CHPATER -1
INTRODUCTION

1.1 Background of the Study:

To start with, performance in terms of profitability is benchmark for any business enterprise including the banking industry. Extension of credit is one of major activities of banks and financial institution. Credit represents the bulk of the bank and financial institution's asset portfolio. However, increasing NPAs have a direct impact on banks profitability as legally. Banks are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets as per the central bank guidelines. Also, with increasing deposits made by the public in the banking system, the banking industry cannot afford defaults by borrowers since NPAs affects the repayment capacity of banks. Further central bank successfully creates excess liquidity in the system through various rate cuts and banks fail to utilize. This benefit to its advantage due to the fear of burgeoning non-performing assets.

Economic development is the foundation development of any country. Economic development is supported by the financial infrastructure of that country. Financial institution constitutes an important part of the financial infrastructure. The main function of the bank is the collection of idle funds and mobilizes them to productive sector causing overall economic development, which finally leads to national development of the country. Bank pools the fund through deposit and mobilize them to productive sector in the form of loans and advances. Bank is the 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 sources.

It cannot be denied that the issue of development rest upon the mobilization of resources and the bank deals in process channelising the available resources in the needed sectors. Commercial bank collects deposits from the public and the largest portion of deposited funds is utilized by disbursing loan and advances. The balance sheet of a commercial bank reflects deposit constitutes a major portion of the liabilities and the loan and advances constitutes a major portion of the asset side. Similarly the profit of the bank depends upon the spreads that if enjoys between the interest it receive from the borrowers and that to be paid to the depositors. An average bank generates about 70% of its revenue through its lending. The return that the bank enjoys of deposit mobilization through loan and advances is very attractive but they do not come free of cost and free of risk. There is risk in lending. The bank graces number of risk like interest rate risk, liquidity risk, credit risk, borrower risks etc. such risk in excessive from had led many banks to go bankrupt in number of countries.

Amongs many risk that bank faces one of the most critical is borrower risk- the risk of non payment of the disbursed loan. Failure to collect fund disbursed may sometimes result in the bank's inability to make repayment of the money to depositors and return to the shareholders. The bankers have the responsibility of safeguarding the interest of the depositors, shareholders and society the are serving. If bank behaves unresponsively the cost born by the economy is enormous. Banking sector is volatile and sensitive sectors of national economy, which require effective monitoring and efficient supervision. Smooth and effective operation of banking activities is most for sustainable economic growth of a country. The regulatory agency should always be watchful of banking activities carried out by government and non governmental banking and financial institution.

Assets and liabilities are the two major parts of balance sheet of commercial bank. Cash reserves, deposits to other banks, investment in securities, loan and advances and other assets comprise the total assets. Liabilities comprise public deposits, borrowings, other current liabilities and share capital. As this study is focused with the Non-performing Asset (NPA), it is mainly concerned with the assets of bank. Generally, the loan and advances occupy more than two third parts of assets of bank in balance-sheet and it is found that they produce more than half of bank revenues. Therefore, in practice loan quality is mostly studied as assets quality. In banking literature, loan is often found synonymously used to assets. According to Onsite Inspection Manual, for Commercial Banks and Finance Companies, Volume-II, published by Nepal Rastra Bank, the study of asset quality is mainly concerned with loans quality. So, it should be clear that asset is used to indicate the meaning of loan.

Since this study is mainly concerned with loan, some facts are highlighted regarding loan. The deposits of public create loanable fund. Banks make their profits by issuing loans. But loans also have higher probability of default than other assets. The loans, which are actively working gives well, return to the banks. The default loans cause the loss in return to the bank. For the strength and stability of banking system, the assets/loan should yield positive returns. The assets/loans, which do not yield positive returns, become Non-performing Asset, NPA. In a narrow sense, Non-performing Asset, NPA refer to loan and advances, which do not yield any positive, return or contribute to the profits of banks. In a broader sense, NPA includes the unutilized cash balances, physical assets and the workforce. In this study major concern is with the narrow sense of NPA, which means the loan/assets that do not yield positive return in cash.

It is well known that the loans, which do not yield positive return in cash, are NPA. Since the loans do not yield positive returns in cash, it has direct effect to lender bank. In this situation bank can not pay the interest to the depositors and dividend to the share holders. If the interest income which has to maintain the operational expenses including depositor's interest and share holders' expectations could not be regularized, it may have great financial effect to the bank. On one hand the outstanding interest is not allowed to show as income and on the other hand loan and advances become non-performing, which creates the situation of additional expenses to profit and loss account of bank. As a result there may be significant effect in the financial position of the bank." (Adhikary, 2062:167)

“Accumulation of NPA of Commercial banks has many serious consequences. First, NPA effect the profit of banks as they do not yield any positive returns and higher the NPA, lower the profits earned by the banks. Second, NPA impose strains on profits, as provisioning requirement has to be made by profits. Third, existence of large volume of NPA reflects adversely on the financial strength of the banks will be recorded because of possible bank failure due to accumulation of NAP. Fourth, in a situation of growing NPA, banks become shy of extending advances and in this process all economic activities are likely to suffer. Fifth, when banks go on losing income because of NPA good borrowers have to bear higher cost to compensate for the loss of caused by the defaulters. Though, this may not make up the entire loss, good borrowers can get loan at somewhat lower rates in the absence of high level of NPA. Lastly, the entire banking system gets weakened as the very survival of banks would be threatened by the growing volume of NPA and therefore, efforts are needed to resolve this most intractable problem faced by banks.” (Sreekantaradhya, 2004:346)

Here are provided some of excerpts from some famous scholars regarding the effects of NPA. “Non-performing Asset, NPA could wreck bank’s profitability both through a loss of interest income and write off the principle loan amount. It tackles the subject of entire starting from the stage of their identification till the recovery of dues in such amount.” (Bindani. 2003:3)

“To start with performance in terms of Profitability is a benchmark for any business enterprise including the banking industry. However, increasing Non-performing Asset, NPA have a direct impact on banks profitability, as legally are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets.”(Manmohan, 2002:6)

Performing Assets are those loans that repay principle and interest to the bank from the cash flow it generates. Loans are risky assets, though a bank wants most to its resources in granting loans and advances. If an individual bank has around 10% Non-performing Asset (NPA), it sounds the death knell of that bank catteries- paribus (call other thing remaining constant). The objective of bound loan policy is to maintain the financial health of the banks, which result in safety of depositor’s money and increase in the returns to shareholders. Since the loan is a risky asset, there is inherent risk in every loan. However the bank should not take risk above the certain degree irrespective of returns prospects. (Dahal & Dahal, 1999/2000: 115)

Loan and advances are the most profitable assets among all the other assets in a bank. Banks universally desires the assets, which constitute primary source of income to them. According to Dr. Walter Leaf, “In the item of advance to customers we have reached the central portion of the activities of bank.” In this statement the banker is brought into direct relation with the public. His capacity and judgment and his usefulness to the community is judged by the way he lends the money left with him by the depositors. The major aim of the bank, as a business institution is making huge profit along with safeguarding the interest of depositors. Since loan and advances are more profitable than any other assets, he is willing to lend as much his fund as possible. While lending, he has to be careful about the safety of such loan and advances. Again in the word Dr. Leaf, “The bankers have to timer the liberality with caution. If he is too liberal, he may easily impair his profits by bad debts, if he is too timid, he may fail to obtain and adequate return on the fund, which are confided to him for use. It is his capacity in lending that bank manager judged.” (Radhaswami & Vasudevam 1979:550)

Loan and advances dominate the assets side of balance sheet of any bank. Similarly, earning from such loans and advances occupy major place in income statement of the bank. Lending can be said to be the raison de etre of a bank. However, it is very important to be reminded that most of the bank failures in the world are due to shrinkage of the value of the loan and advances. Hence loan is known as risky assets. Risk of non-repayment of loan is known as credit risk or default risk. Performing loans have multiple benefits to the society while Non-performing Asset (NPA) erodes even existing capital" (Dahal & Dahal, 1999/2000: 114).

1.2 Statement of the Problem

The main features of Commercial Bank are mobilizing the deposit and lending them to different needy sectors. Lending or loan and advances are the major source of income to commercial Banks. Without loan and advances, banks neither maintain its operational expenses nor can give good interest to depositors and dividend to shareholders. Generally loan and advances of commercial banks occupy more than 40% of total assets. So it is necessary to manage the good portfolio of loan and advances in banks. In the economy of developing countries, loan and advances are the major functions of commercial banks and the interest earning from them is the main source of income.

However, lending (loan and advances) also carries credit risk, which from the failure of borrower to fulfill its contractual obligation during the course of transactions. Such failure doesn't yield positive return in cash, which cause the rise of NPA. It is obvious that the NPA are the rising or swelling problem in the banking sector of Nepal and this issue is becoming more and more unmanageable. At present total NPA in the banking sector is about NRS 35 billion, while it is even worse in case of two largest governments sector banks: Rastriya Banijya Bank (RBB) and Nepal Bank Limited, NBL.

According to the governor of Nepal Rastra Bank, Mr. Bijaya Nath Bhattarai, the NPA of NBL and RBB are found to be 49.64 percent and 50.70 percent respectively as on the end of Asadh 2062. (NRB Samachar, 2063)

Learning the above statements, it is obvious that Nepalese Banking Sector has been becoming victim of huge NPA. Such situation raises the question, whether Nepalese management team in bank is competent enough? Whether NRB fails to regulate the commercial Banks?

In the above backdrop, the research study is focused on the following research questions.

i. Whether or not the Nepalese Commercial banks are following NRB's regulation/directives regarding their lending and provision for NPA?
ii. What is the proportion of NPA to total assets and lending in Nepalese Commercial Banks?
iii. How does NPA effect in return on shareholders equity (ROE) and return on total assets(ROA)?

1.3 Objectives of the study

The main objectives of this study are to examine and find the level of, NPA to total assets, total deposits and total lending of Nepalese Commercial Banks. The specific objectives are:

i. To study about the proportion of NPAs to total assets, total deposits and total lending of both the banks under study.
ii. To study Non performing loan to total loan.
iii. To examine and evaluate the effects of NPA on ROA and ROE of Banks.
iv. To make recommendation to overcome the difficulties in managing NPA of the banks with high level of NPA.

1.4 Limitation of the Study

The research work has the following limitations:

i. Primarily this study is concerned only with NPA of Nepalese Commercial Banks. It does not consider other financial aspects of the banks.
ii. The study is concentrated only on commercial banks of Nepal. Hence findings were not applicable to other financial institutions; "the development banks i.e. the grade 'b' financial institutions and finance companies i.e. the grade 'c' financial institutions."
iii. The study is basically based on secondary data, which may or may not provide exact vision of the field. Hence, the findings will be in accordance of the data. Personal judgment sampling method is applied to draw the sample.
iii. The study covers the five years period data of fiscal years 2060/61 to 2064/65.

1.5 Significance of the Study

Banking habit has been an inseparable part of modern people. Whether it is in industrial sector or personal life it has served a lot. For the safety of the depositors along with fulfillment of the need groups, banking behavior has served well. Since commercial banks are the bridge between savers and need group of money, there should be balance between the desires of these two groups. In other words depositors get nothing unless deposits are flowed as loan and advances to borrowers and paid back interest to the depositors. But it is not always true that all loan and advances yield positive income to banks. In practice, there is certain probability of becoming default rate in loam and advances. Such defaulted loan and advances are known as NPA and they create credit risk.

Generally it is found that the loan and advances occupy 60 percent of the commercial banks' assets. The income of the commercial bank is covered by interest income earned to loan and advances in huge figure. Such earnings are possible only when the loan and advances are not defaulted. The defaulted loan and advances on one hand, has to maintain the provision against such loam and advances. So, defaulted loan and advances has double effects: minimizing the income of bank and unsafe risk of deposits.

Success of any banks doesn't depend on how much money a bank can lend? But it depends quality of the loan. Therefore we can say that the success of the bank depends upon the amount of its performing assets/loans.

This study mainly concerned with the analysis of the NPA to total assets, total deposits and total lending of Nepalese commercial banks. Therefore it is significant to find out the level of NPAs. It is also significant to find out whether Nepalese commercial banks have maintained loan loss provision according to NRB directives or not. It also examines NPA to ROA and ROE of the bank. Lastly it also provides literature to the scholars and new researchers who want to do further research in this field.

