A PROPOSAL

THE EFFECT OF CREDIT RISK MANAGEMENT ON PROFITABILTY OF FINANCE COMPANIES IN NEPAL: A COMPARATIVE STUDY OF MANJUSHREE FINANCE LIMITED, POKHARA FINANCE LIMITED AND GOODWILL FINANCE COMPANY LIMITED

Submitted by:

Suman Maharjan

People's Campus Roll No: 52/074

Symbol No: 7349/18

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CHAPTER I

INTRODUCTION

1.1 Background of study

Banks or financial institutions are subjected to a wide array of risks in the course of their operations and generally banking risks fall into three categories: financial, operational, and environmental risks (Bratanovic and Greuning, 2009). The banking industry, in any economy, has achieved a great prominence in the economic environment and it influence predominant role in granting credit facilities. The credit function of banks enhances the ability of investors to exploit desired profitable ventures. Credit creation is the main income generating activity of banks (Kargi, 2011). However, it exposes the banks to credit risk. The Basel Committee on Banking Supervision (2001) defined credit risk as the possibility of losing the outstanding loan partially or totally, due to credit events.

Credit risk is an internal determinant of bank performance. The higher the exposure of a bank to credit risk, the higher the tendency of the banks to experience financial crisis and vice-versa. Among other risks faced by banks, credit risk plays an important role on banks‟ profitability since a large chunk of banks‟ revenue accrues from loans from which interest is derived. However, interest rate risk is directly linked to credit risk implying that high or increment in interest rate increases the chances of loan default. Credit risk and interest rate risk are intrinsically related to each other and not separable (Drehmann, Sorensen, & Stringa, 2008).

Credit creation is the main income generating activity for the banks and financial institutions. But this activity involves huge risks to both the lender and the borrower. The risk of a trading partner not fulfilling his or her obligation as per the contract on due date or anytime thereafter can greatly jeopardize the smooth functioning of BFI's business. On the other hand, a bank with high credit risk has high bankruptcy risk that puts the depositors in jeopardy. But then the increasing tendency for greater risk taking has resulted in insolvency and failure of a large number of the banks (Kargi, 2011). Therefore, granting credit is one the primary function of BFIs to generate sufficient

income and this activity leads the banks towards credit risk that significantly affects the financial performance of BFIs.

1.2. Problem statement

Credit risk is the most noticeable risk in the banking and possibly the most important in terms of potential losses. Credit risk is not curbed to the risk that borrowers are unable to pay; it also includes the risk of payments being delayed, which can also cause problems for the bank (Hosna, Manzura, & Juanjuan, 2009). In order to assess and manage risks, bfis must have effective ways to determine the appropriate amount of capital that is necessary to absorb unexpected losses arising from their market, credit and operational risk exposures. In addition to this, profits that arise from various business activities of the banks need to be evaluated relative to the capital necessary to cover the associated risks (Amidu & Hinson, 2006).

Based on the statement of the problems, this research study deal with following research questions;

i. Is there a significant relationship between credit risk management and profitability position of the sample finance companies?
ii. How does the credit risk management impact on profitability position of sample finance companies?
iii. How will profitability (ROA) behave in the future fixed period?

1.3. Objectives of study

This research study is guided by the following general objectives;

i. To analyze the relationship between credit risk management and profitability position of the sample finance companies.
ii. To measure the impact of credit risk management on profitability of the sample finance companies.
iii. To identify the key financial indicators those are being used by the sample finance companies to monitor the credit risk.
iv. To explore the profitability position of the selected finance companies.

1.4. Rationale of the study

The main focus of this research was on the position of profitability and credit risk indicators, as well as the influence of credit risk on profitability. Because it was only one metric to evaluate an organization's prosperity or recession, this study was useful for credit performance analysis in any finance industry. This study had the following rationale to assets the credit risk management of the finance companies;

i. This study is expected to be useful to the management of the finance company to understand credit risk problem and to provide necessary recommendations.
ii. It is hoped that the findings of this study will be valuable to the academicians, who may find useful research gaps that may stimulate interest in further research in future.
iii. The understanding of the research will help the policy makers to redesign required policies and programs for credit risk management.
iv. It will facilitate the investors of the company to figure out the information, related to credit risk of the company, to be disclosed by the company on the financial statements.
v. It will be useful to spread the financial literacy to the readers regarding the credit risk management for various other purposes.

