A STUDY ON NON-PERFORMING ASSETS IN COMMERCIAL BANKS OF NEPAL

By:

Sumana Khatri Chhetri
Prithivi Narayan Campus
T.U. Registration Number: 12984-95

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RECOMMENDATION

This is to certify that the thesis:

Submitted by

Sumana Khatri Chhetri

Entitled

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has been prepared as approved by this Department in the prescribed format of Faculty of Management. This thesis is forwarded for examination.

Supervisor		Head of Department
Name:	**Puspa Raj Sharma, PhD**	**Signature:**
Signature:		Campus Chief
		Signature:

Date:

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We have conducted the viva-voce examination of the thesis presented by

Sumana Khatri Chhetri

Entitled

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and found the thesis to be the original work of the student and written according to the prescribed format. We recommend the thesis to be accepted as partial fulfillment of the requirements for Master's Degree in Business Studies (M.B.S.)

Viva-Voce Committee

Chairperson, Research Committee: ……………………………………………

Member (Thesis supervisor): …………………………………………………

Member (External expert): ……………………………………………………

Member: …………………………………………………………

Date:

ACKNOWLEDGEMENT

Research and Development is one of the keys to innovate and generate new ideas. Research in today's world is power and is one of the key drivers to resolve immediate and chronic problems encountered by organizations and by nation and to contribute in the general knowledge of literature.

The global financial structure is changing at a jet speed and we (Nepal) cannot be exception in this era of borderless land (globalization) in terms of financial integration and economic development. We also need to address our domestic problem and face the upcoming challenges in our financial sector. We too have to be abreast with the latest happenings and at the same time contribute to the global phenomena of innovations.

With such vision to resolve one of the most daunting problems and challenges of the financial system, i.e. the accumulation of Non Performing Assets (Loans), this research has been undertaken to study on non-performing assets in commercial banks of Nepal. I have taken considerable help from various journal articles, working papers, World Bank, Nepal Rastra Bank and other such institutional resources.

In the event of preparing this paper it would be unfair if I don't extent my appreciation and indebt-ness to respectful dignitaries who have rendered substantial contribution. I owe great debt, for his intellectual support, precious time and insightful supervision to. Puspa Raj Sharma, PhD and without his support the research would never have been of worth. I would also like to extend my family and friends for their valuable suggestion in the preparation of the research instrument.

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ABBREVIATION

ADB	:	Asian Development Bank
BOK	:	Bank of Kathmandu
EBL	:	Everest Bank Limited
GDP	:	Gross Domestic Product
HBL	:	Himalayan Bank Limited
KBL	:	Kumari Bank Limited
LBL	:	Laksmi Bank Limited
LBL	:	Lumbini Bank Limited
MBL	:	Machapucharre Bank Limited
NBBL	:	Nepal Bangladesh Bank Limited
NBL	:	Nepal Bank Limited
NCCB	:	Nepal Credit and Commerce Bank
NIBL	:	Nepal Investment Bank Limited
NIBL	:	Nepal Investment Bank Limited
NIC	:	Nepal Industrial and Commercial Bank
NPA	:	Non Performing Assets (Bad Loans)
NPL	:	Non Performing Loans (Bad Loans)
NRB	:	Nepal Rastra Bank
NRs.	:	Nepalese Rupees
NSBI	:	Nepal State Bank of India
RBB./ RBL	:	Rastriya Banijya Bank
SCB	:	Standard Chartered Bank
WB	:	World Bank

CHAPTER I

INTRODUCTION

1.1 Background of the Study

Nepal is a developing country. More than the 80% population is dependent upon agriculture. For development of nation, ninth development plan have been completed, since B.S. 2014 and the 10th plan is running. Still agriculture system is running in traditional method. This sector is unable to provide full supply of national food demand. The achievement of economic development of Nepal is less than population growth. Poverty and unemployment situation is growing day by day. With this economic situation the urgently rapid economic development is necessary.

National development of any country depends upon the economic development of that country and economic development is supported by financial infrastructure of any country. Banks constitute an important segment of financial infrastructure of any country. Bank came into existence mainly with the objective of collecting the idle fund and mobilizing them to productive sectors causing overall economic development, which finally leads to national development of the country.

A bank can be de defined as a financial department store which renders a most of financial services besides taking deposit and giving loans. Banks pools the fund scattered in the economy and mobilize them to the productive sector in the form of loans and advances banks is a financial institution, which deals with money by accepting various types of deposits, disbursing loan and rendering various types of financial services. It is the intermediary between the deficit and surplus of financial resources. (Bhuwan Dahal and Sarita Dahal, 2002)

Banking when properly organized, aids and facilitates growth of trade and industry and hence of national economy. In the modern economy banks are to be considered not as dealers in money but as the leader of development. Banks are not dust storehouse of the country's wealth but are the reservoirs of resources necessary for economic development (M. Radhaswami and S.V. Vasudevan, 1991).

It can not be denied that the issue of development rests upon the mobilization of resources and banks deals in the process of channelising the available resources in the needed sector. Commercial banks collect deposits from the public and the largest portion of the deposited money is utilized in disbursing loans & advances. The balance sheets of the commercial banks reflect deposits constitute a major position of the liabilities and loans and advances constitute a major portion of the assets. Similarly the profit of the bank depends upon the spread that it enjoys between the interest it receives from the borrowers and that to be paid to the borrowers. An average bank generates 60-70% of its revenues through its lending activities. The return that the bank enjoys of deposit mobilization through loans and advances is very attractive but they do not come free of cost and free of risk. There is risk inherent in lending portfolio. Banking sector is exposed to number of risk like interest rate risk, liquidity risk, credit risk, borrowers risk etc. Such risks in excessive from had led many banks to go bankrupt in a number of countries.

Among the many risk that the bank faces one of the most critical is the borrower's risk- the risk of non-payment of the disbursed loan and advances. Failure to collect money disbursed may sometimes results in the banks inability to make repayment of the money to the depositors and return to the shareholders. The risk involved is so high it can bring bank to a verge of bankruptcy. The bankers have the responsibility of safe guarding the interest of the depositors, the shareholders and the society they are serving. If a bank behaves irresponsibly, the cost born by the economy is enormous. Gandhi (2002) concluded that banking system is volatile and sensitive. It requires effective monitoring and efficient supervision. Smooth and effective regulation of banking activities is a must for sustainable economic growth of a country. The regulatory agency should always be watchful of banking activities carried out by governmental and non-governmental bank and financial institution.

Due to their central role in the economy, government and central banks try their best to rescue banks from such situations. Hence to protect the banks from such situation and protect depositors and shareholders money, central bank issues various directives and guidelines from the time to time with modifications and amendments for the sound regulation of the banking system all the banks have to abide by the rules and regulation issued by the central bank.

1.2 Focus of the Study

Banks disburses loans and advances for a certain predetermined fixed or every loans has its maturity period or expiry date and borrowers must repay the loans by the maturity period but there is no certainty that all the loans are recovered within in the maturity period but some loans can not recovered even after its maturity and remain and remain a non performing assets of the bank. Banks in Nepal are in poor health. Increasing non-performing assets is one of the severe problems of the Nepalese banks.

Bank investments in the form of loans are not giving desired return. Banks are facing problems in recovering the granted loans that had turned to NPA. The government owned to banks have huge amount of NPA. Even the private and joint venture banks are also facing the problems of increasing NPAs. This problem may lead to bankruptcy of bank and failure of banking system adversely affecting the depositors and other parties of the society. This study focuses on the fact that NPA and its effect on Nepalese commercial banks.

1.3 Statement of the Problem

Nepal too as said earlier has similar problems of bad lending, which are very difficult to get back. Is it the economic slowdown only, which is creating all the problems associated with the good loans becoming bad or there are any other aspects as well. In addition, this study has attempted to seek the answers of following questions.

- What are the contributing factors, which causes the appreciation of non-performing assets in commercial banks?
- What is the effect of appreciation of non-performing assets in commercial banks?
- What is the effect of non performing assets in net profit of commercial bank in Nepal?

1.4 Objectives of the Study

The major objective of the study is to evaluate the cause and effect of non-performing assets of commercial banks in Nepal. The specific objectives are as follows:

- To analyze the contributing factors this causes the appreciation of non-performing assets in commercial banks.
- To examine the effect of non-performing assets on the performance of commercial banks.
- To examine the effect of non performing assets in net profit of commercial bank.

1.5 Significance of the Study

This study is first attempt to identify the cause and effect of non-performing assets in commercial banks. Thus, outcomes of this study will help to find out the measures which banking sectors can follow to convert the bad loan in to good ones and it will also fruitful to the policymakers. It will also provide literature to the researchers who want to carryout further research in same avenues.

1.6 Delimitation of the Study

The study has the following delimitations.

- This study is concerned only with non-performing assets (NPAs) of Nepalese commercial banks. It does not consider other aspects of the Nepalese commercial banks.
- The study is focused on the Nepalese commercial banks only. Hence, finding may not be applicable to other banks (i.e. development banks, finance companies and other companies of Nepal)
- Because of the strict policy of the commercial banks the study is mainly based of annual reports of respective banks, NRB reports, articles, publication, journals etc. have been taken into consideration. Any mis presentation, mistakes, omission etc may affect the outcome to the study.
- All the analysis in this study is based on the data of fiscal year 2000/01 to 2004/05.

1.7 Organization of the Study

The study has been organized into five chapters – Introduction, Review of Literature, Research Methodology, Presentation and analysis of Data, and Summary, conclusions and Recommendations.

The introduction chapter includes the background of the study, focus of the study, statement of the problems, objectives of the study, significance of the study, delimitations of the study and organization of the study. The second chapter deals with the review of the available literature. It includes theoretical review and review of related studies. The third chapter deals with the research methodology. It is concerned with the methodology adopted in the research work. It consists of research design, population and sample, nature and sources of data, data collection and processing techniques, data analysis tools and limitation of the methodology. In the same way, fourth chapter deals with presentation and analysis of data. Finally, summary, conclusions and recommendations of the study are given in the chapter five.

CHAPTER II

REVIEW OF LITE RATURE

2.1 Conceptual Review

The first section of this chapter presents the review of concept of commercial banks, Non-performing assets and the second one presents the review of relevant unpublished studies and research articles published in different international journals.

2.1.1 Concept of Commercial Banks

Commercial banks are major financial institution which occupy quite important place in the framework of every economy because they provide capital for the development of industry, trade, and business and other resources sectors by investing the saving collected as deposits. They contribute to the economic growth of the nation. Beside this, commercial banks render numerous services to their customers in view of facilitating their economics and social life. All the economic activities of each country are greatly influenced by the commercial banking business of that country. Thus commercial banks have becomes heart of Financial system.

In general, commercial banks are those financial institutions which play the role of financial intermediary in accepting deposits and granting loans (from surplus units to deficits units of the society). A commercial bank is a profit seeking business firm, dealing in money, like other commercial enterprise, a bank too seeks to earn maximum profit (income) through the suitable employment of its sources. It accepts deposits for the purpose of lending or investment and thereby hopes to make profit – profit which is adequate enough to enable the bank to pay interest at the prescribed rates to its depositors, meet establishment expenses, build reserve pay dividend to the shareholders etc.

Shekhar (1974) explained that commercial banks are profit seeking joint stock company either branch banking type which attract deposits of all kinds- current, fixed, saving – and make investment in such a way that satisfy the short term rather than long term.

Vaish (1993) stresses that commercial bank is a financial institution which accepts the demand and time deposits from business, institution and individual and engages in both business and consumer lending.

The bank which deals in exchanging currency, accepting deposits giving loans and doing commercial transaction is known as commercial bank. (Dahal & Dahal: 2002)

2.1.2 Historical Development of Commercial Banks

The evolution of banking industry had started a long time back, during ancient times. There was reference to the activities of money changers in the temple gerusalem in the new testament. In ancient Greece, the famous temple of Delphi and Olympia served as the great depositories for people's surplus funds and these were the centers of money lending transactions. However, as a public enterprise, banking made its first beginning around the middle of the 12^{th} century in Italy. The bank of Venice, founded in (1157A.D) was supposed to be the most ancient bank. Following it, were establish the bank of Barcelona and the bank of Genoa in 1401 A.D. and 1407 A.D. respectively. Subsequently Bank of Amsterdam set up in 1609 A.D. which was very popular then, the bank of Venice and the bank of Geneva continued to operate until the end of eighteenth century. With the expansion of commercial activities in Northern Europe, there sprang up a number of private banking houses in Europe and slowly it spread throughout the world.

However, the development of banking in Nepal is relatively recent, like other countries, landlords, moneylenders, merchant, goldsmith etc are the ancient bankers of Nepal (In which commodity money such as gold and silver coins generally accepted as a means of payment). Though establishment of banking industry was very recent, some crude banking operations were in practice even in the ancient times. In Nepalese chronicle, it was recorded that the new era known as Nepal Sambat introduced by Shankhadhar, a sudra merchant of kantipur in 880 A.D. This shows the basis of money lending in Ancient Nepal. The establishment of “Tejarath” during the year 1877 A.D. was the first step in institution development of banking sector in Nepal. Tejarath Adda did not collect deposit from public but granted loans to public against the collateral of billions. Consequently, the major parts of the country remain untouched from these limited banking activities. The development of trade with India and other country’s increase the necessity of the institutional banker, which can act more widely to enhance the trade and commerce and to touch remote non-banking sector in the economy.

Reviewing this situation, the “Udyog Parishad” constituted in 1936 A.D. One year after its formulation, it formulated the “Company Act” and “Nepal Bank Act” 1937 A.D.

Modern banking practice emerged with the establishment of Nepal Bank Limited in 1937 A.D. However the stand of Nepal Bank Limited alone in total monetary and financial sector was not sufficient and satisfactory. This Nepal Rastra Bank was set up in 1956 A.D. to develop Nepalese financial system to the higher level. It was empowered by act to have direct control over financial institutions within 1956 A.D. Similarly, on 1966 A.D. Rastriya Banijya Bank was established as a fully government owned commercial bank. With the emergence of RBB, Bank service spread to both urban and rural areas but customers failed to excessive political and bureaucratic interference.

Despite of all these efforts of the government, financial sector was sluggish, with the opening of Nabil Bank ltd. (before this it was called Nepal Arab Bank ltd.) in 1984 A.D., the dear of opening commercial banks was opened to the private sector. NABIL emerged as the first joint venture bank when the banking industry is totally dominated by government and semi-government Banks mainly to revitalize the economy accelerating productivity in various sectors and to provide efficient customer service.

Likewise Nepal Indo-suez Bank ltd. (Later it has been called Nepal Investment Bank Ltd.) and Nepal Grindlays Bank ltd. (later it has been called Standard Chartered Bank Ltd.), Nepal Bangladesh Bank Ltd. Were established under joint venture 1986, 1987 and 1994 A.D. respectively.