Since the study was on the background of the above stated facts, mainly it helped to identify the NPAs to total assets, total lending and total deposit of the banks.

1.6 Organization of the Study:

The thesis report has been divided in to five chapters. They are:

i. Introduction
ii. Review of Literature
iii. Research Methodology
iv. Data Presentation and Analysis
v. Summary, Conclusion and Recommendation

The first chapter deals with introduction of the study, objectives of the study, limitation of the study, significance of the study and organization of the study.

While second chapter deals with the visit and study of different resource needed during the course of study. This study and visit include the websites of various sources; Nepal Rastra Bank, International Monetary Affairs, different books, various publications of Nepal Rastra Bank, different related newspapers articles, speech of different scholars related to banking sectors and the published and unpublished documents of concerned banks were studied.

The third chapter is concerned with the research methodology used to evaluate and analysis. Research methodology includes research design, source of data, population and sample selected, data gathering procedure, data processing procedure, research variable and statistical procedure.

The fourth chapter mainly focused with the data presentation and analysis. In this course, the collected data from the various sources are tabulated, processed and analysed. This chapter has given the life to the whole study. The different ratios of NPA to total lending, total asset and total deposit are analysed. For the sake of easy understanding, the figures are presented in the diagram as well. Similarly, the figures are explained in the words so that their pros and cons can be further studied by the readers as well.

The summary of the whole study is presented in the fifth chapter as summary. They include introduction to commercial banks, introduction to NPAs, prudential regulations, the actual data position of the banks, the regulation compliance situation by the banks etc.

In the conclusion, the effects of NPA to return on assets (ROA) and return on shareholder's equity (ROE) are analysed. It is concluded that higher the level of NPA, lower the level ROA or ROE. Similarly, the way out to increase the ROA and ROE are also discussed in conclusion.

Finding out the reason why banks are suffered with NPA, some suggestions are made to reduce or avoid the rise of NPA level. The corporate governance to other operational measures is recommended for the reduction and avoidance of NPA level.

CHAPTER-II
REVIEW OF LITERATURE

The review of literature consist of examination and review some of the related books, articles published in different economic joural, bulletin, dissertation papers, magazines newspapers and websites. In brief, this chapter including review of following

2.1 Introduction:

Before learning about NPA, brief introduction about commercial bank and its functions are given as follows on the basis of the facts studied from different texts and scholars.

The universal behavior of commercial bank is to earn profits by its financial transactions. Such major transactions are to accept deposit by the people and different organizations and lend them as loan able fund to different need sectors. These need sector may be an individual or institution and industries. The bank should pay interest to the depositors and receives interest from the borrowers. Generally all banks receives higher rate of interest from borrowers than paying it to depositors. In the modern commercial banking habit, the deposit fund is diversified to different investment sectors as per the investment policy of the bank. This policy depends on the economic, commercial, industrial and competitive market condition of the country, banking habit of the people, foresightedness and experience of bankers. Regarding the commercial transaction of the bank, Professor Bangehot has said, “Adventure is the life of commerce, but caution if not timidity, is the essence of modern banking.” So commercial banks should have the art of utilizing its loan able funds to different investment sectors with caution to earn money.

In the course of reviewing literature, the commercial bank is defined in Commercial Bank Act, 2031 B.S., as “A commercial Bank means the bank which deals in exchanging currency, accepting deposits, giving loans and doing commercial transactions.”

Bank of Venice established in 1157 A.D., is the first commercial bank. The beginning of commercial bank's functions was confided to accepting deposits and giving loans. However, their functions have now increased manifold. Nepal Bank limited established on the 30th Kartik, 1994 B.S. is the first commercial bank in Nepal. (Dahal & Dahal, 2002:167)

The bank and financial institutions Ordinance, which was first issued in 2061 B.S. after the dissolution of Commercial Bank Act, 2031 B.S., Development Bank Act, 2052 B.S., Finance Company Act, 2042 B.S., Agricultural Development Act, 2024 B.S., Nepal Industrial Development Corporation Act, 2016 B.S., has specified the definition of commercial bank as 'A' Grade institutions to be operating ordinance, Memorandum of Authority MOA and Memorandum of Article MOA, in order to carry out the functioning accepting deposits, foreign exchange, to give loan and advances, to grant overdraft loan, to act as agent of government transaction, to buy and sell the NG or NRB bond and to carry out other modern banking transactions with modern technologies.

Assets and liabilities are the two major parts of balance sheet of commercial bank. Cash reserves, deposits to other banks, investment in securities, loan and advances and other assets comprise the total assets. Liabilities comprise public deposits, borrowings, other current liabilities and share capital. As this study is focused with the NPA, it is mainly concerned with the assets of bank. Generally, the loan and advances occupy more than two third parts of assets of bank in balance-sheet and it is found that they produce more than half of bank revenues. Therefore, in practice loan quality is mostly studied as assets quality. In banking literature, loan is often found synonymously used to assets. According to Onsite Inspection Manual, for Commercial Banks and Finance Companies, Volume-II, published by NRB, the study of asset quality is mainly concerned with loans quality. So, it should be clear that asset is used to indicate the meaning of loan.

Since this study is mainly concerned with loan, some facts are highlighted regarding loan. The deposits of public create loan able fund. Banks make their profits by issuing loans. But loans also have higher probability of default than other assets. The loans, which are actively working gives well, return to the banks. The default loans cause the loss in return to the bank. For the strength and stability of banking system, the assets/loan should yield positive returns. The assets/loans, which do not yield positive returns, become NPA. In a narrow sense, Non-performing Asset (NPA) refer to loan and advances, which do not yield any positive, return or contribute to the profits of banks. In a broader sense, NPA includes the unutilized cash balances, physical assets and the workforce. In this study major concern is with the narrow sense of NPA, which means the loan/assets that do not yield positive return in cash.

2.2 Parent Discipline and Classification Model of NPA

In the course of research some of the information on managing and defining NPA in different countries are is explained in brief as follows:

2.2.1 India

As Narasimham Committee of India pointed out the international practice, the NPA is defined as an advance where, as on the balance sheet date-

(a) In respect of term loans, interest remains past due for a period of more than 180 days.

(b) In respect of overdraft and cash credits, accounts remain out of order for a period of more than 180 days.

(c) In respect of bills purchased and discounted, the bill remains overdue and unpaid for a period of more than 180 days.

(d) In respect of other accounts, any amount to be received remains past due for a period of more than 180 days.

Until recently, there was no clear definition of NPA in India. Different banks were following different practices and overdue of banks were generally considered as NPA and it is only after the publication of the Narasimham committee I Report that a uniform definition came to be accepted. (Sreekantaradhya,2004:123)

At present all banks in India are adopting the definition of NPA in the same manner as Narasimham Committee I has pointed out the definition of NPA adopted in international practice.

In pre-reform period of banking and finance, the classification of loan and advances were made on the basis of classification of assets. According to this, assets were classified into eight health categories, named as follows:

i. Satisfactory
ii. Irregular
iii. Sick (viable under nursing)
iv. Sick (non-viable/sticky)
v. Advances recalled
vi. vi. Suit filed accounts
vii. Decreed debts and
viii. Debts classified by banks as bad debts/doubtful.

Banks had discretion in making this classification and also the approach was not objective and this kind of classification was also not helpful for identification of non-performing assets. Since 1992, a new system of classification has been followed which will be described in the latter subheading.

2.2.2 Nepal

It is found that NRB, the central bank and as an apex regulatory and supervisory authority of the country has been issuing the directives to banks and financial institutions as per the international norms and practice. In this regard, though there is no clear definition of NPA, it refers to those loans and advances which are not able to serve the interest and the installment within the given time period.

In Nepalese context, NPA was not defined before 2001. It was simply assumed that the last four categories: evidence of substandard, substandard, doubtful and bad loan out of six was considered as NPA. The practice of classification of loan in Nepalese context can be divided into two eras: pre-liberalisation and after liberalisation. Pre-liberlisation regulation consist of those directives which were issued to commercial banks, NIDC and ADB/N before directives were issued to finance companies where as the regulation after liberalisation consists the directives issued to commercial banks, development banks, finance companies and cooperatives carrying out the functions of limited banking transactions. In this regards the legal provisions regarding the classifications of loan and advances are enumerated as follows.

2.2.2.1 NRB Circular No. Bai./Le./61/credit, dated 2045/11/19 by, to Commercial Banks by Regarding Classification of Loan and Advances and provisioning.

This circular had given the directives to banks to classify the loan and advances on the basis of overdue aging as follows:

i. Good loan: non-overdue and overdue amount of principal or interest or both up to 6 months

ii. Substandard loan: overdue amount of principal or interest or both for six months to 1 year.

iii. Doubtful loan: overdue amount of principal or interest or both for 1 to 5 years.

iv. Bad loan: the overdue loan and advances which were overdue and security were nominal or lost, loanee was insolvent or out of contact and writ was filed in the court during the course of recovery respectively were known as bad loan. In the case of non-overdue loan and advances, if security was nominal or lost or loanee was insolvent or writ was filed in the court during the course of loan recovery was known as bad loan. As per this circular, the overdue amount of principal or interest or both for more than 5 years would lie in bad loan category. As directed by the circular, banks had to make no provision for good loan, where as other category loan were made to maintain required loan loss provision.

2.2.2.2 NRB Circular No. Bai./le./61/credit 1137, dated 2047/10/16 to NIDC regarding Loan Classification and Provisioning

As per this circular, NIDC's loan and advances had to classify into six categories: namely good, acceptable, evidence of substandard, substandard, doubtful and bad. The basis of classifying such loan were debt service cover ratio, regularity of payment history, industry outlook situation, financial position of client/company, management quality and collateral quality coverage.

The provisioning of loan for NIDC was specified as follows:

Loan Category	Provision
Good	1 percent
Acceptable	1 percent
Evidence of substandard	5 percent
Substandard	25 percent
Doubtful	50 percent
Bad	100 percent

2.2.2.3 NRB Circular No. Bai./le./61/credit 1165, dated 2047/12/8 to Commercial Banks regarding Loan Classification and Provisioning

This circulation provided regulation regarding loan classification and provisioning of loan and advances of commercial banks on the same category as it was directed to NIDC by circular dated on 2047/10/16.

2.2.2.4 NRB Circular No. Bai./le./61/credit 1230, dated 2048/05/04 to ADB/N regarding Loan Classification and Provisioning

As per the circular, ADB/N had to classify its loan and advances into five categories on the basis of debt service cover ratio, regularity of repayment history, industry outlook, financial turnover of client, management quality and collateral quality and coverage ratio. The loan and advances overdue up to 6 months were classified as good loan, where as overdue for 6 months to 1 year as evidence to substandard, overdue for 1 to 2 years Substandard, overdue for 2 to 5 years as doubtful and overdue for more than 5 years were classified as bad loan.

The provisioning for good loan was not necessary as per this directive where as 10 percent provisioning was required for evidence to substandard, 25 percent for substandard, 50 percent for doubtful loan and 100 percent provisioning was required for bad category of loan.

At present there is newly formulated regulation regarding loan classification and their provisioning which will be discussed in subheading 2.3 “Immediate Parent Discipline and Classification Model.”

2.3 Immediate Parent Discipline and Classification Model

Present discipline regarding loan classification and the provisioning in Nepal and India are enumerated as follows.

Nepal

After the economic liberalization in Nepal, numerous banks and other financial institutions were established. In order to regulate such banks and institutions, separate regulations were issued to banks and financial institutions. They are enumerated as follows:

To be effective from fiscal year 2058/59, NRB issued new directives in 2058 regarding the loan classification and loan loss provisioning including Development banks, finance companies and cooperatives. As per these directives, on the basis of their overdue aging, loan and advances of commercial banks were classified in to four categories, namely pass or good, substandard, doubtful and bad loan. The loan and advances other than good category were defined as NPA in these directives. Similarly, such loan and advances of development banks finance companies and cooperatives carrying out limited banking transactions were also classified in to the same four categories with the same definition of NPA. The categories of loan and their provisioning are given as follows:

Loan categories	Criteria of Classification	Provisioning
Pass loan	Not past due and past due for period up to 3 months (performing loan)	1%
Substandard loan	Past due for a period of 3 months to 6 months	25%
Doubtful loan	Past due for a period of 6 months to 1 year	50%
Loss loan	Past due for a period of more than 1 year or	100%

The present directives effective from the 1 Shrawan 2062 are the, "Unified Directives, 2062, Issued to Bank and Financial Institutions Licensed by NRB." The directives for classification of loan and advances and provisioning against them for the purpose of minimizing possible risk in bank's lending by using the authority given sub-section 1 of section 79 of NRB Act, 2058 and section 49 of Bank and Financial Institutions Ordinance, 2062 are as follows.

