcome the Non Performing Assets.

1.6 Significance of the Study

Loan is the main area of the commercial banking. It plays the significant impact on the commercial bank's profitability and goodwill. But most worry factor in banking industry is the total management of loan. Due to mismanagement and economic condition the commercial banks are facing high level of NPA. This has wide spread suspicion on the performance on the commercial banks.

Nepal Government has just enacted the debt recovery act approved the long waited regulation on debt recovery to speed up the financial reforms in the financial sector.

The proposed study will make comparison between the NPA of commercial banks of Nepal and International standard. It will also check the NPA level between the commercial banks. It will wipe out some misconception that general people having about NPA of commercial banks.

This study would be important as it provides theoretical as well as conceptual framework of different aspects of Non Performing Assets (NPA).

1.7 Limitations of the Study

Errors are inevitable but we have to give full effort to minimize them. We have to do many things staying within many types of limitations and boundaries. The study has been subject to the following limitations:

- The study is based on data and information provided by commercial banks and published in the report of NRB.
- The study has been based on secondary data.
- The figures are rounded for nearest rupee.
- This research is based on data and information of only five fiscal years.
- The study has been conducted in limited time.

1.8 Organization of the Study

The whole study is divided into five chapters.

First Chapter: Introduction

The First chapter is the introduction. This includes background, statement of the problem, objectives of the study, significance of the study, limitation of the study and organization of the study.

Second Chapter: Review of Literature

The second chapter deals with the review of available literature. In this chapter both conceptual and theoretical review is done. It includes reviews of books, reports, journals, websites, etc.

Third Chapter: Research Methodology

The third chapter will explain the research methodology used in the study, which includes research design, source of data, populations and samples, methods of data analysis, etc.

Fourth Chapter: Data Presentation and Analysis

The fourth chapter includes presentation of data collected from different sources and analysis of the result.

Fifth Chapter: Summary, Conclusion and Recommendations

The last chapter summarizes the main conclusion that flows from the study and offer suggestion for further improvements and conclusions of the study.

CHAPTER-II
REVIEW OF LITERATURE

In this chapter the concept and ideas are collected from the books and related studies and publications. The conceptual framework or the review of books is presented below.

2.1 Financial Institution

Financial institutions are the organizations that issue financial claims against themselves and use the proceeds to purchase primarily the financial assets of others. They are financial intermediaries through which savers can indirectly provide funds to borrowers. They actively participate in the money market and the capital market, as both suppliers and demanders of funds. They act as the bridge between the savers and users of the fund. In other words, they collect the scattered deposits and give loans or invest to maximize their wealth.

"Financial institutions refer to any institution established with the objective of providing loan to agriculture, cooperative, industry or any other specific economic sector; or of accepting deposit from the general public. The term also refers to any other institution called financial institution by NG by publishing a notice in Nepal Gazette. However, the term does not signify commercial bank."*(NRB Act, 2012)*

"Financial institutions are interposed between the ultimate borrowers and lenders to acquire the primary securities of the borrowers and provide other securities for the portfolio of the lenders"-(Gurley and Shaw , 1997 :198)

In a broad sense, financial institutions include all the institutions engaged in the business of financial intermediation between depositors and borrowers. These financial institutions can be classified into: *(Dahal & Dahal, 1992: 168)*

a) Banking Financial Institutions

Banks are the financial intermediaries with which people are most familiar. A primary job of banks is to take in deposits from people who want to save and use these deposits to make loans to people who want to borrow. Banks pay depositors interest on their deposits and charge borrowers slightly higher interest on their loans. The difference between these rates of interest covers the banks' costs and returns some profit to the owners of the banks.

Besides being financial intermediaries, banks play a second important role in the economy: They facilitate purchases of goods and services by allowing people to write checks against their deposits. In other words, banks help create a special asset that people can use as a medium of exchange. A medium of exchange is a n item that people can easily use to engage in transactions. A bank's role in providing a medium of exchange distinguishes it from many other financial institutions. Stocks and bonds, like bank deposits, are a possible store of value for the wealth that people have accumulated in past saving, but access to this wealth is not as easy, cheap, and immediate as just writing a check. *(Mankiw, 2000:557)*

This institution offers the public both deposit and credit services, as well as a growing list of newer and more innovative services, such as investment advice, security underwriting, and financial planning *(Rose, 2001:82)*. They devote most of their resources to meeting the financial needs of business firms. However, banks have significantly expanded their offerings of financial services to consumers and units of government. It includes Commercial banks, Development banks, etc.

b) Non Banking Financial Institutions

These institutions began primarily to reach small savers and help these customers achieve home ownership and other personal goals. Non Banking Financial institutions include Finance companies, Cooperatives, Credit Unions, Saving banks, money market funds, Postal Saving, Insurance companies, Welfare Fund, etc.

2.2 Commercial Banking at Galance *(NRB, Banking and Financial Statistics,2007:7)*

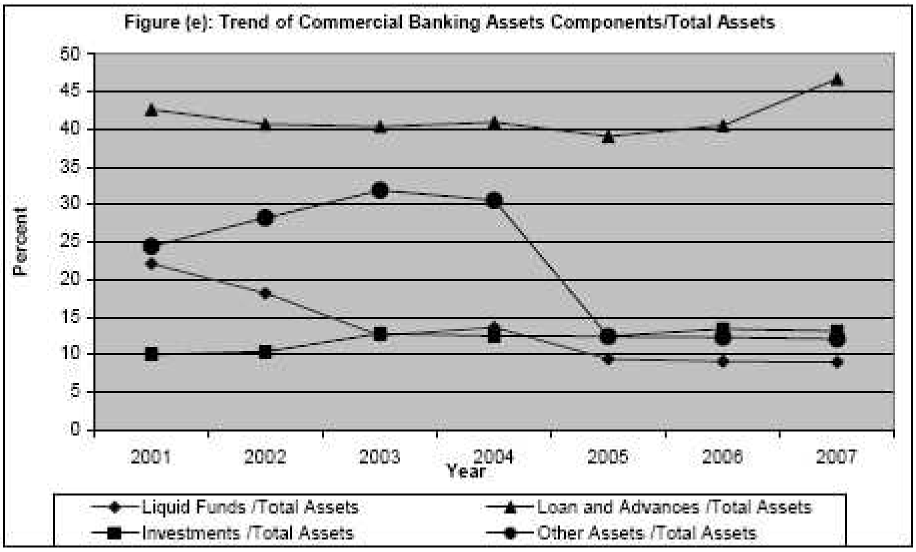
The number of commercial bank branches operating in the country reached to 552 including 45 commercial bank branches and 102 other non- commercial bank branched of ADB/N in mid July 2007. Of the total bank branches more than 46 percent bank branches are concentrated in the central region. By the end of mid July 2007, 254 branches are being operated in this region. In the eastern, western, mid-western and far western region 119, 114, 36 and 29 bank branches are in operation respectively.

As an increment of number and business of commercial bank contributed to impressive growth in the size of total assets i.e. sources of fund. In the mid July 2007, the total sources of fund of commercial bank increased by higher rate of 14.45 percent compared to 4.84 percent in preceding year. The total sources of fund of the commercial banks reached to Rs. 490638.1 million in mid July 2007. It was Rs. 428706.2 million in 2006. 10. Loans and advances, the major component of assets, constituted the 46.66 percent of total assets in mid July 2007. Similarly, investment and liquid funds, another component of assets, registered the 19.06 percent and 8.98 percent of total assets in the same year. In the preceding year the respective share of loan and advances, investment and liquid funds were 40.44 percent, 19.15 percent and 9.06 percent.

In the current year the loan and advances increased by higher rate of 32.05 percent compare to 8.61 percent in the last year. By the end of mid July 2007 the total outstanding amount of loan and advances of commercial bank reached to Rs.228951.9 million. It was Rs. 173383.4 million in mid-July 2006.

Figure 2.1

Trend of Commercial Banking Assets Components/Total Assets



Of the component of liabilities, capital funds, despite the significant improvement, remained negative of Rs.4149.5 million in mid July 2007 as against Rs.17742.1 million negative in the last year.

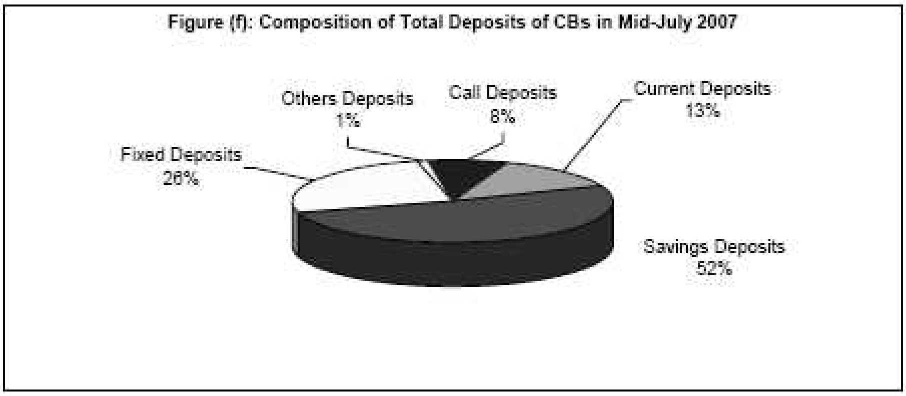
The composition of total liabilities shows that, the deposit held more than two third of total liabilities over the period of 2001-07. As of mid July 2007, it constituted the 68.79 percent. Similarly borrowing held the 2.60 percent in the same year. In the mid July 2006, the respective proportion of deposit and borrowing were 67.93 percent and 2.22 percent.

In the current fiscal year deposit mobilization of commercial bank marginally increased by 15.88 percent compare to 15.39 percent growth in the previous year. By the end of mid July 2007 it reached to Rs. 337497.2 million from Rs. 291245.6 in the last year. Of the component of deposit, current deposit accelerated by higher rate of 20.45 percent compared to 7.91 percent in last year. Fixed deposit increased slightly higher of 13.89 percent compared to 13.75 percent in the previous year. However, saving and call deposit growth rate slipped to 15.23 percent and 18.62 percent compare to 16.65 percent and 28.51 percent respectively.

Of the components of total deposit, saving deposit constituted the highest share of 51.77 percent followed by fixed deposit 25.84 percent, current deposit 12.84 percent and call deposit 7.99 percent in mid July 2007. In the last year the respective share of saving, fixed, current and call deposit were 52.07 percent, 26.29 percent, 13.34 percent and 7.80 percent.

Figure 2.2

Composition of Total Deposits of Commercial Banks



The share of borrowings to total liabilities accounted to 2.60 percent in mid-July 2007. It was 2.20 percent in the last year. In the mid July 2007 the borrowing of commercial banks grew by slower rate of 33.93 percent compared to 39.12 percent in previous year. By the end of mid July 2007 it reached to Rs. 12750.4 million from Rs. 9519.6 million in the last year.

Liquid funds increased by 14.45 percent and reached to Rs.44089.7 million in mid-July 2007 from Rs. 38842.1 million in mid-July 2006.

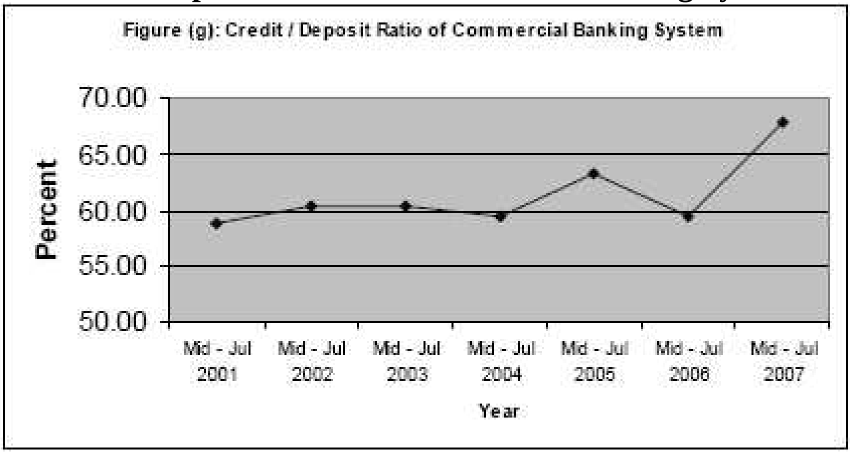
In the purpose wise credit front, the total outstanding loans and advances reached to Rs.231844.7 million in mid July 2007. Out of them the production sector constituted the highest share of 26.90 percent followed by wholesale & retailers 19.68 percent, construction 8.53 percent, service industries 7.92 percent, finance, insurance & fixed assets 6.0 percent agriculture 5.98 percent transportation, communication & public services 5.66 and consumable loan 3.51 percent.

Subsequent decision of NRB to phase out priority sector lending, it will not be compulsory to provide such loan from the fiscal year 2007/08. By the end of mid July 2007, total priority sector credit reached to Rs. 26957.40 million. The inclusion of financial figures of ADB/N in commercial bank resulted to increase significant proportion of priority sector credit to total credit in the current fiscal year. Consequently, it is recorded at 12.75 percent of total outstanding loan of six months ago. It was 5.7 percent (Rs. 10104.1 million) in mid July 2006.

The deprived sector credit increased by 30.20 percent and reached to Rs. 6842.0 million in mid-July 2007 as compared to Rs. 5255.13 million in mid-July 2007. The ratio of deprived sector credit to total credit(six month ago) recorded at 3.24 percent in the current fiscal year. Last year it is was 2.97 percent.

By the end of mid July 2007, the credit/deposit ratio of the commercial banks increased to 67.84 percent from 59.53 percent in the last year. Higher growth rate of loans and advances compared to deposit mobilization contributed to increase in this ratio.

Figure 2.3
Credit/Deposit Ration of Commercial Banking System



In the current fiscal year the net profit of the banking system grew by slower rate of 10.20 percent compared to 53.38 percent in the last year. By the end of mid July 2007 the net profit amounted to Rs. 8797.9 million from Rs 7983.5 in mid July 2006.

In the capital adequacy front, it increased remarkably and turned to positive of 0.17 percent in the current fiscal year as against the negative in last four years. In the previous year this ratio was negative of 5.3 percent.

Table 2.1
Soundness Indicators of Commercial Banking System

	Mid-July						
Indicators	2001	2002	2003	2004	2005	2006	2007
Profitability(Rs. In Million)	-7843	-9428	-3317	3707	5205	7983.51	9797.9
NPL as % of Total Loan	29.3	30.4	28.8	22.8	18.94	14.22	9.65
Total Capital Fund as Percentage or RWA	-5.49	-9.88	-12.04	-9.07	-6.33	-5.30	0.17

The status of non-performing loan of commercial banks shows that, they are making positive improvement over it. By the end of mid July 2007, the ratio of non-performing loans to total loan and advances declined to 9.65 percent. Total amount of non-performing loan remained to Rs. 22182.9 million in the same year. In the last year the percent and amount of non-performing loan were 14.22 percent and Rs. 26770.42 million respectively.

2.3 Financial Markets

The term financial market refers to the network of borrowers and lenders of funds within the economy and to the general market place through which borrowers and lenders are brought together. There is the need for infrastructure since it is typically provided by the arrangements for trading in securities. It is the mechanism created to facilitate the exchange of financial assets.

Investments are made in assets. Assets, generally, are tow types: *Real Assets* (Land, Building, Factories, Vehicles, etc.) and *Financial Assets* (Stocks, Bonds, T-Bills, etc.). These two types of investments are not competitive but complementary. The markets where financial assets are traded are called Financial Markets.

Financial markets can be classified on different basis:

2.3.1 Primary and Secondary Market

This classification is on the basis of securities traded.

Primary market refers to the market where new securities are issued for the first time to raise funds. Securities traded in the primary market for the very first time referred to as Initial Public Offering (IPO).