After the restoration of Democracy in 1990 A.D., Government adopted a more liberal policy in establishing the commercial banks. As a result a number of commercial bank increased dramatically Viz Himalayan Bank ltd., SBI Bank ltd. Everest Bank Ltd. etc. At present 17 commercial banks, 63 finance companies, 34 developing banks and 5 rural development, 19 co-operative societies and 47 non government organization are working under the banking financial ordinance 2061 out of the 17 commercial bank two banks are public sector and 15 are private sector banks.

2.1.3 Functions of Commercial Bank

- The main function of the commercial bank may best be summarized as the accepting deposits and lending of money.
- The primary function of commercial Bank is that of a broker and dealer in money. By discharging this function efficiently, a commercial banker renders very valuable services to the community by increasing capacity of the country and there by accelerating the pace of economic development.
- The bank is also actually distributing its deposits between the borrowers and its own vaults.
- A commercial bank provides a range of investment services.
- A commercial bank undertakes the payment of subscriptions, premium, rents and collections of cheques, bills, promissory notes on behalf of its customer.
- Commercial bank issue letter of credit and traveler’s cheque, the acceptance of bills of exchange the safe custody of valuable and

document, transaction of foreign exchange business, acting as a referee as to respectability and financial standing of customer and providing specialized advisory service to customers.

- Credit cards are introduced for the use of credit worthy customers.

2.1.4 Classification of Assets of Commercial Banks

Commercials banks assets are classified as performing assets and non performing assets.

1) **Performing Assets**: Performing assets/loans are those assets that repay principal and interest timely to the bank from the cashflow it generates. Loans are risky assets though a bank invests most of its resources in granting loans and advances. In context of Nepal the loans classified as “pass” category is term as performing assets.
2) **Non-performing Assets**: Assets are classified as non-performing assets if the borrower does not pay due in the form principal and interest timely to the bank. Non-performing assets have many different meanings which vary from country to country. In some countries it means the loan is impaired, in some countries it means that the payments are significant difference among “countries “how many days the payment should be in arrears before past due status is triggered.

In some developing countries of Asia pacific Economic corporation (APEC) forum, loan is classified as non performing only after it has been in arrear for at least six months. In India, after three months from the date of deemed commercial production to realize interest income, any default or resettlement was considered NPA on the book of account.

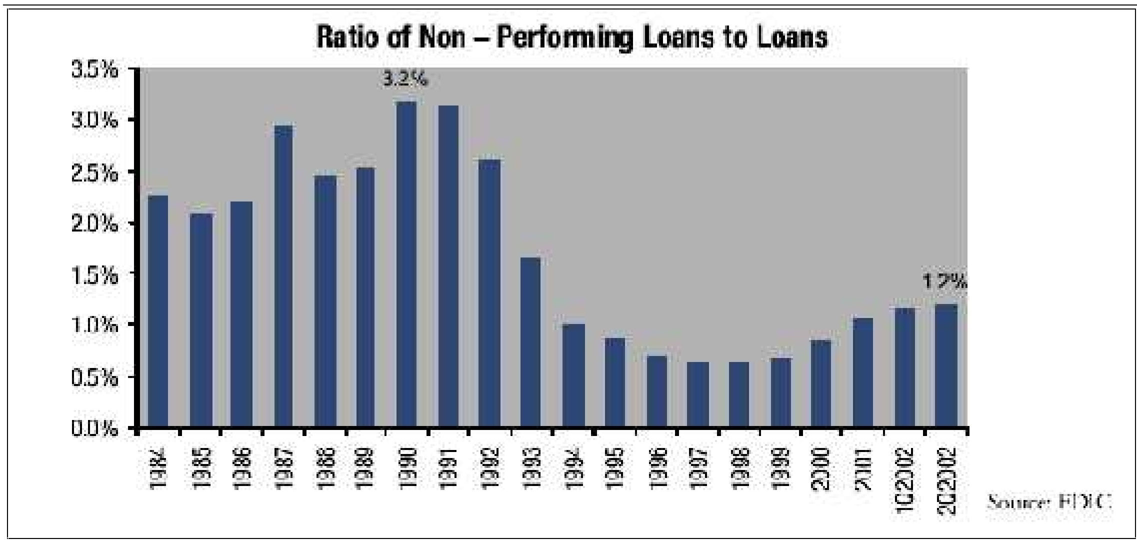
In Nepal also if loan is not past dues for over 3 months, it is non-performing assets, Non-performing assets are classified, according to international practice, into three categories, depending on the temporal position of loans falling under substandard, doubtful and loss categories are regarded as non performing assets.

2.1.5 Global Scenario of Non –Performing Assets

Looking back to the 1980s and early 1990s, bank management teams in US and worldwide have learned some hard lessons. During the period, bank credit cost exploded due to lack of diversity in their loan portfolios. The high credit cost detrimentally crimped earnings and capital levels causing a record number of bank failures.

Figure 2.1

Ratio of NPL to loans (USA)



The above chart indicates the level of credit cost during the crisis period and during the latter part when lessons were learnt from the failures. Adequate measures were taken to avert failures and reduce costs.

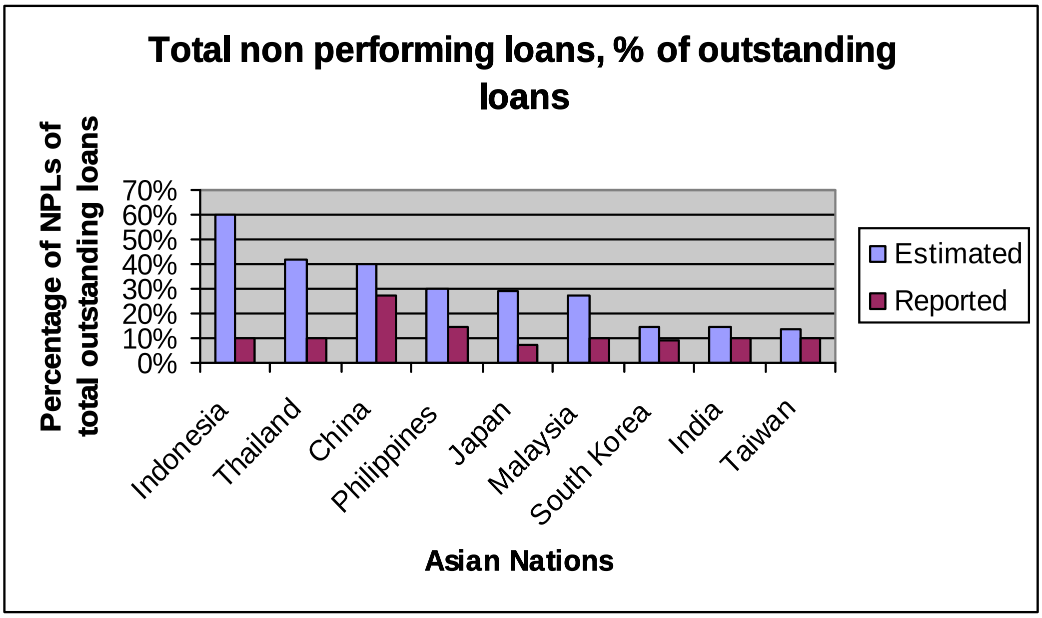
Similarly to emphasis more on the Asian region, a survey was conducted by The Economist (2003). It says that Asia has dramatically recovered from the 1997 debacle and macro economically the crisis countries are in a far sounder state. Yet despite the external strength, Asia still has a vast and unresolved legacy to deal with NPLs which was revealed after the crisis. Unless these rotted assets are not disposed off, the companies responsible for them will not lead the path of restructuring. The accurate estimate is hard to predict since most these economies tend to understate the extent of the problem, as shown in the table and figure below. Ernst and Young estimates a total of approximately US$800 billion or US$ 8 trillion including that of Japan when they assess the loans applying the international practice. Now longer the delay in dealing with these bad loans and disposing them off, the longer the region will take to make full economic recovery.

Table 2.1
Total NPLs of outstanding loans in Asia (Ernst and Young)

Nations	Estimated	Reported
Indonesia	60%	10%
Thailand	42%	10%
China	40%	27%
Philippines	30%	15%
Japan	29%	7%
Malaysia	27%	10%
South Korea	15%	9%
India	15%	10%
Taiwan	14%	10%

Source: Ernst and Young (The Economist, "The Weakest Link: A survey of Asian finance", February 8, 2003)

Figure 2.2



Source: Ernst and Young (The Economist, "The Weakest Link: A survey of Asian finance", February 8, 2003)

An analysis of bank failures owing to credit risk is presented in the appendix (page 1 – 3).

From all the theories and evidences studied above of different regions' problem of NPAs, its quite clear that NPAs are the burden on not only on the balance sheet of the concerned financial institutions but is a hurdle for the economic progress of the nation as a whole because most of the generated cash flows goes into servicing debt and the financial institution put too much emphasis on credit risk management ignoring loans even to the healthier ventures of the economy. Now if we go back to our study above and confine our analysis in the Asian region, what we can be say that a common cause of NPAs is the political influence and the government's policy of directed credit. In China, the state owned enterprises are the key players to generate bad loans, in Korea it's the cheobols and in Japan it's the cereous. Another cause is the ineffective risk management. Basically the practices of the financial institutions are not up to the acceptable level, which should have been followed by the institution while granting credit. The major factor has been politically connected credits rather than emphasizing on the cash flow ability of the concerned firm. One factor which seems to exacerbate the situation is the delay in recognizing and also understating the gravity of the problem. Even if the seriousness is disclosed the government has not been taking immediate steps to resolve the issue. Asia's weak legal mechanism for foreclosure and disposing collateral coupled with governments delay in recognizing and resolving the issue has further worsen the problem which is one of the prime causes why most of the Asian economies has not been able to gear up the transition with the speed it should have done. The issue of moral hazard has also been one of the key issues which have led to the escalation of NPAs in the Asian region.

The major impact has been adverse effect on the profitability of the banks and growth in output has been slowed down. Although the region has been initiating measure to deal with the issue using asset management companies and incorporating international norms but the weak legal mechanism has been one of the hurdle for its speedy resolution.

If we confine our study in the developed economies it has been over investment in real estate finance which, at its bust, has lead to the enhancement of the bad loans. Similar was case in Japan during the early 1990s and in US during late 80s and early 90s.

Hence, the problem of Asian and other western nations has significant differences in the causes and impact of NPAs. In the west more of the macro economic factors were the major causes whereas in Asian economies flaws were observed in the micro level.

2.1.6 Factor Affecting Non-performing Assets

Non-performing Assets may arise due to failure of business for which loan was used. Changes in the perceived norms of the markets may subject to fail the undertaking management of the enterprise is no less significant than financial management to ensure the cashflow as per projection. Whatever may be the reasons for failure of business, it obstructs the carrying out of the timely payments of financial obligations.

On the other part of appraising institutions, if the credit appraisal is not made properly, the stream of income projected at the time of preparing the project does not comply with the time of preparing the project does not comply with the perceived manner. Large portion of NPAs in developing countries arise due to effective and standard credit appraisal system.

Operation of an enterprise alone does not quality the firm successful ensuring prompt repayment of financial obligations. Constraint monitoring of financed activities of credit institutions. Projects normally accepted looking into the sound functioning propositions that include the managerial ability of entrepreneur. Monitoring of project in time provide insurance against failure of enterprises through rectification of minor flaws that arrear during the cause of operation.

NPAs tend to increase when undeserved behaviours of the officials take place. Individuals holding office when resort to take undue benefits. The institution employing such people is bound to suffer incurring difficulties to recover loan promptly.

The credit programmes sponsored by the government are recorded as the sources of NPAs. For political benefits government, without assessing the financial feasibility of credit programme, announces and compels the credit agencies to go along with the declared policies.

Moreover, unscrupulous politicians often want free ride of on the amount of loan delivered by credit agencies under government designed programme such loans are difficult to recover. The fact is evidenced from the experienced in Nepal & India the manifestation of higher percentage of NPAs found in priority sector loans.

According norms and definition of NPA adopted by agencies also amount to higher or lower magnitude of such assets. Every financial institutions may have different norms to declare the assets whether it is non-performing.

The income cycle of the project and amount of loan involved, set the installments of loan repayment. The nature of project also determines the level of NPAs.

In lack of proper attention into the nitty gritty of projects the resources of financial institutions collected through deposits from people may be misutilised. Negligence on the part of the officials while approving the loan will turn into default.

2.1.7 Nepal Rastra Bank Directives on NPA

NRB issues directives relating banking regulations and prudential norms. Among various directives issued in 2001 directive No.2 is relating to loan classification and provisioning. The classifications are as follows:

Pass: Loans and advances whose principal amount are not past due and past due for a period up to 3 (Three) months shall be included in this category. These are classified and defined as performing loans.

Substandard: All loans and advances that are past due for a period of 3 months to 6 months shall be included in this category.

Doubtful: All loans and advances which are past due for a period of 6 months to 1 (one) year shall be included in this category.

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

Loans and advances failing in the category of Sub-standard, Doubtful and Loss are classified and defined as non-performing loan. The following table shows the various classification and provision regarding NPA as follows:

Table 2.2

Time Table of Loan Classification

Classification	For F/Y 2001/02	For F/Y 2002/03	For F/Y 2003/04	For F/Y 2004/05
Pass	Loans & advances not past due and past due up to 3 months.	Loans & advances not past due and past due up to 3 months.	Loans & advances not past due and past due up to 3 months.	Loans & advances not past due and past due up to 3 months.
Sub-Standard	Loans & advances past due for a period of over 3 months to 1 year.	Loans & advances past due for a period of over 3 months to 1 year.	Loans & advances past due for a period of over 3 months to 9 months.	Loans & advances past due for a period of over 3 months to 6 months.
Doubtful	Loans & advances past due for a period of over 1 year to 3 years.	Loans & advances past due for a period of over 3 months to 3 years.	Loans & advances past due for a period of over 9 months to 2 years.	Loans & advances past due for a period of over 6 months to 1 year.
Loss	Loans & advances past due for a period of over 3 years.	Loans & advances past due for a period of over 3 years.	Loans & advances past due for a period of over 2 years.	Loans & advances past due for a period of over 1 years.

Additional arrangement in respect of “Pass” loan

Loans and advances fully secured by gold, silver, fixed deposit receipts and HMG securities shall be included under “pass” category. However, where collateral of fixed deposit receipt or HMG securities or NRB Bonds is placed as security against loan for other purpose, such loan has to be classified on the basis of ageing. Loans against FDRs of other banks shall also quality for inclusion under Pass loan.

Additional arrangement in respect of “Loss” Loan

Even if the loan is not past due, loans having any or all following discrepancies shall be classified as “Loss”.

- No security at all or security that is not in accordance with the borrower’s agreement with the bank.
- The borrower has been declared bankrupt.
- The borrower is absconding or cannot be found.
- Purchased or discounted bills are not realized within 90 days from the due date.
- The credit has not be used for the purpose originally intended.
- Owing to non-recovery, initiation as to auctioning of the collateral has passed six months and if the recovery process is under litigation.
- Loans provided to the borrowers included in the blacklist and where the credit information Bureau blacklists the borrower.

