

**"A Study of Risk and Return Analysis
OF
Commercial Banks in Nepal"
(A Case Study)**

**A Thesis Proposal
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This research study on –Risk and Return analysis of commercial banks in Nepal which is a partial fulfillment for MBS program is based on the research entailing the use of statistical tools and descriptive analysis to explain the risk and return characters of the commercial Banks. This study depicts the basic feature of stock market in relation with the risk and return characteristics of the commercial banks. Measuring the total risk then systemic risk along with the realized rate of return and required rate of return. Source of data is secondary.

This research is spread over six parts. The first chapter part deals with the introductory part; the second one doses with the research methodology, the third part is related with the review of literature, the fourth part with the data presentation and analysis, the fifth and six part, finally briefs with the major findings and recommendations.

First of all, I consider if may privilege and fortune to get an opportunity to work under the able guidance of Professor Mr. Sanjay Shrestha , Professor of Thakur Ram Multiple Campus ,Birgunj. Despite having the hectic schedule, their guidance gave me the inspiration and encouragement to complete this research work, I also would like to record my indebtedness to all the previous thesis researcher by the help of their references and all other friends whose support was very essential for completeness of this thesis.

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Background

There are various factors that are inhibiting the economic development of the country. The per capita income is very low, which remains about US\$ 242 and recorded as the least developed country of the world. The open border with India and the trade policy of India affect Nepalese economy in one or other way. Though tourism industry seemed good as a foreign currency earner, recent political instability at home and in the international stage have direct impact upon this industry. In the last few years, basically after the restoration of democracy (1990) in the country, the government's move towards liberalization and privatization have paved the way for economic growth and the resultant effect has been positive. The continuing thrust to the private sector in the process of national development has helped in establishing many banks, financial institutions and industries under joint venture arrangements.

Capital formation is one of the most important and basic factors for overall economic development. In fact, capital accumulation may be regarded as the core process by which all other aspects of development are possible. The level of capital formation depends upon the level of saving and its mobilization. The trend in recent days in declining interest rates, high inflation and slow growth in per capita income have so far depressed the private saving rate in Nepal. At the same time, public sector saving has also not been improved. The vicious circle of low income, low savings and low investment, which is the key responsible factor for low growth rate of the country, enhances the need for vigorous efforts to increase the level of saving. Saving mobilization and effective credit management system is a must for economic development especially for a country like Nepal where the growth rate is very low. However, the banking and financial system can play a vital role in accelerating the pace of economic development of the country through the mobilization of scattered savings and channeling it in the real sector of the economy. In this regards, the role of capital market would be to give more focus on the efficient and effective savings mobilization and capital formation so as to contribute substantially in the economic development of the country.

The history of modern banking now started after the establishment of Nepal Bank Ltd., the first-ever bank in the country in 1973 A.D. Only the Nepal Bank Ltd. was not able to provide required services all over the country. With the political freedom in 1951, a planned development process has been started in the country that leads to the formulation of first development plan in money supply and help banking development in the country. As such, Nepal Rastra Bank, the central bank of the country was established in 1956 under the Nepal

Rastra Bank Act. 1955.

The role of financial institutions has been instrumental in the overall economic development of the country. Financial systems help pool and utilize resources, reduce costs and risks, expand and diversify opportunities, increase the allocate efficiency of resources, and promote the productivity and economic growth. Larger accumulation of financial resources and efficiency in financial intermediation are essential for promoting investment, productivity and economic growth. Nepal's rising development requirements also call for greater proportions of financial resources being available at the required size, price, modality and place which is served by financial system.

As a precondition to economic liberalization, the industrial Enterprise Act was enacted in 1982 and Foreign Investment and Technology Transfer Act came into effect since 1983. Since 1985 Nepal has been following liberal economic policy. In its first stage of implementation, banking and financial sector was liberalized. A policy to invite foreigners to invest jointly with the domestic investors in the banking and financial sector was introduced. Finance Companies Act, 1986 was also enacted with a view to provide non-banking services to the people in order to promote their economic benefit in general through institutionalized investment. Accordingly, many banks and finance companies were incorporated in the private sector and listed in the securities exchange center. Nepal Rastra Bank liberalized the regulation of interest rate and endeavored to reform and strengthens the financial sector by implementing various prudential financial norms like income recognition, loan classification, and maintenance of adequate loan loss provisions, reserves and capital adequacy ration and liquidity portion of the banks and finance companies. The industrial policy of 1988 introduced various reforms in order to encourage the establishment of corporate enterprises and guaranteed the non-nationalization of private sector industrial organizations As a result, the establishment owned bank in operation till 1984. The recent boom in the established government owned commercial bank the opening of the stock exchange, reserve requirements branch expansion and many others are the manifestation of the adoption of new and more marker oriented policies by the government.