Loan categories	Criteria of Classification	Provisioning
Pass loan	Not past due and past due for period up to 3 months (performing loan)	1%
Substandard loan	Past due for a period of 3 months to 6 months	25%
Doubtful loan	Past due for a period of 6 months to 1 year	50%
Loss loan	Past due for a period of more than 1 year or	100%

As defined in the directive no.2 (1) of Unified directives, 2062, performing loan are the pass or good loans while non-performing loan are substandard, doubtful and bad loan.

Loan loss provision for special category of loan

The loan against gold and silver, fixed deposits, credit cards and HMG Bonds and NRB Bonds are included in good loan.

In case of acting running capital loan up to one year is being rescheduled, and then they are included in the good loan category. In the state that the interest against current capital loan is not regularly received, such loans are classified on the basis of overdue period.

Additional Provision for Bad Loan

Over due or non-overdue loans are classified in bad loan category if:

i. Security is not enough

ii. Borrower is declared bankrupt/insolvent,

iii. Loanee is out of contact,

iv. Reimbursement is not received within the ninety days of the maturity period of purchased or discounted bills and convergence of non-fund based facility like letter of credit and guarantee amount to fund based loan,

v. Loan is misused,

vi. Six months period of auction process after the default of loan repayment is exceeded or the case is filed in the court in the course of loan recovery,

vii. Loan is given to a blacklist person,

Viii. Project/business firm is not operationally viable, project or business is not being operated or

ix. Credit card loan is not written off within 90 days of over due date.

Loan loss provision made for performing loan is called “General loan loss provision” and loan loss provision made for Non-performing Assets (NPA) is called “Specific loan loss provision.”

India

It is already mentioned that until recently there was no clear definition of NPA in India. It was well defined and brought in practice only after Narashimham Committee defined NPA on the basis of international practice of defining it. Till then, different commercial banks were defining and adopting NPA separately.

As per the circular no. BP.BC. 79/21-043-92 dated April 27, 1992 and circular No. BB.BC.59/22.04.943-92 dated December 17, 1992, the RBI has identified the NPA as an account of loan where on the balance sheet date in respect of;

- Term loan interest remains "past due" for more than 180 days, overdraft and cash credit account remain out of order.
- Bills purchased or discounted remain overdue or unpaid for more than 180 days,
- Other accounts receivable remain past due for 180 days.

The same circular further clarifies that an NPA is a credit facility in respect of which interest has remained unpaid for two quarters. According to the circulars the loans are classified based on weakness and dependence on collateral securities into four categories and prescribed the provisioning rate as follows (Tannan, 1997).

Loan categories	**Criteria of Classification**	**Provisioning**
Standard	Not disclose any problem and not carry risk (actually a performing loan)	1% of outstanding loan
Substandard loan	Overdue for not exceeding 2 years	10% of the total outstanding loan
Doubtful loan	Overdue for exceeding 2 years	a. 100% provision on unrealizable value of the security b. 20% if the asset has to remain doubtful up to 1 year c. 50% if the assets has remained doubtful up to 3 years d. 50% if the asset has remained doubtful for more than 3 years.
Loss loan	Uncollectible/unrecoverable loans, continuance as a bankable asset is not warranted	Entire amount should be written off. If assets are permitted to remain in the books for any reason, 100% outstanding should be provided for.

Source: Govind Ghimire; Thesis on NPA of Commercial Banks: Causes and Effects

Srilanka

In the case of Central Bank of Srilanka has issued directives to commercial banks regarding the classification of loan and advances. As per the existing CBSL directives, banks have to classify outstanding loan and advances into four categories. The loan classification and their provisioning requirements are as follows:

Loan category	Criteria for loan classification	Provision requirement
Good loan	Not overdue and overdue up to 90 days	No
Substandard loan	Overdue for 90 days to six months	20% of the total outstanding loan
Doubtful loan	Overdue for six months to 18 months	50% of total outstanding loan
Loss loan	Overdue for 18 months and above	100% of total outstanding loan

2.4 Conclusion

The conclusion is drawn after learning the parent discipline exercised by Nepalese, Indian and Srilankan central banks. Managing NPA is great challenge in the contemporary banking business. As far as possible, uniform practices have been introduced to international banking business.

Till the very late of 1990, there was no clear definition of NPA even in India. As per the international practice, Narasimham Committee report helped uniformly define and adopt practice of NPA in all commercial banks in India. Before the RBI circular dated April 17, 1992 and December 27, 1992; Indian banks used to classify the loan and advances into eight health categories its assets. After the 1992 circular, loan and advances of banks are uniformly classified into four categories: namely, standard, substandard, doubtful and loss and the last three categories constitute non-performing assets.

In the context of Nepalese commercial banks there was no clear definition of NPA before 2001 A.D. There were separate directives and classification model to CBs and ADB/N and NIDC. With clear definition of NPA, the separate directives were issued to commercial banks other financial institutions in 2057 B.S. to be effective from fiscal year 2058/59. As per these directives, the overdue loan and advances other than good loan were defined as NPAs. Considering there was no significant difference in the functions of CBs and other FIs, unified directives were issued to them with clear definition of NPA, which comprise overdue loan and advances other than good loan to be effective from the 1^{st} Shrawan, 2062 B.S.

The CBSL has also issued to commercial banks and financial institutions in Srilanka defining NPA other than good category loan. The classification model and provision is also almost similar to Nepalese banks.

Since NPA degrades the profitability of banks it is great challenge to the contemporary banking sector. Considering this fact, international practice has been introduced to manage NPA. The introduction of loan classification and provisioning introduced in every country is its example.

2.5 Review of Thesis, Journals and Books

2.5.1 Review of Thesis

According to the findings of Govind Ghimire, Nepal Commerce Campus, in his thesis submitted to Tribhuvan University, the relation of NPA in the profitability of the bank is inversed. The growth of net profit is negative due to the increase in loan loss provisioning against NPA. Thus profitability is affected by the growth of NPA because in case that the increment ratio of NPA is higher than that of operating profit, significant portion of operating profit is used for maintaining required loan loss provisioning and there is reduction on net profit. He further concludes that the expansion of excessive credit may cause the growth of NPA where as this trend of NPA cause the contraction in credit expansion. Return on shareholder's equity is affected because the profits earned are swallowed by the amount of provision against NPA. Not only this, the cost of maintaining these assets include administrative cost, legal costs and cost of procuring the resources locked in against NPA. Similarly, NPA adversely affect the investors' confidence because it brings down the profits and affect the shareholder's value.

In brief, NPA lower the ROE and ROA, lower image and rating of the bank, disclosure reduce the investor's confidence, increase costs and difficulties in raising capital, do not generate any income require provisioning and harness the profitably, locks in the borrowing cost of resources, loss the opportunity due to non recycling of funds, carries 100 % risk weight on net NPA for CAR, blocks capital, more costly in recovery and administrative aspect and effects on employee morale and decision making in the bank.

Similarly Dinesh Kumar Kahdka, in his thesis submitted to Tribhuvan University concludes that return on assets, ROA and return on equity, ROE of the bank somehow depend on upon NPA. The high degree of negative correlation between NPA and ROA and between NPA and ROE clearly indicates that there is inverse relation between NPA and ROA as well as between NPA and ROE. It means a bank should reduce its NPA to increase ROA and ROE of the bank and vice-versa.

2.5.2 Review of Books

The researcher went through different books searching the definition and items of bank assets. To know more about of bank assets, it is necessary to know about balance sheet bank. According to Frederick Mishkin, Mr. Murari Mohan Joshi and Unified Directives Issued to Banks and Financial Institutions by NRB, balance sheet of commercial bank is introduced as follows.

Balance sheet of a Commercial Bank

"To understanding how bank operates, first we need to examine its balance sheet, a list of bank's assets and liabilities. As the name implies, this list balances, that is, it has the characteristics that,

[Total Assets = Total liabilities +capital]

Banks obtain funds by borrowing and by issuing other liabilities such as deposits. They then use these funds to acquire assets such as securities and loans. Banks make profits by charging an interest rate on their holdings of securities and loans that is higher than the expenses on their liabilities."(Frederick & Wesley, 2003:347.)

"The balance sheet of a commercial bank is a statement showing its assets and liabilities as on particular date. It is usually prepared at the end of each year. The balance sheet of bank has greater importance than that of an ordinary trading company. The bank deals in other people's money and hence the entire community is in the balance sheet. The business of the bank is reflected in the balance sheet. Its proof rays the result of the bank operation during the year. It may also be regarded as indicating the ways in which bank raises its funds and the way in which it uses them. Every bank inhibits a copy of its balance sheet in its premises. (Radhaswami & Basudeavam, 1979:550)

Since there is no common or standard form for presenting the balance sheet, the present balance sheet of commercial bank, as specified by Nepal Rastra Bank under the unified Directives, 2062, issued to Bank and Financial Institutions Licensed by NRB, is as follows:

-----------------Bank Limited

-------year

----------------dated balance sheet (in Rs. 0000)

Capital and Liabilities			**Assets**		
Previous Year	Particulars	This Year	Previous Year	Particulars	This Year
Xxxxx	1. Share capital	Xxxxxx	Xxxxxx	1. Cash balance	Xxxxxx
Xxxxx	2. Reserve funds	Xxxxxx	Xxxxxx	2. Bank balance	Xxxxxx
Xxxxxx	3. Borrowings	Xxxxxx	Xxxxxx	3. Money at call	Xxxxxx
Xxxxxx	4. Deposits	Xxxxxx	Xxxxxx	4. Investment	Xxxxxx
	5. Other liabilities	Xxxxxx	Xxxxxx	5. Loan and advances	Xxxxxx
				- Bill purchased	Xxxxxx
				6. Fixed Assets	Xxxxxx
				7. Other Assets	Xxxxxx
xxxxxxxx	Total	xxxxxxxx	xxxxxxx	Total	xxxxxxx

Liabilities in Brief

The liabilities of a bank represent the sources of its funds, to which are employed by the bank in the ordinary course of its business. Such funds obtained from issuing liabilities are used to purchase income- earning assets.

Assets in Brief

Assets of a bank represent the property, loan and advances and investment made by the bank. Assets are the uses of funds that are acquired by issuing liabilities to purchase income-earning assets. The various sub-headings or uses of funds in the assets are enumerated as follows in detail.

Assets of Bank.

The assets are given in the right hand side or the bottom part of the balance sheet. The assets side indicates the manner, in which the funds entrusted to the banks, are employed. The successful and fruitful working of the bank depends on ability and efficiency of management that distributes/uses the fund among the various kinds of investments known as assets. The various items of fund uses on the assets side are briefly discussed as follows.

Cash Balance

Cash balance is the first asset in the portfolio of a commercial bank. It is perfectly liquid form of assets. It refers to the cash in the hand or kept in its vault and cash held to meet the demands of the customer. Cash balance is also known as cash reserve ratio and this reserve ratio is determined as per the direction of central bank in the country in accordance to the fiscal as well as monetary policy of the country. If this reserve or balance is not necessary to keep within the specified limit, then central doesn't make any regulation regarding this reserve. At present, there is no direction to commercial banks by NRB regarding the cash balance in their vault.

Bank Balance

Bank balance includes all the money at central bank, commercial banks and other financial institutions. According to the central bank directives, commercial bank has to maintain required reserve ratio at central bank in certain percent of its total deposits, which is called central bank reserve/balance. As per directives by the central bank or for other purposes, certain cash may be kept in other bank, which are known as balance at commercial banks. Similarly, banks may deposit their money to other financial institutions as well. Present regulation has made provision for minimum 5% mandatory reserve at NRB to its total deposits. Cash balance and bank balance are regarded as the first line of defense to bank.