Additional arrangement in respect of term loan.

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

Loan loss Provisioning

The loan loss provisioning, on the basis of the outstanding loans and advances and bills purchases classified as per this directives, shall be provided as follows:

Classification of Loan	Loan Loss Provision
Pass	1 Percent
Sub-standard	25 Percent
Doubtful	50 Percent
Loss	100 Percent

Loan loss provision set a side for performing loan is defined as “General loan loss provision” and loan loss provision set aside for non-performing loan is defined as “specific loan loss provision”.

Where the banks provide for loan loss provisioning in excess of the proportion as required under the directives of NRB, the whole amount of such additional provisioning may be included in general loan provision under the supplementary capital.

2.2. Research Review

In this section, attempt has been made to review the relevant studies done by other researcher previously. It includes review of thesis, reports and articles.

2.2.1 Review of Related Thesis

Ojha (2002) has carried out research on “Lending Practices: A study on Nabil Bank Limited, Standard Chartered Bank Nepal Limited”. His main objectives of study are to analyze, the various aspects of bank’s performance regarding the lending quantity, quality, efficiency and its contribution in total income. The problems, conclusion and recommendation figured out by him in this thesis are discussed as below.

As stated by him, over liquidity caused due to lack of good lending opportunities, risk arising due to mismanagement of lending portfolio, increasing non-performing assets etc. are some of the problems that is facing by Nepalese banking sector. His main objective is to analyze the various aspects of bank’s lending in various sector of economy, the individual bank’s lending in various sector of economy, the individual bank’s performance regarding the lending quantity and quality.

He concludes “The highest growth rate, proportionately high volume of loans and advances, the best contribution in priority and agricultural sector and the high level of deposits mobilization of HBL ha put this bank in the top position in the lending function. However the better activity ratio of SCBNL has proved this bank the best in managing the lending portfolio according to the demand of profit oriented business. The high volume of lending activities and high volume of productive sector loan of NABIL has put the bank in the top position in absolute terms. The increasing provision on loan loss and high volume of non-performing assets in NABIL & HBL certainly attracts the high attention of any person interested with these banks. The high volume of NPA of HBL may have caused due to the accumulated bad debts that is kept behind the curtain to show the high efficiency of management."

He suggested that following the normal guidelines of NRB and acting upon this also reduce many of the credit risk arising from borrowers. He recommended banks to be more cautious and realistic while granting loans and advances. As suggested by him, the major solution of reducing the risk is to avoid lending in more risky area until the bank does not fully satisfy itself regarding the future viability of the project. He further suggested that the establishment of Asset Management Co. (AMC), which helps commercial banks in collecting their debts and improving their credit rating efficiency. Should be initiated. As per his options , lack of proper credit appraisal, default by blacklisted borrower and professional defaulter, the over confidence in commercial banks regarding credit appraisal efficiency and negligence in taking information from credit information bureau has caused many of the bad debts in these banks.

Khadka (2002) has carried out research on "A comparative Study on Investment Policy of commercial Banks" with an objective to find out the relationship between deposits, investment, loans and advances and net profit .she has made the following conclusion while comparing the performing of NBL with NABI, SCBNL and NIBL.

She concludes "NBL is comparatively less successful in on balance sheet as well as off balance sheet operation than of other CBs. It predicts that in the coming days if it could not mobilize and utilize its resources as efficiently as other Cbsto maximize the returns,it would lag behind in the competitive market of banking. Profitability positions of NBL is comparatively worse of other CBs. It predicts that NBL may not maintain the confidence of shareholders, depositors and its all customers if it cannot increase its volume even in future."

As the banks experience many difficulties in recovering the loans and advances and their large amount is being blocked as non performing ,she suggested that there is an urgent need to workout a suitable mechanism through which the overdue loan can be realized.

Khadka (2004) has carried out study on Non-performing Assets of commercial Banks with the objectives to find out level of NPAs in total assets, total deposit and total lending of Nepalese commercial banks, to find out the effects of non-performing assets on ROA and ROE of Nepalese commercial banks and to find out whether the Nepalese commercial Banks are following the NRB directives regarding loan loss provision for Non-performing loan/assets or not.

He concludes that the level of NPA in sampled commercial bank is not so alarming. The situation is quite satisfactory But the increasing trend remain continue in coming days, the situation will be unmanageable and alarming. The commercial banks could not give full attention towards supervising their lending and towards recovering theory bad loans perfectly. Level of NPA has been increasing. The level of NPA of NBBL, NSBI, NIBL and BOKL seems very unsatisfactory. If the situation is not handling right now, it will be unmanageable and difficult to handle.

In other Hand the level of NPA of Nepal Investment Bank and NABIL Bank has been gradually decreasing every year. The NPA of NIBL is least (minimum) than all of other banks at the end of 2059/060.It is also well known fact that the least NPA level has plays a key role to get the award of “Bank of the Year 2003” for NIBL.

The High Degree of negative correlation of different commercial banks between NPA and ROA and NPA and ROE indicates towards the inverse relation between NPA and ROA and NPA and ROE. It means the level of NPA effect the return on assets and return on shareholder’s equity. Therefore, Banks should reduce their level of NPA to increase the ROE and ROA. Last but not least, it is not wrong to say NPA should be reduced to maintain sound financial health of the bank.

2.2.2 Review of Relevant Articles /Journals

Non-Performing Assets: 'A need for rationalization'

In article by Chhetri (2057) titled "Non- Performing Assets : A need for Rationalization" the writer has attempted to provide connation of the term NPA and its potential sources, implication of NPA in financial sector in South East Asian Region. He had also given possible measures to contain NPA. "Loan and Advances of financial institutions are meant to be serviced either part of principal of interest of the amount borrowed in stipulated time as agreed by the parties at the time of loan settlement. Since the date becomes past dues, the loan becomes non-performing assets. The book of account with lending institution should be effectively operative by means of real transaction effected on the part of debtor in order to remain loan performing."

As stated by the writer, the definition of NPA differs from country to country. In some of the developing countries of Asia Pacific Economic Cooperation (APEC) forum, a loan is classified as non-performing only after it has been arrear for at least six months. Similarly, it is after three months in India. Loan thus defaulted are classified into different categories having their differing implication on the asset management of financial institution, He also stated that NPAs are classified according to international practice into three categories namely Substandard, Doubtful and loan loss depending upon the temporal position of loan default. "Thus the degree of NPA assets depends solely on the length of time the assets has been in the form of non–oblige by the loan. The more time it has elapsed the worse condition of assets is being perceived and such assets are treated accordingly." As per Mr. Chhetri 's view ,failure of business for which loan was used ,defective and below standard credit appraisal system, credit programme sponsored by Government, slowdown in economy /recession, diversion of fund are some of the factors lending to accumulation of NPAs.

He said that there is serious implication of NPAs, on financial institution, he further added that the liability of credit institution does not limit to the amount declared as NPA but extend to extra amount that requires by regulation of supervisory authority in the form of provisioning as the amount required for provisioning depends upon the level of NPAs and their quality. As per his view, rising level of NPAs create a psyche of worse environment especially in the financial sectors. He mentioned that by reviewing the activities of the financial institution like earning interest, rescheduling the loan and law of land etc NPAs can be reduced.

Finally he concluded that financial institutions are beset with the burden of mounting level of NPAs in developing countries." Such assets debar the income flow of the financial institution while claming additional resources in the form of provisioning thereby hindering gainful investment. Rising Level of NPAs cannot be taken as stimulus but the vigilance demanded to solve the problem like this, eventually will generate vigour to gear up the banking and financial activities in more active way contributing to energizing growth."

'Bad Loans of Banking Sector – Challenges and Efforts to Resolve it'

Neupane (2060) in his article titled as above has thrown some views regarding bad loans of banking sector. As mentioned by him there was various types of risk inherent in the credit. One who manages risk, earns profit. He further added that the recent financial crises in banking sector is due to weak accounting procedures, defect in loan classification, lack of transparency, loss control measures etc. Like the other writer, Mr. Neupane has also stated that NPL is the indicator of financial crises and the factors leading to NPL is economic slowdown .recession, bad intention of the borrower, lack of credit policy .increase in interest rate etc. NPL increases resource mobilization cost and reduce profit–earning capacity of the bank. He has also mentioned that the international standard of acceptable NPA is 4% but there is about 26% NPL in Nepalese Banking Sector which is due to high level of NPL of two nationalized banks .as stated by the writer, the major implications of NPL are banks cannot return depositers money on demand and it limit s lending capacity of the bank. The writer has suggested internal and external measures for reducing NPL and its effect. Internal measure s comprises classification of loans and advances and providing provisions for probable loss and external measures comprises of help from Credit Information Bureau (CIB), appointment of Asset management Company (AMC) and Debt Recovery Tribunal (DRT).

He concluded Banks must give priority for reducing NPA. He has also mentioned that many countries are various measure for reducing loan loss. Recently the president of Philippines has announced tax rebate system for reducing NPA. Now it is high time to improve bad debts of banking sector with firm determination.

'Portion of NPA in commercial Banks- High in Public, Low in Private'

Sapkota has written an article titled "Portion of NPA in Commercial Banks – High in Public, Low in Private" which was published in rajdhani on 19 may 2004. In this article Mr. Sapkota has stated that problem of NPL is seen less in Private banks in comparison to Public banks. The NPA of two big nationalized banks being about 60% of the total loans is very serious situation. He further mentioned that in order to improve this situation and to make healthy banking environment ,financial reform programme has been brought as it s consequences ,the management of two big banks was handed to foreign company on a contract but the ratio of NPA was not reduced. Even most the privately owned banks has NPA within international standard, some privately owned bank's NPA is higher that international standard. As per international standard 5% NPA is acceptable. He also states that, Nepal's total NPA of banking sector is 30%, which is very high.

2.2.3 Review of Foreign Research

Reddy (2002) has compared and contrasted the causes of NPA and remedial measures adopted across some Asian nations. He asserts that in China, moral hazard has been one of the major problems. The state owned enterprise's is under the impression that the government will bail them out in case of trouble and so they continue to take high risks and have not really made efforts to achieve profitability and to improve operational efficiency. The state's bankruptcy laws favour borrowers and law courts are not reliable enforcement vehicles. Political and social implications of restructuring big SOE's force the government to keep them afloat.

Similarly Reddy (2002) also concludes on various factors of causes of NPAs in Japanese Banking. Huge investment in real estate during the boom phase and the recession caused prices to crash and turned a lot of these loans bad. Ineffective legal mechanism to dispose bad loans were time consuming and expensive and NPAs remained on the balance sheet. The measures administered to stimulate the economy supported industrial sectors like construction and real estate, which may have further exacerbated the problem. Crony Capitalism to the Keiretsus, i.e. relationship lending without much emphasis on capturing the probability of default and the expected cash flows and therefore, compromising on basic credit principles is also one of the factors. Another factor has been weak corporate governance coupled with no-bankruptcy doctrine was a moral hazard in Japanese economy. Inadequate accounting systems and information flow makes assessment of loan performance outside a bank in Japan difficult.

Gamble (2003) quotes "Lenders all over the world have the same problem: how to get debtors to pay them back. Basic game theory dictates that in interactions between a lender and a debtor, the debtor's best strategy is to default. Of course, lenders know this, so often their best strategy is not to make the loan at all. Despite this obstacle, loans are made. Lenders use various means to ensure repayment. In emerging markets social norms with second and third party enforcement are popular."

Gamble starts his work with the above quote to explain the prevalent practice of lending to friends, cronies, and guanxi (connections) without formal credit analysis. Gamble also asserts that according to Coase theorem, an efficient legal infrastructure is essential to a market economy but at the same time the same infrastructure restrict government power, specially the power to allocate capital as the government sees fit. The misuse of this power has been one of the main culprits contributing to economic disaster throughout the world, especially in Asia. Financial and banking systems have been crippled and huge tax payers money has been used to bail out the under water organizations.

Gamble explains that the bad loans are the result of three things. People, i.e. relationship lending, policy i.e. directed credit and practice, i.e. inadequate credit risk analysis. Evans, Simpson and Mahate (2004) also hold the view that inadequate credit risk assessment and management practices are the major causes of NPA in Japan.

However, Barseghyan (2004) states that the accumulation of NPAs and the government's delay in the bailout of the rotted banks is the primary cause of Japan's ongoing economic stagnation owing to NPAs. He basically argues that when the government provides deposit guarantee to the banks, losses incurred by the banks (i.e. bad loans) is intuitively the government's debt. If the government postpones the actual payment of this debt, but insist that the banks fully honour their obligations to depositors, the banks face dilemma on how to meet the old depositors' obligation because some of their assets have disappeared. Then in such cases the banks resort to Ponzi scheme: i.e. pay the old depositors using the new deposits.

Similarly according to Fakao (2003), in Japan the bursting of bubble (NPAs) developed into full-fledged financial crisis in the late 1990s. In order to cope with the crisis, the government has injected capital directly into the banking sector and banks have written off enormous amounts of bad loans, i.e. moral hazard problem. Reddy discusses the causes in other Asian regions. He views that directed credit, compressed growth policy and lack of proper monitoring are the major causes in Korea. Similarly in Thailand the major causes are weak management of exchange rate risk, weak legal system, real estate speculation, steep rise in the interest rate and poor credit risk assessment. The Indian NPA accumulation problem is due to weak legal mechanism for asset disposal, political influence on lending and directed credit policy of the government. Batra (2003) further strengthens Reddy's works by adding weak corporate governance, ineffective weak audit and inspection etc as the primary causes of NPA accumulation in the Indian Banking system. Reddy further explains the similarities and differences of NPA across Asian countries. The major similarities are poor information quality, weak legal system, and use of government funds (moral hazard problem).

Saez, (2001) views that the banking sector in the developing world is fraught by financial distress caused by mounting bad loans and other non performing assets owned by the state owned commercial banks. These distortions are results of interventionist policies into the financial system. The governments do not enforce efficient measures to tackle the problem of state owned bank insolvency.

Similarly in terms of the US loan crisis, Stirob and Metl (2002) states that the decline in credit quality during 2001/02 was narrowly confined to a small number of industries, particularly the telecommunications industry. The macro economic conditions such as “double dip” recession, increased uncertainty about national security and geopolitical events, global weakness, and concerns over further corporate scandals lead to increased credit problems.

As far impact of NPA is considered, Higgins and Merfeld (1987) highlight on the possible threats of financial stability from the build-up of debt. Henry Kaufman (1987) concluded that high level of debt results in adverse economic and financial disruptions unless structural changes are made. According to Kaufman, the rapid growth in domestic debt is accompanied by deterioration in the quality of credit. Increased debt could also intensify the prospect of a deep long recession. Higher debt means the need of higher cash flows but recession curtails the cash flows. This means cash flows goes for servicing high level of debts leaving less for investments or the existing income is insufficient to meet debt servicing obligations. In both cases, Kaufmann states, the high level of debt financing elongates recession.