Secondary market refers to the market where existing or already outstanding securities are traded among investors. NEPSE is an example of a secondary market. *(Rose, 2001:12)*

2.3.2 Money and Capital Market

On the basis of life-span of securities, financial markets are classified as Money and Capital market.

Money Market refers to the market where short term and highly liquid debt securities are traded. A money market typically involves financial assets that have a life span of one year or less. Money market instruments include short-term marketable, liquid, and low-risk securities. It includes T-Bill, negotiable certificate of deposit (CDs), Bankers' acceptances, Commercial Papers, etc.

Capital markets are the markets meant for long-term securities. Capital markets typically involve financial assets that have life spans of greater than one year.*(Rose, 2001:15)*

2.3.3 Loan and Security Market

Another way of classifying financial market is to divide them into market for loans and market for securities.

Market for Loan is negotiated face to face directly between the borrower and lender.

Securities market is impersonal or open market where buyers and sellers of securities are unknown to each other. Trading is done through the help of the brokers or dealers.*(Shrestha & Bhandari, 2004:16)*

2.4 Types of Loan

A loan - unlike equity - is a fixed payment contract, irrespective of whether there is profit or not. Yet businesses fail and the contractual payments are not honored. If the loan is secured through collateral, the bank can seize and sell the collateral, but in many countries that involves legalities and delays.

Loans and Advances are the primary assets of the commercial banks. Most of bank's funds are used to acquire earning assets, which provide the bulk of revenue and enable them to cover expenses, including the cost of capital. There are various types of bank loans, according to the way in which the interest payments are calculated. Bank loans may be classified as: *(Shrestha & Bhandari, 2004: 263-266)*

2.4.1 Amortized Loans

Amortized loan refers to the determination of the equal annual loan payments necessary to provide a lender with a specified interest return and repay the loan principal over a specified period, so the loan takes the form of an annuity.

In the amortized loans system, first step is to calculate installments to be paid for every period. Suppose the loan amount is Rs. L, the rate of interest is k percent per period, and the number of payments is n, then the installment payment can be calculated as follows:

$$PeriodicalInstallment = \frac{Loanborrowed}{PVIFA_{K,n}}$$

2.4.2 Add-On Loans

The term "add-on" means that the interest is calculated and then added to the amount received to determine the loan's face value. The sum of the principal and interest is then divided over the number of periods to calculate the constant periodic payments.

2.4.3 Discount Interest Loans

In a discount interest loan, the bank deducts the interest in advance (beginning of the period). In this type of loan, the lender receives payment of all the interest that will accrue on the loan at the time the loan is granted. Since the interest is prepaid, the borrower must only repay the principal, usually in equal payments.

2.5 Loan Management

Loan and advances dominate the asset side of the balance sheet of any bank. Similarly, earnings from such loans and advances occupy a major space in income statement of the bank. Lending can be said to be the raison d' etre of a bank. However, it is very important to be reminded that most of the bank failures in the world are due to shrinkage in the value of loan and advances.

Hence, loan is known as risky assets. Risk of non-repayment of loan is known as credit risk or default risk.(Bhandari, 2003:114)

Performing loans have multiple benefits to the society while non performing loan erodes even existing capital. Considering the importance of lending to the individual bank and also to the society it serves, it is imperative that the bank meticulously plans its credit operations. Sound credit policy, whose objectives are as follows, is a foundation in this direction:

i. To have performing assets
ii. To contribute to economic development
iii. To give guidance to lending officials
iv. To establish a standard for control

The established credit policy normally speaks about the following components:

2.5.1 Loan Volume

The policy should contain the credit deposit ratio (CD ratio) the bank wishes to maintain. CD ratio is very much influenced by the behavior of bank's liabilities. The higher the volatile deposit and volatile borrowings lower the volume of loan and vice versa. Moreover, the bank should fix the amount of loan it wishes to give to a single borrower. Limit should not be more than the one set by regulatory authorities. In Nepal, a bank can give maximum loan to a borrower as follows:

Funded credit: 25% of bank's core capital
Non-Funded Credit: 50% of bank's core capital

2.5.2 Loan Mix

The bank gives loan to various sectors. This is necessary for the long term survival of the bank. Even if any sector is doing very well, the bank does not put is total money in that sector. If the bank concentrates its lending only in one sector, failure of the sector may cause bankruptcy of the bank. Even if two individual borrowing units of two sectors have the same level of risk, the portfolio risk is minimized due to diversification. There is a practice of fixing maximum amount of loan bank wants to give in one sector. Normally, the ceiling is fixed in relation to core capital o the bank. As per NRB, if a bank wishes to have credit exposure (funded+ non-funded) in any sector more than 100% of its core capital, the same should be approved by the Board of Directors and should be notified to NRB.

Similarly, the policy should have reference to short term and long term loan mix. This is very much affected by the nature of bank's deposits mix and interest rate movement in the market. The bank having short term maturing liabilities go for regular amortizing and self liquidating loans though, normally, the long term loan gives higher rate of return. However, in the scenario of rising interest rate, bank can make more money by having loan portfolio maturing in the short term.

2.5.3 Pricing

The policy should have reference to the pricing of loan services. Profitability in loan is calculated as follows:

P = I-O-C-D

Where, P=Profitability, I=Interest, O=Operating expenses, C=Cost of fund

D=Expected default loss

There is a practice of fixing prime lending rate. Based on the risks, percentage is added in the prime lending rate. The higher the risk, the higher will be the rate. Being a custodian of public money, the bank however should not take risk beyond a certain level irrespective of how high the lending rate is. The policy should speak whether the bank adopts fixed or floating or mixed type of interest rate in its loan portfolio. The policy should speak about compensating balance (the balance the borrower is required to maintain at the bank as a condition of the loan) and commitment fee.

Credit policy should positively react to interest rate structure in the market. Flexibility required. However, no concession beyond certain level of interest rate on the borrower's threat that they would shop around.

2.5.4 Lending Authority

This is one of the very critical aspects of loan management. Misuse of lending authority puts the bank at a risk. Some banks adopt centralized while some banks adopt centralized while some banks adopt decentralized approach regarding lending authority. Under centralized approach, lending authority is not given to branch staff. Under decentralized approach, a certain limit is given to forward to Head Office for approval. Both the approaches have inherent merits and demerits. The apex lending authority in a bank is the Board of Directors but the board has also cap like single borrower limit (one obligor limit) set by NRB. Under both the approaches, some banks fix limit to the official the approving authority. In some banks, lending authority however is not tied up with the level; rather it is tied up with the knowledge and experience of lending officials. The latter looks more scientific though it may cause some dissatisfaction in the organization.

2.5.5 Securities

The Policy should say what types of securities the bank wants to take and does not want to take. Some banks do not take bullions and only personal guarantees as securities. Similarly, the policy should cover about the selection of valuators. Marketability, convenience and transferability should be the guiding factors for selection of securities. Moreover, the policy should talk about different types of documents to be executed for various types of loan so that proper charge can be created on the securities.

2.5.6 Risk Analysis

The policy should have reference to the acceptable character of the borrower. Though it should not be like a straitjacket, the policy should specify the acceptable liquidity, leverage, coverage, efficiency and profitability ratios so that there can be consistency in the risks perceived by all lending officials.

2.5.7 Loan Administration & Control Mechanism

Structure of loan administration plays a key role in the effective loan management. Being loan a risky asset, efforts should be made to have proper control in the every step of loan management. In certain countries, there is a 'four eyes' concept. A single person can not do anything. There should be involvement of at least two officials or tow departments. If a bank has separate relationship maintenance and inspection, there is possibility of findings mistakes of one department by others. It helps keep non-performing assets (NPA) at low level. This may entail more cost but is peanut compared to the risk it minimizes. Moreover, this helps increase bank's business with good customers resulting in more income.

Though the bank expects loan repayment from the cash flow generated from the operation of the borrower, the default of loan cannot be ruled out. To protect bank against such happenings, the bank takes various types of securities so that in the event of default these securities are disposed for recovery of loan. Hence, the policy can have reference to securities disposal and other recovery measures.

2.5.8 Loan Classification and Provisioning

Though all loans are good at the time of disbursement, with the passage of time, they show the sign of problem. Based on the health of the loan, the loan should be classified and provided accordingly. Provisioning is made as cushion against possible losses and to reflect the true picture of bank's assets. Hence, there is a practice of showing net loan (total loan-loan loss provision) in the financial statements instead of gross loan. The bank should comply with statutory regulation relating to loan classification and provisioning.

NRB regulation on classification and provisioning is as follows:

Type	Criteria	Provision Requirement
Pass	Principal overdue up to 3 months	1%
Substandard	Principal overdue up to 6 months	25%
Doubtful	Principal overdue up to 1 Year	50%
Bad	Principal overdue above 1 Year	100%

Pass loan is called 'Performing' and others are called 'Non-Performing Assets'. Provision requirement in case of loan given against personal guarantee only is additional 20% for Pass, Substandard and Doubtful loans. Provision for restructured, rescheduled and swapped loan is 12.5% only.
For better management of loan portfolio, the management can have more classifications and can have more stringent criteria than the one fixed by regulating authorities.

2.5.9 Statutory directives

Management should devise the policy keeping in mind the statutory directives. Lending function of a bank is heavily influenced by the directives because the quality of a bank's loan portfolio has to do more with risk and safety than any other banking operation.

Credit facility helps create jobs and income to thousands of the people directly and indirectly thereby raising their living standard. Hence, regulatory authorities make efforts to ensure there is no discrimination to any community or any individual on the ground of race, sex, religion, age, education level etc. In USA, the community Reinvestment Act 1977 requires the banks to meet the credit needs of individuals and businesses in their territories. Similarly, Equal

Credit Opportunity Act 1974 bars the banks from denying credit facilities to any individual because of their sex, religion, race, age etc.

Major regulation of NRB relating lending activities of the banks are as follows:

- Single borrower limit
- Sectoral limit
- Directive Credit(priority sector and deprived sector limit)
- No loan to restricted areas
- No loan to directors/employees/shareholders holding more than 1% share of the bank
- Interest rate deviation

2.5.10 Quality of Lending Officials

Experience, knowledge, adaptability etc of lending officers should be considered while formulating the policy.

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

2.6 Loan Approval Process

Loan is approved by the approving authority only after being convinced that the loan will be repaid together with interest. There are many processes involved to approve the loan which are as follows: *(Dahal & Dahal, 1992: 121)*

2.6.1 Application

A borrower is normally required to submit an application to the bank along with required documents:- Project Proposal, historical financial statements and documents pertaining to company's legal existence.

2.6.2 Conducting the Interview

Though the documents submitted give much information about the borrower; collecting information by interviewing the borrower is of great importance. Normally, such an interview takes place at the bank premise.

The interviewer normally a loan officer should attempt to gain as much information as possible during the initial interview. This should be done in a friendly and positive manner. Respect should be shown for the applicant's business situation and ideas. Complex terminology not familiar to the applicant should be avoided.

There is the danger that the interviewer, who is very sensitive to the risk of making an undesirable loan, may appear overly negative. The interviewer may seem to be looking for that one answers that will justify rejecting the application. Needless to say, if the business person leaves with this feeling, more harm than good has come from the interview. This demands a great deal of finesse.

If a loan should not be made, it is better to make this determination in the initial interview than after both the lender and the applicant have invested extensive time and effort. Thus, as many pertinent questions as possible should be asked during the initial interview. When the interviewer recognizes that the loan should not be made, the applicant should be informed. The turndown should be made clearly and as politely as possible.

What to learn during Interview

- Loan Purpose
- Loan Amount
- Repayment source
- Repayment schedule
- History of the Business
- Banking relationship

2.6.3 The Credit Analysis

Following steps are taken to analyze/appraise loan application:

Historical Analysis

Historical analysis refers to analysis of past financial statements and business risk. The former is quantitative while the latter is qualitative analysis. The financial analysis exhibit the financial performance of the management and business risk analysis helps to the major risk factors (supply, production, demand, collection, management) observed in the past and how management mitigated them. The underlying purpose of historical analysis is to know the major factors in borrower's present condition and past performance which foreshadows borrower's likely success or failure in repaying the debt in future.

There is a practice of analyzing 5Cs of Credit (Character, Capacity, Condition, Capital and Collateral) by the financial institutions.

Character: It refers to the personal traits (ethics, honesty and integrity) of borrowers which is very important for lending decision. Serious purpose, truthfulness in answering the queries, responsibility and seriousness in making all the efforts to repay loan make up what a lending official call the Character. Dishonest borrower always finds a way to avoid the restrictions imposed through the loan agreement. No further credit analysis is made if the lending official feels the borrower lacks character.

Capacity: Capacity is being used in two senses. 1. Legal Capacity to borrow money. 2. Capacity to generate enough income to repay loan or through liquidation of assets.

Condition: Condition refers to the general economic condition beyond the control of the borrower that affects the business of the borrower. This is basically security, political and other social conditions under which the business has to operate. Loan is given to the borrower if lending official feels general condition is favorable for that type of business.

Collateral: Loan is given if the banker is satisfied that the borrower can repay money from the cash flow generated from operating activities. However, the bank wants to ensure that their loan is repaid even in case of default. In such cases, the banker asks for additional securities. Collateral can be fixed in nature – land, building, machinery- or working capital like inventories and account receivables.

Capital: Capital refers to net worth of the borrower. This is covered under capacity above while analyzing the leverage ratio. Leverage ratio will be high if the borrower has low capital. A bank gives loan only when it finds leverage ratio acceptable to it or if the borrower has enough capital.

2.6.4 Forecast and Risk Rating System

Based on the Findings of historical analysis, and in light of present and foreseeable future environment, the analyst has to forecast impending major risks. The analyst should also highlight to what extent inherent risks will be mitigated and how unmitigated risks can be covered.

Analysis of credit information attempts to answer the question "How risky would it be to lend to this applicant?". Most commercial loans are risky to some degree. Upto a certain risk level, a lender may justify granting a particular loan and attempt to compensate for the relatively high risk by charging a high rate of interest and adequate securities. Above a certain risk level, loans will not be granted. Thus, it can be said that credit analysis: (1) determines which loans will be made and which will not and (2) provides a ranking from low risk to high risk for those loans that are made, thus helping determine the rates of interest to be charged and the value of securities to be obtained.

2.6.5 Return

The amount of loan has got inherent cost as it is obtained from either shareholder or depositor or creditor. The analysis should be made to calculate total return (interest, fee and commission) and compare whether it meets bank's standard.

2.6.6 Liquidation

The analyst should ascertain bank's ability to recover loan in case of liquidation of the borrower. If liquidation analysis reveals insufficient security, additional security may be asked for.

2.6.7 Creditworthiness and Debt Structure

If the analyst finds the borrower creditworthy and decides to extend loan, he should structure the debt facility to be extended.

2.6.8 Collateral

Bank analyzes various financial statements like Balance sheet, Profit and Loss Account, Cash Flow Statement of borrower for financial appraisal and for the assessment of borrower’s credit-worthiness. Bank decides to sanction the loan mainly relying on the borrower and his proposition. However, it proves very costly for the bank in the event the borrower and his proposition fails. To safeguard bank’s interest, bank asks for security which proves to be cushion in case of default. There are two types of securities:

a. Primary Security: The security deposited by the borrower himself is known as primary security. This includes promissory note and tangible securities offered by the borrower.

b. Collateral Security: Collateral means “additional” or “secondary”. If the bank feels that primary security is insufficient, the borrower is asked to provide additional security. Thus, collateral security means security deposited by the third party to secure advance made to the borrower. This includes guarantee and tangible securities offered by the third party.