Money at Calls and Short Notice

Commercial banks invest their funds to very short-term loan. Money lent at call and short notice is repayable either on demand or at a very short notice, generally less than 24 hours or 24 hours to 7 days or 10 days period. Cash is an idle asset and the bank must not keep cash beyond the amount considered absolutely necessary. To meet seasonal demand and other contingency liabilities, bank maintains these highly liquid but earning assets, which can be converted into cash quickly and without loss of value. Bank regards this is a secondary reserve as against cash, which its primary reserve. Unlike cash, this asset brings some revenue income to the bank. Since this loan can be returned at the time of demand, it is regarded as the liquid asset. So such loan is regarded as the second line of defense to bank.

Discounted and Purchased Bill

Commercial banks purchase and discount short term domestic and foreign bills of exchange, treasury bills, check, draft etc. Bills purchases and discounted such are for short period and they are liquid assets. Banks receives income by such transactions. After the complete maturity period of purchased bills banks receives income/discounted amount from concerned person, company or firm. Such bills are marketable, so they can be sold in the market to receive cash any time. In time of nee, commercial banks rediscount such bills with the central bank of the country. This facility makes it a shift bale asset. The rediscounting rate will generally be higher than the borrowing rate of the bank. Hence, the bank incurs a loss, if the bills are rediscounted. The loss is minimized in the case of short dated bills. The commercial bank discount and purchase such bills without minimizing the required cash balance/excess reserve in the bank. All discounted and purchased bills amount are assets of the bank and they are known as the third line of defense to the bank.

Investment

Bank cannot earn enough through cash balance and short term loan. So they invest their assets in different investment alternatives. Such investments include government bond and securities, shares of industries and debentures. Government securities are secured than other investment for banks. So banks invest a large proportion of their funds in government securities and other gilt-edged securities. When the demand for loan and advances increase, the banks probably sell the securities. These securities can be converted into cash easily and without any loss of value. If the securities are sold before maturity, the bank incurs capital loss. If the interest rate rises, then also bank face the loss. The investment yields a fair high rate of return, if the security is sold on due maturity period. Generally, share investments are for long term period and they can't be converted into cash easily. Debentures can be sold any time in return for cash.

Loan and Advances

Loan and advances are the most important particular of assets in balance sheet of bank. Generally, loan and advances covers more than 40% of the total assets of bank and interest income from them are the major income of the bank. The profitability depends on the extent to which bank grants good loan and advances to customers. Loans are granted in the form of overdraft, cash credit and ordinary loan. Adequate security is maintained against granted loan. Loan and advances are known as the fourth line of defence to banks.

Fixed Assets

Fixed assets are the fixed investment or the least liquid assets of the bank. They cannot be realized in cash in times of an emergency. They cannot also be realized without without much loss of value. So these assets are called dead stock of bank. Bank buildings, furniture, machines, computers are the examples of fixed assets. These assets don't make any profit to bank and usually provides depreciation on them annually. So the values of these assets shown in the balance sheet will be much less than their real value. Such assets can be sold at the time of bank bankruptcy.

Other Assets

Other assets include silver, gold and other items, such as interest receivable, commission receivable, advance payment to staff, non-banking assets, expenses to be written off reconciliation amount and advance tax payment etc. These items are shown separately under suitable headings.

Liabilities:

Banks' liabilities include different heads viz. share capital, the deposits of people, borrowings from other bank and financial institutions, reserve funds, provision and other contingent liabilities.

Share capital

Share capital is the amount collected by the bank promoters to operate bank. As per the memorandum of Association of the bank, the utmost limit of capital bank can issue is determined, which is known as authorized capital. The part of the authorized capital, which is issued to public subscription, is known as issued capital and the portion of subscribed capital which is taken by public is known subscribed capital. Bank doesn't get whole amount of subscribed capital at once. The portion of share amount which is received at the time of subscription is known as paid capital and the total amount called out of subscription is known as called capital.

Deposits

Deposits occupy the major space in the liabilities of the bank balance sheet. Normally it is more than 70 percent of the total liabilities. As per NRB directives, commercial banks can collect fixed deposits, saving deposits, current deposits and other deposits as introduced by the banks policy to carry out its business. These are the liabilities because bank must pay interest on them and payback the deposit amount to depositors.

Borrowings

Banks borrow from other commercial banks, central banks and other financial institutions to carry out their business in the state of lack of business funds.

Reserve funds

Reserve funds constitute general reserve funds; share premium, capital reserve fund, assets revaluation fund, dividend equalization fund, retained earnings (profit/loss) and other reserve fund. The portion of undistributed profit establishes general reserve fund.

Other Contingent Liabilities

They include dividend to be distributed and unclaimed dividends, pension and gratuity funds, provident fund, sundry creditors, interest payable, income tax provision, loan loss provision against Non-performing Asset (NPA), interest suspense account and rebates etc.

2.5.3 Importance of Loan and advances to Bank

Commercial Banks grants certain part of its assets as loan and advances. Such loan and advances are granted against enough securities and interest received against them is normally higher than they pay interest to deposits. Loan and advances are less liquid but are more profitable. These are known as fourth line of defense to bank regarding the chance of being converted to current cash. More than 70 percent of bank income is earned by the interest income received against such loan and advances. Without the transaction of loan and advances, bank neither can maintain its operating expense nor ca pay interest to depositors and dividend to shareholders. In the bank of developing economy granting loan and advances are major transaction and interest received against such loan and advances are the major portion of income to total income. The loan and advances in our countries' commercial bank occupy more than 45 % of total assets.

"Banks make their profits primarily issuing loans. Some 68 percent of bank assets are in the form of loan and advances, and in recent years they have generally produced more than half of bank revenues. A loan is a liability for the individual or corporation receiving it but an asset for a bank because it provides income to the bank. Loans are typically less liquid than other assets because they cannot be turned into cash until the loan matures. If the bank makes a one year loan for example, it can not get its funds back until the loan comes due in one year. Loans also have a higher probability of default than other assets. Because of the lack of liquidity and higher default risk, the bank earns its higher return on loans." (Frederick S. Mishkin, 2003:356)

"Loan and advances dominate the assets side of balance sheet of any bank. Similarly earnings from such loan and advances occupy major space in the income statement of bank. Lending can be said to be raisen de eter of a bank. However, it is important to be reminded that most of the bank failures in the world are due to shrinkage in the value of loan and advances. Hence, loan is known as risky assets. Risk of non repayment of loan is also known as credit risk or default risk." (Dahal & Dahal, 2002:114)

2.5.4 Review of Other Books and Journals

2.5.4.1 Effects of NPA in the Performance of Bank

The major characteristics of NPA are no positive yield to banks in cash. It has multiple effects, on one hand bank may not be able to pay the interest to the depositors and on the other hand, bank has to maintain loan loss provision against NPA, which cause decrease on its profitability. NPA has direct impact on return on assets, ROA and return on equity ROE, the two main parameters for measuring profitability of banks. Return on assets will be affected because the total assets include the NPA; they do not contribute to profit which is one of the components in ROA ratio.

Here are provided some of excerpts from some famous scholars regarding the effects of NPA. NPA could wreck bank's profitability both through a loss of interest income and write off the principle loan amount. It tackles the subject of entire starting from the stage of their identification till the recovery of dues in such amount." (Bindani, 2003:3) "To start with performance in terms of profitability is a benchmark for any business enterprise including the banking industry. However, increasing NPA have a direct impact on banks profitability, as legally are not allowed to book income on such accounts and at the same time banks are forced to make provision on such assets."(Manmohan, 2002:6)Performing Assets are those loans that repay principle and interest to the bank from the cash flow it generates. Loans are risky assets, though a bank wants most to its resources in granting loans and advances. If an individual bank has around 10% NPA, it sounds the death knell of that bank ceteries-paribus (call other thing remaining constant). The objective of bound loan policy is to maintain the financial health of the banks, which result in safety of depositor's money and increase in the returns to shareholders. Since the loan is a risky asset, there is inherent risk in every loan. However the bank should not take risk above the certain degree irrespective of returns prospects. (Dahal & Dahal, 1999/2000: 115) Loan and advances are the most profitable assets among all the other assets in a bank. Banks universally desires the assets, which constitute primary source of income to them.

According to Dr. Walter Leaf, "In the item of advance to customers we have reached the central portion of the activities of bank." In this statement the banker is brought into direct relation with the public. His capacity and judgment and his usefulness to the community is judged by way he lends the money left with him by the depositors. The major aim of the bank, as a business institution is making huge profit along with safeguarding the interest of depositors. Since loan and advances are more profitable than any other assets, he is willing to lend as much his fund as possible. While lending, he has to be careful about the safety of such loan and advances. Again in the word Dr. Leaf, "The bankers have to timer the liberality with caution. If he is too liberal, he may easily impair his profits by bad debts, if he is too timid, he may fail to obtain and adequate return on the fund, which are confided to him for use. It is his capacity in lending that bank manager judged." (Radha swami & Vasudevam 1979:550)

Loan and advances dominate the assets side of balance sheet of any bank. Similarly, learning from such loans and advances occupy major place in income statement of the bank. Lending can be said to be the **raison de etre** of a bank. However, it is very important to be reminded that most of the bank failures in the world are due to shrinkage of the value of the loan and advance. Hence loan is known as risky assets. Risk of non-repayment of loan is known as credit risk or default risk. Performing loans have multiple benefits to the society while NPA erodes even existing capital” (Dahal & Dahal, 1999/2000: 114).

2.5.4.2 NPAs in Nepalese Banking Sector

As studied in the “Banking and Financial Statistics” as of mid-July-2005, Vol. 45; published by Nepal Rastra Bank, the successful restructuring of two large banks resulted in better performance of whole commercial system and with marginal improvement in the level of NPA and advances, still stood at a significantly high level. The aggregate NPA to total loan ratio was 29.3% in mid-July 2001 and it reduced to 18.85% (Rs.28103.7 million) in mid-July 2005. The governor of Nepal Rastra Bank, Mr. B.N. Bhattarai has expressed his serious concern regarding the Non-performing Asset (NPA) in Nepalese Banking sector. As he has expressed in NRB Samachar 2063, the performing assets of NBL and RBB are found to 49.64 % and 50.70 % respectively as on the end of Asadh 2062. “The governing organs of the state should advance with hands to hands together to force the willful defaulters for the repayment to the banks’ loan, who borrowed from the deposits of the general public in the bank. (Governor B.N. Bhattarai, NRB, in the symposium entitled “The Role of Judiciary in the Financial Sector Reform” jointly organized by NRB and the Supreme Court of Nepal.) As expressed by him in the same program, the recovering of the huge Non-performing Asset (NPA) of two large banks is challenging and there are no alternatives of rescuing them to protect from the risk of financial system degradation of the country.

Bhisma Raj Dhungana, director of NRB, writes regarding the NPAs in the book entitled 'Nepal Rastra Bank in Fifty Years', a commemorative publication published on the occasion fifty years of Npal Rastra Bank: “Despite the various efforts in NBL and RBB restructuring, the level of NPA has not at the prudent level. The level of NPA should be lower than 5% where the level of NPA in these banks is still above 50%. The loan recovery efforts do not show that the NPA would be solved within 3-4 years period in these banks. There fore efforts are required to recover the NPA. In this connection Judicial, Political and social support and effort would be beneficial to overcome this problem more quickly."

According to aggregate or consolidated financial statement of commercial banks available in the fiscal year 2062/63 B.S., the total NPA in public sector banks and private sector banks are 51.72% and 5.57% respectively. Together this figure stands at 18.94%.

