CHAPTER - I
INTRODUCTION

1.1. Background of the Study

Nepal is a small landlocked under developing country situated 26° 22" to 30° 27" northern latitude and 80°04" to 88°12" eastern longitude between two large country India and China. Total area of Nepal is 147181 k.m. which is 0.3 percent of Asia and 0.03 percent of the world. Average length of eastern Mechi to western Mahakali is 885 kms and average gap between Northern sides to southern side is 193 kms. It is an underdeveloped country with per capita income of US$ 290 according to World Bank and almost 32 percent of the population lives below the poverty line.

Nepal is one of the countries in the world in terms of rich and unique in natural resources and attributes like it's bio-diversity, socio-cultural, cultural heritage, manifested in its architecture, temples, sculptures, monuments etc. Beside from this, it is also richly gifted with natural resources mountain Everest, green forests, many perennial rivers and source of minerals. Actually slow pace of developing of Nepal is due to illiteracy, lack, of finance, landlocked position, poor resources mobilization and its utilization, weak infrastructure development, institutional weaknesses, poor economic policy and unstable eco-political environment. For this to overcome, the process of capital accumulation among other perquisites should be enhanced. The economic development of nation is on initial stage. Nepal has adopted mixed and liberal economic policy with the implicit objective to help the state and the private sector. For the economic growth and development, government has now initiated various economic policies such as industrial policy, foreign investment policy, privatization policy and trade and transit policy.

Economic conditions show the actual value of any country. So bank and financial institution is the backbone of economic development. Bank and financial institution play vital role of developing economic condition under develop country like Nepal. Economic activities are guided by finance. Financial institutions provide capital to develop trade, industry and business. Bank, development banks, finance companies, co-operative

societies, insurance companies, stock exchanges helps in the economic development of the country. Capital and financial instrument plays an important role in accelerating the economic growth of a nation, which in turn is determined among other, by saving and investment propensities. Liberalization, globalization as well as privatization are most common and essential part of investment and other activities in financial sector of Nepal. The liberalization policy attracts foreign investor as well as national investor to invest financial sector & commercial sector, as well as Joint Venture Company. Which help to rises the life standard of people and boost up national prosperity.

The development of the country is always measured by its economic development through economic indices. Therefore, every country gives emphasis on the upliftment and prosperity of its economy. The financial institutes act as intermediaries or catalyst to transferring the required financial resources and other services. A new organized financial institution including financial companies, commercial banks and others financial intermediaries play an important role for the development of the country. They collect scattered financial resources from the mass and invest them among those who are associated with the social, commercial, and economic activities of the country. They are indispensable part of the development process. Therefore, a competitive and reliable banking is essential to the nation for the development.

Government has to formulate and implement strategies focusing overall industrialization of the nation and development of a sound banking system is necessary for the rapid industrial development and overcome the current pitiable economic situation. Financial infrastructure of an economy consists of financial intermediation, financial institution and financial markets. Financial institution, in this economy plays a role of catalyst in the process of economic growth of the country. In this country, a bank is a financial institution, which plays a significance role in the development of a country. It facilitates the growth of trade and industry of national economy. However, bank is a resource for economic development, which maintains the self-confidence of various segments of society and extends credit to the people. Banking sector plays a vital role for the country's economic development opportunities to people. Such economy of the country

secures proper growth. In this way, it is crystal clear that a sound banking system is must for the industrial development and creates employment and investment opportunities to people as well as overall economic development of the country.

Credit risk management is one of the most important functions of a financial institution and the composition of loans and advances directly affects the performance and profitability of the bank. There is intense competition in banking business with limited market and less investment opportunities available.

Credit risk management is the heart of commercial banking; consequently the formulation and implementation of lending policies are among the most important responsibilities of directors and management. Well formulated lending policies and careful lending practices are essential if a bank is to perform its credit. Credit management affects on the company's profitability and liquidity so it is one of the crucial decisions for the financial institutions. The banks take almost care in analyzing the creditworthiness of the borrowing customer to ensure that the interest and the principal amount on loans are timely recovered without much trouble and legal process. A sound lending policy is essential for the good performances of the bank and further to attain economic objectives directed towards acceleration of the development. Lending policy should be carefully analyzed and the banks should be careful while performing its credit creation effectively and to minimize the risk factor.