2.7 Action Guidelines according to state of Loan

On different states of loan different actions should be taken. *(Dahal & Dahal, 1992:55)*

2.7.1 Pass Loan

Provide “good” service, retain customer. Consider new facilities

2.7.2 Indicative of Sub-Standard

- Obtain legal review of all documentation
- No new facilities.
- Frequent contact to gain more information/monitor problems
- Suggest ways to strengthen company and protect Bank
- Consider inter-creditor agreements

2.7.3 Substandard

- Service not at issue, move immediately to strengthen Bank’s position.
- Seek reduction in facilities and/or increase in security, restructure debt if advantageous to Bank
- Take “hard-line” with management, demand specific plan to improve situation

- Look for ways to improve management, control management,etc.

2.7.4 Doubtful

- No interest taken to profit
- Look for ways to avoid losses
- Take legal action now, sell security if advantageous to bank, force management to repay/finance
- Structure workout agreements with other creditors if necessary and advantageous
- Offset where possible, control payments
- Monitor weekly, track performance, control all assets and liabilities, if possible
- Look for ways to control all cash flows, appoint receivers as appropriate

2.7.5 Bad

- Loss inevitable, take provisions to cover loss and all costs of liquidation
- Look for ways to minimize losses, study timing of sales
- Be creative, but remember the time value of money

These are general guidelines for managing loans and advances according to its state.

2.8 Financial Performance and Financial Institution

Financial soundness is a situation where depositor's funds are safe in a stable banking system. The financial soundness of a financial institution may be strong or unsatisfactory varying from one bank to another. External factors such as deregulation; lack of information among bank customers; homogeneity of the bank business, connections among banks do cause bank failure. Some useful measures of financial performance which is the alternative term as financial soundness are coined into what is referred to as CAMEL. The acronym "CAMEL" refers to the five components of a bank's condition that are assessed:

Capital adequacy, Asset quality, Management, Earnings, and Liquidity. A sixth component, a bank's Sensitivity to market risk, was added in 1997; hence the acronym was changed to CAMELS. (Note: that the bulk of the academic literature is based on pre -1997 data and is thus based on CAMEL ratings.) Ratings are assigned for each component in addition to the overall rating of a bank's financial condition. The ratings are assigned on a scale from 1 to 5. *(Bhandari,2003:127)*

Capital Adequacy: This ultimately determines how well financial institutions can cope with shocks to their balance sheets. The bank monitors the adequacy of its capital using ratios established by The Bank for International Settlements. Capital adequacy in commercial banks is measured in relation to the relative risk weights assigned to the different category of assets held both on and off the balance sheet items.

Asset Quality: The solvency of financial institutions typically is at risk when their assets become impaired, so it is important to monitor indicators of the quality of their assets in terms of overexposure to specific risks trends in non-performing loans, and the health and profitability of bank borrowers especially the corporate sector. Credit risk is inherent in lending, which is the major banking business. It arises when a borrower defaults on the loan repayment agreement. A financial institution whose borrowers default on their repayments may face cash flow problems, which eventually affect its liquidity position. Ultimately, this negatively impacts on the profitability and capital through extra specific provisions for bad debts.

Earnings: The continued viability of a bank depends on its ability to earn an adequate return on its assets and capital. Good earnings performance enables a bank to fund its expansion, remain competitive in the market and replenish and /or increase its capital. A number of authors have agued that, banks that must survive need: Higher Return on Assets (ROA)., better return on net worth/Equity (ROE), sound capital base i.e. the Capital Adequacy Ratio (CAR), adoption of corporate governance ensuring transparency to stakeholders that is equity holders, regulators and the public.

Liquidity: Initially solvent financial institutions may be driven toward closure by poor management of short-term liquidity. Indicators should cover funding sources and capture large maturity mismatches. An unmatched position potentially enhances profitability but also increases the risk of losses. The “M” represents Management, given that this paper is hinged on financial performance, the management component in not considered in the measure.

Generally, literature on corporate governance comprises attributes such as financial transparency, disclosure and trust among others and it is revealed that financial transparency and disclosure enhance trust between the stakeholders and organizations like commercial banks. Capital Adequacy, Earnings and Liquidity are the key dimensions of measuring financial performance in Commercial Banks. In summary, this literature forms an underpinning for the establishment of the association between corporate governance and financial performance.

2.9 Risk

Risk is defined as the variability of the returns of a period. The deviation between the expected and actual return brings variability in the return and the variability is termed as risk. The higher the deviation between expected and actual return, the higher will be the risk. Risk is the uncertainty or returns and if there is certainty there is no risk at all. Risk and return in investment go together and without risk no more return can be expected. *(Pradhan, 2004:84)*

2.9.1 Sources of Risk

Various factors contribute to investment uncertainty. The major causes of uncertainty that contribute to investment risk are as follows: *(Bhattarai, 2006:107)*

2.9.1.1 Liquidity Risk

Liquidity risk is associated with uncertainty created by the inability to sell the investment quickly for cash. The return variability will increase if price discounts and sales commission are to be given in order to liquidate assets in time. The less the liquidity, the greater will be the risk. So, two factors- price and time are associated with liquidity.

2.9.1.2 Interest Rate Risk

It is the potential variability of a return caused by changes in the market interest rates. Market interest rate influences the value of an asset and hence its return. If the market interest rate rises, the value of an asset will decrease. A higher interest rate means a higher discount rate and a higher discount rate causes a lower present value of any asset.

2.9.1.3 Default Risk

Default risk is related to the probability that some or all of the initial investment will not be returned. The degree of default risk is closely related to the financial condition of the company issuing the security and the security is rank in claims on assets in the event of a default or bankruptcy.

2.9.1.4 Call ability Risk

Some securities are issued with a call provision i.e. a company may call back the securities issued before their maturity. The call ability risk is the portion of securities total variability of return that derives from the possibility that the issue may be called.

2.9.1.5 Convertibility Risk

Convertibility risk is that portion of the total variability of return from a convertible bond or convertible preferred stock that reflects the possibility that the investment may be converted into the issuer's common stock at a time or under terms harmful to the investor's best interests.

2.9.1.6 Bull-Bear Market Risk

The various market forces make securities price upward and downward. The upward trend of market price (Bull Market) and downward trend of market price (Bear market) create a long lasting source of investment risk.

2.9.1.7 Industry Risk

Industry risk is that portion of an investment's total variability of return caused by events that affect the products and firms that make ups and downs to the industry. Some of the factors which affect all the firms in an industry may be the industry's life cycle, international tariffs or quotas, industry-related taxes and availability of industry related raw materials

2.9.1.8 Management Risk

Management errors are difficult to analyze, investors can reduce their risk by buying shares in those corporations in which the executives have the significant equity investment instead of buying shares in the corporation in which executives have no equity investment.

2.9.1.9 Political Risk

Political risk is the portion of assets' total variability of return caused by changes in the political environment (domestic and international as well as the internal changes of the company.

2.9.1.10 Purchasing Power Risk

It is the variability of return an investor suffers because of inflation. Inflation (or a rise in general prices over time) seems to be the normal way of life in most countries today. However, when inflation takes place, financial assets (such as cash, stocks, and bonds) may lose their ability to command the same amount of real goods and services they did in the past. To put this another way, the real rate of return on financial assets may not adequately compensate the holder of financial assets for inflation.

2.9.2 Risk Diversification

The process of adding securities to a portfolio in order to reduce the portfolio's unique risk and, thereby, the portfolio's total risk. By combining securities of low risks with securities of high risks, success can be achieved by an investor in making a choice of investment outlets. Combination of securities can be made in many ways. *(Bhattarai, 2006:133)*

2.9.2.1 Simple Diversification

It is the random selection of securities that are to be added to a portfolio. Equal weight is given to all the assets. It was found in many research studies that 10 to 15 securities in a portfolio would bring adequate returns.

2.9.2. Diversification across Industry

It is diversification across industries. Under this technique, assets in the portfolio are selected from different industries rather than from one industry.

2.9.2.3 Superfluous Diversification

Under a simple diversification a maximum risk reduction is attained through the inclusion of 10 to 15 assets in the portfolio. If we add further more assets in the portfolio, such diversification is called superfluous diversification. No further risk reduction is possible but instead it arouses more portfolio management problems like, high research cost, high transactions costs, impossibility of good portfolio management, etc. The performance of the portfolio will not improve and will lower the net return to the investor. Hence, the superfluous diversification should be avoided.

2.9.2.4 Simple Diversification across Quality Rating

Diversification of our portfolio is also possible across the quality rating assets or securities. Different rating agencies rate different companies and their assets on the basis of the possibility of default risk or the risk of bankruptcy. Under a simple diversification across quality rating categories, we select assets randomly from the homogeneous quality ratings. The highest quality portfolio of randomly diversified stocks will be able to achieve lower levels of risk than the simple diversified portfolio of lower quality stocks.

2.9.2.5 Markowitz Diversification

A more analytical technique to diversify a portfolio is Markowitch diversification. The basic portfolio model was developed by Harry Markowitz, who derived the expected rate of return for a portfolio of assets and an expected risk measure.

Markowitz diversification is based on the correlation. Under this theory, if portfolio is made by combining assets which are less than perfectly positively correlated (+1), the reduction in risk is possible without sacrificing portfolio returns. The lower the correlation between assets, the more the Markowitz diversification will be able to reduce the portfolio's risk. If the assets are perfectly negatively correlated (-1), the riskless portfolio is possible.

2.10 Corporate Governance

Corporate governance is about building credibility, ensuring transparency and accountability as well as maintaining an effective channel of information disclosure that would foster good corporate performance. It is also about how to build trust and sustain confidence among the various interest groups that make up an organization. Indeed the outcome of a survey by Mckinsey in collaboration with the World Bank in June 2000 attested to the strong link between corporate governance and stakeholder confidence Given that a study has already been carried out on the extent to which board composition affects team processes (orientation communication feedbacks, coordination, leadership and monitoring), board effectiveness and performance of the selected financial institutions in Uganda, the researcher picked three basic tenets of Corporate Governance; Transparency, Disclosure and Trust in relation to commercial bank financial performance in Uganda, these tenets fall under the accounting field. The constructs/tenets are reviewed in the following sections. *(Rogers, 2003:4)*

2.10.1 Transparency

Transparency is integral to corporate governance, higher transparency reduces the information asymmetry between a firm's management and financial stakeholders (equity and bondholders), mitigating the agency problem in corporate governance. In Uganda lack of transparency is attributed to the closures of commercial banks.

2.10.2 Bank Transparency

The concept of Bank transparency is broad in scope it refers to the quality and quantity of public information on a bank's risk profile and to the timing of its disclosure, including the banks past and current decisions and actions as well as its plans for the future. The transparency of the banking sector as a whole also includes public information on bank regulations and on safety net operations of the central bank.

Weak transparency makes banks' asset risks opaque. Stock market participants including professional analysts such as Moody's encounter difficulties in measuring banks credit worthiness and risk exposures. Ball (2001) argues that timely incorporation of economic losses in the published financial statements (that is, conservatism) increases the effectiveness of corporate governance, compensation systems, and debt agreements in motivating and monitoring managers. For instance, improved governance can manifest in a reduction of the private benefits that managers can extract from the company or in a reduction of the legal and auditing costs that shareholders must bear to prevent managerial opportunism. Governance research in accounting exploits the role of accounting information as a source of credible information variables that support the existence of enforceable contracts, such as compensation contracts with payoffs to managers contingent on realized measures of performance, the monitoring of managers by boards of directors and outside investors and regulators, and the exercise of investor rights granted by existing securities laws. There are a number of issues to consider in this regard. First, the existence of a strong financial accounting regime is likely a precondition for the existence of a vibrant stock market and in its absence the notions of equity-based pay and diffuse ownership of firms become moot Institutional Variables Used to Measure Corporate transparency comprises Financial accounting disclosures of major stakeholders, Timeliness of disclosures, Information dissemination and completeness of information. Robert & Abbie concur with BPS especially on institutional transparency, they outline the transparency dimensions as; Completeness of financial information, Release of information, Timeliness, and Means of dissemination.

2.10.3 Disclosure

Greater information provision (disclosure) on the company's capital and control structures – can be an important means to achieve this goal. High quality and relevant information is crucial for exercise of governance powers. Full Disclosure seeks to avoid financial statements fraud. Prior studies have concentrated on disclosure of items such as management earnings forecasts or interim earnings, or have examined a very general disclosure index of financial and/or non - financial items. The CIFAR Index (i.e. a disclosure index created by the Center for Intentional Financial Analysis and Research (CIFAR) rates annual reports on the inclusion or omission of about 90 (rather traditional and mandatory financial) items from the following categories; general information, income statements, balance sheet, funds flow statement, accounting standards, stock data and special items.

2.10.4 Dangers of Voluntary Disclosure

The most common arguments against voluntary disclosure from a managerial perspective are fear of giving away sensitive information to competitors and procurement of extra costs for collecting and disclosing the information. However, it is worth noting that as competition continues to bite, the "basket of secret" information tends to reduce.

2.10.5 Financial Disclosure

Financial disclosure, which is a key component of the newly proposed Basel Capital Accord, is reviewed in the following paragraphs. In April 2003, the Basel Committee on Banking Supervision , headquartered at the Bank for International Settlements in Switzerland, released the new Basel Capital Accord, which replaced the 1988 Capital Accord with an attempt to set regulatory capital requirements that are comparable across countries. The purpose of pillar three is to complement the other pillars by presenting an enhanced set of public disclosure requirements focusing on capital adequacy. This pillar is examined in more detail than the first 2 pillars given that disclosure represents one of the key variables in the scope of this study.

2.10.6 Details of Pillar Three

Pillar Three addresses the issue of improving market discipline through effective public disclosure. Specifically, it presents a set of disclosure requirements that should improve market participants' ability to assess banks' capital structures, exposures, management processes, and, hence, their overall capital adequacy. The proposed disclosure requirements consist of qualitative and quantitative information in three general areas: corporate structure, capital structure and adequacy, and management. Corporate structure refers to how a banking group is organized; for example, what is the top corporate entity of the group and how are its subsidiaries consolidated for accounting and regulatory purposes. Capital structure corresponds to how much capital is held and in what forms, such as common stock. The disclosure requirements for capital adequacy focus on a summary discussion of the bank's approach to assessing its current and future capital adequacy.

2.10.7 The Concept of Trust

Trust means many things. Everyone knows intuitively what it is to trust; yet articulating a precise definition is not a simple matter. Trust is difficult to define because it is so complex, in fact, has observed.

"There appears to be widespread agreement on the importance of trust in human conduct, but unfortunately there also appears to be an equally widespread lack of agreement on a suitable definition of the construct".

Trust is a multifaceted construct, which may have different bases and phases depending on the context; it is also a dynamic construct that can change over the course of a relationship *(Wayne & Megan, 2002:20)*.

2.10.8 Facets of Trust

There are at least five facets of trust that can be gleaned from the literature on trust. Benevolence, reliability competence, honesty and openness are all elements of trust *(Wayne & Megan, 2002:20).*

Benevolence perhaps the most common facet of trust is a sense of benevolence **-** confidence that one's well being or something one cares about will be protected and not harmed by the trusted party.

Reliability at its most basic level trust has to do with predictability that is, consistency of behavior and knowing what to expect from others. In and of itself, however, predictability is insufficient for trust. We can expect a person to be invariably late, consistently malicious, inauthentic, or dishonest when our well-being is diminished or damaged in a predictable way, expectations may be met, but the sense in which we trust the other person or group is weak.

Competence: Good intentions are not always enough when a person is dependent on another but some level of skill is involved in fulfilling an expectation an individual who means well may nonetheless not be trusted. Competence is the ability to perform as expected and according to standards appropriate to task at hand, many organizational tasks rely on competence.

Honesty: Honesty is the person's character, integrity and authenticity Rotter (1967) defined trust as "the expectancy that the word, promise, verbal or written statement of another individual or group can be relied upon". Statements are truthful when they confirm to "what really happened "from that perspective and when commitments made about future actions are kept. A correspondence between a person's statements and deeds demonstrates integrity.