1.5 Limitation of Study

Since this research study is based on the secondary nature of data therefore this study has some limitations, they are mentioned below;

i. The study has been conducted among few students only. Thus, the findings may not be generalizable for the whole students.
ii. Only seven independent variables have been considered in the entire study.
iii. Only three finance companies have been selected out of 17 finance companies
iv. The study is carried out within the limited time period.
v. The validity of this research study is dependent on the data published in the annual report of the finance companies.

CHAPTER II

LITERATURE REVIEW

2.1 Literature Review

A literature review is a method of collecting new unexplored data about a research topic. Basic information about credit risk and its impact on the profitability of finance companies in Nepal was analyzed as part of the study. Theoretical review and empirical review are the two sections. The first segment introduces the theoretical idea of credit risk and its profitability of finance companies, while the second half examines relevant dissertations and reports.

Bayyoud and Sayyad (2015) tried to assess the relationship with the profitability of the commercial and investment banks in Palestine. For a more comprehensive analysis of Palestine banking sector, investment and commercial banks both were chosen for assessing the relationship between credit risk management and profitability. Explanatory research design was chosen for this study in assessing the casual effect relationship between the research variables. The regression model was used for gathering quantitative findings while structured interview from bank managers was selected for gathering qualitative data. The findings of the regression model in the current study confirmed that there is no consequence of credit risk on profitability of commercial and investment banks of Palestine. Additionally, it was also found that there is no difference between the Palestinian commercial and investment banks concerning the relationship.

Annor and Obeng, (2017) had conducted their research study to assess the impact of credit risk management on the profitability of six selected commercial banks listed on the Ghana stock exchange. Secondary data was used to examine the relationship between credit risk management and the profitability of selected banks, balance panel approach was employed. Data for the study was collected from the annual financial report of the sample banks between the years 2007 to 2016. For the purpose of this study, the researchers have adopted the random effect model within the panel estimation technique framework. The study also has used return on equity (ROE) to measure profitability of bank, non-performing loans, loan loss provisions ratio, loan to asset ratio and capital adequacy ratio as credit risk. The researchers have found through this study that the credit

risk management has significant relationship with the profitability of banks. While capital adequacy ratio had positive relationship with a bank’s profitability; non-performing loans, loan loss provisions ratio and loan to asset ratio shows statistically significant negative relationship with the profitability of a bank. Based on the above findings, this study recommends that banks should access and manage credit risk indicators vigorously in order reduce their exposure to these risks.

Rasika and Madushani, (2019) investigated the impact of the credit risk management on profitability using a panel data set of 22 licensed finance companies in Sri Lanka from FY 2010 to FY 2016 based on higher market capitalization companies. For the purpose of the study, descriptive research design has been adopted and the secondary data was obtained from the financial statements of the selected finance companies. Using STATA 12 computer software “panel unit root test” was performed to test the stationary of the collected data set in order to avoid the so-called spurious regression. The multi-co linearity among the selected variables was tested using variance inflation factor. Panel data may have individual effect, time effect, or both, which are analyzed by using fixed effect model, random effect model or pooled ordinary least squares (OLS) regression model. At the end of this research paper, it was concluded that Credit Risk Management has a significant impact on Profitability. It is recommended to take prompt actions to minimize NPLR and LP and to maintain sufficient CAR by following best practices of credit risk management.

Pantha, (2019) had examined the impact of Credit Risk Management on Bank Performance of Nepalese Commercial Bank. This study attempts to investigate impact of credit risk management on bank performance by taking panel data of selected 9 commercial banks operated in Nepalese economy with 72 observations for the period 2009/10 to 2016/17. The dependent variables is return on asset which measure bank performance while the independent variables are default rate, cost per loan asset and capital adequacy ratio. For the purpose of this study, the secondary data have been used. Empirical results are based on fixed effect model and random effects model for balanced panel data. The finding suggests that default rate and cost per loan asset are the significant variables explaining the banks' performance.

My and Quoc, (2022) had analyzed the relationship between credit risk and bank financial stability. The aim of this study is to investigate the influence of credit risk on bank financial stability of Vietnamese commercial banks. This study has employed a panel of 286 observations gathered from financial statements from fiscal year 2005 to 2019 to construct a multivariate regression model. Furthermore, to assess the hypotheses proposed, pooled OLS, FEM, REM, GLS, and GMM methods are used; this approach is consistent with research trends. The selection of basic variables and making research hypotheses are mainly based on empirical evidence, mainly from the previous research. This research study proposes three models for three phases: the first determines the factors that affect a bank's credit risk, the second investigates the impact of profitability on bank profitability, and the third examines the impact of credit risk on bank financial stability. The findings of this study reveal a direct relationship between bank credit risk, profitability, and bank financial stability, as well as a partly indirect association.