The financial system of Nepal comprises of the central bank, viz. Nepal Rastra Bank, 19 commercial banks, 4 specialized Development banks, 5 Rural development banks, 45 finance companies, 2 contractual saving institutions, Viz. employees provident fund and citizen investment trust, deposit Insurance and credit guarantee corporation, credit information bureau {CIB}, Nepal Stock Exchange {NEPSE}, Stock Exchange Board, 12 Insurance Companies, 29 Cooperatives, 30 NGO's and postal Savings Banks. This stand denoted to risk and return analysis of some of these enterprises.

Primary Market

Before the establishment of the Securities Exchange Centre (SEC) there was no any institutional arrangement to undertake new issue and manage the sales of the shares and debentures of the corporate bodies. A public limited company could make public offering according to the provisions of the Companies Act. 1964. When the SEC came into existence, it started managing new issues of shares and debentures according to the guidelines for new issues and sales management 2043 (1986).

Secondary Market

The corporate bodies were required to list their shares and debenture in the SEC in order to qualify for the trading. However, the government bonds issued under the National Debt Act were exempted from such compulsory-listing obligation.

Securities Exchange Act 1983 made it obligatory to trade the securities through the recognized Centre or through their licensed brokers. Therefore, the securities Exchange Center opened its floor for secondary trading of corporate shares in November 1984. Before this, the SEC was restricted to the trading of Government Bonds.

Along with the formation of Security Exchange Board, His Majesty's Government converted the Securities Exchange Centre Ltd. into Nepal Stock Exchange Ltd. (NEPSE) in 1993 with a view to reform the capital market. It is a non-profit making organization operation under Securities Exchange Act 1983. Brokers and market makers operate on the trading floor as per the Securities Exchange Act rules bylaws of NEPSE. Nepal Stock Exchange started its trading operation on 13 January 1994 through its licensed members.

The Securities Board was constituted in 1993 under Sec. 1 of the Securities Exchange Act. 1983. Its main objective is to provide essential policy direction for the systematic and regular exchange of securities and develop competitive stock exchange market by protecting and promoting the interest of the investors. Nepal Stock Exchange is a trading (operational) Institution, whereas Securities Exchange Centre carried on both the functions. Though any corporate body desirous to carry out the transaction of securities can submit application to the Board for obtaining the license, till now Nepal Stock

Exchange Ltd. alone is representing the securities market in the country.

A brief looking-back of stock Market with reference to commercial banks

The first six months of 1994 (Mid. January to Mid-June) witnessed an upward trend in the stock market of Nepal. Strong public sentiment towards the corporate shares caused the prices of equity share of most of the companies, especially shares of companies in the banking and finance sector to go up abruptly without any proportionate strong financial backing. Following the declaration of attractive dividend rate by joint venture banks, investors exhibited a grave concern over the income gain irrespective of the other information like nature and financial strength of the company. The NEPSE Index tremendously went up to 265, the monthly share market turnover reached a record level of Re. 963.9 million and the market capitalization of the listed shares reached Rs. 16407 million. But this period onwards, the bearish tendency in the history of stock market in Nepal began gradually. Most of the investors were not aware of the risks associated with the corporate investment. They were neither familiar with the corporate information nor there were and financial information disseminated.

By the end of 2000/2001, the 115 companies listed on the Stock Exchange were capitalized at 46.3 billion and turn over for the year was 2.3 billion. The capitalization of the Nepalese Stock Market as a percentage of GDP was a little over 4% in 1996. By mid-July 2001, market capitalization has reached 11.8% of GDP.

Out of total market capitalization, banking industry has been contributing major pie. In 1996 July, Market capitalization of commercial Bank was 10,395 million, which has been soared up to 27630.31 million in 2001 July. Contribution of commercial banks in terms of market capitalization under the review period has been in increasing trend except in 2000July.

Statement of the problem

In the context of Nepal, there are no any separate institutions, which may provide information required to make rational decision that can accelerate the stock investment and market efficiency. Government policy is less encouraging in promotion common stock investment. Most of the Nepalese investors invest their fund in single security rather than investing in portfolio of security through diversification of risk. Not only general public but also even most of educate people related on such subject cannot prominently analyze the risk and return in stock market investment.