Openness: Openness is the extent to which relevant information is shared; it is process by which individuals make themselves vulnerable to others. The information shared may be strictly about organizational matters or it may be personal information, but it is a giving of oneself such openness signals reciprocal trust a confidence that neither the information nor the individual will be exploited and recipients can feel the same confidence in return. Individuals who are unwilling to extend trust through openness end up isolated.

2.11 Relationship of Transparency, Discloser, Trust and Financial Performance

Transparency, disclosure and trust, which constitute the integral part of corporate governance, can provide pressure for improved financial performance. Financial performance, present and prospective is a benchmark for investment. The Mckinsey Quarterly surveys suggest that institutional investors will pay as much as 28% more for the shares of well governed companies in emerging markets. According to the corporate governance survey 2002, carried out by the Kuala Lumpur stock exchange and accounting firm Price Water House Coopers (PWC), the majority of investors in Malaysia are prepared to pay 20% premium for companies with superior corporate governance practices. (Rogers, 2003:7)

2.12 NRB Directives to Commercial Banks relating to Credit *(NRB, Unified Directives, 2006)*

2.12.1 Directive Credit

Banks have to extend a certain percentage of loan and advances in the deprived and priority sector. Currently, deprived sector lending should be at least 0.25% to 3% depending on the banks and priority sector lending at least 12% inclusive of deprived sector lending to their total credit portfolio. However, monetary policy of FY 2059/2060 BS announced by NRB has pledged to phase out priority sector credit programme in next five years but to continue with deprived sector credit programme.

In case of shortfall in any sector, the concerned bank has to pay penalty at the highest lending rate of the bank during the shortfall period which is monitored quarterly.

2.12.2 Single Borrower Limit

Single borrower's limit refers to the maximum credit limits that can be extended to a customer, firm, company or companies of the same group. Such limit is currently as under:

a. Funded: 25% of Core Capital
b. Non-funded: 50% of Core Capital

The bank, where, a single borrower enjoys credit limit more than above should bring it within the limit. If above limit is not observed by a bank, 30% additional risk weight is assigned to such credit portfolio warranting additional capital.

Interest Spread

Weighted interest spread between lending rate and deposit rate should not exceed 5%. Such rate is calculated as under:

$$WALR = \frac{InterestIncomeforSixMonths}{AverateInterestEaringAssets}$$

Outstanding on the Month-end of 6 months.

$$WADR = \frac{InterestExpensesForSixMonths}{AverageDepositOuts\tan ding}$$

on the Month end of 6 months

WALR=Weighted Average Lending Rate
WADR=Weighted Average Deposit Rate
Interest Spread=WALR-WADR

Interest in move in excess of 5% spread on bi-annual basis (mid January and mid-July) should be retained in the bank as Interest Spread Reserve and no dividend can be given out of this fund. However, this fund is treated as supplementary capital.
Interest Spread limit of 5% was scrapped on 25th July 2002.

Interest Rate
Banks are free to fix interest rate on deposits and loans. Interest rates on all types of deposits and loans should be published in the local newspapers and communicated to NRB minimum on a quarterly basis and immediately when revised. Deviation of 0.50% from the published rate is allowed on all types of loans and deposits.

2.12.3 Loan Classification and Provisioning

A bank is required to classify their loan on the basis of overdue aging schedule and provide on a quarterly basis as follows:

Type	Criteria	Provision Requirement
Pass	Principal overdue up to 3 months	1%
Substandard	Principal overdue up to 6 months	25%
Doubtful	Principal overdue up to 1 Year	50%
Bad	Principal overdue above 1 Year	100%

Pass loan is called 'Performing' and others are called 'Non-Performing Assets'. Provision requirement in case of loan given against personal guarantee only is additional 20% for Pass, Substandard and Doubtful loans. Provision for restructured, rescheduled and swapped loan is 12.5% only.

Provision for Pass Loan made up to 1.25% of total risk weighted assets is treated as supplementary capital.

Investment portfolio of the bank should be accounted at market value or cost whichever is less. If investment securities have not been listed in the stock market, 100% provision should be made against such an investment and deposited at ‘Investment Adjustment Reserve’.

2.12.4 Sectoral Credit Limit

Credit concentration in one sector increases the risk of a bank. Hence, NRB requires banks to monitor its credit portfolio in following ways:

a. Level I : Sector where credit of a bank ranges from 50-100% of core Capital

Bank has to devise a proper Credit Information System to monitor such credit at least quarterly.

b. Level II : Sector where credit of a bank is above 100% of Core capital

Board of Directors of the bank should decide annually whether it wants/does not want to have credit exposure more than 100% in any sector. Decision of the Board should notify to Banking Operations Department and Supervision and Inspection Department of NRB.

2.12.5 Prohibition

Banks are prohibited to do following activities:

- Purchase and sale of goods with transaction motive
- Purchase of fixed assets not for own use
- Extending credit facilities against the security of own share
- Extending credit facilities to the director or the member of his undivided family.
- Extending credit facilities to the director or the member of his undivided family.
- Extending credit facilities to the shareholder holding more than 1% share and to his undivided family.
- Extending credit to the company where the director or the members of his undivided family have 10% stake.
- Acting as the managing agent.
- Declaration/distribution of divided to shareholder before complete amortization of preliminary expenses accumulated loss and before appropriation of fund for capital adequacy, reserves and provisions.

2.13 Treatment of NPA in Macroeconomics Statistics

(Subramanyam, 2003:1)

2.13.1 Part A – Policies and Practices

2.13.1.1 Classification of Loans and Off-Balance Sheet Items

There is no uniform system of classification of loans and off-balance sheet items. Many countries have adopted, mainly through regulatory and supervisory framework, a three- tier approach towards classification of Non-

Performing Assets (NPAs), corresponding to 'substandard', 'doubtful' and 'loss' categories, using delinquency period as the main bench mark. Thus, 'substandard' assets are those where principal and/or interest are more than 90 days past due; 'doubtful' assets are those where principal and/or interest are at least 180 days past due; and 'loss' assets are those where principal and/or interest are at least 1 year past due. This classification category is also applied to contingent accounts or Off-Balance Sheet items, since they are treated the same way as loans. The delinquency period is applied for classification of various 'on-balance' sheet assets and 'off-balance' sheet items, so as to provide, among others, an objective criterion for appropriate classification, depending on the possibility of collectability. However, if, in the bank's judgment, an asset is impaired to such an extent and its collectability is in serious doubt that it should straightaway be classified as 'doubtful' or 'loss', the bank will do so, at any time, without waiting for the delinquency period. The delinquency period varies across countries and it differs in relation to the types of accounts. Also, in some countries, banks themselves classify the loans, on the basis of judgmental factors. In view of the varied practices followed, primarily depending on the structure of the banking system, credit delivery systems, and socioeconomic conditions, it will not be advisable to prescribe a set of definition of Non-Performing Assets. One may rely on the approach adopted by the national authorities.

2.13.1.2 Provisioning Requirements

The practices of provisioning differ among countries, following the asset classification system adopted. Most of the countries have adopted the standard requirements of provisioning - 20 percent of the outstanding balance in respect of 'substandard' category of assets; 50 percent in respect of 'doubtful' category; and 100 percent in respect of 'loss' category. While some countries have imposed lower percentages, yet, some others have adopted the system of provisioning, in a phased manner. Recognition of collateral - fully or partially -

in assessing the provisioning requirements, as applicable in some countries, has great impact on provisioning. Also, tax deductibility of specific provisions towards loan losses, as extended by tax authorities in some countries, constitutes a strong positive incentive for banks to make adequate provisions. It is, therefore, necessary that banks should be required to fully explain the policies and procedures adopted in making provisions towards NPAs.

2.13.1.3 Recognition of Income on Non-Performing Loans (NPLs)

Stricter regulations have been laid down by supervisory authorities in many countries with regard to income recognition on Non-Performing Loans (NPLs). The suspension of interest payments is required on loans that are classified as 'non-performing' ['substandard', 'doubtful' and 'loss']. Any uncollected interest payment on NPLs is considered non-accrued interest. Previously accrued, but uncollected interest is reversed out of income. Failure to do so would overstate income. Uncollected interest is normally put in a memorandum account. NPLs are restored on an accrual basis only after full settlement has been made on all delinquent principal and interest.

2.13.1.4 Criteria for 'Write-off' of Bad Loans

The policy with regard to 'write-off' of bad loans by banks is set by the Board of Directors, depending, among others, on the repayment culture and legal system prevalent. It will be inadvisable for the regulatory authority to lay down specific guidelines as to when a loan could be considered as 'non-recoverable' and written- off. The banks may, however, be exhorted that balance sheets would need to be cleansed, as early as possible.

2.13.2 Part B – Reporting Requirement

2.13.2.1 Interest Income

Ideally, interest income should reflect only interest income realized and should exclude interest accrued on NPLs, so as to avoid overstating of income. The banks may be required to report the balance of uncollected interest on NPLs, as a memorandum item. It would be useful, if additions and deletions during the preceding specified period are also reflected.

2.13.2.2 Loans

It will be appropriate to record the "specific provisions" as a contra item, thus reducing the total loans outstanding, so as to reflect the recoverable value of the loans. Thus, while specific loan loss provisions are reported as contra asset, nonetheless, provisions, other than for loan losses, should, however, appear under "liabilities"

2.13.2.3 Non-Performing Assets (NPAs)

The banks may be required to report Non-Performing Loans (NPLs), preferably under various categories, as a memorandum item. It is important that the amount of outstanding NPLs should not include interest not realized. The additions and deletions during the preceding specified period may also be reflected. The total of on-balance sheet assets, other than loans, and off-balance sheet items, classified as 'non-performing', may be reported separately, under various categories. Additions and deletions during the preceding specified period should also be reported.

2.13.2.4 Provisions

"General" provisions may be required to be reported as a separate item under 'capital and reserves'. The "specific" provisions may be required to be reported, so as to facilitate arriving at provision-adjusted NPLs i.e., Net NPLs. Additions and deletions during the preceding specified period may also be required to be reported.

2.13.3 Part C- General

2.13.3.1 Cross Country Comparison of Financial Soundness

If the policies and practices followed in the matter of classification of assets, provisioning, income recognition etc., are fully explained, it will be possible for the analysts to make meaningful cross country comparison of financial soundness.

2.14 Reason for Loan becoming Bad

One undesirable side effect of current trend in banking is a relatively high bank failure rate. For most of its history, the banking industry experienced an extremely low failure rate (only about 1 or 2 percent of the banking population each year failed) due to extensive regulation and conservative management. However, the number of bank failures and the average size of failing banks advanced sharply in the 1980s, through the failure rate slowed down in the 1990s.

Some analysts argue that even more important is the increased volatility of economic and financial conditions, especially interest rates and the prices of foreign currencies. This volatility has made bank earnings and stock prices more unstable and forced bankers to devote more time to the control and management of risk.*(Rose,2001:88)*

When loans are overdue to repay their specific period then it becomes bad loan. By analyzing various studies, following are some important causes for turning a loan into a bad one.

2.14.1 Lack of Credit Policy and Culture

The credit policy generally guides the institution to disseminate and diversify the loans. It also helps in making the decision for whether or not granting the loan to a certain party. Hence a clear and in written form a credit policy is a must. The bank also must have a credit culture *(Bidhani,2003:11)*. They must not only focus on the loan but also the customer who is taking the loan. The credit team should know each and every loan taker and should watch from near. The bank now is not only the lender it must also act as the financial advisor also to the customer.*(Gajurel, 2006:89)*

In Nepal only few financial Institutions have a clear-cut credit policy. At the same time credit policy should also be strictly adhered to.

2.14.2 Undue Influence/Pressure

One of the major factors contributing in Banks Non Performing assets is the undue Influence exerted by politician, bureaucrats, board members and senior executives of the bank itself. This is the reasons most of the state owned commercial banks and some private banks have large NPA.*(Subramanyam,2003:1)*

2.14.3 Cut Throat Competition

The number of commercial banks is growing rapidly. It is nearly saturated. But the market size is very small and the economic situation is not improving. In such situation, the commercial banks have very less option to invest. Due to this, there is unfair competition exercised by the banks to attract the customer. In such situation, NPA may increase due to sanctioning the loan without studying and analyzing the client properly.

2.14.4 Lack of Vision

The success of any organization lies on the ability to think and have long term vision. Creativity is very essential thing for the managers to drive the whole organization to success. The managers should be able to create new products. In Nepal, there is a culture of copying others product. Recently almost all commercial banks are catering consumer loan.*(Gajurel, 2006:89).* Lack of

Vision result in investment in those area which will turn the loan to NPA. *(Bidhani, 2003:12)*

2.14.5 External Factors

There are many external factors that turn a good loan to bad. Economic condition of the country, Political situation, technological change, etc. also plays a key role in turning a good loan to bad. We have currently witnessed the closer of the factories in the tarai region of Nepal due to political instability. This closer of factories, result in inability to repay loan taken by the organization although the business man do not intend to be a defaulter.(Source: National Daily Newspapers and Business magazines)

2.15 Review of previous Studies

For the purpose of this study, relevant thesis works regarding several aspects of banking sectors conducted by different intellectuals and students are discussed bellow.

The study conducted by **Suman K.C**.(2007) on "Credit Portfolio Management of commercial banks in Nepal" found following major findings and suggested following major recommendations:

Major Findings:

a. The result shows no significant difference in NPA of commercial banks and international standard of 4%.
b. The recent regulation relating to loan loss Provision has no effect on profitability and liquidity shows the positive result. It means Profitability and liquidity has been unaffected by the recent stringent regulation relating to Loan Loss Provision.
c. Correlation coefficient regarding Provision for Loan Loss with RoA and RoE indicate that there is a negative relationship between them.

Major Recommendations:

a. Investment view Point: There should be good investment decision which increase the corporate value of the firms.
b. Bank should be sensitive to adverse movement in the external factors such as interest rate, exchange rate and commodity prices.
c. Pricing of Loan should be based on compensating risk of loan.
d. Proper and Prudent Management.
e. Follow the regulations of Nepal Rastra Bank.

Saroja Poudyal (2006) in his research “A Study of NPA of Commercial Banks of Nepal” came across following major findings and gave following major recommendations:

Major Findings:

a. In recent years Nabil has shown significant decrease in Non Performing Assets, which is the result of banks effective credit management and its efforts in recovering bad debts through establishment of recovery cell.
b. High degree of Negative correlation exists between NPA and RoE of Nabil bank. The banks should reduce there level of NPA to increase RoE and RoA and Profitability.
c. Loan loss provision for Doubtful loan seems to be higher in case of both banks Nabil and SCBNL.

Major Recommendations:

a. Create credit appraisal department to receive application and gather necessary information and give approval for lending.
b. Credit administrative department to disburse loans transaction, the repayment of principal and interest and provide information regularly to executive level.

c. Legal Department to properly execute necessary legal documents for the safeguard of bank. Update the documents and its validity.
d. Credit control Department (Recovery Cell) to regularly follow up the borrowers about their installment dues and remind them their due dates in case of default.

He concludes the ineffective credit policy, political pressure to lend to low credit profile borrowers, overvaluation of collateral are major causes of mounting NPA of the banks. Other factors leading to accumulation of non performing assets is weak loan sanctioning process, ineffective credit monitoring and supervision system, economic slowdown, borrowers' misconduct, etc. He further suggests continual review and classification of loan enables banks to monitor quality of their loan portfolios and to take remedial action to counter deterioration in credit quality. In addition to this establishing recovery cell, hiring Assets Management Company are also measures to resolve the problem of non performing loan.

Prakash Lamsal (2006) in his study titled "Financial Analysis of Agriculture Development Bank" found following major findings and gave following major recommendations.