Alan (1990) clarifies the relationship between credit crunch and bad debts. According to Budd a credit crunch is a situation when financial intermediaries, particularly banks, become reluctant to lend to the private sector. If this reluctance is accompanied by an increased desire by the general public to hold money, the effects on demand and output may be more acute. Many of the conditions of credit crunch were present in US in the early 1990s and are still predominant in Japan owing to the escalation of bad loans and the reluctance by the banking sector to flow credit into the private sector. In the short run, a credit crunch could turn a mild recession into severe slump; in the longer term, economic recovery could be hindered by a lack of financial intermediation. Similarly Hoshino and Ma (2003) also hold the same view and assets that credit crunch in Japan is due to the accumulation of NPAs.

Batra (2003) in the Indian context looks at more micro perspective view and concludes that mounting NPAs has adverse impact on the profitability of the concerned financial institution. The banks excessively emphasis on credit risk management and as such commits type two error of losing even a good customer. Perotti (1993) also reaffirms Batra's point. Similarly, David (1996) states that the escalation of NPAs increases the cost of fund as more and more provisions are needed (capital requirement) and hence, the banks become relatively uncompetitive. The other adverse impact because of the lower profitability is that the equity price of the concerned financial institution gets affected.

Gamble (2003) further states the impact of the accumulation of the NPAs. He asserts that beside the possibility of cropping a deep depression in the economy, the accumulation of bad loans has several other adverse economic effects. Unresolved NPAs means inefficient allocation of capital in the economy and it also discourages the injection of capital into the healthier sector of the economy. If the NPAs are allowed to rot the banking books then it could spread to the rest of the economy, as it has in Japan.

CHAPTER III

RESEARCH METHODOLOGY

Research Methodology is a way to systematically solve the research problem. It may be understood as a science of studying how research is done. Research is a systematic inquiry of any particular topic and methodology is the method of doing research in a well manner. Hence research methodology is the systematic study of research problem that solves them with some logical evidence. More specially, it describes about the research design, population and sample, nature of source of data and tools that will be used to analyze data.

3.1 Research Design

Research design is the specification of methods and procedures for acquiring the information needed. It is the plan, structure and strategy of investigation conceived so as to obtain answers to research questions and to control variance. This research is aimed at studying the cause and effect of non-performing assets in commercial banks of Nepal. Descriptive and analytical research design is followed for the study.

3.2 Population and Sample

Population refers to the entire group, events or things of interest that a researchers wishes to investigate. There are altogether 17 commercial banks in Nepal. All seventeen commercial banks are selected as a sample for the study.

- Nepal Bank Ltd.
- Rastriya Banijya Bank Ltd.
- NABIL Bank Ltd.
- Standard Chartered Bank Ltd.
- Nepal SBI Bank Ltd.
- Himalayan Bank Ltd.

- Everest Bank Ltd.
- Kumari Bank Ltd.
- Bank of Kathmandu
- Machapuchchhre Bank Ltd.
- Laxmi Bank Ltd.
- NCC Bank Ltd.
- NIC Bank Ltd.
- Siddhartha Bank Ltd.
- Lumbini Bank Ltd.
- N B Bank Ltd.
- Nepal Investment Bank Ltd.

3.3 Source of Data

Only secondary data has been used in this study. The major source of data are Annual reports of related banks, Articles published in newspapers, Journal , Magazines and other publications, Unpublished thesis and dissertation, Various reports published by NRB and Various related websites.

3.4 Data Analysis Tools

Only financial and statistical tools have been used for the analysis of data. Further to represent the data in simple form diagrams and graphs have also been used.

3.4.1 Financial Tools

While adopting financial tools, a ratio is used as benchmark for evaluating the financial position and performance of any firm. “Financial analysis is the use of financial statements to analyze a company’s financial position and performance and to assess future financial performance.”

3.4.1.1 Ratio Analysis

Ratio analysis is widely used tool of financial analysis. A ratio is simply one number expressed in terms of another and as such it express the numerical or quantitative relationship between two variables. Ratio analysis reflects the relative strength and weakness of any organization and also indicates the operating and financial growth of the organization. Ratio help to summarize large quantities of financial data and to make quantitative judgement about the firm's financial performance. The relationship between two accounting figures expressed mathematically is known as financial ratios. Even though there are many ratios, only those ratio have been calculated which are related to the subject mater. Following ratios have been computed and analyzed in this study.

Ratio analysis is the widely used tool of financial analysis. A ratio is simply one number expressed in terms of another and as such it expresses the numerical or quantitative relationship between two variables. Even though there are many ratios, only those ration have been calculated which are related to subject matter.

a) Non-Performing Loans to Total Loans and Advances Ratio

This ratio determines the proportion of non-performing loans in the total loan portfolio. Higher ratio implies the bad quality of banks in the form of loans and advances. Hence lower NPL to total credit ratio is preferred. As per international standard only 5% NPL is allowed but in the context of Nepal 10% NPL is acceptable .It is calculated as follows:

Non-Performing loans to total loans and advances

$$= \frac{\text{Non Zperforming Loan}}{\text{Total Loan and Advances}}$$

3.4.2 Statistical Tools

Statistical tools are the mathematical techniques used to facilitate the analysis and interpretation of numerical data. Statistical analysis is one particular language which describes the data and makes possible to talk about the relations and the difference of the variables.

3.4.2.1 Regression Analysis: Regression analysis is used as a tool of determining the strength of relation between two variables. Thus, it is a statistical device, with the help of which, we can estimate or predict the value of one variable when the value of other variable is known. The unknown variable, which we have to predict, is called dependent variable and the variable whose value is known is called independent variable. The analysis used to describe the average relationship between two variables is known as simple linear regression analysis.

Karl Pearson's Coefficient of Correlation (r): Correlation analysis is the statistical tool, which is used to describe the degree to which one variable is linearly related to other. The most important method of measuring the correlation between the two variables is "Karl Pearson's Coefficient of Correlation". It has been used in the study to measure the degree of association between two variables profitability and capacity utilization rate.

The Coefficient of Determination (R^2): It in a measure of degree of association between a dependent variable and an independent variable. It measures the goodness of fit of the regression line. It is used in the study as a measure of adequacy of the regression model. The value of R^2 lies between 0 to 1. The fit of the model is said to be "better" the closer is R^2 to 1.

3.4.3 Specification of Model

Following simple regression model has been used to test the theoretical relation between non-performing assets and net profit of commercial banks in Nepal.

$$Y = a + bX \quad \ldots \quad \ldots \quad \ldots \quad (3.11)$$

Where,

Y = Net profit

X = Non-performing assets

a = Y- Intercept

b = Slope

In the above model

a = $\bar{Y} - b\bar{X}$

b = $\dfrac{XY - n\overline{XY}}{X^2 - n\overline{X}^2}$

3.5 Limitation of the Methodology

For the analysis, the secondary data were collected through annual reports of commercial bank, journals, national news paper and websites of related studies.

After highlighting the research methodology, the next chapter c[illegible]ntrates on presentation and analysis of the study.

CHAPTER IV

PRESENTATION AND ANALYSIS OF DATA

4.1 Presentation and Analysis of Data

The presentation and analysis of data section is the main text the study of Non-performing assets of commercial banks of Nepal to gain insight into the predetermined objectives of the study for the purpose of presentation of data, data collected from various sources are classified and tabulated as requirement of the study and in accordance to the nature of collected data. Different arithmetical and statistical tools are used to analysis the data. To make easier and make clearer to understand, data are presented in the required figure also simple percentage was used to analyze the data as arithmetical tools. Karl Person's correlation coefficient was used to analyze data as statistical tools.

4.1.1 Ratio Analysis

Ratio analysis is widely used tool of financial analysis. A ratio is simply one number expressed in terms of another and as such it express the numerical or quantitative relationship between two variables. Ratio analysis reflects the relative strength and weakness of any organization and also indicates the operating and financial growth of the organization.

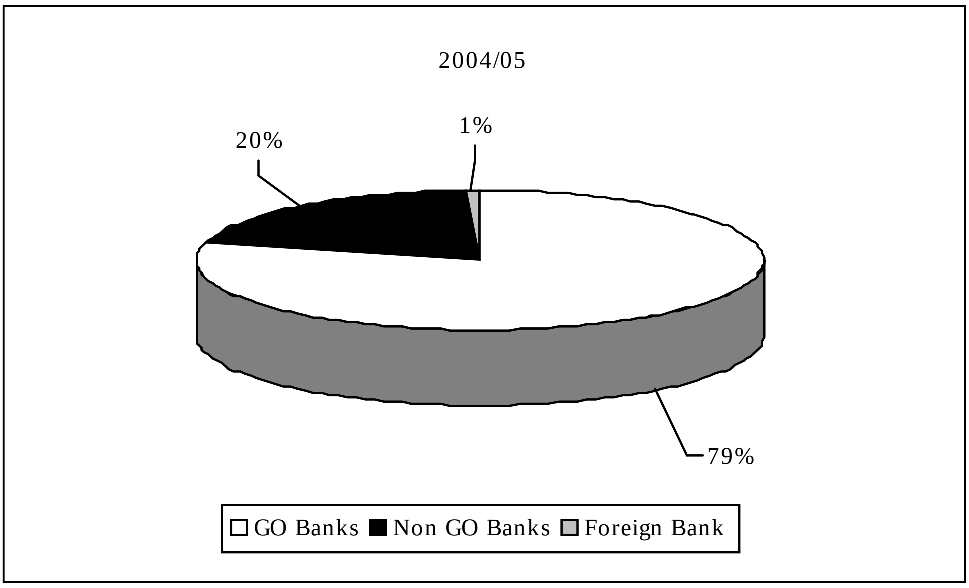
Table 4.1

NPA of Private and Public Banks

Rs. in '000'	***2000-01***	***2001-02***	***2002-03***	***2003-04***	***2004-05***
Banks	NPL	NPL	NPL	NPL	NPL
NBL	10,372,946	10,834,411	10,964,620	9,639,698	8372,555
RBB	12,336,787	14,889,012	16,005,211	14,470,914	13,690,072
NIBL	201,434	130295	117,251	181,263	281,190
SCB	297,051	275934	247,807	252,359	226,521
HBL	1,367,198	797610	1,093,136	1,147,263	1,000,767
NSBI	483,388	289766	561,593	345,739	440,753
NBBL	613,769	1,275,216	1,013,500	1,042,592	1,832,964
EBL	118,021	42388	111,091	104,848	128,771
BOK	325,386	396679	421,018	400,153	308,484
NCCB	546,894	1,154,557	700,679	600,041	519,428
NIC	132,363	193,254	170,686	146,729	185,574
LBL	277,545	441,641	302,966	237,194	561.245
MBL	4,530	71,123	31,114	24,900	20,008
NABIL	1,351,724	556878	449,498	286,380	144,497
LBL	-	-	-	-	44,436
KBL	-	14,327	36,339	28,105	53,970
SBL			-	25,242	67,981
Total	28,429,036	31,363,091	32,226,509	28,933,420	27,879,216
GO Banks	22,709,733	25,723,423	26,969,831	24,110,612	22,062,627
Non GO Banks	5,719,303	5,639,668	5,256,678	4,822,808	5,816,589
Total =	**28,429,036**	**31,363,091**	**32,226,509**	**28,933,420**	**27,879,216**

Source: NRB Annual Report.

Figure 4.1



From the tables(2–4) in he appendix and the table /figure above it becomes clear that the chunk of the NPAs of the Nepalese banking sector is occupied by the state owned banks, the second share is that of domestic bank stand only a small portion by the one and only foreign bank. Among the state banks, it's the Nepalese government owned banks which occupies almost 79% of the total NPAs. Hence the problem is not associated with the domestic banks, which is run by relatively efficient management or the foreign banks, it's the state owned banks which primarily occupies the biggest part of the NPAs figures. Among the domestic banks, NBBL has the highest share of NPAs in 2005 followed by HBL. If we analyze the level of NPA of domestic banks, there has been reduction in F/Y 2002, 2003 and 2004 in comparison to F/Y 2001. However, NPA has increased in F/Y 2005. But if we consider the state owned banks, their NPA levels has been ever increasing to the year 2003 despite the fact that the two ailing banks has been handed over to foreign management and since then levels of NPAs has been decreasing following years. As fiscal year ending 2004/2005, as shown in the table 4.1 and figure 4.1, the govt. owned banks occupies 79% of the NPA followed by 20% by domestic banks and only 1% by the foreign bank.

Table 4.2

Non-performing Loans to Total Loan and Advances Ratio

(FY 2000/01)

(Rs. in thousand)

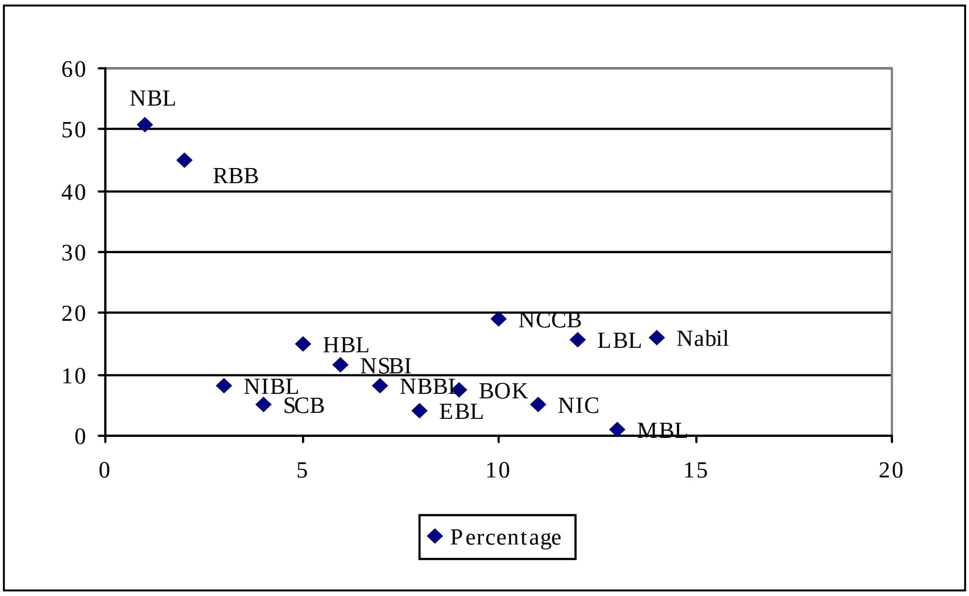
Banks	Total Loan	NPL	Percentage
NBL	20,418,937	10,372,946	50.80
RBB	27,375,123	12,336,787	45.07
NIBL	2,429,026	201,434	8.29
SCB	5,681,353	297,051	5.23
HBL	9,015,347	1,367,198	15.17
NSBI	4,188,414	483,388	11.54
NBBL	7,358,838	613,769	8.34
EBL	2,999,387	118,021	3.93
BOK	4,285,932	325,386	7.59
NCCB	2,889,448	546,894	18.93
NIC	2,617,760	132,363	5.06
LBL	1,786,131	277,545	15.54
MBL	498,528	4,530	0.91
Nabil	8,443,502	1,351,724	16.01
Laxmi			
KBL	265,734		
SBL			
Total	100,253,460	28,429,036	

Source: NRB Annual Report.