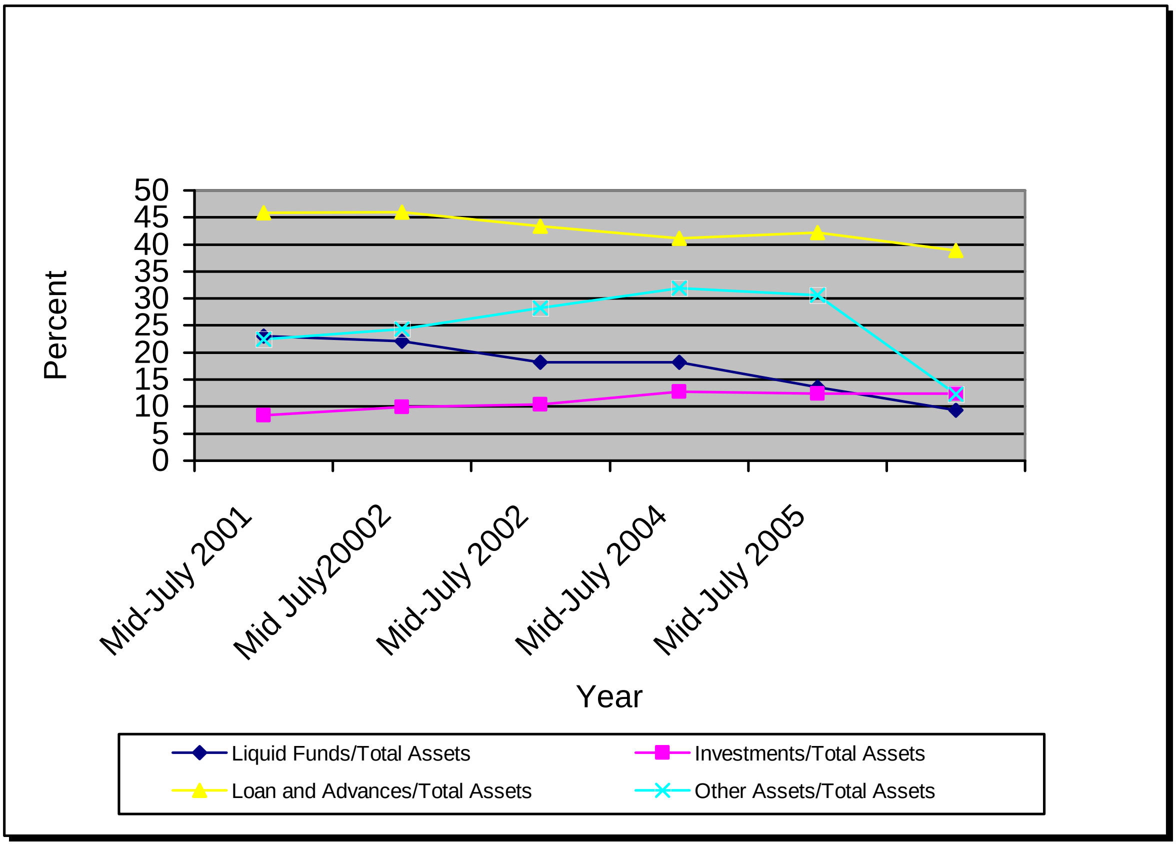
2.5.4.3 A Glimpse of Performance of Nepalese Commercial Banks.

1. The numbers of commercial bank branches operating in the country in the mid- July 2005 totaled 422, of which 375 belonged to 17 commercial banks and the remaining 47 belonged to ADB/N, performing commercial banking transactions. The regional distribution of these banks seemed to be much skewed. Of the total bank branches, 202 branches are being operated in the central development region, followed by eastern development region (88) and western development region (83). Only 27 and 22 branches are being operated in the mid-western and far western development region respectively.
2. The size of total assets of commercial banks increased continuously over the last few years. The total assets, which were Rs. 209471.5 million in mid-July 2000, expanded to Rs. 339816.7 millions in mid-July 2004 and Rs. 411033.7 million in mid- July 2005. It expanded on an average 14.43 percent per annum during 2000-05 and increased by 20.96 percent in mid-July 2005 compared to that of mid-July 2004.

Loans and advances remained major component in total assets of the commercial banks during 2005. However, the share of loans and advances in total assets declined in the recent years. The total loans and advances as percent of total assts was 46.0 percent in mid July 2000. It decreased to 41.2 percent in mid-July 2004 and 39.8 percent in mid-July 2005. Similarly, the share of liquid funds in total assets declined in the period 2000-05. It dropped to 13.6 percent in mid-July 2004 and from 23.o percent in mid-July

2000.Unlike the loans and advances and liquid funds, the share of investment in total assets increased in the same period. It increased to 14.6 percent in mid-July 2000 and remained more or less at constant level in mid-July 2005.

Figure No.4.1 Trend of Commercial Banking Assets Components/Total Assets

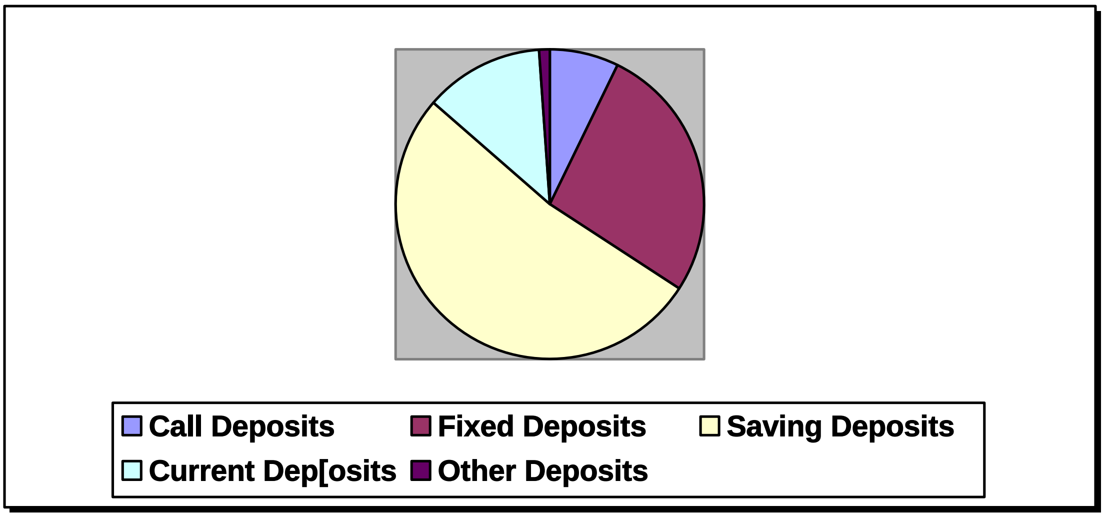


3. Deposit liabilities held almost two third of total liabilities over the period 2000-05. Deposits reached to Rs. 252409.8 million in mid-July 2005 from Rs.233811.2 millions ion mid-July 2004, with an increased of 8 percent. However, deposits as a percent of total liabilities declined in recent years. It has comedown to 61.4 percent in mid-July 2005 whereas these figures stood at 68.8 percent in mid-July 2004 and 74.0 percent in mid-July in 2000. Exhibiting declined trend, total deposits of banking system grew at a moderate rate of 10.25 percent per annum during 2000-05. It increased by 8.0 percent in mid-July 2005. The growth rate was 14.7 percent in the last year. Saving deposits, with increasing trend, held

major share in total deposits. In mid- July 2005, saving deposits gripped 51.50 percent on total deposits followed by current deposits 13.73 percent, fixed deposits 26.67 percent, call deposits 7.01 percent and other deposits 1.10 percent.

All components of deposits experienced healthy growth rate during 2000-05. Call deposits grew with the highest average of rate of 36.6 percent followed by saving deposits 14.62 percent, current deposits 11.26 percent and fixed deposits 1.6 percent during last five years. As compared to the figures of mid- July 2004, current deposits, saving deposit and fixed deposits increased by 2.72 percent, 13.89 and 3.36 percent in mid-July 2005. In 2004, these growth rates were 16.86 percent, 17.38 percent and 2.91 percent respectively. But call deposits decreased in mid-July 2005 by 2.10 percent as compared to the figure of mid-July 2004, whereas it had increased by 50.16 percent in 2004. Other deposits increased by 55.02 percent that of 2004.

Figure No.4.2 Credit Deposit ratio of Commercial Banking System



4. Non-deposits resources, which include capital and reserves, and borrowings, accounted only 5.4 percent of total liabilities in mid-July 2005. With an increase of 23.1 percent, it reached to Rs. 22006.2 million in mid-July 2005 from Rs. 17878.0 million that of mid-July 2004. It expanded with an annual growth rate of 16.9 percent over the

past five-year's period. This growth rate is higher than average growth rates of deposits and total liabilities of the same periods.

5. Liquid funds decreased by 17.0 percent and reached to Rs. 38369.4 million in mid-July 2005 from Rs. 46252.8 million in mid-July 2004. Liquid fund was Rs. 48240.0 million in mid-July 2000. On an average it declined at the rate of 4.48 percent per annum during 2000-05. On the other hand, investments increased by 27.35 percent per annum during 2000-05 and reached to Rs. 60181.0 million in mid-July 2005 from Rs. 17967.3 million that of mid-July 2000. Investments in mid-July 2005 were 27.35 percent higher than that of previous year, i.e. mid July 2004.

6. Growth of total loan and advances remained moderate in the last five years. Total loan and advances registered an average rate of 11.19 percent per annum during 2000-05 and reached to Rs. 163718.8 million in mid-July 2005. The outstanding amount of loan and advances was Rs. 140031.4 million in mid-July 2000. Loans to private sector always dominated on the overall outstanding figure of loan and advances. Of the total outstanding loans and advances of Rs. 163718.9 million, 96.02 was allocated to private sector, 1.5 percent to government enterprises, 2.39 to bills purchased and discount and 0.10 percent against bills in mid-July 2005.

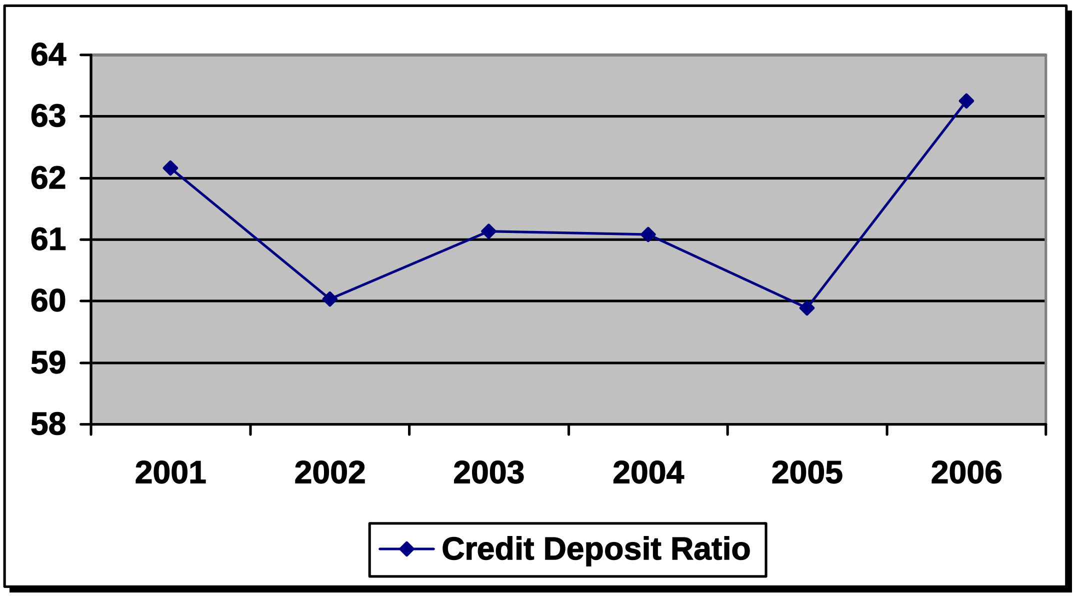
   Major portion of the loan portfolio of the banking system was distributed to productive sector, and wholesale and retail business sector. Credit to productive sector alone stood at Rs. 53743.5 million (33.73 percent of the total loan and advances) and credit to wholesale and retail business was Rs. 34412.3 million (21.60 percent) in mid-July 2005. Agriculture sector tapped only 2.77 percent of total credit in this period. Other major credit distributed sectors included service industries (9.41 percent), construction (5.47 percent), and transportation, communication and public services (5.65 percent).