Major findings:

a. Non Banking asset is the source to increment the Non Performing Assets.
b. Overdue is the initial phase of the Non Performing Assets. In general every year, high overdue outstanding is seen in presented data. Over due has to be reduced in the years to come.
c. Among the analyzed six years data of the ADB/N, Non Performing interest is in increasing trend. It is a burden to the bank.
d. Profitability ratios of ADB/N do not give satisfactory result over the six years period.

Major Recommendations:

a. Project base lending is very essential and regular observation of the invested projects has to be maintained.
b. Return trend of the invested projects are very much important. There are study factors to observe the performance of the banks so that returnable projects are to be invested.
c. Make the very effective and full autonomy body division to the Non Performing Assets management.
d. Government has to initiate to help the bank to collect the bad loans by initiating the legal force. Bank has to take effective helps from the government in collection of bad loans.
e. Vision of the bank management has to be cleared for the project base lending. Coercion to lend should not be exercised by the promoters and policy makers

He concluded Project analysis in the pre-phase of loan investment to be made better to reduce non performance of loan. If the projected financial position of the project is good it will give good return. Chronic loan has to be recovered by giving attractive incentives to the staffs and very accretive rebate properly. Timely regular monitoring and evaluation of the project should be done.

Govind Ghimire (2005) in his research, "Non Performing Assets of commercial banks: caused and Effect" found following major findings and advised following major recommendations:

Major Findings:

a. Non Performing Assets on overall profitability of the bank tend to have inverse relationship. Profitability is affected due to provisioning requirement.

b. There is some relationship between credit extend and increment on Non Performing assets.
c. It may be significant in case of aggressive credit expansion. Findings showed that Non Banking Assets is created due to having Non Performing Assets.

Major Recommendations:

a. Float loan on business position, viability and business need. Proper attention of personal integrity of borrowers should be taken.
b. Strong follow up system in commercial banks for recovery of due loans. It is required to have general proactive of follow up before the loans turn into bad.
c. Avoid Credit Concentration to a single sector and project.
d. Strong Legal system should be created. Government should be create necessary laws and take necessary actions. The tribunal constituted under Bank and Financial Institutions loan recovery Act 2058 should pay special attention while translating the provision of the act into practice. Bank should be empowered to proceed to arrest the will defaulters.
e. Formation of Assets Management Company.
f. Avoidance of Undue Pressure.

He concluded that profitability of commercial banks has been affected due to increasing level of Non Performing Assets. Bad intension, weak monitoring, and mismanagement were found the major responsible factors for NPA growth. He further suggested the bank to analyze the loan proposal properly before extending any loan and conduct all feasibility study do the project. The banks should also act immediately to collect the bad loans.

In the research conducted by **Dirga Narayan Kafle** (2005) on “Non Performing Loans of Nepalese Commercial Banks”, devised following major findings and suggested following major recommendations to be adopted in order to decrease the level of NPA and increase the efficiency of the commercial banking industry.

Major Findins:

a. The return on assets(RoA) and return on Equity (RoE) of the bank somehow depend upon Non Performing Loan. The bank should reduce its NPL to increase RoA and RoE of the bank.
b. Management inefficiency is one of major cause behind high level of NPA of Commercial banks.

Major Recommendations:

a. Those banks having high level of NPL should take immediate action. The bank should dispose off the collateral taken from the borrower and recover principal and interest amount.
b. Corporate structure of the anks play key role in the effective loan management. There should be separate department for credit appraisal, documentation, disbursement, relationship maintenance and inspections.
c. Management efficiency should be enhanced. Hence necessary training should be given to the managers and staffs.

In the study of **Rajesh Bhandary** (2004) titled “Analysis of Non Performing Assets of Commercial Banks of Nepal”, he found following major findings and suggested following major recommendations.

Major Findings:

a. There is negative correlation exists between NPA with ROA and RoL.
b. The external factors are more contributing for the growth of NPA in any banks. Political and economic situation of the country and borrower related factors were found most crucial in the conversion of good loans into bad.

c. Lack of asset management company, Execution of the court proceedings and cumbersome legal procedure and economic recession and political instability are major problems associated with the management of NPA.

Major Recommendations:

a. Formulation of NPA management committee and reviewing of its performance on monthly basis may bring the colour in the management of NPA.
b. Approaching to loan recovery tribunal for dispose off bad loans from loan portfolio.
c. All banks should make initiative towards the establishment of Asset Management Company so that bad loans of the banks could be removed from the Balance Sheet.

Prashanth K. Reddy (2003), on his study on " A comparative study of Non Performing Assets in India in the Global context-similarities and dissimilarities, remedial measures" has stressed on the importance of a sound understanding of the macroeconomic variables and systemic issues pertaining to banks and the economy for solving the NPA problem along with the criticality of a strong legal framework and legislative framework. He gave following suggestions:

a. Don’t eliminate-manage. Banks should focus on management of NPA rather than elimination.

b. Foreign experiences must be utilized along with a clear understanding of the local conditions to create a tailor made solution which is transparent and fair to all stakeholders.

a. He further argues that changes required to tackle the NPA problem would have to span the entire gamut of Judiciary, Policy and the bureaucracy to be truly effective.

M. Rogers (2003) concludes trust has a significant impact on financial performance; given that transparency and disclosure boosts the trustworthiness of commercial banks.

Major Findings:

a. Credit risk as a measure of disclosure had negative relationship with financial performance, this is in harmony with extant finance literature which highlights that, it is probable that when risky lending increases the payback declines. This in turn negatively affects commercial banks earnings.

Major Recommendations:

a. Banks both local and international should enforce full disclosure practices and transparency practices thereby enhancing trust in order to survive in the competitive financial landscape.

b. Given that the corporate governance can influence over 34% of the financial performance of banks, commercial banks need to adopt and strengthen the corporate governance principles especially on dimensions of timeliness in delivering the financial reports

2.16 Research Gap

This research is not a new research in Non Performing Assets of Commercial banks of Nepal. There are many research conducted in this topic. In other research, most researchers used correlation between the Non performing assets with Net Profit, Return on Equity and Return on Assets.

In this research, ANOVA test has been used to test the significant difference between the levels of NPA among the commercial banks, which has not been done in other research. In this research six commercial banks are taken into consideration including three joint venture banks and three non joint venture banks. In this research the recommendations are given regarding pre sanction period, post sanction of loan and after loan turning to non performance.

The NPA is in decreasing trend. Most of the banks found to have controlled NPA. The researcher found inverse relations between the NPA and RoE and NPA and RoA. The level of NPA among the banks found to have significant difference. Non Performing Assets have adversely affected the profitability of the bank.

CHAPTER - III

RESEARCH METHODOLOGY

3.1 Background

Research methodology describes the method and process applied in the entire aspect of the study. It deals with the methodology adopted in analysis of the data of the study. The population and sample, source and data collection techniques, and data analysis tools and the hypothesis to be tested, which are associated with the study, have been discussed in this chapter.

3.2 Research Design

Research design is a plan, structure and strategies of investigation to obtain the specified objectives. The structure of Research is outline of scheme and paradigm of operation of the variables. So it can be also called roadmap for Research study or blueprint of the study.

The Research design is the overall operational pattern of frameworks of the project that stipulates what information is to be collected, from which source, by what procedures, how to conduct analysis, etc.

The research design of this study is analytical as well as descriptive. This study is the evaluation of Non Performing Assets (NPA) of commercial banks of Nepal.

3.3 Population and Sample

The Commercial banking industry is the population of this research. Currently there are all together 25 commercial banks in operation in Nepal. Six out of twenty are joint venture commercial banks, which were established in collaboration with international banks. Following are the commercial banks currently operating in Nepal.

For the purpose of study only six commercial banks three out of joint venture and three out of pure Nepalese investment bank are taken as sample for the study. The total collection of commercial banks is the population. The sample commercial banks are as follows:

Population & Sample

Table 3.1

S. No.	Commercial Banks(Population)	Selected Banks	Sample %
1.	Standard Chartered Bank		
2.	Nabil Bank Ltd	1	
3.	Nepal Investment Bank Ltd.		
4.	Rastriya Banijya Bank Ltd.		
5.	Nepal Bank Ltd.		
6.	Himalayan Bank Ltd.	1	
7.	Nepal Bangladesh Bank Ltd.	1	
8.	Everest Bank Ltd.		
9.	Nepal SBI Bank Ltd.		
10.	Kumari Bank Ltd.		
11.	Bank of Kathmandu Ltd.	1	
12.	Nepal Commerce and Credit Bank Ltd.		
13.	Lumbini Bank Ltd.		
14.	Siddhartha Bank Ltd.		
15.	Nepal Industrial and Commercial Bank Ltd.	1	
16.	Laxmi Bank Ltd.		
17.	Machhapuchhre Bank Ltd.	1	
18.	Global Bank Ltd.		
19.	Citizens Bank Ltd.		
20.	ADB Nepal		
21.	Prime Bank Ltd.		
22.	Sunrise Bank Ltd.		
23.	Bank of Asia		
24.	Development Credit Bank Ltd.		
25.	NMB Bank Ltd.		
	Total Population = 25	Total Sample = 6	24%

Source: Banks and Financial institution Regulatory Department of NRB

3.4 Types and Sources of Data

For the purpose of analysis in this research, mainly the secondary data will be used. The facts and figures provided by the banks will be taken into consideration. But some data which are not published will be directly collected from the bank. The bank professionals will also be interrogated wherever needed.

The main source of data is the annual reports published by the banks. The statistical reports of the NRB are also the main source. Furthermore the publications of Ministry of Finance (MoF), Security Exchange Board of Nepal (SEBON), etc. and other data published in the News paper and Magazines are also used.

3.5 Data Collection Techniques

In order to collect the data annual report published by commercial banks and Nepal Rastra Bank (NRB), Economic report and other published statistical are collected. Data from such reports are used in this study and to obtain the additional information, informal talk made with bank personals. Similarly information is collected from News papers, Magazines, Web sites, bulletin, booklets and journal published from relative banks.

3.6 Data analysis Tools

For the fulfillment of the study objectives various financial tools as well as statistical tools have been employed. The description of financial tools as well as statistical tools is described below.

3.6.1 Statistical Tools

3.6.1.1 Mean (Average)

It is the most popular measure for representing the entire data. It is the average of the data. It is further used in many statistical and financial analysis tools

Mean $\overline{X} = \frac{\Sigma X}{n}$

3.6.1.2 Correlation Analysis

The degree of relationship between two variables is known as simple correlation(Sharma and Chaudhari,2003:405). The most widely used in practice for calculating correlation coefficient between two variables is "Karl Pearson's correlation coefficient". The correlation coefficient between two variables X and Y, usually denoted by r(X,Y) or r_{xy} or simply r, is a numerical measure of linear relationship between them and is defined as

r_{12}= correlation coefficient between X_1 and X_2

$$= \frac{n\sum X_1X_2 - \sum X_1 \sum X_2}{\sqrt{n\sum X_1{}^2 - (\sum X_1)^2}\sqrt{n\sum X_2{}^2 - (\sum X_2)^2}}$$

The value of r lies between -1 and +1. Symbolically,

$$-1 \le r \le +1$$

The correlation coefficient is symmetric in two variables, i.e. $r_{xy}=r_{yx}$ (It can be verified by exchanging X and Y in the formula). It is a pure number independent of the unit of measurement.

<u>Interpretation of correlation coefficient</u>

i. When r = +1, there is perfect positive correlation

ii. When r = -1, there is perfect negative correlation

iii. When r = 0, there is no correlation.

iv. When r lies between 0.7 and 0.999(-0.7 to -0.999) there is a high degree of positive (or negative) correlation.

v. When r lies between 0.5 and 0.699(-0.5 to -0.699) there is a moderate degree of positive (or negative) correlation.

vi. When r is less than 0.5, there is low degree of correlation.

3.6.1.3 Analysis of Variance (ANOVA)

Analysis of Variance often abbreviated ANOVA is a powerful statistical tool for tests of significance to evaluate differences among the parameters of several groups. It is specially designed to test whether the means of more than two quantitative populations are equal. It consists of classifying and cross-classifying statistical results and testing whether the means of a specified classification differ significantly.(Sharma, Chaudhari,2003:330)

There are two types of ANOVA; One way ANOVA and Two way ANOVA.

In one factor ANOVA only one factor is considered at a time and we may conduct the experiment through a number of sample studies. The main objective of one way ANOVA is to analyze difference among the group means by considering one factor (one variable). Through an analysis of the variation in the data, both among and within the several groups, we are able to draw conclusions about possible differences in group means.

F-test statistics:

$$F = \frac{MSC}{MSE}$$

Where,

MSC= Mean sum of squares within samples (columns) = $\frac{SSC}{K-1}$

MSE= Mean sum of squares within samples (errors) = $\frac{SSE}{n-K}$

There are many situations where the response variable of interest may be affected by more than one factor. Under two-way ANOVA, the effect of two factors (two variables) is studied simultaneously. The data are classified according to two different factors. The effect of one factor is studied through the column wise figure and totals and of the other through the row wise figures and totals.

The two-way ANOVA F-test statistics are:

$F = \dfrac{MSC}{MSE}$ .... (1) With d.f. is [(c-1),(c-1)(r-1)]

and $F = \dfrac{MSR}{MSE}$ ....(1) with d.f. [(c-1),(c-1)(r-1)]

where

MSC=Mean sum of squares of variations between columns
MSR= Mean sum of squares of variations between rows
MSE= Mean sum of squares of variations due to error (residual)

In order to find MSC, MSR and MSE, we need to find SSC, SSR, SST and SSE.

3.6.2 Financial Tools

3.6.2.1 Technical (Trend) analysis

In this analysis the past trend is analyzed of any data and future movement is predicted. Technical analysis presents the past data in the charts and predicts the patterns of future. It shows where the organization is going in that particular matter of analysis. In the technical analysis different charts and pictures are used which makes it simple to understand. It is used to analyze the data as well as to present the data.(Francis,1998:198)

3.6.2.2 Ratio Analysis

a. Net Profit to Loan and Advances = $\dfrac{Net\ \mathrm{Pr}ofit}{Loan\ \&\ Advances} \times 100\%$

b. NPA to Loan and Advances = $\dfrac{NPA}{Loan\ \&\ Advances} \times 100\%$

It is the percentage of Non Performing Loan and Advances to total loan and advances. It shows how much of the total loan and advances are not performing well.

Return on Equity

This ratio assesses the effectiveness of the management with respect to both its operating and financing decisions.(Pradhan,2004:59)

c. ROE = $\frac{NetIncome}{CommonEduity} \times 100\%$

Return on Total Assets (ROA)

This ratio measures the return on total assets after interest and taxes

d. ROA = $\frac{NetIncome}{TotalAssets} \times 100\%$

These three net Profit Ratio, ROA and ROE are used to check the profitability of the firm. It measures the efficiency and effectiveness of the firm's management.

3.7 Test Of Hypothesis

As per objective of the study, following hypothesis are formulated

Hypothesis 1

There is no significant difference between the NPA level of commercial banks of Nepal and international Standard of 4%.

Hypothesis 2

There is no significant difference between the NPAs of Commercial banks of Nepal.

CHAPTER – IV

DATA PRESENTATION AND ANALYSIS

This is the main part of the research. It is the body of the report. In this chapter all data and facts are collected and presented in a simple and effective way to make it understandable to everyone. In this chapter, another important task is also done. That is the analysis of the collected data using different statistical, financial, and other tools; to find out the valuable information.

4.1 Analysis Of Loan & Advances, Npa And Net Profit

In this section the Loan and advances, Non Performing Assets and Net Profit trend and it's level are analyzed of the whole commercial banking industry as well as selected banks.