Figure 4.2

Scatter of NPL as a Percentage of Total Loan

(FY 2000/01)



The above Table and Figure exhibit the ratio of non-performing loans to total loan of all commercial banks in FY 2000/01. Out of these two government owned banks NBL and RBB higher ratio of 50.80% and 45.07% respectively. This portrays the critical condition of the banks. These banks have NPL very much higher than the acceptable standard of 10% and among the private commercial bank NCCB has higher ratio of 18.93%, likewise, Nabil has 16.01%, HBL, LBL, NSBI have moderate ratio of 15.17%, 15.54% and 11.54% respectively and remaining other banks NPL to total loans ratio is with in the standard of 10%. MBL has lowest ratio of 0.91% in this year.

Table 4.3

Non-performing Loans to Total Loan and Advances Ratio

(FY 2001/02)

(Rs. in thousand)

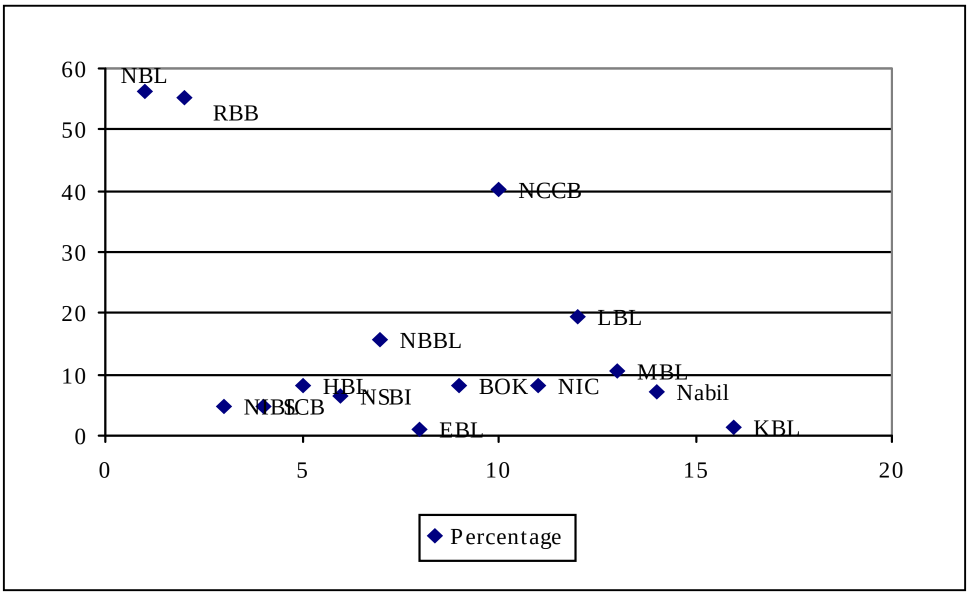
Banks	Total Loan	NPL	Percentage
NBL	19252874	10,834,411	56.27
RBB	27037369	14,889,012	55.07
NIBL	2713525	130,295	4.80
SCB	5696182	275,934	4.84
HBL	9557138	797,610	8.35
NSBI	4584395	289,766	6.32
NBBL	8083987	1,275,216	15.77
EBL	4044228	42,388	1.05
BOK	4890072	396,679	8.11
NCCB	2878288	1,154,557	40.11
NIC	2368851	193,254	8.16
LBL	2285492	441,641	19.32
MBL	680295	71,123	10.45
Nabil	7801849	556,878	7.14
Laxmi	0		
KBL	1126605	14,327	1.27
SBL	0		
Total	103001150	31,363,091	

Source: NRB Annual Report.

Figure 4.3

Scatter of NPL as a Percentage of Total Loan

(FY 2001/02)



The above Table and Figure shows the ratio of NPL to total loan of all commercial banks in FY 2001/02. Out of these, NBL and RBB have higher ratio of 56.27% and 55.07% respectively and shows increasing trend. Then followed by NCCB with the ratio of 40.11%, it shows NCCB is also in critical condition like NBL and RBB another private bank LBL also has 19.32% and MBL has 10.45% out of these, other's have ratio within standard of 10% which shows decreasing trend. EBL has lowest ratio of 1.05%.

Table 4.4

Non-performing Loans to Total Loan and Advances Ratio

(FY 2002/03)

(Rs. in thousand)

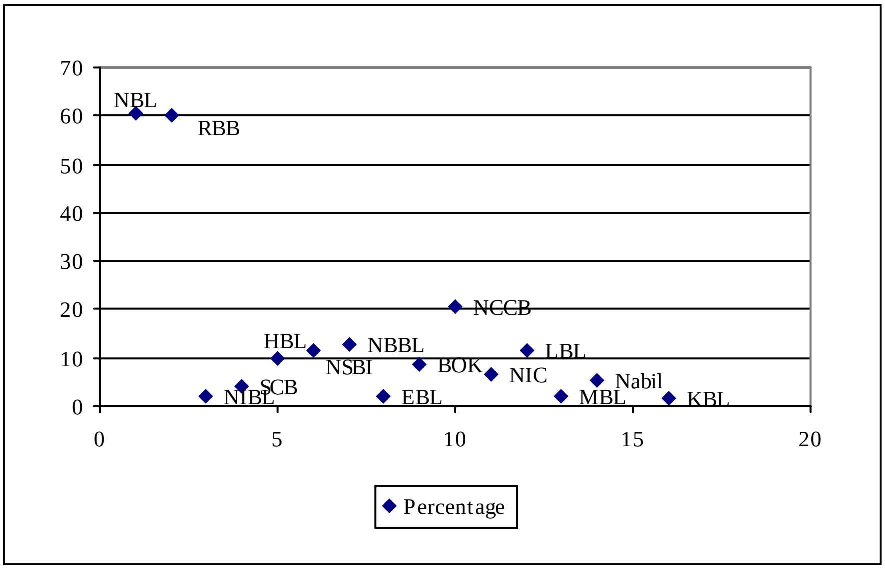
Banks	Total Loan	NPL	Percentage
NBL	18,132,330	10,964,620	60.47
RBB	26,608,830	16,005,211	60.15
NIBL	5,921,768	117,251	1.98
SCB	6,000,169	247,807	4.13
HBL	10,844,603	1,093,136	10.08
NSBI	4,795,841	561,593	11.71
NBBL	7,961,508	1,013,500	12.73
EBL	5,049,591	111,091	2.20
BOK	4,856,032	421,018	8.67
NCCB	3,396,408	700,679	20.63
NIC	2,562,853	170,686	6.66
LBL	2,618,548	302,966	11.57
MBL	1,495,865	31,114	2.08
Nabil	8,113,682	449,498	5.54
Laxmi	775,940	-	
KBL	2,137,588	36,339	1.70
SBL	629,030	-	
Total	111,900,588	32,226,509	

Source: NRB Annual Report.

Figure 4.4

Scatter of NPL as a Percentage of Total Loan

(FY 2002/03)



The above Table and Figure shows ratio of NPL to total loan is also higher in NBL and RBB which has higher than previous year is 60.47% and 60.15% respectively and among other private bank NCCB has higher ratio of 20.63% and other, HBL, NSBI, NBBL and LBL have moderate ratio of 10.08%, 11.71%, 12.73% and 11.57% respectively. KBL has lowest ratio of 1.70% in this FY.

Table 4.5

Non-performing Loans to Total Loan and Advances Ratio

(FY 2003/04)

(Rs. in thousand)

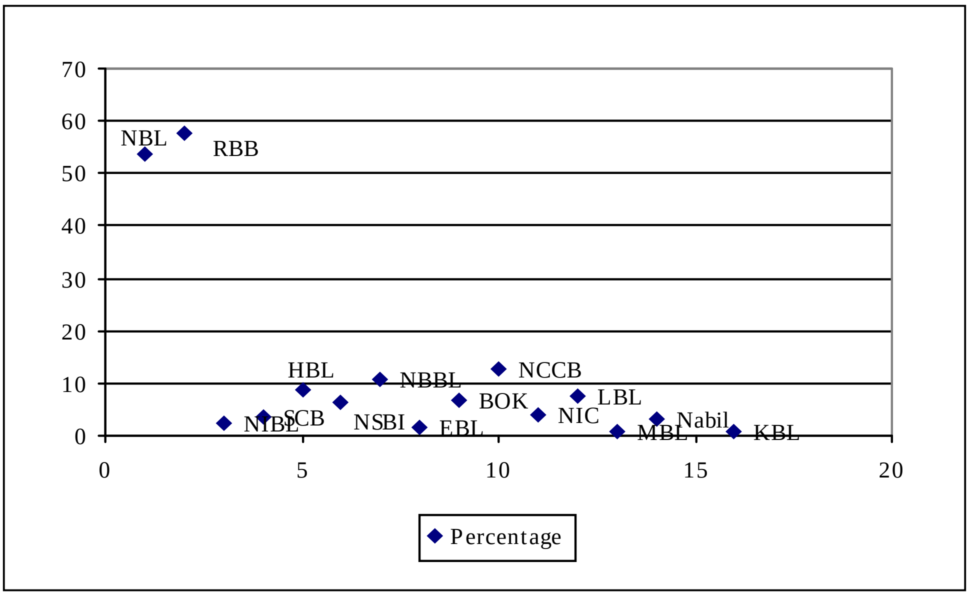
Banks	Total Loan	NPL	Percentage
NBL	17,937,659	9,639,698	53.74
RBB	25,105,680	14,470,914	57.64
NIBL	7,338,583	181,263	2.47
SCB	6,693,873	252,359	3.77
HBL	12,919,628	1,147,263	8.88
NSBI	5,531,824	345,739	6.25
NBBL	9,644,699	1,042,592	10.81
EBL	6,095,814	104,848	1.72
BOK	6,008,303	400,153	6.66
NCCB	4,717,303	600,041	12.72
NIC	3,743,087	146,729	3.92
LBL	3,222,745	237,194	7.36
MBL	2,540,816	24,900	0.98
Nabil	8,548,657	286,380	3.35
Laxmi	1,750,931	0	
KBL	3,698,026	28,105	0.76
SBL	1,567,826	25,242	
Total	127,065,454	28,933,420	

Source: NRB Annual Report.

Figure 4.5

Scatter of NPL as a Percentage of Total Loan

(FY 2003/04)



The above Table and Figure exhibit higher position of NPL in NBL and RBB i.e. 53.74% and 57.64% which is lower than previous year but higher than other private banks in this FY. NCCB and NBBL have moderate ratio of 12.72% and 10.81% respectively lowest ratio is 0.76% i.e. KBL has. Another remaining banks have ratio of acceptable standard of 10%.

Table 4.6

Non-performing Loans to Total Loan and Advances Ratio

(FY 2004/05)

(Rs. in thousand)

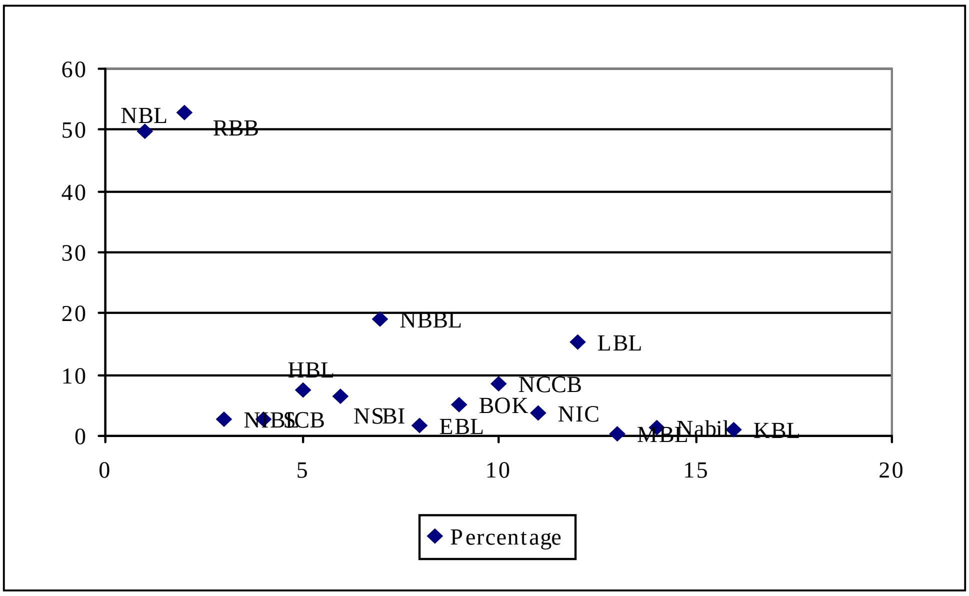
Banks	Total Loan	NPL	Percentage
NBL	16,866,549	8,372,555	49.64
RBB	25,835,199	13,690,072	52.99
NIBL	10,453,160	281,190	2.69
SCB	8,420,855	226,521	2.69
HBL	13,451,169	1,000,767	7.44
NSBI	6,739,343	440,753	6.54
NBBL	9,626,912	1,832,964	19.04
EBL	7,900,061	128,771	1.63
BOK	6,182,044	308,484	4.99
NCCB	6,011,898	519,428	8.64
NIC	4,909,365	185,574	3.78
LBL	3,685,128	561,245	15.23
MBL	5,130,256	20,008	0.39
Nabil	10,946,742	144,497	1.32
Laxmi	2,726,135	44,436	
KBL	5,681,053	53,970	0.95
SBL	2,634,922	67,981	
Total	147,200,791	27,879,216	

Source: NRB Annual Report.

Figure 4.6

Scatter of NPL as a Percentage of Total Loan

(FY 2004/05)



The above Table and Figure exhibit NBL has the ratio NPL 49.64% and RBB has relatively higher than NBL i.e. 52.99. In this FY NBBL has ratio of 19.04% which is higher among other private commercial bank followed by the LBL has 15.23% MBL has lowest ratio of 0.39% and other have ratio within acceptable standard.