CHAPTER III

RESEARCH METHODOLOGY

3.1. Research Framework

This study has seven independent variables and one dependent variable.

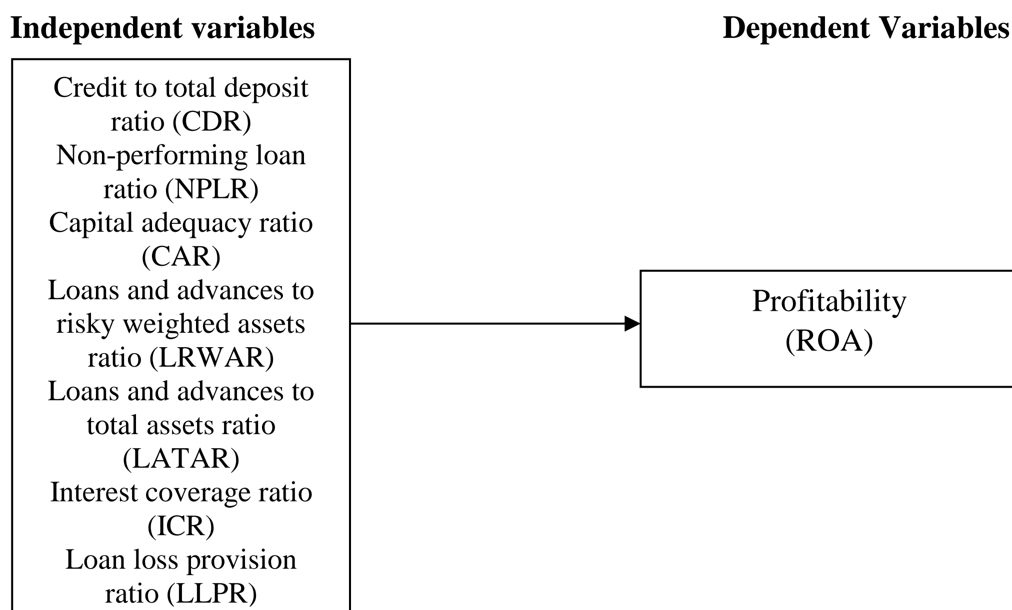

Figure1. Research framework of the study

3.2. Population and sample

The population of the study is the entire aggregation of items or individuals from which samples can be drawn. The population selected for this study was 17 finance companies operating in Nepal as of fiscal years 2078/79. Due to the large size of population, it is not possible to test every finance companies in the population. Therefore, three finance companies i.e. Goodwill finance companies, Manjushree Finance Companies are selected out of total population size through random sampling method.

3.3. Nature and sources of data collection

The study will be based on secondary data. Various Journals, books, magazines, newspapers, articles, etc. are the sources of secondary data. The necessary data are collected from respective annual report.

3.4. Research methods

This study uses a quantitative approach and is included in the type of explanatory research. The independent variables in this study are Credit to total deposit ratio, Non-performing loan, Capital adequacy ratio, Loans and advances to risky weighted assets ratio, Loans and advances to total assets ratio, Interest coverage ratio and Loan loss provision ratio. While the dependent variable in this study is the profitability (ROA). The type of data in this study uses secondary data types, namely annual report data that has been available on their respective websites. The population selected for this study was 17 finance companies operating in Nepal as of fiscal years 2078/79. Due to the large size of population, it is not possible to test every finance companies in the population. Therefore, three finance companies i.e. Goodwill finance companies, Manjushree Finance Companies are selected out of total population size through random sampling method.

3.5. Organization of study

This study has been divided into five chapters: Introduction, review of literature, research methodology, data presentation and analysis and summary, conclusion, recommendation.

Chapter-I: Introduction

The first chapter includes the introduction part of the study. It includes background, problem statement, objectives of study, hypothesis of the study, rationale of study, limitations of the study and chapter plan.

Chapter –II: Literature Review

This chapter deals with conceptual framework of study and reviews of major empirical work in the area. This study is based on the framework provided by the chapter.

Chapter-III: Research Methodology

This chapter carries out research design, nature and source of data, data gathering process, population and sample and tools for data analysis.

Chapter-IV: Results and discussion

This is the core part of the study. It deals with the empirical analysis of the study. Analysis is the systematic and examination of available facts so that certain conclusion can be drawn and inferences can be made.

Chapter-V: Summary and conclusion

This chapter summarizes the whole spectrum of the study. It also offers recommendation for the improvement in future. Likewise, at the front part of the study, table of contents, recommendation, acknowledgement, list of tables and figures, abbreviation are included where bibliography and appendices are included at the end of the study.

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