4.1.1 Commercial Banking Industry

Table 4.1

Loan and Advances, NPA and Net Profit of Commercial Banking Industry

(In billion)

Year	**2003**	**2004**	**2005**	**2006**	**2007**
L&A	103.16	111.9	127.06	147.2	188.3
NPA					
Private Banks	5.64	5.12	4.82	5.82	8.38
Public Banks	25.72	26.97	24.11	22.06	17.20
Industry	31.36	32.226	28.93	27.88	26.77
NPA to L&A (%)	30.4	28.80	22.77	18.94	14.22

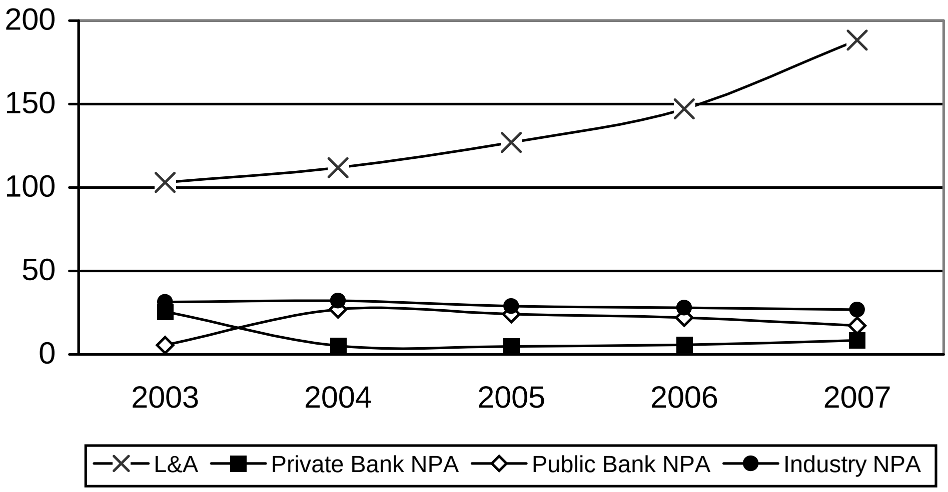
Source: NRB, Banking and Financial Statistics (July, 2007)

The Loan and advances of the whole commercial banking industry is growing significantly. It is a positive aspect of the economy as well as prosperity of a country. At the same time the NPA of the whole industry is also in decreasing slowly but steadily. It is also very encouraging for the industry.

The NPA of the Public commercial banks are relatively high compared to the Private Banks. They have the NPA level which is out of the tolerance level. Due to high NPA level with the public commercial banks the NPA of whole banking industry seems very high. If we look at the NPA of Private commercial banks they have low NPA but they also need to do a lot to bring the NPA to a minimum level. The encouraging aspect is the NPA level of both Private and Public banks are in decreasing trend.

Figure 4.1

Loan & Advances of the Commercial Banking Industry



4.1.2 Profitability of Commercial Banks of Nepal

Table 4.2
Profitability of Commercial Banks of Nepal

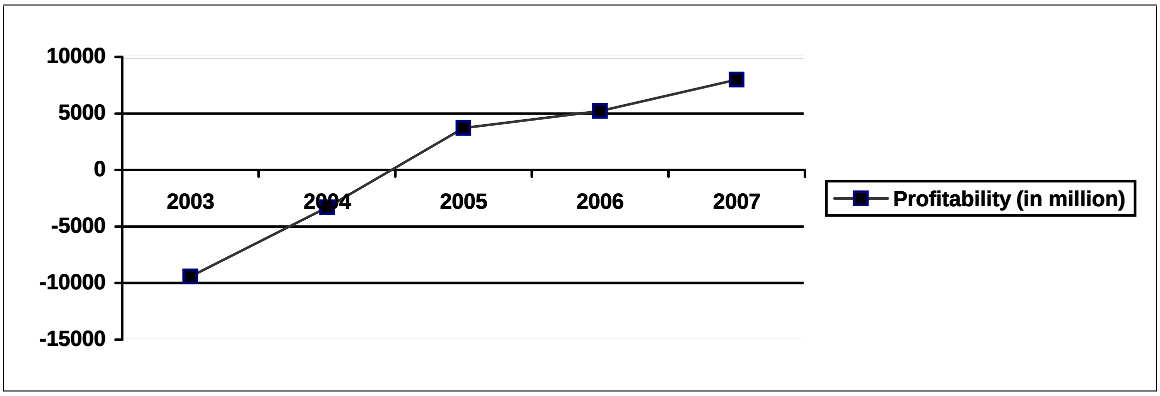
(in Million)

Year	2003	2004	2005	2006	2007
Profitability (in million)	-9428	-3317	3707	5205	7983.51

The whole commercial banking industry was in loss until fiscal year 2004. The whole commercial banking industry was Rs. 9428 million loss in FY 2003 and in 2004 Rs. 3317. From the F.Y. 2005 the Profit figure started to become positive. The profit is also increasing yearly.

Figure 4.2

Profitability of Commercial Banks of Nepal



4.2 Loan & Advances, Net Profit & Npa Of Selected Banks

4.2.1 Nabil Bank Ltd.

Table 4.3

Loan & Advances, Net Profit and NPA of Nabil Bank

(In million)

Year	2003	2004	2005	2006	2007
L&A	7739	8113.68	8548.66	10946.74	13278.78
NPA	552.57	449.63	286.68	144.51	165.98
Net Profit	272	146	455	520.11	635.26
NPA/L&A (%)	7.14	5.54	3.35	1.32	1.25

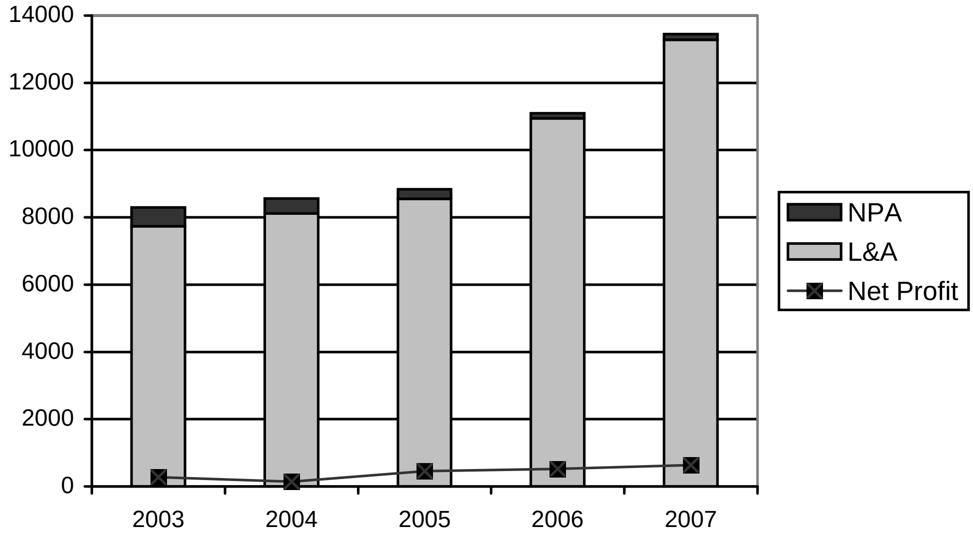
Source: Annual Reports of NABIL

Nabil bank has increasing trend in the Loan and Advances. It is one of the largest lenders in Nepal. Where as it's Non Performing Assets ratio is in decreasing trend. It has improved a lot in the quality of the Loan and Advances. The NPA ratio to total loan and advances has dropped to 1.25% in the F.Y. 2007 from 7.14% in the F.Y. 2003. The Loan amount is also nearly doubled from 7739 million in F.Y. 2003 to 13278.78 million in F.Y. 2007. Nabil bank is exhibiting the quality of management by providing large loan with very low Non Performing Loan.

The net Profit of Nabil Bank is growing significantly. In FY 2007 Nabil bank earned Rs. 635.26 million which is 21.95% higher than previous year. In FY 2004 the net profit was only Rs. 146 million which is lower than in FY 2003. In FY 2003 Nabil bank earned Rs.272 million net profit.

Figure 4.3

Loan and Advances, Net Profit and NPA of Nabil Bank



The figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the Net Profit of Nabil Bank Ltd.

4.2.2 Himalayan Bank Ltd.

Table 4.4

Loan & Advances, Net Profit and NPA of Himalayan Bank

(In million)

Year	2003	2004	2005	2006	**2007**
L&A	9557.14	10844.6	12919.17	13451.17	15939.63
NPA	1156.41	1092.84	1147.46	1001.35	978.69
Net Profit	235	212	263	308	457.45
NPA/L&A (%)	12.1	10.08	8.88	7.44	6.14

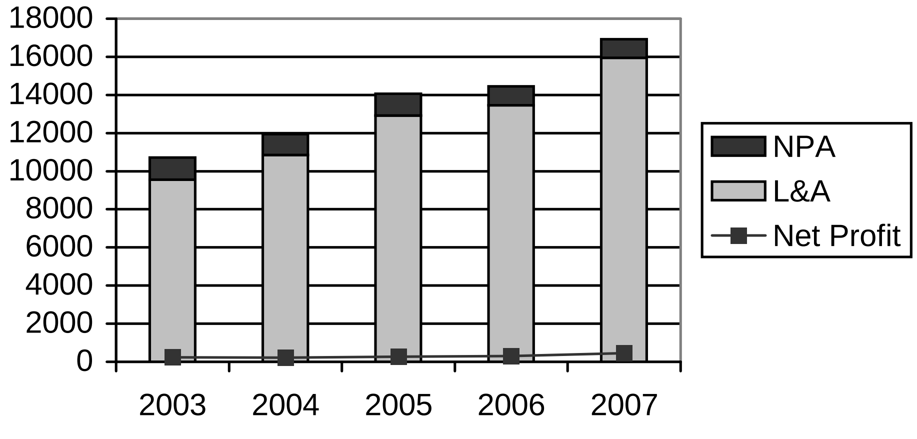
Source: Annual Reports of HBL

Himalayan bank has increasing trend in the Loan and Advances. Where as it's NPA is in decreasing trend. Himalayan bank is aggressive in the sanction of loan. It is one of the highest lending commercial banks of Nepal. But its loan quality is not satisfactory compared to other commercial banks operating in Nepal. Although it's NPA is in decreasing slowly, it has to do a lot to improved the quality of the Loan and Advances. The NPA has dropped to 6.14% in the F.Y. 2007 from 12.1% in the F.Y. 2003. The Loan amount has increased from 9557.14 million in F.Y. 2003 to 15939.63 million in F.Y. 2007.

The Net Profit of HBL is growing slowly and steadily. HBL earned 457.45 million in FY 2007 which is 48.52% higher than previous fiscal year. In FY 2004 the net profit was only Rs. 212 million which is lower than in FY 2003. In FY 2003 HBL earned Rs. 235 million net profit If it reduce its Non Performing Assets and collect the non performing loan the net profit will go very high.

Figure 4.4

Loan & Advances, Net Profit and NPA of Himalayan Bank



The above figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the Net Profit of Himalayan Bank Ltd.

4.2.3 Bank of Kathmandu Ltd.

Table 4.5

Loan & Advances, Net Profit and NPA of BoK

(In million)

Year	2003	2004	2005	2006	2007
L&A	4890	4856.03	6008.31	6182.05	7489
NPA	396.58	420.87	399.94	308.51	190.17
Net Profit	9	82	128	140	202
NPA/L&A (%)	8.11	8.67	6.66	4.99	2.52

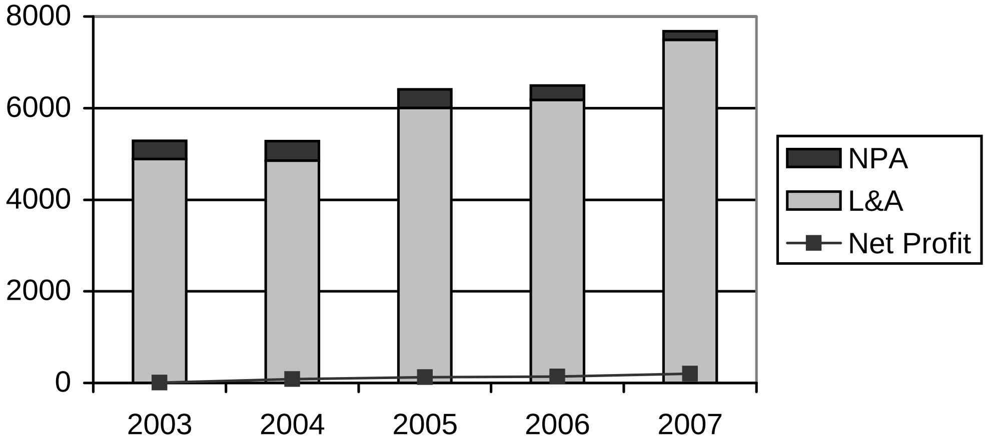
Source: Annual Reports of BoK

Bank of Kathmandu has increasing trend in the Loan and Advances. Where as it's NPA is in decreasing trend. It has improved a lot in the quality of the Loan and Advances. The growth rate of Loan and advances of Bank of Kathmandu is relatively slow compared to other banks. It has slow but steady growth rate. The NPA is also decreasing slowly and steadily. The NPA has dropped to 2.52% in the F.Y. 2007 from 8.11% in the F.Y. 2003. The Loan amount is also nearly doubled from 4890 million in F.Y. 2003 to 7489 million in F.Y. 2007.

The Net profit of Bank of Kathmandu has progressive trend. Bank of Kathmandu earned 202 million in FY 2007 which is 44.29% higher than previous year. In FY 2004 the net profit was only Rs. 82 million which is lower than in FY 2003. In FY 2003 Bank of Kathmandu earned Rs. 9 million net profit. The Bank of Kathmandu has been performing outstandingly in current years. The rate of profit increment is considerably high. Within five years Annual profit of Rs. 9 million to Rs. 202 million proves that it has been doing its business very well.

Figure 4.5

Loan & Advances, Net Profit and NPA of BoK



The above figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the Net Profit of Bank of Kathmandu Ltd.

4.2.4 Machhapuchhre Bank Ltd.

Table 4.6

Loan & Advances, Net Profit and NPA of Machhapuchre Bank

(In million)

Year	**2003**	**2004**	**2005**	**2006**	**2007**
L&A	680.3	1495.86	2540.79	5130.22	6068.9
NPA	71.09	31.1	24.98	19.86	16.99
Net Profit	-44.1	15.26	46.75	84.87	133.99
NPA/L&A (%)	10.45	2.08	0.98	0.39	0.28

Source: Annual Reports of MPBL

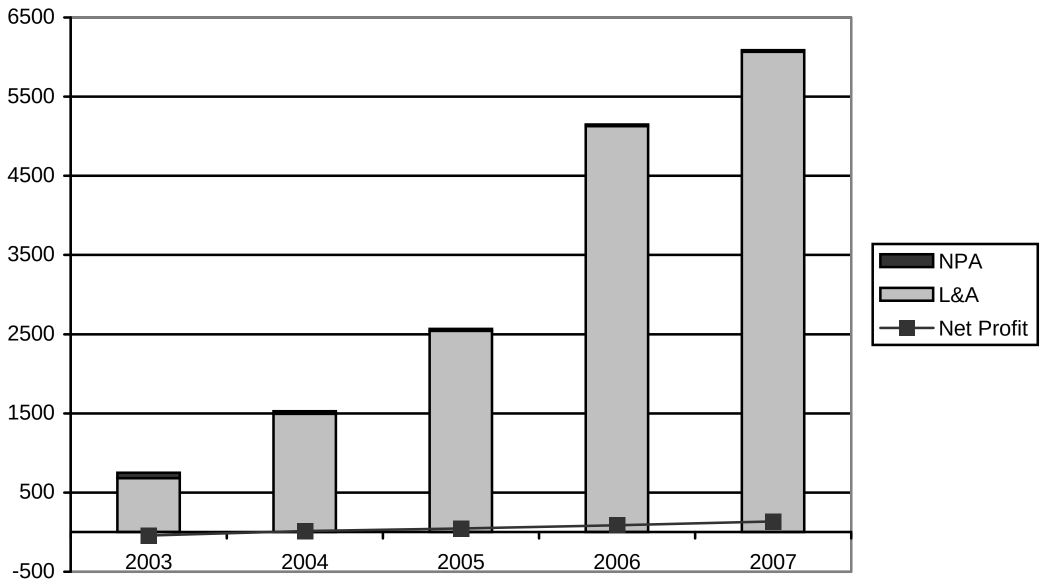
Machhapuchhre bank has significant improvement in the distribution of Loan and advances as well as in maintaining the quality of the Loan. It has increasing trend in the Loan and Advances. It has the lowest NPA among the commercial banks operating in Nepal. It has improved a lot in the quality of the Loan and Advances. The NPA has dropped to 0.28% in the F.Y. 2007 from

10.45% in the F.Y. 2003. The Loan amount grew rapidly from 680.3 million in F.Y. 2003 to 6068.9 million in F.Y. 2007.