4.1.2 NPA to Total Deposit

Table 4.7

NPA and Total Deposit for the last five Years

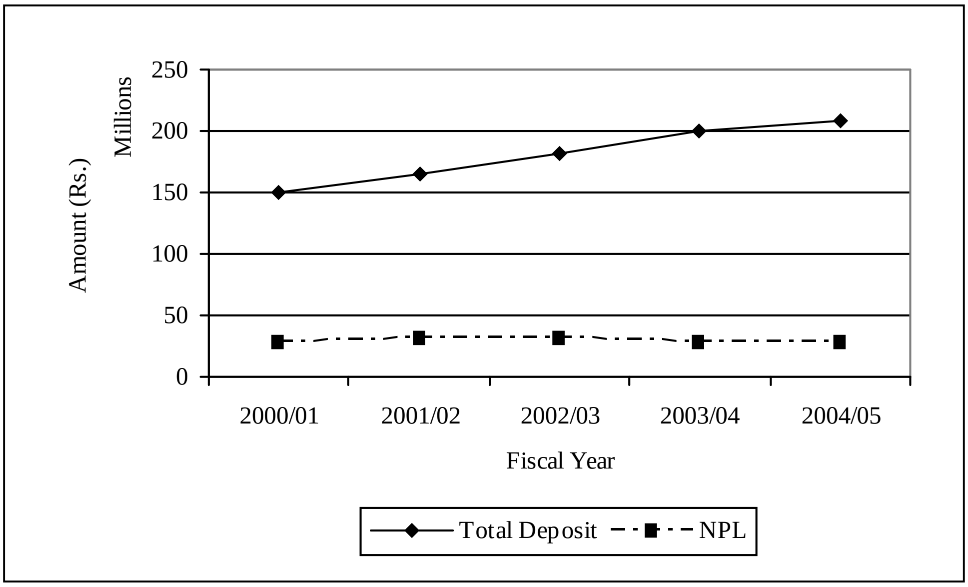
(Rs. in thousand)

Fiscal Year	Total Deposit	NPL
2000/01	150,586,100.00	28,429,036.00
2001/02	165,092,000.00	31,363,091.00
2002/03	180,873,100.00	32,226,509.00
2003/04	200,286,400.00	28,933,420.00
2004/05	207,902,400.00	27,879,216.00

Source: NRB Annual Report.

Figure 4.7

NPA and Total Deposit for the last five Years



Analysing the diagram of NPA and deposit, there seems to be hardly any impact on the growth rate of deposit. Now the Primary reasons why the deposit has been growing is mobilization of foreign earning through official banking channels and hence, remittance is one of the major factors of growth. If we analyze the growth of deposit of government owned which are technically insolvent, is quite strange because even their deposit is growing. This clearly shows that the public (domestic and those earning abroad) is almost completely unaware of financial Position and those who leaves their money in such insolvent banks are under the impression that the government will bail them out in case of financial distress. Again Nepal does not have any history of bank run and such people have never experienced and panic situation.

4.1.3 NPA and Total credit

The Total credit figures (figure 4.8) are still growing but at a slowing rate. Since the problem of asset quality has been started to be reported from the year 2002 and more and more banks have definitely become attentive because of the burden of NPAs on their balance sheet. The five year analysis definitely does not give any real picture.

Table 4.8

Total Credit and NPA

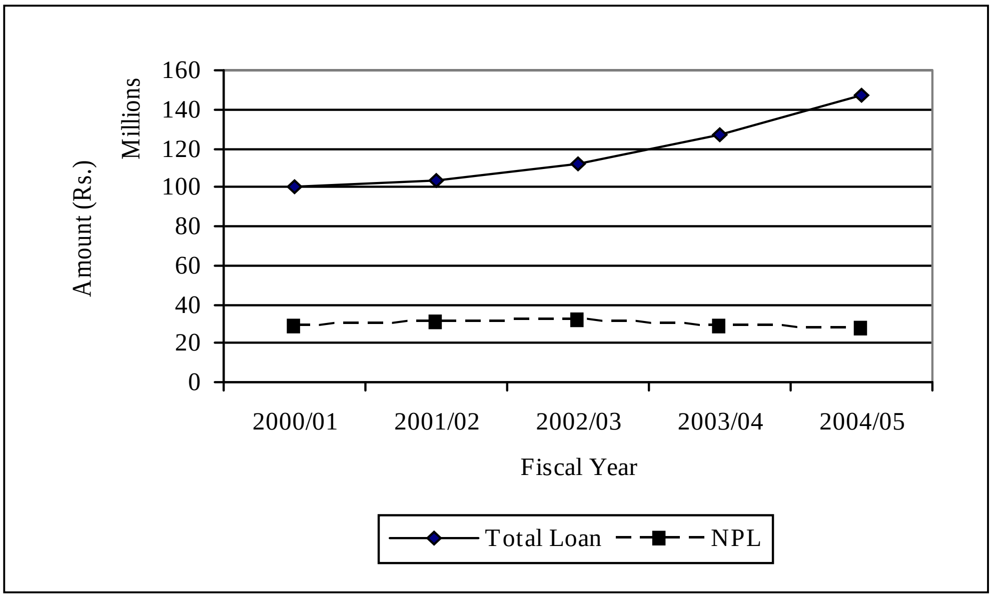
(Rs. in thousand)

F.Y.	Total Loan	NPL
2000/01	100,253,460.00	28,429,036.00
2001/02	103,001,150.00	31,363,091.00
2002/03	111,900,588.00	32,226,509.00
2003/04	127,065,454.00	28,933,420.00
2004/05	147,200,791.00	27,879,216.00

Source: NRB Annual Report.

Figure 4.8

Total Credit and NPA



4.1.4 NPA and Interest Income

The interest income (figure 4.9) has been declining ever since the central bank imposed the strict norms of disclosing bad loans. This can be linked with the decline in the growth rate of the credit flows and also with the competitive pressure due to increasing number of banks and other non bank financial institutions competing for credit products.

Table 4.9

NPA and Interest Income

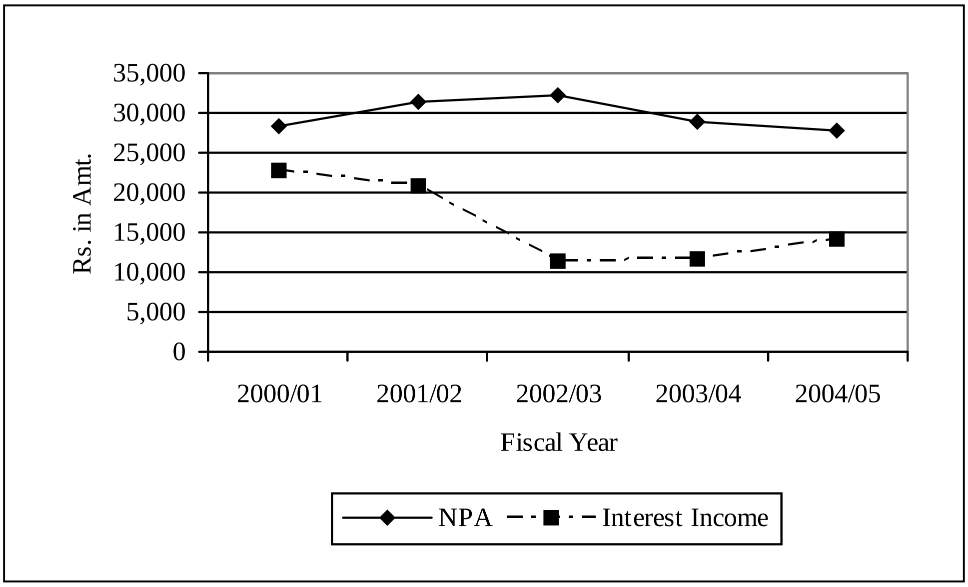
(Rs. in million)

Fiscal Year	NPA	Interest Income
2000/01	28,429	22,677
2001/02	31,363	20,832
2002/03	32,226	11,411
2003/04	28,933	11,548
2004/05	27,879	14,152

Source: NRB Annual Report.

Figure 4.9

NPA and Interest Income



4.1.5 NPA and Net Profit

There are many factors, which directly or indirectly affect the net profit of the organization. NPA is one of them which directly affect the profitability of the bank. Therefore, the NPAs and net profit of five successive fiscal year is presented in the following table.

Table 4.10

NPA and Net Profit

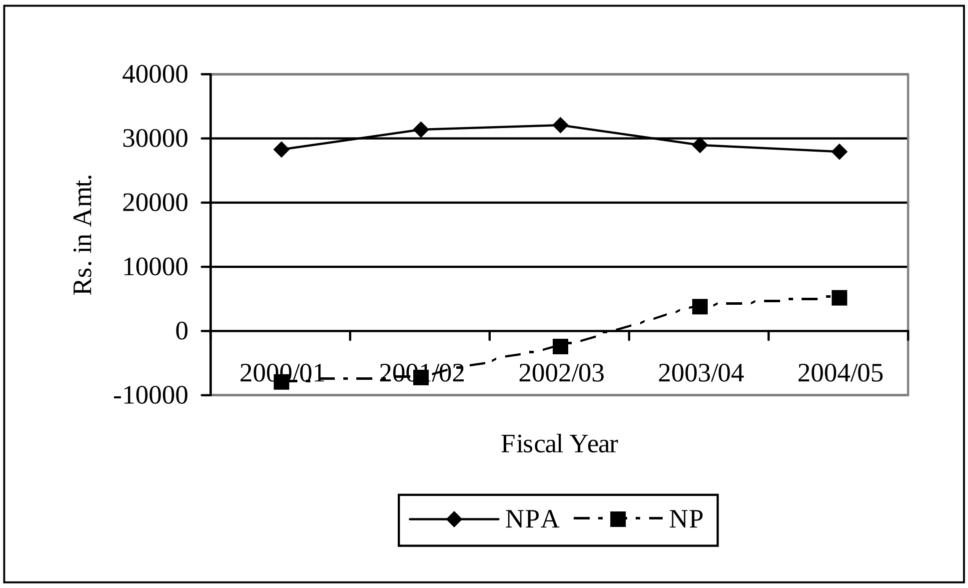
(Rs. in million)

Fiscal Year	NPA	NP
2000/01	28429	-7,843
2001/02	31363	-7,382
2002/03	32226	-2,461
2003/04	28933	3707.48
2004/05	27879	5263.5

Source: NRB Annual Report.

Figure 4.10

NPA and Net Profit



Net profit after tax of the commercial banks, as a whole for financial ending on mid July 2002 (FY 2001-2002) was negative at NRs 7382 million i.e, banks have incurred losses during the given period .The figure still remain negative in the year 2001/02 and 2002/03 i.e. NRs.7382 millions and NRs 2461 million respectively but the figure is positive in the FY 2003/04 and FY2004/05 means banks makes profit these year as a whole.

Table 4.11

Net profit of Government and Private Commercial Banks

Fiscal Year	Gov. owned Bank	Other Private Commercial Bank	Total
1999/2000	-2666	1344	-1322
2000/01	-9261	1418	-7843
2001/02	-8093	711	-7382

Source: NRB Annual Report.

As seen from the figures obtained from the supervision department, for the fiscal year 2001/02 fourteen non government owned banks have, in total ,earned Net profit after taxes of NRs.711 million during three given period recording shortfall by NRs.707 million (i.e. by 49.86%) from previous year. The Nepalese government owned banks (NBL and RBL) have recorded net losses amounting to

Rs. 8093 million during the financial year. Hence, again it becomes absolutely clear from the data there is a direct inverse relationship of NPA and net profit owing to the provision for bad loans.

4.1.6 Correlation and Analysis

The result of the Karl Pearson's coefficient of correlation analysis has been presented in Table 4.12.

Table 4.12

Correlation between NPA and Net Profit

		NPA	Net Profit
NPA	Pearson Correlation	1	–0.437**
	Sig. (2-tailed)	.	0.462
	N	5	5
Net Profit	Pearson Correlation	–0.437**	1
	Sign. (2-tailed)	0.462	.
	N	5	5

**Correlation is significant at the 0.01 level (2-tailed)

The result of Karl Perarson's coefficient of correlation analysis shows there is negative relation between net profit and non-performing assets. It indicates that higher NPA will yield less profit of commercial banks.

Statistical software SPSS programme was used to run simple regression model. Here, net profit has been considered as dependent variable and non-performing assets has been considered as independent variable. The result of regression analysis has been shown in table no. 4.13.

Table 4.13

Coefficient of Determination (R^2) – Regression Results

Model	R	R Square	Adjusted R	Std. Error of the Estimate
1	-0.437	0.191	–0.078	6323.46283

The coefficient of determination (R^2) between net profit and non-performing assets of commercial bank is 0.19 i.e. 19%. It implies that the influence of NPA on profitability of commercial banks is not highly significant.

4.2 Major Finding

Following are the major finding of the Study

4.2.1 In Nepal, there are 17 commercial banks out of these 2 commercial banks. Nepal / Bank Limited and Rastriya Banijya Bank are government owned and others are private sector commercial banks.

4.2.2 The ratio of non-performing loans to total loan of all commercial banks in FY 2000/01. Out of these two government owned banks NBL and RBB higher ratio of 50.80% and 45.07% respectively. This portrays the critical condition of the banks. These banks have NPL very much higher than the acceptable standard of 10% and among the private commercial bank NCCB has higher ratio of 18.93%, likewise, Nabil has 16.01%, HBL, LBL, NSBI have moderate ratio of 15.17%, 15.54% and 11.54% respectively and remaining other banks NPL to total loans ratio is with in the standard of 10%. MBL has lowest ratio of 0.91% in this year.

4.2.3 The ratio of NPL to total loan of all commercial banks in FY 2001/02. Out of these, NBL and RBB have higher ratio of 56.27% and 55.07% respectively and shows increasing trend. Then followed by NCCB with the ratio of 40.11%, it shows NCCB is also in critical condition like NBL and RBB another private bank LBL also has 19.32% and MBL has 10.45% out of these, other's have ratio within standard of 10% which shows decreasing trend. EBL has lowest ratio of 1.05%.

4.2.4 The ratio of NPL to total loan is also higher in NBL and RBB which has higher than previous year is 60.47% and 60.15% respectively and among other private bank NCCB has higher ratio of 20.63% and other, HBL, NSBI, NBBL and LBL have moderate ratio of 10.08%, 11.71%, 12.73% and 11.57% respectively. KBL has lowest ratio of 1.70% in this FY.

4.2.5 The position of NPL in NBL and RBB i.e. 53.74% and 57.64% which is lower than previous year but higher than other private banks in this FY. NCCB and NBBL have moderate ratio of 12.72% and 10.81% respectively lowest ratio is 0.76% i.e. KBL has. Another remaining banks have ratio of acceptable standard of 10%.

4.2.6 NBL has the ratio NPL 49.64% and RBB has relatively higher than NBL i.e. 52.99. In this FY NBBL has ratio of 19.04% which is higher among other private commercial bank followed by the LBL has 15.23% MBL has lowest ratio of 0.39% and other have ratio within acceptable standard.

4.2.7 Total Deposit of all commercial banks in 2000/1 is 150586 million. 165092 million in FY 2001/02 and 207902 million in 2004/05. NPA of commercial banks in FY 2000/01 is 28429million and it increases in FY 2001/2 to FY 2002/03 from 31363 million to 32226 million and decrease from FY 2003/04 but deposit is increasing till FY 2004/05. It shows that increase in NPA does not directly affect the deposit of commercial banks.

4.2.8 NPA of all commercial banks in FY 2000/01 is 28429 million it increases to 32226 millions in FY 2002/03 and it decreases to 28933 millions then after FY 2003/04. But interest income is 22677 million in FY 2000/01 and it decreases to 11411 millions in FY 2003/04 due to increase in portion of NPA and little bit higher in FY 2003/04 and FY 2004/05.