6. With 49.79 percent increase, priority sector credit reached to Rs. 13499.24 million in mid-July 2005 from Rs. 9012.3 million mid-July 2004.Priority sector credit as percent of total credit stood at 8.25 percent in mid-July 2005 and 6.44 percent in mid-July 2004. Similarly, deprived

sector credit increased by 55.62 percent and reached to Rs.4367.91 million in mid-July 2005 as compared to Rs.2806.8 million in mid-July 2004. It had grown by 21.74 percent in mid-July 2004 as compared to mid-July 2003. Deprived sector credit amounted to 2 percent of total credit in mid-July 2005.

7. Credit- deposit ratio of the banking system did not undergo a noteworthy change during 2000-05. It remained 60 percent during 2004 and increased to 65 percent in mid-July 2005.

Figure No.4.3 Credit Deposit ratio of Commercial Banking System



The successful restructuring of two big banks resulted in better performance of whole commercial banking system. The banking system was experiencing a continuous losses trend during 2000-03 but it turned to post a net profit of Rs. 3707.48 million in mid- July 2005.

The net profit of the banking system further improved and reached to Rs. 5263.5 million in mid-July 2006.

8. Despite some improvement, the aggregate capital funds to total risk weighted assets ratio of the banking system remained negative even in mid-July 2005.The huge negative capital funds of two big banks namely RBB and NBL converted the total capital base of the banking system to be negative. The capital adequacy ratio stood at -4.46 percent in mid-July 2005 and -8.92 as on mid-July 2004.

Table 2.5.5A

Soundness Indicators of Commercial Banking System

Indicators	Mid-July				
	2001	**2002**	**2003**	**2004**	**2005****
Profitability (Rs.in million)*	-7843	-9428	-3317.25	3707.48	5205.31
NPA as Percentage of Total Loan*	29.3	30.4	28.7	22.8	18.85
Total Capital Fund as Percentage of RWA*	-5.49	-9.88	-11.74	-8.92	-4.46

* Excluding ADB/N

**Provisional Figures

9. With marginal improvement, the level of NPA and advances still stood at a significantly high level. The aggregate NPA to total ratio was 29.3 percent in mid-July 2001 and it reduced to 18.85 (Rs.28103.7 million) in mid-July 2005.

2.5.4.4 Global Development of NPAs

The core banking business is of mobilizing the deposits and utilizing it for lending to investors. Lending business is generally encouraged because it has the effect of fund being transferred from the unproductive or idle sector to productive sectors through banking system, which result into economic growth. However, lending also has credit risk, which arises from the failure/default of borrower to fulfill its contractual obligations either during the course of transaction or future obligations.

In the contemporary banking sector, a question that arises is how much risk can a bank afford to take? The result of recent happenings in the business world, such as, Enron, World Com, Xerox, etc. global crossing do not give much confidence to banks. The result of case after case, these giant corporate became bankrupt and failed to provide investors with clearer and more complete information there by introducing a degree of risk that many investors could neither anticipate nor welcome. The history of financial institutions also reveals the fact that the biggest banking failures were due to credit risk.

Due to this fact, banks are restructuring their lending operations to secured arenas only with adequate collateral on which to fall back upon on a situation of default.
(Source:http://www.indianinfoline.com/legal/feat/thle.html/)

The South East Asian Nations, which were known as “Asian Miracle” regarding economic growth faced great financial and banking crisis since the beginning of July 1997. The cyclone of financial crisis, which was known as “Asian Flu” in international financial sector resulted serious financial crisis to Indonesia, Thailand and South Korea. The banking sector’s short term capital investment to long term projects; especially to real Estate business, increase in NPA and people’s habit of extravagant or luxurious life style even by the amount of borrowings. (Ganesh K. Shrestha, Mirmire, Vol-1, 2055, Baisakh)

2.5.4.5 Credit Risk and NPA

Quite often Credit Risk Management, CRM is confused with managing Non-performing Asset, NPA. However, there is an appreciable emergence between the two. NPA are the result of past action whose affects are realized in the present i.e. they represent credit risk that has already materialized and default has already taken place.

On the other hand, managing credit risk is much more forward-looking approach and is mainly concerned with managing the quality of credit portfolio before default takes place. In other words, an attempt is made to avoid possible default by properly managing credit risk.

Considering the current global recession and unreliable information in financial statements there is high credit risk in the banking and lending business.

To create a defense against such uncertainty, bankers are expected to develop an effective internal credit risk models for the purpose of CRM.(http://www.indianinfoline.com/legal/feat/thle/html/)

2.5.4.6 Non-performing Asset, NPA in East Asia

Introduction

Three years have passed since the financial crisis hit Asian economies in July 1997. As a result, East Asian countries in 1998 recorded negative growth ranging from 5 to 12 percent. In 1999, however, economies improved in several countries South Korea in particular recorded a “V” type of recovery. Although the growth process has slowed somewhat in 2000, progress continues and on the basis of the recent rapid recovery, there is optimism that the East Asian financial crisis has ended. On the other hand, there is also the opinion that the situation doesn’t warrant optimism, as structural reforms, including NPA problems in the financial and corporate sectors, have not progressed sufficiently. This paper looks into the issues that beset East Asian Economies, based on the assessment of the current status of NPA restructuring in Malaysia, South Korea, Thailand and Indonesia.

Immediately preceding the Asian financial crisis, Japan was tackling an NPA problem that resulted from the bursting of the so-called bubble economy in 1990. Economic depression has continued for nearly ten years since then, and the Japanese economy has yet to get back the track sustainable growth. The chief cause of this crisis, in a nutshell, was that the government did not take measures to deal with NPA in a timely manner. Cooperative Credit Purchasing Company was launched in 1993 to buy NPA, and the Housing Loans Management Company was set up in 1996 to deal with the problem of housing-related NPA. These efforts were inadequate and the real solution had to wait for large-scale public funds that were made available to financial institutions in March 1998, eight years after the bursting of bubble economy. The process of resolving NPA in Japan was indeed too little, too late. Japan adopted the policy of waiting for the economic environment to take a favorable turn, instead of taking swift, decisive action.

On the other hand, many East Asian countries addressed the problem of NPA rather swiftly. South Korea, for example, immediately injected large amount of public funds into financial institutions. Three years after financial crisis, the solution to NPA is progressing relatively well in South Korea and Malaysia, while Thailand and Indonesia are lagging behind. To solve the issue of NPA, it is necessary to make structural improvements, especially in the financial system and corporate governance that actually caused the NPA problems.

The economic growth rate in each of these countries is projected to register a downward trend in 2000, compared to the previous year, and the current account surplus is diminishing. Since East Asian economies depend heavily upon the US economy, its current slowdown will be a damper to these countries' recovery. It is therefore necessary to analyze the current status of NPA problems, financial restructuring and corporate governance to make sure they can cope with adversely changing economic environments.

Private Debt as Main Cause

The main characteristic of the external debt of East Asian economies was the large amount of private sector debt. As opposed to this, the main characteristics of the external debt issue in Latin America, beginning with Mexico in 1982, was the huge amount of public debt owed by governments to foreign banks. Many South American governments couldn't raise funds from the market, as the economic fundamentals of public finance, current account balance and inflation deteriorated, leading to their failure to repay their debt. In comparison, the fundamentals of East Asian economies were rather strong compared to Latin American nations in the 80s.

Many of the East Asian governments closed down unhealthy financial institutions soon after crisis occurred, while public funds were made available to those that were allowed to continue. The South Korean and Indonesian governments provided guarantees on deferred external debts in agreements with foreign banks. The Thai government declared that it would not close down bank, in order to maintain credit lines from banks. All the governments with the support of the IMF maintained a policy of not bailing out corporate debt. The Miyazawa plan of US$30 billion also did not cover facilities to private companies.

Status of Bad-Loan Measures

The policies adopted by South Korea, Malaysia, Indonesia and Thailand to deal with the problem of NPA were as follows:

- Establishment of assets management companies to gather NPA
- Allocation of public funds to banks and other financial institutions
- Creation of a framework for the promotion of autonomous, non-courtroom negotiations between creditors and debtors

These governments either revamped existing organizations, or created new ones to implement the above policies in 1998. Further, in Thailand and Indonesia, it was necessary to revise bankruptcy laws, since they were not functioning properly. For this reason, negotiations between creditors and debtors were delayed. For both countries it was only in 1999 that revised bankruptcy laws were created, contributing towards smoother negotiations between creditors and debtors on NPA.

Three years after the crisis, differences in their growth chart are beginning to emerge. The quarters in which the NPA problem was adequately treated and restructuring of NPA started to make significant progress and the trend in their bad loan ratio (bank credit in arrears for over three months) are indicated below.

	Malaysia	South Korea	Thailand	Indonesia
A.M.C.	1998/3q	1998/1q	None	1999/2q
Funds infusion	998/3q	1998/1q	1999/1q	1999/3q
Promotion of NPA negotiations	1998/4q	1998/2q	1999/2q	2000/1q
Bad Loan Ratio (%)				
1999 (Mo)	18.1 (6)	8.4 (6)	47.7(5)	58.7 (3)
2000 (Mo)	11.2 (2)	8.4 (1999/12)	31.3(7)	NA

As seen from the above Malaysia and South Korea have taken the lead, whereas Thailand and Indonesia have lagged behind, especially, Indonesia which began to address this problem only in 1999.

Thailand is yet to set up an assets management company (AMC). Further, the NPA ratio of bank is comparatively low in South Korea and Malaysia, but in Thailand it is currently around 30 percent, despite a small decline, and in Indonesia it is said as high as before. Let us briefly look at the steps taken by individual countries against NPA.

Malaysia:

The measures taken by the Malaysian government were against NPA were swift and strong. Originally, the external debt of companies was not large, and the debt capital adequacy ratio was relatively low. Further, since the Company Act of 1965 was relatively well structured in comparison to Thailand, out-of- court settlement progressed relatively smoothly under the Bankruptcy Act. Danaharta, the AMC, completed purchase of NPA by December 1999, and the NPA ratio fell to 11.2 percent by February 2000. Danamodal, the organization for the infusion of public funds, has pumped Ringgit 6.4 billion (equivalent to US$2 billion) into 10 banks so far and already six of them have repaid their debt amounting to US$ 600 million. Therefore, the capital adequacy ratio of banks had improved to 12.8 percent in March 2000. The Corporate Debt Restructuring Committee, an organization promoting out-of court restructuring, entered the field somewhat late, but by March 2000 there were 68 applications totaling US$9.5 billions. All debt restructurings are scheduled to be settled by September 2000, including transfer to Danaharta.

The Malaysian Central Bank has taken initiative to settle NPA problems by year-end. The authorities will also restructure financial institutions, consolidating them into around 10 groups that will be completed within this year. Since it is necessary to open up the domestic market by 2003, per the arrangement with the WTO, the government needs to strengthen the competitive edge of banks. Since Malaysia has not resorted to IMF loans, its financial reforms may not be as forceful as other countries and there is concern that it may have undergone only partial structural changes in the financial system and corporate governance.

South Korea

Like Malaysia, the South Korean government took immediate steps against NPA. The Korea Asset Management Corporation, which was set up in December 1997, has settled NPA worth 35 trillion won (US$57.6 billion) and recovered 18 million won (US$16.2 billion). Further, the government initially decided to provide 64 trillion won (US$ 7.6 billion) in public funds, but made fresh allocations, so far pumping 89.6 trillion won (US$ 107.7 billion) in public funds into the banks and non-banking financial institutions. As a result, bank lending started increasing in May 1999.

The process of out-of-court negotiations between creditors began somewhat late; it was in June 1998 that a framework targeting 73v medium and small business was agreed upon. With regard to five large business conglomerates, the government has carried out reforms based on five principles: enhanced transparency, withdrawal of financial guarantees, and improvement of financial structures, business restructuring and strengthening of managerial responsibility. The cross financial guarantee within a business group (equivalent to US$ 20 billion as of December 1997) was resolved to a great extent by March 2000, but the debt capital adequacy ration (target below 200%) is yet to be improved. (As on December 1999, it stood at 359 percent for four business conglomerates, on a consolidated basis). In July 1999, Daewoo went bankrupt, and the Hyundai group is currently in the process of dismantling due to the inadequate liquidity of Hyundai Construction. The pace of improvement varies group to group, but on the whole, reforms of large business by the government are behind original schedules.