As the economic status and awareness towards economic activities are very poor development and growth of capital market in Nepal is still in its infancy. Investors use their own guess and hunches to invest their wealth because they do not have any knowledge about financial assets and they also do not know to take decision to construct an ideal portfolio and to reach a profitable decision. Investors of Nepal invest their wealth on the basis of looking the past trends of stock price, so some time they have to face heavy loses.

It is, therefore necessary to import required knowledge to investors and make them able to analyses risk and return of individual stock as well as portfolio so they can minimize their risk.

Investors feel more risk in stock investment than its real risk. To build their confidence, unbiased analysis and information about it is a must unavailability of a simple and clear ways or technique, risk and return of individual stock and portfolio is there fore being a major requirement to increase stock investment and stock market efficiency as well. Brokers, issue manager, stock broker and all the related person in those fields must become necessary to set the policies, evaluate relative risk ness of their decision and impression to general investor “ securities market t and other institutional set up are yet to work toward providing knowledge and skill to Investors:”

Beating above all in the mind following research issues is identified.

- i. How should investors decide to invest based on risk and return?
- ii. What is the comparative risk and return position of selected manufacturing companies?
- iii. Does the risk and return vary significantly?
- iv. To what extent there is systematic risk in relation to total risk.
- v. Would portfolio construction within these sectors be profitable?
- vi. What sort of relationship exists between returns and various financial variables for these sectors? Etc.

Objectives of the study

The major objective of the study is to determine whether the shares of commercial banks are correctly priced or not by analyzing the required rates of return using the Capital Assets pricing Model. The specific objectives are as follows:

- i.) To analyze the trend in EPS, DPS, MPS and PE over a period of time.
- ii.) To examine NEPSE index trend and annual return there of.

- iii.) To estimate CAPM, Betas for the related companies and analyze their implications.
- iv.) To measure systematic and unsystematic risk of the selected commercial banks and examine their implications.
- v.) To evaluate the relationships between returns of selected stocks.
- vi.) To identify the qualitative factors affecting the NEPSE.

Rationale of the Study

The study aimed to be undertaken by the researcher will bring the output that would be useful and worthy in terms of:

- 1 It provides the consolidated basic data and information about the NEPSE and the commercial banks under study.
- 2 It makes an effort to reflect the picture of NEPSE in terms of private banking sector.
- 3 This research is mainly focused on risk and return aspect. The interested and concerned individuals/ agencies can take help from the findings of this study.
- 4 This study would be of help to guide the investors.

Scope and limitation of the study

Disclosure of financial information is very limited, and accessibility is equally poor as well. Some of the listed companies have not followed disclosure of financial and other information as per requirement. Further more, information regarding dividend in particular for the research purpose is not sufficient. As the researcher has aimed to analyze the risk and return on base of monthly data, though it is substantially important, it is felt to find out data about the date of share split, stock dividend and other information regarding dividend is virtually impossible. It is that is why, the researcher, has gathered data and analyzed on quarterly basis with out adjustment of stock dividend and stock dividend. One of which is there is no such a trend in price change in the share price as theoretically conceived following the stock split and stock dividend distribution. The other reason is the assumption that all available information is impounded in an efficient market. All sampled banks distribute cash dividend in annual basis. The researcher has segregated the annual dividend in quarters as the observed data is on quarterly basis. The same kind of observation regarding cash dividend has been made in the past years in international arena. As the stock price movement correlates other macro variable factors, data and/ or information on those factors is equally important. In this light, study covers up to f/y 2005. The study covers five fiscal years from 2001 to 2005. This study is confined to the study o only 4 commercial banks enlisted in NEPSE particularly in relation with risk and return.

Organization of the Study

This study will be divided into five chapters. They are as follows:

Introduction: This chapter covers background of the study, statement of problem, research hypothesis, objectives, significance of the study and limitation of study.

Literature Review: This chapter also focuses on review of literature. It contains the conceptual framework and past research literature on Nepal & Foreign context, unpublished thesis and journals.

Research Methodology: This chapter deals with the research methodology to be adopted for the study consisting research design, source of data, population and sample.

Presentation and Analysis of Data: The fourth chapter deals with presentation analysis and interpretation of data. It consists testing of hypothesis, analysis of questionnaires, analysis of open-end opinions and major findings of the research.

Summary, Conclusion and Recommendation: The last chapter covers the summary, conclusion and Recommendation of our study.

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