4.2.9 Net profit of the commercial banks is negative i.e. -7843 million in FY 2000/01 and -7382 million in FY 2001/02 and remain negative till FY 2002/03 due to huge amount of NPA in government owned bank (NBL and RBB) and gain profit in FY 2003/04, FY 2004/05 because portion of NPA decrease from FY 2003/04.

CHAPTER V

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

Banks Plays an important role in the economic development of the country as the issue of development always rests upon the mobilization of resources. Banks deals in the process of canalizing the available resources to the needy sector causing overall economic development. This research primarily aimed to find out the cause of the problem havocking the financial system of a very small and poor economy like Nepal. The World Bank very reluctantly provided credit to continue the financial sector reform and their primary cause of reluctance was that the government was not doing enough to deal with catastrophe of mounting non performing loans.

There has been no formal research on the problem of such colossal gravity and an effort has been made in this research to find what caused the buildup of NPAs and its impact in Banking sector of Nepal.

Through review of the available literature was made which primarily included different economies starting with china ,Japan , Indonesia ,Korea , USA, UK, and India . The cause of the Problem has been of diverse nature in different economies. In most of the cases, Particularly in Japan and USA, extensive investment in real estate and its consequent bust was the prime reason and in other cases such as china Indonesia, and India. It's the unhealthy and unethical lending practices particularly flow of Politically influenced credit into the politically connected big businesses were the primary reasons .In most of the cases the credit never came back in form of repayment or even if it did , not culminated into full repayment. In some cases, the adverse effect of portfolio concentration was also one of the causes due to directive.

The impact of such accumulation of huge NPAs were directly seen in the form slow growth of the economy as a whole due to the problem of credit crunch. Another impact was on the Profitability of the banking sector due to the deterioration in the interest income and huge Provisioning. The banking sector in the most of the affected cases became reluctant to induce credit flows even in the most profitable and productive sector ,making type II error . The inability of the banks to take off the bad assets out of the balance sheet was more exacerbating Problem of the credit crunch.

With the background of varied form of problems of the bad loans and their impact data from the Nepalese commercial banks has been analyzed .The secondary data analysis clearly disclosed the gravest problem faced by the banks, particularly the government owned banks which occupied almost 79% of bad loans of the commercial banks. It is due to the bad loan problems of the two Nepalese state owned banks, Nepal Bank limited and Rastriya Banijya Bank, the banking sector is not in good condition.

The study revealed many causes but the most important factors were political influence in the flow of credit into big businesses which never has intention to pay back. Technical inefficiencies has also been one of the major factors whereby most of the banks, government owned and the domestic banks, follow the age old expert system where the experienced manager uses its judgment and makes decision on the basis of managerial hubris. Most of the times the credit analysis fail to capture the default probabilities. The overvaluation of the collateral and hence, over lending (over borrowing) is another issue. Even if there is collateral, the legal mechanism is very lengthy, complicated and cumbersome to foreclose and dispose the bad loans from the balance sheet. Ineffective monitoring and supervision by the central bank is also another reasons for the growing figure of the NPAs. The central bank in Nepal only started recognizing the ailing assets of the banking sector from the year 2001 and by the time it initiated the compliance of international norms, it was too late and assets had already become bad .The supervision procedures are more of the compliance in nature and are not forward looking . The authorities never run due carefulness on the credit analysis policies adopted by the bank and does not bother to consider whether the analysis captures the probability of the adverse situations.

The impact was clearly felt on the interest income and net income of the banking sector. The government owned banks is still in big loss, in fact because of their loss, the entire banking sector in Nepal not in good shape. Further, bad loan adversely affect the profitability of banking sector.

5.2 Conclusions

Liberalization of financial sector started in 1980s with the aim to streamline it. After that the financial sector widened with more banks and financial institutions. The total number of financial institutions stood at 181 in mid July 2005. Regarding banking sector there are 17 commercial banks 26 development banks. Even the financial sector developed rapidly in quantity, but in terms of quality it is far behind the developed countries, Banks came into existence mainly with the objectives of collecting idle funds. Mobilizing them into productive sector and causing an overall economic development. The bankers have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving. Lending is the major function of any commercial bank and it is the most income generating asset of any commercial bank but there is risk inherent in the lending portfolio, banks have to make loan loss provision by categorizing the loan into different category as per the NRB directives. Increasing none performing loan is the serious problem of the banking sector in Nepal.

It has been found that NBL and RBB have very high position of non-performing loan resulting to higher provision. Even the private sector banks have higher non-performing loan and accordingly higher provision. However, in recent two years private commercial banks is non-performing loan has shown significant decrement.

The massive non performing assets occupied by the government owned banks are also a matter of grave concern for the depositors as well. The government does not have any deposit insurance scheme and is not in position to bail them out. Now with almost 79% of bad loans of the system housed by the two state owned banks, the country's lending channel is in chaos. In almost 99% of the rural areas, its only these two state owned banks (NBL and RBB) are operating and their contribution is of immense importance as far as source of formal credit for the pathetically poor peasants are concerned and hence, their reluctance to offer credit can have havoc on the performance of the entire economy. In the Nepalese context, these two institutions are so large and complex that their operation and hence, their failure would affect all other players as well and hence, government cannot just allow these two banks to fail because they are too big to fail. The regulator should make every effort not to use public money, because if used, the burden will fall on the already aggrieved tax payers.

Now at the micro level, the issue of mounting NPAs is a sign of inefficient and ineffective practices adopted by the commercial banks, particularly in the government owned banks. The central authority, Nepal Rastra Bank, had a big role to play in the escalation of NPAs because of inadequate and ineffective monitoring.

At the bank level, all the three aspects of credit i.e. people, policy and practices are responsible for good credit going bad. As far people are concerned, managerial hubris and relationship lending (particularly in the state owned banks) are the major factors. The policy of the government to invest certain percentage into the priority sector is also one the key factors which affect the diversification of the credit portfolio.

Since most of the lending are politically influenced, although relatively less in the non government owned banks, good banking practices are absent in the credit granting process. Good corporate governance, prudent operations, transparency and even profit are not the priority of the banks. The only thing that dominates the credit is whether the borrower is favoured one or not and has any political connection. Even the most basic practices are ignored. No proper documentations are initiated, collateral is over valued and the legal procedure to gain legal interest is cumbersome and lengthy.

5.3 Recommendations

High level of non-performing assets not only decreases the profitability of the banks but also affect the entire financial as well as operational health of the organization. If the NPA does not control immediately, it will be proved it as a curse for the banks in future. Therefore, following are some of the recommendations in light of the study to address the problems.

5.3.1 Transparency should be maintained in the operation of the financial institution. The central authorities should encourage banks to disclose almost all the relevant financial and most importantly non financial (particularly risk management) information much needed to assess the financial health and performance of the institution. Since the major part of the bank's portfolio is loan and advances, the central bank should impose tough measures to reveal all the qualities of credit assets as well as qualitative information of the major borrowers and their bad loans.

5.3.2 Loan is given if the banker is satisfied that the borrower can repay money from the cash flow generated from operating activities. However, the banks want to ensure that their loan is repaid even in case of default. To protect banks from such happenings, the banks take collateral from the borrower so that in the event of default this collateral is disposed for recovery of loan. Therefore, bank should take enough collateral so that the bank at least can able to recover its principle and interest amount in care of being unable to repay by the borrower.

5.3.3 The legal mechanism should be made effective and the procedure to foreclose collateral and dispose them to remove the bad loans from the balance sheets.

5.3.4 Lack of proper financial analysis of borrower by the banks, is one of the major cause behind increasing NPA of Nepalese commercial banks. Therefore proper financial analysis should be performed before giving loan to the borrower.

5.3.5 Management inefficiency is one of other major cause behind high level of NPA of Nepalese commercial banks. Therefore, all banks should provide necessary training regarding loan management to the managers and staffs who are involving loan management to the managers and staff who are involving in management their lending by expects within or outside the country whatever possible.

5.3.6 The monitoring and supervision initiated by the central bank should not only be compliance in nature but should also be forward looking, particularly in the risk management practices of the financial institutions. Since credit risk is the largest source of risk in a bank's balance sheet, regulators should pay attention on the qualitative aspects of risk management and should not be blind folded to asses the minimum capital requirement or the leverage aspect only.

5.3.7 The government should make every effort to get the rid of the huge volume of NPAs as early as possible as the delay may further invite graver credit crunch situation. The best possible way out considering the economy of the Nepal is to restructure the loans which have the potential to be settled and to expedite the process of asset liquidation i.e. forcing the willful defaulters to pay or else initiate foreclosure for settlement. The other possible and prompt option is the establishment of Asset Management Company, which the government is considering but the effort should be accelerated.

5.3.8 The central bank should adopt international standards for loan classification and provisioning. The regulator should also enforce prudential standards and best practice codes and should also ensure ways to discipline those that don't comply with them.

5.3.9 The problem of lack of proper and reliable intelligence on the characteristics of borrowers is also one of the major problems. The regulator should make every effort to ensure good bank co-operation between banks and the Credit Information Bureau (CIB). The CIB should be made efficient and sophisticated for maintaining good data management system so that it should be able to provided reliable and relevant information needed by the lenders.

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Appendix
Table 1

Source: BIS Working Paper 13, Bank Failures in Mature Economy, pg. 67

Summary of G10 banking crises

Risk Type	Switzerland (91-96)	Spain (78-83)	UK			Germany	Norway (88-93)	Sweden (91-94)	Japan (94-02)	US			
			BCCI (1991)	Small Banks (91-92)	Barings (1995)	Herstatt (1974)				Cont'tal Illinois (1984)	S & L (82-95)	New England (90-91)	Sub-Prime (98-00)
Credit	√	√	√	√	**X**	**X**	√	√	√	√	√	√	√
Market	**X**	**X**	**X**	**X**	√	√	**X**	√	**X**	**X**	√	**X**	**X**
Operational (inc. fraud)	**X**	√	√	**X**	√	√	**X**	**X**	**X**	**X**	**X**	**X**	√
Shock													
Macro: real economy	√	√	√	√	**X**	**X**	√	√	√	**X**	√	√	**X**
asset prices	√	√	**X**	√	**X**	**X**	√	√	√	**X**	√	√	**X**
Banking system													
Financial liberalisation	√	√	√	√	**X**	√	√	√	√	**X**	√	**X**	**X**
Poor regulation/supervision	**X**	√	**X**	**X**	**X**	**X**	√	√	√	**X**	√	**X**	**X**
Risk concentration	√	√	**X**	√	**X**	**X**	**X**	√	√	**X**	√	**X**	√
Bank specific	**X**	**X**	√	**X**	√	√	**X**	**X**	**X**	√	√	**X**	√
Impact													
Whole banking system	**X**	√	**X**	**X**	**X**	**X**	√	√	√	**X**	√	**X**	**X**
Small banks only	√	**X**	**X**	√	**X**	**X**	**X**	**X**	**X**	**X**	**X**	√	√
One bank	**X**	**X**	√	**X**	√	√	**X**	**X**	**X**	√	**X**	**X**	**X**
Systemic risk	**X**	√	**X**	√	**X**	√	√	√	√	√	√	**X**	**X**
Crisis resolution													
Speed of resolution	**quick**	**quick**	**quick**	**slow**	**quick**	**quick**	**quick**	**quick**	**slow**	**quick**	**slow**	**quick**	**quick**
Mainly closures	**X**	**X**	√	√	√	√	**X**	**X**	**X**	**X**	**X**	**X**	√
Main type of support	**private**	**public/ private**	**X**	**private/ public**	**X**	**X**	**public/ private**	**private/ public**	**public**	**public**	**public**	**public**	**public**
Fiscal cost of resolution (% of annual GDP)*	**< 1**	**5**	**Nil**	**0.007**	**Nil**	**Nil**	**3.1**	**4.0**	**(a)**	**.0003**	**2.1**	**Nil**	**Nil**
Regulatory changes	√	√	√	**X**	√	√	√	√	√	√	√	**X**	√

Notes: **X** denotes no or not a cause of failure. **Nil** denotes that the failure cost was either zero or close to zero.
Sources: Fiscal data from Swiss National Bank; Cuervo, Álvaro: "La crisis bancaria en España" Ed. Ariel, 1985; UK Small Banks: Bank of England Annual Report, 2000; Norwegian Ministry of Finance; Sveriges Riksbank; FDIC and FDIC respectively.
(a) The Japanese Financial Services Agency reported that Japanese banks held Y40.1trillion ($342 billion) in non-performing loans as of September 2002.

Bank Failures owing to credit risk

(BIS Working Paper 13: Bank Failures in Matured Economies) Even the most highly developed economies have suffered massive bank failures in the past three decades. Central bankers and other vigilant authorities fear widespread bank failures because they exacerbate cyclical recession and might trigger financial crisis. Moreover studies have show that the estimated output losses during banking crisis, have been, on average over 10% of the GDP and bank lending and profitability have remained subdued for years afterward **(IMF (1998), Bordo et el (2001) and Hoggarth and Saporta -2001).**

There have been quick responses to such failures in the form of regulatory and legal compliance aimed at averting future bank failures and to reduce the cost of such bank failures. The most influential among these is the imposition of regulatory capital ratios which is aimed at providing buffer during period of instability and to make capital more sensitive to bank risks.

There have been number of recent official working papers and other academic studies to find causes of bank failures and policy responses to bank failures across countries. The Groupe de Contact (1999) study based on 117 individual banks in 17 nations and coupled with country reports from few nations (France, the UK and Scandinavian countries) found ***that a majority of banking difficulties revealed credit problems and sometimes as operational risks***. Market risk was rarely a significant problem. Inefficiency in management and lack of proper and adequate control measures were contributory factors in nearly all cases. Although 90% of the banks did depicted capital ratios in accordance to the regulatory requirement when difficulties emerged but the internal report of **the Groupe de Contract** concluded that the suggested loan loss provisioning did not accurately reflected asset impairment and thus capital ratio were overstated. The reported also suggest that in general even though the in cases where asset impairment was properly measured, the quantitative information lacked the qualitative factors such as poor management.

(FDIC 1997) In a major study regarding the causes, responses and lesson learnt from the banking crisis in the US during 1980s and early 1990s, following policy lessons (general) emerged: (quoted)

1. Bank regulation can limit the scope and cost of bank failures but is unlikely to prevent failures that have system causes.

2. For most of the period studied, there were no risk-based capital requirements and therefore there was little ability to curb excessive risk taking in well capitalised healthy banks.

3. Problem banks must be identified at an early stage if deterioration in the bank's condition is to be prevented, e.g. frequent bank examinations.

4. The presence of deposit insurance helped maintain a high degree of financial stability throughout the crisis, but not without cost. According to Curry and Shibut (2000), the saving and loan crisis cost the US tax payers \$123.8 billion, 2.1% of 1990 GDP. ***Cost those included was moral hazard risk (associated with deposit insurance). Chief among these were funnelling of vast sums of money into high-risk commercial real estate lending. In addition to moral hazard, this lending was also encouraged by ill-conceived deregulation and disruptive tax law changes***.