Thailand

The process of settlement of NPA is delayed in Thailand, primarily because the government's response has been rather weak. It did not adopt a centralized solution to NPA, but rather encouraged each bank to set up and transfer NPA to its assets management company. By this method, where valuation is depreciated at the time of transfer, there is the risk of not doing enough or delaying the transfer, since it is left to the discretion of individual banks. In addition, the actual amount of public funds made available was less than banks needed. As a result, the solution to the problem of NPA has been delayed and lending has not yet picked up.

A framework for corporate debt negotiations outside court was set up in September 1998, but revision of the bankruptcy Act was left pending before the upper house for as long as one year. Bankruptcy court began to function in the third quarter of 1999 and by June 2000, 553 large cases worth US $ 23 billion were reorganized. Nevertheless, the whole process has been lagging behind.

In Thailand, it is not usual to settle matters before a court of law. There is strong public resistance to pumping public funds into a particular financial institution, and dislike of official interference in management when a public fund infusion is made. Unless the government overcomes these obstacles, a quick solution to Thailand's NPA problems will be elusive. According to an announcement by the Bank of Thailand, between October 1999 and February 2000 NPA worth 343.33 billion baht were reduced based on the agreement for restructuring of NPA, but fresh NPA worth 201.3 billion baht were also generated. Further, as a result of reorganization, loans that were regarded as healthy became bad; such loans totaled 55.8 billion baht. But loans that were settled once, but turned bad imply that the restructuring process has not carried out properly.

Indonesia:

Among the four nations cited here, Indonesia was most seriously affected by the Asian economic crisis, and many of its banks became insolvent. Despite the pumping in one of large amount public funds-including emergency loans by the central bank-the road to recovery is still long, and solution to the NPA problem has been most delayed among the four East Asian countries. The Indonesia Bank Restructuring Agency (IBRA) was established in January 1998, to pool NPA and to infuse public funds. It presently holds NPA worth 625trillion Rupiah. A breakdown includes: share of corporate real estate worth 125 trillion Rupiah collected from the owners of 28 banks (later nationalized) that received emergency funding from the central bank; NPA of national/nationalized or liquidated banks worth 250 trillion Rupiah, and share of banks worth 250 trillion Rupiah, taken over as a result of capital allocation. In short, a considerable amount of inferior quality loans I included. One year after its inception, IBRA countries to be bogged down by politics, and there was scarcely any progress in the resolution to NPA in 1999.

IBRA started its activities after President Wahid's government assumed office in November 1999, and when Mr. Chachuk became its President in January 2000. A basic agreement to restructure 35 percent of IBRA's top debtors was reached with the IMF in J8ne 2000, and it is believed that the 21 top debtors account for one-third of total NPA of 250 trillion Rupiah. All are either related to the Suharto family or their followers. The problem of NPA in this country is complicated, since it involves political as well as economic issues.

The Jakarta Initiative began in charge out-of-court settlements, was set up in January 1998. It began to function only in the first quarter of 1999, after it was reorganized as the Jakarta Initiatives Task Force, and given legal sanction following the promulgation of the revised Bankruptcy Act. It is said to have settled 57 NPA cases worth US$3.3 billion in 1999. Foreign banks, which provided loans to relatively better companies, have settled in many cases through negotiations with individual debtors, without going through the Jakarta Initiatives Task Force.

Future Issues

There is no other or effective method other than to solve problems through government initiative. South Korea and Malaysia achieved positive results through powerful government intervention. On the other hand, the absence of separation between management and capital, along with aversion to government intervention in some cases (such as family-managed companies in Thailand), has delayed the process of recovery. In Indonesia, political reforms were given precedence over the resolution of NPA. More over, a large number of NPA held by local and national banks, which were transferred to IBRA, are of inferior quality. The occurrence of scandals related to NPA has further complicated the matter, and resolution ha been delayed further. It is feared that the NPA problem may delay the economic recovery in countries like Thailand and Indonesia**.**

To solve NPA problems and to inject capital into banks, many countries except for Malaysia had to incur a financial burden that exceeded the cost originally estimated. In Indonesia, public funds provided to financial sector-focusing on national banks-amounted to 650 trillion rupiah (US$87 billion). The combined external and public debt of Indonesia has jumped to US$ 150 billion. While recovery rate of NPA in Malaysia is over 60 percent, in Indonesia it is estimated to be much lower, since the loans held by IBRA are of inferior quality.

As seen in Thailand's case, the fact that once-restructured loans became bad again calls for caution. This occurs when an "easy" approach is taken towards corporate restructuring. It is often the case that financial restructuring is carried out by simply extending the loan period, and there may be a number of doubtful cases where restructuring has been carried out without strict cash flow management. Even in Malaysia, it has been said that simple extension of the loan period is the main method used, while debt equity conversion and changes in management is hardly seen. As compared to other regions such as Latin America, there are few instances of conversion of debt into equities. According to the accounting practices of some East

Asian countries it is believed that once NPA are restructured, they may be recognized as healthy loans that do not require reserves. Therefore, there may be cases where banks and creditors have entered into problems may simply be deferred. Though it is not easy to grasp the details of corporate restructuring, it is necessary to pay attention to the fact that the decline in NPA does not necessarily mean that the real amount of NPA hasn't been reduced. Five Thai banks and two South Korean banks have been sold to foreign investors. In Thailand, as a result of a build-up in capital through the stock market instead of infusion of public funds, it is said that acquisition of shares of big banks by foreigners has taken place in a significant manner. In Indonesia, as seen in the failure by a foreign bank to buy out Bank Bali, acquisition of banks by foreign capital has not succeeded. In Malaysia, there are no instances of acquisition of Malaysian banks by foreign capital. In Latin America, as a result of opening its market acquisition of banks by foreign capital is quite common, but it is still limited in East Asia. In Thailand and South Korea, management of banks based on foreign capital will prove to have a positive impact on the local financial system.

Although the process of recovery has been delayed in Thailand and Indonesia, considerable progress is expected in the coming one to two years. It is vital to reform the structural elements that caused NPA problems. Some NPA in Indonesia resulted from business practices based on the connection, bribery, and lenient credit screening by banks. Fundamental changes are necessary to correct such system. Revamping financial supervisory systems concerned with the health of bank management, introduction of a strict accounting system and transparency at the managerial level is necessity. Moreover, improvement in corporate management should be advanced under government initiatives backed by public support. Whether or not East Asian economies can strengthen their capacity to cope up with future financial crisis depends very much upon whether or not East Asian countries succeed in their challenge to reform their banking and corporate structure.

CHAPTER III
RESEARCH METHODOLOGY

3.1 Introduction

Research methodology is a systematic way to solve the research problem. In other words, research methodology describes the methods and process applied in the entire aspect of the study. Research methodology refers to the various sequential steps (along with a rational of each steps) to be adopted by a researcher in studying a problem with certain objectives in view (Kothari,1994:9) .Thus the overall approach to the research is presented in this chapter. This chapter consists of research design, sample size and selection process, data collection procedure and data processing techniques and tools.

3.2 Research Design

The overall plan of the proposed study is made to specify the appropriate research methods and procedures for obtaining specific findings as objectively, accurately and economically as possible. The planning of subject matters studied are balance-sheet, profit and loss account, loan classifications and their provisioning, of sample selected banks and the directives issued by NRB regarding the loan classifications and their provisioning matters.

The populations of the study are taken the whole banks in the banking operations while samples are taken Everest Bank Limited, EBL and the Machhapuchhre Bank Limited, MBL.

As per the nature and requirement of the study, descriptive research design is adopted with analytical approach.

3.3 Sources of Data

The major portion of the data collected is from the secondary sources. The sources include the published annual reports of concerned banks, the different periodical publication of Research Department and Bank and Financial Institutions Regulation Department of NRB as well. The different websites related to the required data are also visited during the data collection.

3.4 Population and Sample

All the licensed 25 commercial banks are considered as the total population of the study. Out of them, those, which are being operated with their corporate office or head office located in Kathmandu valley, are considered as the target population for the study. During the time of this study, total of 25 commercial banks are being operated as licensed NRB. Among them only 18 commercial banks are carried out their function with their head office in Kathmandu valley. Including 25 commercial banks with their head office in Kathmandu and the Machhapuchhre Bank, MBL with its corporate office in valley are considered as the targeted population of the study.

The total population, target population and the sample drawn are the following table.

Table 3.4.1

Total Population, Target Population and Sample Drawn

SN	Total Population	Target Population	Sample Drawn
1.	Nepal Bank Limited	Nepal Bank Limited	Everest Bank Ltd.
2.	Rastriya Banijya Bank	Rastriya Banijya Bank	Machhapuchhre Bank*
3.	Nabil Bank Limited	Nabil Bank Limited	
4.	Standard Chartered Bank Ltd.	Standard Chartered Bank Ltd.	
5.	Nepal Investment Bank Ltd.	Nepal Investment Bank Ltd.	
6.	Himalayan Bank Limited	Himalayan Bank Limited	
7.	Nepal SBI Bank Limited	Nepal SBI Bank Limited	
8.	Nepal Bnagladesh Bank Ltd.	Nepal Bangladesh Bank Ltd.	
9.	Everest Bank Ltd.	Everest Bank Limited	
10.	Bank of Kathmandu Ltd.	Bank of Kathmandu Ltd.	
11.	Kumari Bank Limited	Kumari Bank Limited	
12.	Siddhartha Bank Limited	Siddhartha Bank Limited	
13.	NCC Bank Limited		
14.	Lumbini Bank Limited		
15.	NIC Bank Limited		
16.	Laxmi Bank Limited		
17.	Machhapuchhre Bank Ltd.	Machhapuchhre Bank Ltd.*	
18.	Agricultural Development Bank	Agricultural Development Bank	
19	Sunrise Bank Limited		
20	Global Bank Ltd		
21	Citizen Bank International Ltd		
22	Bank of Asia Nepal		
23	Prime Commercial Bank Nepal		
24	DCBL Bank Ltd.		
25	NMB Bank		

(Source: Nepal Rastra Bank, Banking and Financial Statistics, Mid January, 2008)

3.5 Data Collecting Procedure

The study is based on the secondary data. So they are collected directly visiting the head office of the concerned banks. For this purpose the annual published report of the concerned banks are utilized and gathered the necessary data. Similarly quarterly Economic Bulletin, the publication of the Research department and the Banking and Financial Statistics the publication of Bank and financial Institutions department of NRB also are used during the data collection. The websites of the concerned banks also were visited in the course of data collection.

3.6 Data Processing Procedures

At first the raw data are collected from the various sources, which include the annual financial report of concerned banks, the various publications of NRB and the relevant websites of concerned banks. They are classified as per the nature of the study and in accordance of the data. The tabulation is specially made on the basis of their consequent three fiscal year's data available and need base headings; such as performing loan, total NPA, substandard loan, doubtful loan and bad loan. The tabulation mainly contains the calculation of the percentage of required variables, as it is needed. The tabulation also comprises the total assets, total deposits, total lending, calculation of the return on total assets and the return on shareholder's equity. Simple percentage tool is used as arithmetic tool and Karl Pearson's coefficient of correlation as a statistical tool.

3.7 Research Variables

As the study was mainly based on the NPA, the level of NPA in different parameter was the major research variable. Except NPA, this study also focused on the level of Performing Assets, effect of NPA on ROA and ROE of concerned banks. Other research variables used in this study are total deposits, total lending, total assets and Loan Loss Provision.

3.7.1 Total deposits: The amount of total deposits in the sample selected banks.

3.7.2 Total Lending: Total loan and advances and amount of bill purchased and discounted of the sample selected banks are studied as total lending.

3.7.3 Total Assets: Total assets of the banks comprise all the assets of balance sheet item excluding preliminary expenses, profit & loss A/C (Dr.) and other fictitious assets (goodwill etc.).

3.7.4 Net profits: Profit earned during the normal course of bank's operation (which includes profit or loss from bank's extra-ordinary items) after tax and other mandatory provisions required as per bank's policy. It is profit finally remained for appropriation purpose (dividend and other general reserve)

3.7.5 Loan Loss Provision: Loan loss provision is the amount charged to profit and loss account against the revenue due to credit risk involved in loan and advances disbursed by banks.