The Net Profit of the MPBL is growing significantly in the last five years. . MPBL earned 457.45 million in FY 2007 which is 48.52% higher than previous year. In FY 2004 the net profit was only Rs. 212 million which is lower than in FY 2003.

Figure 4.6

Loan & Advances, Net Profit and NPA of Machhapuchre Bank



The above figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the Net Profit of Machhapuchhre Bank Ltd. The figure clearly shows the growth ratio of Loan and Advances of the Bank. The growth of Loan and Advances has not increased the Non Performing assets of the bank which is the main success of the Machhapuchre Bank. Compared to the size of Loan and Advance bar the Non Performing Assets bar is very small.

4.2.5 Nepal Industrial and Commercial Bank Ltd.

Table 4.7

Loan & Advances, Net Profit and NPA of NIC Bank

(In million)

Year	2003	2004	2005	2006	2007
L&A	2368.85	2562.86	3743.09	4909.36	6657.38
NPA	193.3	170.69	146.59	185.43	173.09
Net Profit	6.82	25.94	68.26	113.75	96.59
NPA/L&A (%)	8.16	6.66	3.92	3.78	2.6

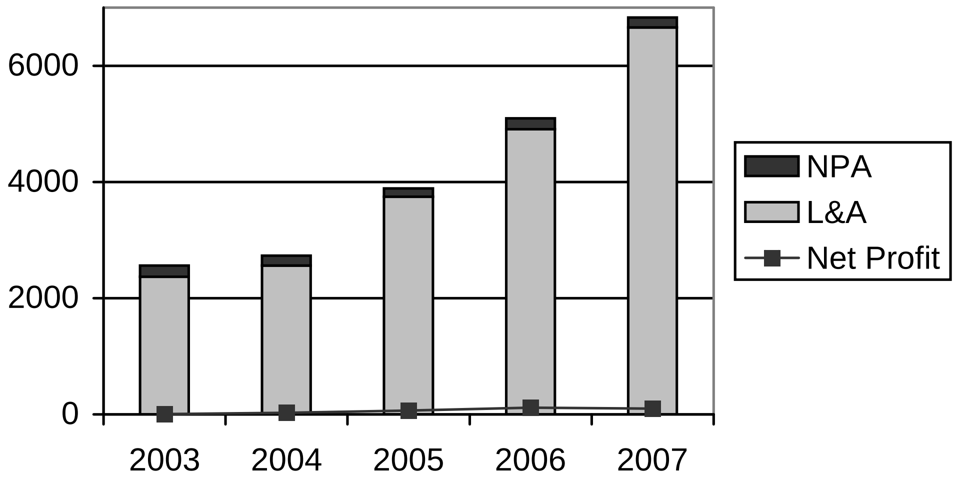
Source: Annual Reports of NIC Bank

Nepal Industrial and Commercial (NIC) bank has increasing trend in the Loan and Advances. In the other hand, it's NPA is in decreasing trend. It is a positive signal of a good bank. It has improved a lot in the quality of the Loan and Advances. The NPA has dropped to 2.6% in the F.Y. 2007 from 8.16% in the F.Y. 2003. The Loan amount is also grew significantly from 2368.85 million in F.Y. 2003 to 6657.38 million in F.Y. 2007

The Net Profit of the Nepal Industrial and commercial bank grew significantly upto fiscal year 2006 but in the FY 2007 the bank's net profit decreased slightly compare to previous fiscal year. NIC earned 96.59 million in FY 2007 which is 15.09% lower than previous year. In FY 2003 NIC earned Rs. 6.82 million net profit.

Figure 4.7

Loan & Advances, Net profit and NPA of NIC Bank



The above figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the net profit of Nepal Industrial and Commercial bank Ltd.

4.2.6 Nepal Bangladesh Bank Ltd.

Table 4.8

Loan & Advances, Net Profit and NPA of NBBL

(In million)

Year	2003	2004	2005	2006	2007
L&A	8084	7961	9644.7	9626.91	9010.7
NPA	991.1	1013.28	1042.18	1832.94	2664.65
Net Profit	65.48	71.65	26.43	-749.5	-1797
NPA/L&A (%)	12.26	12.73	10.81	19.04	29.57

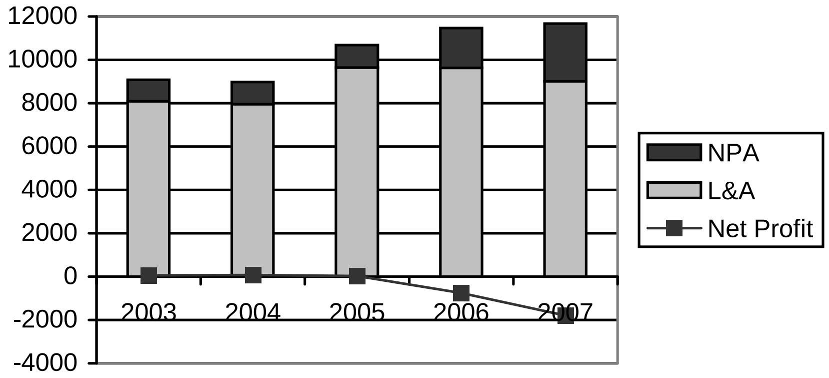
Source: Annual Reports of NBBL

Nepal Bangladesh bank has fluctuating trend in the Loan and Advances. It's NPA is very high compared to other commercial banks operating in Nepal. It has to give a lot of effort to improve the quality of the Loan and Advances. But it's NPA level shows that it's effort is unsatisfactory. The NPA was 12.26% in the F.Y. 2003 and in the F.Y. 2007 it remained at 12.27. There is no significant improvement in the Loan and advances. The Loan amount was 8084 million in F.Y. 2003 and it was 8478.77 million in F.Y. 2007.

NBBL was running in Profit till fiscal year 2005 but after that it is in net loss. The Net loss grew to Rs. 1797 million in FY 2007 which was Rs 749.5 million on FY 2006. It's Net Profit was Rs 65.48 million in FY 2003. It's NPA also grew significantly. NBBL is one of the bank with highest NPA.

Figure 4.8

Loan & Advances, Net Profit and NPA of NBBL



The above figure depicts the level of Loan and Advances, the level of Non Performing Assets and the trend of the net profit of Nepal Bangladesh Bank Ltd.

4.3 Correlation Analysis

In this section the relation between Non Performing assets and Net Profit, Return on Shareholder's Equity and Return on Assets are analyzed and the data and information are depicted.

4.3.1 Correlation between NPA and Net Profit

The correlation between the ratio of NPA to L&A and ratio of Net Profit to L&A is analyzed to find out what type of relationship does exist between these two entities of individual banks.

Table 4.9

Correlation Coefficient between NPA and Net Profit

Banks	Nabil	BoK	HBL	MBL	NIC	NBBL
Correlation Coefficient	–0.735	–0.7114	–0.4576	–0.9964	–0.3619	–0.4797

Source: Annex I,II,III,IV,V, and VI

The correlation coefficient between the NPA and Net Profit of all the commercial banks are negative. It means the NPA and Net profit have inverse relationship, that means when the NPA is high the Net profit will decrease and when the NPA decreases the Net Profit increases.

The Machhapuchhre Bank has the highest degree of inverse correlation between the NPA and the Net Profit followed by the Nepal Bangladesh Bank. The Nepal Industrial and Commercial Bank has the lowest degree of inverse correlation between the NPA and the Net Profit followed by Himalayan bank.

4.3.2 Correlation between NPA and RoE

Table 4.10

Correlation Coefficient between NPA and RoE

Banks	Nabil	HBL	BOK	NIC	MPBL	NBBL
Correlation Coefficient	–0.9320	0.1680	–0.8765	–0.9118	–0.9548	–0.987

Source: Annex I, II, III, IV, V and VI.

The NPA of all commercial banks found to have inverse correlation with the Return on the Common Equity (RoE) except Himalayan bank Ltd. Although the Himalayan bank has positive correlation, it is very low. Rest of the banks found to have high degree of negative correlation. The reason behind the HBL's correlation being positive is HBL is very aggressive in providing loan and it's loan outflow ratio is very. Due to it's high outflow of loan, it's revenue has increased rapidly that increased the RoE. This increase in RoE is very high compared to the effect of the NPA on the Profit it has.

The inverse relationship between the NPA and ROE, shows the increase in Non Performing Assets will decrease the return on the equity capital of the bank.

4.3.3 Correlation between NPA and ROA

Table 4.11
Correlation between NPA and RoA

Banks	Nabil	HBL	BOK	NIC	MPBL	NBBL
Correlation Coefficient	–0.9564	–0.6091	–0.7055	–0.8428	–0.9462	–0.4813

Source: Annex I, II, III, IV, V and VI.

The NPA of all commercial banks found to have inverse correlation with the Return on the total Assets (RoA). The banks are found to have high degree of negative correlation. The Nabil Bank Ltd has the highest degree of inverse correlation between the NPA and RoA.

The inverse relationship between the NPA and RoA, shows the increase in Non Performing Assets will decrease the Return on total assets of the Bank.

From the above correlation analysis of Non Performing Assets with Net Profit, Return on Share holders' equity and Return on total assets, it is found that NPA has inverse relationship with Net Profit, Share holders equity and total assets. These three ratio exhibits the profitability of the business. Hence, Non

Performing Assets reduces the profitability of the banks and return to the share holders and employment of assets.

4.4 Comparative Performance Of Sample Banks

Table 4.12

Comparative Performance of Sample Banks

(In Million)

FY	**2006/07**					**2006/07**				
Banks	L&A	NPA	Net Profit	NBA	LL Provision	L&A	NPA	Net Profit	NBA	LL Provision
NaBL	13278	182	635.26	Nil	356.23	10946	180	235	Nil	3
HBL	15939	1037	457.45	21.73	1113.5	13451	1001	308	31.9	1026.6
BoK	7489	203	202	7.3	229.41	6182	308	139	24	269.46
NIC	6657	179	96.59	2.6	245.96	4909	185	113.75	3.5	197.6
MPBL	6068	16.9	133.99	12.53	77	5130	19.8	84.87	4.35	68
NBBL	9010	2664	-1797	205.7	2990	9626	1778	-781	147	1802

Source : Annual Reports of corresponding Banks

In the fiscal year 2006/07, Nabil bank earned the highest net Profit followed by HBL. The Nepal Bangladesh Bank is the only bank which is in lost among the sample banks. Rest of the banks net profit has increased except Nepal Industrial and Commercial banks.

Nabil is the best regarding the Non Banking Asset (NBA). It has nil in NPA whereas NBBL has the highest NBA on fiscal year 2007.

Loan loss Provision is the fund set aside to minimize the effect of possible loan losses of the banks. The loan loss is directly related to NPA. Among the sample banks MPBL has the lowest NPA hence it has lowest provision for loan loss. The NBBL which has the highest NPA has highest Loan loss Provision. Due to high NPA large sum has to be set aside for provision, due to which its loanable fund decreases affecting its revenue. HBL has the second highest amount set aside for loan loss provision. It's NPA is also second highest after NBBL. But due to its highest loan and advances it's profit is very high. Its NPA is also comparatively high.

From Profit and NBA, Nabil bank is the best among the sample banks. From NPA and Loan loss provision Machhapuchhre bank is the best. HBL is very aggressive. It has highest loan and advances and its profit is high but at the same time its NBA, NPA and Loan Loss Provision is also very high. BoK and NIC banks performed moderately on FY 2006 and 2007. Nepal Bangladesh bank's performance is not satisfactory. Its running in net loss for continuous two years and its NPA, NBA as well as Loan loss Provision is very high. It needs to give special effort to uplift its condition.

4.5 Major Causes of NPA In Nepal

From various studies and from the experts of Banking and Economics of Nepal, the researcher concludes following major causes of NPA in commercial banks of Nepal.

4.5.1 Undue Pressure

The main causes of increase of NPA and NBA in commercial banks are due to undue pressure and influence from the political parties, promoters, Bureaucrats, and other influential people to sanction loan to low credit profile and overvaluation of the collateral. Especially willful defaulters take help of such pressure group to sanction loan.

4.5.2 Lack of Credit Policy

Only few banks are found having proper credit policy. The concentration of loan to a single sector also helped to increase the NPA. The banks should be clear where to invest and how much to invest. The condition of the industry should also be analyzed properly before lending that industry.

4.5.3 Political instability

Due to political instability and the violence many industries were closed turning there loan Bad. Regular strikes and undue demands from the worker union deteriorate the environment for conducting business and trade. The Political instability affects every sector of the nation adversely

4.5.4 Government Inactivity

The Government of Nepal is found unwillingness towards punishing willful defaulters. The Government has not made any law to control the banking crime. It is because most of such defaulters are often the major donor for the political parties for their campaign.

4.5.5 Managerial Inefficiency

In most of the banks the Non performing assets grow not only due to the willful defaulters but also by the inefficiency of the management to manage the loan and advances. Due to improper planning and incorrect maintenance of the loan even the good loan turn into bad. The management should also be able to find out new sectors to lend and produce to products. The banks should regularly revise the creditors’ performance and classify accordingly.

There are other causes also but these are found playing major role in increasing the Non Performing assets.

4.6 Hypothesis Test

4.6.1 Hypothesis 1

There is no significant difference between the NPA level of commercial banks of Nepal and international Standard of 4%.

Tabulated Value	Calculated Value	Result
t_{tab}=2.015	t_{cal} =0.6689	$t_{cal} < t_{tab}$

Since $t_{cal} < t_{tab,}$
∴ H_0 is accepted.

∴ There is no significant difference between the NPA level of commercial banks of Nepal and international Standard of 4%.

4.6.2 Hypothesis 2

There is no significant difference between the NPAs of Commercial banks of Nepal

Tabulated Value	Calculated Value	Result
F_{tab} = 2.62	F_{cal} =2.6882	$F_{cal} > F_{tab}$

Since $F_{cal} > F_{tab}$;
∴ H1 is accepted.

∴ There is significant difference between the levels of NPA among the six commercial banks.

In Fiscal year 2007 the NBBL has the highest level of NPA (29.57%) where as the lowest is 0.28% of MPBL. The second highest is 6.14% of HBL.

4.7 Major Findings of the Study

After analysis the data the following findings are revealed:

The loan and advances of whole commercial banks are in increasing trend. Yearly it is increasing. The net profit of the commercial banks is also increasing. The total loan disbursed by the whole commercial banking industry reached to 118.3 billion in F.Y. 2007 which was only 103.16 billion in F.Y. 2003.