Table 2

NPLs of State Owned Banks

Rs. in '000'	***2000-01***			***2001-02***			***2002-003***		
Banks	Total Loan	NPL	***NPL to Total Loans***	Total Loan	NPL	***NPL to Total Loans***	Total Loan	NPL	***NPL to Total Loans***
State Owned Banks									
NBL	20,418,937	10,372,946	***50.80%***	19,252,874	10,834,411	***56.27%***	18,132,327	10,964,620	***50.80%***
RBL	27,375,123	12,336,787	***45.07%***	27,037,369	14,889,012	***55.07%***	26,608,828	16,005,211	***45.07%***
NSBI	4,188,414	483,388	***11.54%***	4,584,395	289,766	***6.32%***	4,795,837	561,953	***11.54%***
Total	**51,982,474**	**23,193,121**	***44.62%***	**50,874,638**	**26,013,189**	***51.13%***	**49,536,992**	**27,531,784**	***55.58%***
% of total NPA	**51.85%**	**81.58%**		**49.39%**	**82.94%**		**44.58%**	**85.42%**	

Source: Nepal Rastra Bank

Continuation

Continuation of Table 2

Rs. in '000'	***2003-04***			***2004-05***		
Banks	Total Loan	NPL	***NPL to Total Loans***	Total Loan	NPL	***NPL to Total Loans***
State Owned Banks						
NBL	17,937,659	9,639,698	***53.74%***	16,866,549	8,372,555	***49.64%***
RBL	25,105,680	14,470,914	***57.64%***	25,835,199	13,690,072	***52.99%***
NSBI	5,531,824	345,739	***6.25%***	6,739,343	440,753	***6.54%***
Total	**48,575,163**	**24,456,351**	***50.35%***	**49,441,091**	**22,503,380**	***45.52%***
% of total Loan and NPA	**38.23%**	**84.53%**		**33.59%**	**80.72%**	

Table 3

NPLs of foreign bank

Foreign Bank		***2000-01***			***2001-02***			***2002-03***	
SCB	5,681,353	297,051	***5.23%***	5,696,182	275,934	***4.84%***	6,000,169	247,807	***4.13%***
Total	**5,681,353**	**297,051**	***5.23%***	**5,696,182**	**275,934**	***4.84%***	**6,000,169**	**247,807**	***4.13%***
% of total loan and NPA	**5.67%**	**1.04%**		**5.53%**	**0.88%**		**5.40%**	**0.77%**	

Source: Nepal Rastra Bank (NRB) – Central Bank of Nepal

Continuation

Continuation of Table 3

Foreign Bank	***2003-04***			***2004-05***		
SCB	6,693,873	252,359	***3.77%***	8,420,855	226,521	***2.69%***
Total	**6,693,873**	**252,359**	***3.77%***	**8,420,855**	**226,521**	***2.69%***
% of total Loan and NPA	**5.27%**	**0.87%**		**5.72%**	**0.81%**	

Table 4
NPLs of Domestic Banks

Domestic Banks		2000-01			2001-02			2002-03	
NIBL	2,429,026	201,434	8.29%	2713525	130,295	4.80%	5,921,768	117,251	8.29%
HBL	9,015,347	1,367,198	15.17%	9557138	797,610	8.35%	10,844,603	1,093,136	15.17%
NBBL	7,358,838	613,769	8.34%	8083987	1,275,216	15.77%	7,961,508	1,013,500	8.34%
EBL	2,999,387	118,021	3.93%	4044228	42,388	1.05%	5,049,591	111,091	3.93%
BOK	4,285,932	325,386	7.59%	4890072	396,679	8.11%	4,856,032	421,018	7.59%
NCCB	2,889,448	546,894	18.93%	2878288	1,154,557	40.11%	3,396,408	700,679	18.93%
NIDC	2,617,760	132,363	5.06%	2368851	193,254	8.16%	2,562,853	170,686	5.06%
LBL	1,786,131	277,545	15.54%	2285492	441,641	19.32%	2,618,548	302,966	15.54%
MBL	498,528	4,530	0.91%	680295	71,123	10.45%	1,495,865	31,114	0.91%
Nabil	8,443,502	1,351,724	16.01%	7801849	556,878	7.14%	8,113,682	449,498	16.01%
Laxmi	-	-	0.00%	0	-	0.00%	-	-	
KBL	265,734	-	0.00%	1126605	14,327	1.27%	2,137,588	36,339	0.00%
SBL	-	-		0	-	0.00%	629,030	-	-
Total	**42,589,633**	4,938,864	11.60%	46,430,330	5,073,968	10.93%	42,589,633	4,447,278	10.44%
% of total NPA	**42.48%**	**17.37%**		**45.07%**	**16.17%**		**38.06%**	**13.80%**	
Total	**100,253,460**	**28,429,036**	28.36%	**103,001,150**	**31,363,091**	30.45%	111,900,588	32,226,509	28.36%

Source: Nepal Rastra Bank

Continuation of table 4

Domestic Banks	2003-04			2004-05		
NIBL	7,338,583	181,263	***2.47%***	10,453,160	281,190	***2.69%***
HBL	12,919,628	1,147,263	***8.88%***	13,451,169	1,000,767	***7.44%***
NBBL	9,644,699	1,042,592	***10.81%***	9,626,912	1,832,964	***19.04%***
EBL	6,095,814	104,848	***1.72%***	7,900,061	128,771	***1.63%***
BOK	6,008,303	400,153	***6.66%***	6,182,044	308,484	***4.99%***
NCCB	4,717,303	600,041	***12.72%***	6,011,898	519,428	***8.64%***
NIDC	3,743,087	146,729	***3.92%***	4,909,365	185,574	***3.78%***
LBL	3,222,745	237,194	***7.36%***	3,685,128	561,245	***15.23%***
MBL	2,540,816	24,900	***0.98%***	5,130,256	20,008	***0.39%***
Nabil	8,548,657	286,380	***3.35%***	10,946,742	144,497	***1.32%***
Laxmi	1,750,931	0	***0.00%***	2,726,135	44,436	***1.63%***
KBL	3,698,026	28,105	***0.76%***	5,681,053	53,970	***0.95%***
SBL	1,567,826	25,242	***1.61%***	2,634,922	67,981	***2.58%***
Total	71,796,418	4,224,710	***5.88%***	89,338,845	5,149,315	***5.76%***
% of total NPA	**56.50%**	**14.60%**		**60.69%**	**18.47%**	
Total	**127,065,454**	**28,933,420**	***22.77%***	**147,200,791**	**27,879,216**	***18.94%***

Table No. 5

Total Loan, Deposit and NPL for the fiscal year 2000-01

Rs. in '000'	***Fiscal year ending mid July - 2000-01***			
Banks	Total Loan	Total Deposit	NPL	***NPL%***
NBL	20,418,937	35,528,600	10,372,946	***50.80%***
RBL	27,375,123	40,500,400	12,336,787	***45.07%***
NIBL	2,429,026	4,256,200	201,434	***8.29%***
SCB	5,681,353	15,430,100	297,051	***5.23%***
HBL	9,015,347	17,613,600	1,367,198	***15.17%***
NSBI	4,188,414	6,618,400	483,388	***11.54%***
NBBL	7,358,838	8,578,800	613,769	***8.34%***
EBL	2,999,387	4,574,500	118,021	***3.93%***
BOK	4,285,932	5,724,100	325,386	***7.59%***
NCCB	2,889,448	3,772,700	546,894	***18.93%***
NIDC	2,617,760	3,575,800	132,363	***5.06%***
LBL	1,786,131	2,097,400	277,545	***15.54%***
MBL	498,528	700,000	4,530	***0.91%***
Nabil	8,443,502	1,583,900	1,351,724	***16.01%***
Laxmi	-		-	***0.00%***
KBL	265,734	31,600	-	***0.00%***
SBL	-	-	-	***-***
Total	100,253,460	150,586,100	28,429,036	***28.36%***

Source: NRB

Table No. 6

Total Loan, Deposit and NPL for the fiscal year 2001-02

Rs. in '000'	***Fiscal year ending mid July - 2001-02***			
Banks	Total Loan	Total Deposit	NPL	***NPL%***
NBL	19252874	34,060,100	10,834,411	***56.27%***
RBL	27037369	38,964,600	14,889,012	***55.07%***
NIBL	2713525	4,174,800	130,295	***4.80%***
SCB	5696182	15,835,700	275,934	***4.84%***
HBL	9557138	18,595,200	797,610	***8.35%***
NSBI	4584395	5,572,200	289,766	***6.32%***
NBBL	8083987	9,514,000	1,275,216	***15.77%***
EBL	4044228	5,461,100	42,388	***1.05%***
BOK	4890072	5,735,900	396,679	***8.11%***
NCCB	2878288	3,709,000	1,154,557	***40.11%***
NIC	2368851	3,165,300	193,254	***8.16%***
LBL	2285492	2,646,100	441,641	***19.32%***
MBL	680295	994,800	71,123	***10.45%***
Nabil	7801849	15,370,600	556,878	***7.14%***
Laxmi	0	112,600		
KBL	1126605	1,180,000	14,327	***1.27%***
SBL	0	-	-	-
Total	103001150	165,092,000	31,363,091	***30.45%***

Source: Nepal Rastra Bank

Table 7
Total Loan, Deposit and NPL for the fiscal year 2002-03

Rs. in '000'	***2002-03***			
Banks	Total Loan	Total Deposit	NPL	***NPL%***
NBL	18,132,330	34,737,400	10,964,620	***60.47%***
RBL	26,608,830	39,308,600	16,005,211	***60.15%***
NIBL	5,921,768	7,922,800	117,251	***1.98%***
SCB	6,000,169	18,755,500	247,807	***4.13%***
HBL	10,844,603	21,002,800	1,093,136	***10.08%***
NSBI	4,795,841	6,522,800	561,593	***11.71%***
NBBL	7,961,508	10,548,000	1,013,500	***12.73%***
EBL	5,049,591	6,694,900	111,091	***2.20%***
BOK	4,856,032	6,169,600	421,018	***8.67%***
NCCB	3,396,408	4,294,100	700,679	***20.63%***
NIDC	2,562,853	3,143,900	170,686	***6.66%***
LBL	2,618,548	2,959,800	302,966	***11.57%***
MBL	1,495,865	1,778,700	31,114	***2.08%***
Nabil	8,113,682	13,437,700	449,498	***5.54%***
Laxmi	775,940	691,800	-	***0.00%***
KBL	2,137,588	2,513,100	36,339	***1.70%***
SBL	629,030	391,600	-	***0.00%***
Total	111,900,588	180,873,100	32,226,509	***28.80%***

Source: Nepal Rastra Bank

Table 8
Total Loan, Deposit and NPL for the fiscal year 2003-04

Rs. in '000'	***2003-04***			
Banks	**Total Loan**	**Total Deposit**	**NPL**	***NPL%***
NBL	17,937,659	36,288,500	9,639,698	**53.74%**
RBL	25,105,680	40,313,600	14,470,914	**57.64%**
NIBL	7,338,583	11,706,300	181,263	**2.47%**
SCB	6,693,873	21,161,400	252,359	**3.77%**
HBL	12,919,628	22,760,900	1,147,263	**8.88%**
NSBI	5,531,824	7,232,100	345,739	**6.25%**
NBBL	9,644,699	12,747,300	1,042,592	**10.81%**
EBL	6,095,814	806,400	104,848	**1.72%**
BOK	6,008,303	7,741,600	400,153	**6.66%**
NCCB	4,717,303	5,959,600	600,041	**12.72%**
NIC	3,743,087	5,146,400	146,729	**3.92%**
LBL	3,222,745	3,777,600	237,194	**7.36%**
MBL	2,540,816	2,754,600	24,900	**0.98%**
Nabil	8,548,657	14,098,000	286,380	**3.35%**
Laxmi	1,750,931	1,684,300	0	**0%**
KBL	3,698,026	4,816,500	28,105	**0.76%**
SBL	1,567,826	1,291,300	25,242	**1.61%**
Total	127,065,454	200,286,400	28,933,420	**22.77%**

Source: Nepal Rastra Bank

Table 9

Total Loan, Deposit and NPL for the fiscal year 2004-05

Rs. in '000'	***2004-05***			
Banks	Total Loan	Total Deposit	NPL	***NPL%***
NBL	16,866,549	34,744,200	8,372,555	**49.64%**
RBL	25,835,199	43,489,200	13,690,072	**52.99%**
NIBL	10,453,160	14,254,800	281,190	**2.69%**
SCB	8,420,855	1,934,400	226,521	**2.69%**
HBL	13,451,169	24,831,100	1,000,767	**7.44%**
NSBI	6,739,343	8,645,800	440,753	**6.54%**
NBBL	9,626,912	12,125,500	1,832,964	**19.04%**
EBL	7,900,061	10,097,800	128,771	**1.63%**
BOK	6,182,044	8,942,800	308,484	**4.99%**
NCCB	6,011,898	6,630,100	519,428	**8.64%**
NIC	4,909,365	6,243,300	185,574	**3.78%**
LBL	3,685,128	4,029,500	561,245	**15.23%**
MBL	5,130,256	5,586,500	20,008	**0.39%**
Nabil	10,946,742	14,586,800	144,497	**1.32%**
Laxmi	2,726,135	3,028,600	44,436	**1.63%**
KBL	5,681,053	6,270,100	53,970	**0.95%**
SBL	2,634,922	2,461,900	67,981	**2.58%**
Total	147,200,791	207,902,400	27,879,216	**18.94%**

Source: Nepal Rastra Bank

APPENDIX 10

Check list regarding NPA Discussion

1. What are the major factors do you think which lead to increase NPA?
2. To what extent, today's banking industry is effeced by the probelmsof NPA?
3. What is the role of NRB to resolve the problems of NPA?
4. What remedial measures do you think should be adopted to control the NPA of banks?

APPENDIX 11

List of Commercial Banks in Nepal

S.N	Name of Bank	Established date
1	Nepal Bank Limited	1937
2	Rastriya Banijya Bank	1966
3	Nabil Bank Limited	1984
4	Nepal Investment Bank Limited	1986
5	Standard Chartered Bank Nepal Limited	1987
6	Himalayan Bank Limited	1993
7	Nepal SBI Bank Limited	1993
8	Nepal Bagladesh Bank Limited	1994
9	Everest Bank Limited	1994
10	Nepal Criedit and Commerce Bank Limited	1995
11	Bank of Kathmandu Limited	1996
12	Lumbin Bank Limited	1998
13	Nepal Industril and Commercial Bank Limited	1998
14	Machhapauchhre Bank Limited	2000
15	Kumari Bank Limited	2001
16	Laxmi Bank Limited	2002
17	Siddartha Bank Limited	2002

Source: NRB, Annual Report.

APPENDIX 12

NPA and Net Profit

(Rs. in million)

Fiscal Year	NPA (X)	Net Profit (Y)
2000/01	28429	-7,843
2001/02	31363	-7,382
2002/03	32226	-2,461
2003/04	28933	3707.48
2004/05	27879	5263.5

Source: NRB Annual Report.