3.7.6 Performing Assets/loan: Performing assets/loan are those loan and advances where interest and principal are regularly served as per the repayment commitment of the loanee.

3.7.7 Non- Performing Assets, NPA: Performing assets/loan are those loan and advances where interest and principal are not regularly served and defaulted as per the repayment commitment of the loanee.

3.7.8 Returns on shareholder's Equity: The shareholder's equity comprises share capital, general reserves, profit & loss a/c and other reserves. In other words it is total assets - outside liabilities. Return on shareholder's equity is calculated as follows,

=Net Profit before Tax/shareholder's equity*100

3.7.9 Returns on Total Assets: return on total assets measures the utilization level of assets. In other words it shows how well a bank is utilizing its assets in business. Returns on total assets is calculated as follows,

= Net profit Before Tax/Total Assets*100

3.8 Statistical Procedures

Simple coefficient of correlation is used to find the correlation between return on ROA and NPA and correlation between NPA and ROE as a statistical tool.

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CHAPTER- V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

Although this chapter is the important chapter for the research because this chapter is the extracts of all the previously discussed chapters. This chapter consists of mainly three parts: Summary, conclusion and recommendation. In summary part, revision or summary of all four chapters is made. In conclusion part, the result from the research is summed up and in recommendation part, suggestion and recommendation is made based on the result and experience of thesis. Recommendation is made for improving the present situation to the concerned parties as well as for further research.

5.1 Summary:

Although banking is a service, it has been a great business to the entrepreneurs in modern age. A commercial bank does the same business to earn profit by its transaction. Generally, commercial bank does the functioning pool between the saving communities and need group of the society. They accept deposit from the public on the condition that they pay the deposit on demand or on short notice. The banks mobilize the funds to different need group on their demand of loan. Apart from accepting deposit, banks are engaged in the exchanging currency, operating other commercial transactions viz. purchase and discount of bills other financial instruments. Among the many items of transactions of the bank, accepting deposit and lending or giving loan and advances occupy major space in its transaction. So bank’s major concern is found to be concentrated on the loan.

The ancient history of banking dates back to Bank of Venice, Italy, in 1157 A.D. Till the modern age, there has been various types of banks, which carry out the banking transactions. The first commercial bank established in Nepal is Nepal Bank Limited, 30th Kartik, 1994. At present there are eighteen commercial banks carrying out their function in the country.

The asset of commercial banks indicates the manner in which the funds entrusted to the bank are employed. The successful working of the bank depends upon the ability of the management to distribute the fund among various kind investments: outstanding loan and advances, investment on shares, debentures and bonds, bill purchase and discount etc. make assets as a whole. Among them loan and advances are the most profitable assets of a bank. These assets constitute primary source of income to the bank. Being a profit making business institution, a bank aims at making huge profit. Since loan and advances disbursed against transparent and clear agreement of interest, they are the most profitable business to the banks which is snot certain in case of investment on share and others instruments. So bank is always willing to invest on loan and advances as much as possible. But it is not so easy to earn by lending and bank has to pay more attention to safety of the disbursed loan and advances. If a bank is too much timid, it may fail to obtain the adequate return on loan able fund, which is confined to it for use. On the other hand, if the bank is too much liberal, it may easily impair its profits with the increment of bad debts or non-performing loan. Therefore, banks should keep in mind the fact that most of the bank failures in the world are due to shrinkage of loan and advances.

Despite being more profitable than other assets, loan and advances carry more risk of non-repayment to the bank. Such risk is known as credit risk or default risk. The outstanding loan and advances of the bank can be classified into two classes: performing assets and non-performing assets. The loan and advances which are not overdue or overdue up to three months are performing loan or pass loan, which are known as performing assets. Where as the loan and advances overdue for more than three months are non-performing loan and they are classified into substandard loan, doubtful loan and bad loan according to their overdue aging period. Loan become non-performing while the principal and its interest amount is not paid back by the borrower to the bank for above stated period. Since NPA is not paid back its interest and principal to the bank, it could wreck banks' profitability both through loss of interest and write off of the principal loan amount. Since loan occupies major space in the assets of the bank, it is synonymously used to the assets in banking literature. Hence in narrow sense, non-performing loan is known as NPA. Performing assets have multiple benefits to the banks as well as to the whole economy while non-performing assets erode even existing capital of the bank.

The existing level of NPA has been great problem in the contemporary banking business of the world. In this context, Nepal can't remain exception of the NPA problem. The level of NPA in Nepalese banking business is quite alarming. It is widespread fact that the bank and financial institution in Nepal are facing the winding problem of NPA and it is challenging even in the future. The latest figure of NPA as of mid-Jan 2006 as mentioned by Mr. M.P. Adhikary, the Director of N.R.B. is Rs. 29.06 billion which is equivalent to 18.19 percent of the total loan. It is a great figure regarding the prudential level of NPA that should be below 5 percent. It is even worse in the case of public sector banks: NBL and RBB which posses around 50 percent NPA till mid-Jan 2006.

Since the level of NPA has been widespread issue in the contemporary banking industry, this study was concerned to find out the level of NPA and its effect on ROA and ROE of Nepalese commercial banks. Due to time constraint and consult to the guide to this thesis, only two commercial banks: the Everest Bank Limited and MBL are selected as sample bank and study was focused on their financial statistics.

Being the apex supervisory and regulatory authority of banking sector, NRB has issued directive regarding the outstanding loan of the banks. According to these directives, a bank has to classify its loan into pass loan, substandard loan and bad loan on the basis of their overdue aging. As classified in this directive, pass or non-overdue loan is known as performing asset while substandard, doubtful and bad loan are known as non-performing asset.

Between the two samples selected banks, both of the banks have similar status regarding the level of NPA. The level of NPA in these banks is below 5 percent till the three consequent years. Though this level found little fluctuating, it is within the acceptable limit below 5 percent and around 1 percent.

5.2 Conclusion:

- The level of NPA to total assets in EBL at the end of fiscal year 2062/63 was 1.38 percent. It decreased to 1.09 percent at the end both fiscal years 2063/64 and 2064/65. It is encouraging NPA level and no alarming situation regarding it. Similarly, the level of NPA to total lending at the end of fiscal year 2063/64 was 2.20 percent. It reduced to 1.72 and 1.63 percent at the end of fiscal year 2063/64 and 2064/65 respectively. The decreasing trend of NPA to its marginal level is quite encouraging in this bank. The level of NPA to total deposit at the end of fiscal year 2062/63 in EBL was 1.66 percent. It decreased to 1.29 percent and 1.28 percent at the end of fiscal year 2063/64 and 2063/64 respectively. The small fluctuation in the level of NPA towards the marginal level is not so serious. Till the date of study, it concludes that the bank is cautious of managing its loan in prudent manner. This result indicates that there is good corporate governance in the bank, which won the first position in overall CAMELS rating by NRB at the second quarter of fiscal year 2064/65.

- The level of NPA to total lending in MBL at the end of fiscal year 2062/63 was 2.08 percent. It increased to 0.98 percent at the end of fiscal year 2063/64 and decreased to 0.39 percent at the end of fiscal year 2064/65. The fluctuation of NPA is within the acceptable level and the trend is not so alarming till the date of study. The level of NPA to total asset in MBL was 1.30 percent at the end of fiscal year 2062/63. It decreased to 0.72 percent at the end fiscal year 2063/64 and to 0.31 percent at the end of fiscal year 2064/65. Similarly, the level of NPA to total deposit in this bank was 1.75 percent at the end of fiscal year 2062/63. It decreased to 0.91 percent at the end fiscal year 2063/64 and further decreased to 0.36 percent at the end of fiscal year 2064/65. There is decreasing trend of NPA in the bank towards the marginal level. So it concludes that the bank is cautious of managing its loan in prudent manner till the date of study. The bank seems to implement the directive of NRB in prudent manner and indicates that there is good corporate governance in the bank.

- NRB as supervisory and regulatory authority of Nepalese banking sector has issued directive regarding the outstanding loan and advances of the bank. According to this directive, a bank has to maintain the provision against the classification of its loan. The directive has made provision of 1 percent against pass loan, 25 percent against substandard loan, 50 percent against doubtful loan and 100 percent against bad loan. The loan loss provisions made by both of the sample banks are enough till the date of study. This result concludes that there is good compliance of NRB directive in both of the banks.

- Finally, we can draw the conclusion that there is no alarming situation of NPA in the sampled banks till the date of study. But external as well as internal forces are always responsible for the transaction of the banks. So there is no situation of keeping themselves quiet in their transactions. The outstanding loan may get changed into bad loan within the days to come. So the banks should keep them alert towards up to date repayment of the loan. For this they have to visit the running projects whether they are operating well or not, where they have invested.

- The crux of this study is that the high degree of negative correlation of the banks between the NPA and ROA or NPA and ROE indicates towards the inverse relation between NPA and ROA or NPA and

ROE. It means that the level of NPA effect the ROA and return on ROE. That is why it is always necessary to reduce the level of NPA to increase the ROE and ROA. The true fact that should always keep in mind by the banks is, reducing the level of NPA, maintains your sound financial health.

5.3 Recommendations:

According to major findings and conclusion some suggestions are made as follows.

- Loan is commonly disbursed against enough collateral by the borrower. Such collateral may be fixed asset or the business oriented firms or projects. Sometimes it happens that the fixed assets are overvalued and other situation arise that the fair financial status of the borrower and his firms are not well assessed. In such situation the borrower fails to repay the loan to the bank. So bank should properly analyze the financial position of the borrower and carry out the valuation of the collateral to be kept against the loan.

- Loan sanction is a risky work since it has to face many technical as well as legal procedures. Good corporate structure with enough staff will help to reduce the risk that may arise from the operational and procedural function of the loan. The lapses in the legal and technical aspects may cause the growth of NPA in the banks since the loan might be sanctioned with low assessment of the projects. So enough staff and good corporate structure helps to reduce the level of NPA in the banks.

- The determination of NPA itself is under the legal and regulatory provision issued by the concerned authority. Therefore, the banks always should make compliance with the regulation issued by the supervisory and regulatory authority. The violence of the regulation weakens the loan management system and results in the growth of NPA in the banks. E.g. single obligor limit, sector limit etc controls flow of huge loan to the same person or sector.

- Well trained and professional managers can handle the functions of loan in good way. Having the power to oversee the market risk and analyze future trend of the business; their own or client's, can manage the loan in well productive way. So training is need for existing managers and staffs and new man powers who can tackle with such challenges should be introduced to the banks. Similarly, corporate governance also helps to manage the loan in sound way. The loan sanction without influence by the Executive chief or directors and in real ground can give good return to the bank. Similarly, the internal auditor should fairly point out the errors committed by the directors or executives of the banks.

- In most of the traditional banks in Nepal, risk identification, measurement, mitigation and control are poor. Therefore, appropriate credit risk management should be introduced in the banks so that the level of NPA will be reduced. Similarly, the supervisory authority's concentration is focused on least priority areas without proper consideration of risk identification and its management in to the bank that causes the growth of NPA.

- There are some such projects which are very much violable in their paper projects but very poor in their business. They have widespread new plan and projects but no certain scope of their future. The loan disbursed to such projects can not repay its principal and interest and changes into NPA very soon. So the banks should invest in them only after proper risk mitigation whether that they are violable in their business or not.

- It is found that big borrowers' borrowings from the banks are changed in to NPA. The borrowers influence the political leaders as well as administrators and don't pay the loan even though they are already NPA. Therefore, the political leaders and administrators should be far from the influence of borrowers to enforce the law made for the recovery of bad loan. Similarly, an ethics should be developed in the borrowers and society for the timely recovery of loan to the banks. The borrowers should be aware of the facts that the loan is the lump of small savings from the people.

- The high level of NPA in the country is still in alarming level. It is the not only the problem of an individual bank but also for the whole nation. Therefore, the government should establish an Asset Management Company, AMC, which can handle the whole NPA in the country. Similarly, an NPA management wing within the institution can help to reduce the NPA in the bank. In the lack of AMC and proper counseling to them, some of the violable companies are also collapsed in the country and contributed to the growth of NPA. E.g. Necon Air wouldn't be closed if there was proper counseling on time.