The NPA proportion to total Loan and Advances of whole commercial banking industry is in decreasing trend. It decreased to 14.22% in FY 2007 from 30.4% in 2003. The NPA of Private banks is very low compared to Public banks. In FY 2003 the NPA of private banks was

Rs. 5.64 billion whereas Public bank NPA amounted to Rs. 25.72 billion. In FY 2007 the NPA of private banks was 8.38 billion whereas Public bank NPA amounted to Rs. 17.20 billion.

Nabil Bank has increased its loan and advances to Rs. 13278.78 million in FY 2007 from Rs. 7739 million in 2003. There is significant drop of NPA. It decreased to Rs. 165.98 million from Rs.552.57 million in five years time. It’s profit has significant improvement. It was Rs.635.26 million in FY 2007 which was only Rs. 272 million in FY 2003.

Himalayan Bank has increased its loan and advances to Rs.15939 million in FY 2007 from Rs. 9557.14 million in 2003. It is the highest lending bank. NPA decreased to Rs. 978.69 million from Rs.1156.41 million in five years time. It’s profit reached Rs. 457.45 million in FY 2007 which was only Rs. 235 million in FY 2003.

BoK’s loan and advances increased to Rs. 7489 million in FY 2007 which was only Rs. 4890 million in FY 2003. Its NPA is Rs. 190.17 million in FY 2007 which was Rs. 396.58 million in 2003. Net Profit increased significantly in five years time and reached to Rs. 202 million from Rs. 9 million.

MPBL has significant improvement in loan and advances and reached Rs. 6068.9 million in FY 2007, which was only Rs. 680.3 million five years back. NPA dropped significantly form Rs. 71.09 million to Rs. 16.99 million in five years gap. In fiscal year 2003, MPBL was in lost but it’ net profit reached to Rs. 133.99 million in 2007.

NIC bank also improved in loan and advances. It’s Loan and advances reached to Rs. 6657.38 million in 2007 from Rs. 2368.85 million in 2003. It’s NPA is comparatively low. It achieved net profit of Rs. 96.59 million in FY 2007 which was only Rs. 6.82 million five years back.

Among the sample banks Himalayan Bank Ltd. has the highest loan and advances amounting to Rs. 15939.63 million and Machhapuchhre Bank Ltd. has the lowest Rs. 6068.9 million in F.Y. 2006.

The Banks are found giving special focus on decreasing the level of NPA. Nepal Bangladesh bank has the highest Non Performing assets. Its NPA amounted to Rs. 2664 million that makes the 29.57% of total loan and advances. MPBL has the lowest NPA that amounted to Rs. 16.99 million in F.Y. 2007 that makes 0.28% of total loan and advances. HBL's NPA lies in second position after NBBL that amounted to Rs. 978.69 million.

The NPA and the Net profit of the banks have negative correlation. That means increase in NPA will decrease the Net profit and vice versa. The whole commercial banking industry was in lost till F.Y. 2004 but after ward it is in profit. The net profit of the industry is in growing yearly. Among the sample banks Nabil bank earned the highest profit amounting Rs. 635.26 million in F.Y. 2007 where as the NBBL is only bank that was in lost. It's net lost was Rs. 1797 million. Rest of the banks earned profit on that fiscal year.

The Non Performing Assets have inverse relationship with Return on Equity and Return on Assets. The Non Performing Assets decreases the ROE and ROA of the organizations. Hence it decreases the profitability of the organization.

The Non Performing Assets level of the commercial banks of Nepal lies within the international standard of 4%. Although it lies within the international level some banks like Nepal Bangladesh Bank Ltd. and Himalayan Bank Ltd. need to give high effort to control it's NPA level.

There is significant difference in the NPA level between the commercial banks of Nepal. They vary significantly from each other. In Fiscal year 2007 the Nepal Bangladesh Bank Ltd. has the highest level of NPA (29.57%) where as the lowest is 0.28% of MPBL. The second highest is 6.14% of Himalayan Bank Ltd. Hence the performance of the commercial banks differ significantly among themselves regarding the loan management.

CHAPTER-V

SUMMARY, CONCLUSION & RECOMENDATIONS

This is the last Chapter and it includes the summary of the whole study. Summary is the main crux of the finding in the research. It also contains the conclusion of the study and it also includes the recommendations to overcome the problems found by the researcher.

5.1 Summary

The non performing Loan is a problem which cannot be eliminated. However it can be controlled and managed to minimize it and to minimize its effect. The Non Performing Loan has many negative effects to the organization. Some of them are as follows:

- Affects adversely on the profitability of the organization. It decreases the profit because the revenue decreases due to Non Performing Loans.
- Decreases the good will and reputation of the organization.
- Decreases the loanable fund

These three are the main effect of the Non Performing Loan to the bank. There are several other minor effects.

Commercial banks play a vital role in the development of a country. Lending is one of the most important function of commercial banks and the composition of loan and advances directly affect the performance and profitability of the bank. Many commercial banks have evolved in Nepal. Hence the competition between them is also growing. The small market and political instability also have adverse effect in whole economy as well as in the banking sector.

The commercial banking industry has been a major source of finance to the organization and big projects. The whole banking industry is growing significantly, which is very good sign. The NPA levels of the commercial banks are decreasing. It is also very positive. The commercial banks should be alert during lending. The NPA has inverse relation with profitability and performance of the Banks.

In Nepal the increase of NPA is especially due to the willful defaulters. Ironically big houses and big companies are the major source of NPA of commercial banks. They used to take loan misusing there reputation, connection to political parties and influence. The political instability and the political pressure/influence for sanction of loan is also a major cause. Lack of proper law and the lack of willingness in the Government has been the main barrier in taking action against defaulters.

Some of the causes of NPA are Lack of credit policy in the bank, Undue influence and pressure from various factors like Promoters, Political Parties, etc, Cut-throat competition, Political instability, Lack of far-sightedness and lack of ability to introduce new products, etc. Government unwillingness to punish defaulters also plays vital role in increase of NPA in Nepal.

5.2 Conclusion

Non-performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital. The economy performs below its production potential.

The Non Performing Asset is the double edged sword that will decrease the revenue and profitability of the bank in one hand and in other hand it decreases the loanable fund due to the necessity to keep fund aside in the form of Loan Loss Provision. The NPA also decreases the efficiency of the bank. It decreases the goodwill and the reputation of the bank. It decreases the confidence level of the shareholders as well as the customers. In the worst case the Bank can be bankrupted.

Since, the NPA has many unpredictable effects not only to the lending Bank but also to whole society and economy of the nation. The NPA germinate from the time of analysis period during the lending process. Hence to decrease the level of Non Performing assets the banks should be aware from the time of lending and the project should be analyzed carefully for its viability. The lending team should be given necessary training, full authority and should also be made responsible. There morale should be raised. They should not be enforced or make them to sanction loan in pressure. The bank should also visit the customer regularly, analyze their performance, there status should be revised in periodic basis, and should also give financial guidance if necessary.

The Non Performing Assets consumes the capital and assets and destroys the whole system. The defaulters or the clients who do not repay the loan back should be punished. Recently a new bill was presented in the parliament for discussion, in which, there were provisions for punishment for defaulters, which is very good news for the bank. It is also a very positive and encouraging movement from the side of the Government. Willful defaulters should be banned by the society. Unfortunately, it comes in papers and news that such defaulters get shelter from political parties. These things should not happen. It’s not a good signal for a developing country. The business houses should also follow it’s business ethics.

In Nepal, Debt Recovery Tribunal is formed by the Government to recover the bad debts of the bank. It should be enacted and should be given full authority and power.

Finally, commercial banks or Nepal are found conscious regarding the Non Performing Assets. There NPA is also within the international level. They have been giving full effort to decrease and minimize the level of NPA which have been accumulated for years. They have got significant achievement in this regard. Most of the banks have decreased the NPA. There is also special effort from Government and from private sector to minimize the NPA and recover the bad loans.

5.3 Recommendations

Following recommendations are given to the commercial banks. The recommendations are classified into three groups.

a. General recommendation for the Bank

The Bank should adopt the following General strategies for control of Non Performing Assets. The suggestions are as follows:

- Large exposure on big corporate or single project should be avoided.
- The bank should not sanction the loan on undue political or any other form of pressure and influence.
- The credit staff team should be given special training and education.
- There is need to shift banks approach on lending from collateral security to viability of the project and intrinsic strength of promoters.
- The bank should use the state-of-art computerized information system to maintain the information of credit and creditors for effective management of the bank.
- A different cell should be created to manage and recovering the NPA.

b. Pre Sanction of Loan

- Thorough analysis should be done before sanction of any loan. Analysis should be based on trends of capacity utilization, profitability etc. History of the client should also be analyzed focusing on 5Cs. Projects with old technology should not be considered for finance.

- Uneven scale of repayment schedule with higher repayment in the initial years normally is preferred.
- As far as possible, repayment of term loans should be fixed on monthly basis rather than on quarterly or semi annual basis.
- Personal guarantees of the promoter directors/major shareholders should normally be insisted upon.

c. Post Sanction of Loan

- Bank should prevent diversion of funds by the promoters in the organization for which loan is sanctioned until the loan is repaid completely.
- The Credit section should carefully watch the warning signals viz. non-payment of quarterly interest, dishonor of check etc.
- Effective inspection system should be implemented and regular inspection of the organization should be carried out.

d. External improvement for decreasing NPA

Following external improvements are necessary to decrease the NPA and recover the loans that have turned bad.

i. Political Stability

Political stability is essential for national development and economical prosperity. The Business and industrial sectors should be kept away from the political instability and political influence. The industries should not be the play ground for the political practice.

ii. Loan Recovery Tribunal

The loan recovery tribunal should be given full power to take actions against the willful defaulters and it should also be given full power to recover bad debts. The banks should also report as soon as possible regarding the bad debts to the Loan Recovery Tribunal to recover the bad loans.

BIBLIOGRAPHY

Bhandari, D.R Raj, (2003), ***Banking and Insurance***, Kathmandu, Aayush Publication.

Bhandari, R., (2004), ***Analysis of Non Performing Assets of Commercial Banks of Nepal,*** Unpublished Masters' Degree Thesis, Central Library, Tribhuvan University. Kathmandu.

Bhattarai, R., (2006), ***Investments Theory and Practice***, Buddha Academic publishers and Distributors Pvt. Ltd, Kathmandu.

Bidani, S.N.(2003); ***Managing Non-Performing Assets***, New Delhi, Vision Publishers

D.E. F. & R.J.Jordan, (1992), ***Securities Analysis & Portfolio Management***, 5th Edition, New Delhi: Prentice-Hall of India Pvt. Ltd.

Dahal, Bhuvan and Dahal, Sarita,1992, ***A Hand Book to Banking***. Kathmandu: Asmita Books and Stationery.

Francis, J.C.(1998), ***Management of Investment,*** 2nd Ed. Singapore: Mc-Graw Hill Book Company.

Gajurel, R. (2006), ***Loan Portfolio of Commercial Banks and their Proportion of NPA***, Unpublished Masters' Degree Thesis, Nepal Commerce Campus, Tribhuvan University, Kathmandu.

Ghimire, G. (2005), ***Non Performing Assets of Commercial Banks: Cause and effect***, Unpublished Masters' Degree Thesis, Nepal Commerce Campus, Tribhuvan University, Kathmandu.

Gitman J. Lawrence, (1985), ***Principles of Managerial Finance,*** 4th Ed. New York:

Grewal, S.S.(1995), ***The Thinking Investor***, 4th Ed. New Delhi: The Vision Books.

Howard, Wolff k. and Pant, P.R., ***A Hand Book for Social Science Research and Thesis Writting***, Kathmandu: Buddha Academy.

Jacob, Nancy L., et. al (1984), ***Investment***, Richard D. Irwin, Inc.

Joshi, Murari Mohan, (1993), ***Money and Banking***, Kathmandu, Taleju Publication.

Kafle, D.N.(2005), ***Non Performing Loans of Nepalese Commercial Banks***, UnPublished Masters' Degree Thesis, Central Library, Tribhuvan University. Kathmandu.

K.C., S. (2007), ***Credit Portfolio Management of Commercial Banks in Nepal***, Unpublished Masters' Degree Thesis, Nepal Commerce Campus, Tribhuvan University,
Kathmandu.

Khothari, C.R., (1994), ***Research Methodology: Method & Techniques,*** II Edition New Delhi: Wishwa Prakashan.

Mankiw, N.G. (2000), ***Principles of Economics***, Second edition, Thompson South western.

Mishkins, F.S, (2003), ***The Economics of Money; Banking and Financial Markets***, Columbia University, Addison Wesley.

Poudyal, S.S, (2006), ***A study of the NPA of Commercial banks of Nepal a thesis, Nepal commerce Campus***, Tribhuvan University, Kathamandu, Nepal.

Pradhan, Dr. R. S,(2004), ***Financial Management***, Buddha Academic Publishers and Distributors.

Rose, P., (2001), ***Commercial Banking Management***, IRWIN

Rose, P., (2001), ***Money and Capital Markets***, McGraw-HillInternational Editions.

Sharma, P.K and Chaudhary, A.K, (2003), ***Statistical Methods***, Kathmandu: Khanal Books and Stationeries.

Sharpe, William and Others, (1999), ***Investments,*** 5th Ed. India: Prentice Hall of India.

Shrestha, Manohar K., Bhandari, Dipak B.(2004), ***Financial Markets and Institutions***, Asmita Books Publishers and distributors, Kathmandu.

Singh, S. et al, (2002), ***Statistical Methods For Research Workers***, New Delhi: Kalyani Publishers.
Wright State University.

Wayne, K. H. & Megan, T. (2002). ***The Conceptualization and Measurement of Faculty Trust in Schools. The Omnibus Trust Scale***, Ohio State University Columbus.

Weston, J. F. and Thomas E. Copeland,(1992) ***Managerial Finance***, Chicago: The Dryden Press.

<u>Journals, Articles and Published Materials:</u>

Adhikari, M. P, (2006), ***Nepalese NPL scenario and Assets Portfolio Concentration***, a paper presented to the the workshop organized by SEJAN.

Annual Reports of Nabil Bank Ltd.
Annual Reports of Himalayan Bank Ltd.
Annual Reports of Bank of Kathmandu Ltd.
Annual Reports of Nepal Industrial and Commercial Bank Ltd.
Annual Reports of Machapuchere Bank Ltd.
Annual Reports of Nepal Bangladesh Bank Ltd.

Editorial, **Alert Defaulters**,(Dec, 2007), Annapurna Post.

IIMA news letter, ***Non-Performing Assets in East Asia***, Institute for International Monetary Affairs, 2000

Lahiri, Ashok K,(2002) "Rising NPAs: Where has all money gone?". (www.rediff.com)

Mark, T, (2000), ***Surveys Reveal Investors Will Pay for Good Governance***, Mckinsey
Quarterly Survey, World Bank and Korea's Yonsei University.

NRB Act, 2012
NRB, ***Banking and Financial Statistics***, (July 2007).
NRB, ***Banking and Financial Statistics***, (July 2006).
NRB, ***Economic Reports-2005***
NRB, ***Unified Directives***, (2006)

Prashanth, K. Reddy,(2003) ***Treatment of Non –Performing Assets (NPAs) in Macroeconomic statistics***, Indian Institute of Management Ahmedabad. CYTL Paper contest

Rojers, Matama, (2003) ***Corporate Governance and Financial Performance of Selected Commercial Banks of Uganda***, Makerere University, Uganda.

Subramanyam, V, (2003) ***Treatment of Non –Performing Assets(NPAs) in Macroeconomic Statistics,***(Website)

Online Resources and Websites:

www.arthaexpress.com
www.finance-yahoo.com
www.forbes.com
www.nepalstock.com
www.nrb.org.np
www.rediff.com
www.sebonp.com