The return of any banks basically depends upon its sound lending policy, lending procedure and investing its fund in different securities and different sectors of market. A sound fund mobilizing policy is not only prerequisite for bank profitability but also crucially significant for the promotion of commercial saving of backward country like Nepal (Joshi, 2004:2).

Liquidity refers to availability of liquid assets or that state of position of a bank that pronounces its capacity to meet its entire obligation. It refers to the capacity of bank to pay cash against deposits. People deposit money at the bank in different accounts with the confidence that the bank will repay their money when they need. To maintain such confidence of the depositors, the bank must keep this point in mind while investing its

excess fund in different securities at the time of lending. So that it can meet current or short - term obligation when they become due for payment (Baxley, 1987:38)

Bank should always know the purpose of loan demanded by a customer because if the borrower misuse the loan granted by the bank he will never able to repay interest and principal. In order to avoid such circumstances, loans should be allowed to the selected borrowers and it should demand all the essential detailed information about the scheme of project in which the bank is lending for. Finance companies must keep in mind the overall development plans of the nation and the credit policy of the concerned authority i.e. central bank (Joshi, 2004:35-37).

Banks are those financial institutions that offer the widest range of financial services especially credit, savings, and payment services and perform the wisest rage of financial services of any business firm in the economy. As a financial institution a bank links the surplus unit with the deficit unit of the economy. Banks today provide a number of financial services to their customers. This multiplicity of bank’s functions and services has led to banks being labeled "financial departmental stores" and to such advertising slogans as your bank – a full service financial institution. Customers can satisfy virtually every type of financial services needs at one financial institution in one location.

The world business scenario has been changing very fast. Most countries around the globe have efficiently eliminated state monopolies of business. The volume of international trade has been increasing year after year. Due to globalization many international companies have been actively doing their business across the national boundaries. This competitive market barrier is becoming the major problem for the survival. Now due to these factors, financial institutions face significant change in a time of new alignments in domestic market and increased international competition.

1.1.1 History of Banking in Nepal

The growth of banking sector in Nepal is not so long. In comparison with other developing or developed country, the institutional development in banking system of Nepal is far behind. The history of banking or modern banking system started in Nepal

from the establishment of the Nepal Bank Ltd in 1994 B.S. It is the first financial institution in Nepal and prior to there was in such organized financial institution in the country. At first though this bank was given the authority and responsibility of central bank, but with the change of time, it was necessary to establish a central bank.

Nepal Rastra Bank, the central bank of Nepal was established in 1956 (2014 B.S) under the Nepal Rastra Bank Act 1956 (2013). It has been functioning as the government's bank and has contributed to the growth of financial sector. The major challenge before Nepal Rastra Bank today is to ensure the robust health of financial institution. Central bank is the apex body of the banking and financial institutions which controls the entire currency, and credit of the economy. Nepal Rastra Bank, the central bank of Nepal regulates, inspects, supervise and monitor the whole functions of bank and finance companies of Nepal. The second commercial bank Rastriya Banijya Bank was established in 1965. The two commercial banks extended their operation extensively throughout the country.

For about two decades no other banks were opened extending branches and sub-branches. Nepal was deeply observing and studying and searching what sorts of programmes, policies, laws and regulations should be brought into practice. The country can't change its status by using its own capital in the country without importing the new technology from foreign country and accordingly, government has adopted liberal economic policy, which encourages the foreign investment on banking sector. From this the real form of the development of the banking system started in Nepal. The banks began to offer their distinct services to the people through new technologies.

The inception of Nepal Arab Bank Limited (renamed as Nabil Bank Limited) since 1984 is a first joint venture bank proved to be a milestone in the history of banking. Nabil Bank gave a new ray of hope to the sluggish financial sector. After this there is a gradual increase in the number of joint venture commercial banks in Nepal. In order to initiate industrialization, Nepal government has given due emphasis to follow liberal and market oriented economic policies, encouragement of private participation in infrastructure

activities such as power, telecommunication, and gradual privatization of public sector companies. Among various factors of industrialization shortage of capital is a most important factor that affects the process if industrialization in least developed countries. Huge financial investment is required in order to set up and develop industries in the country. Nepal government adopted a policy for allowing foreign joint venture commercial banks to operate in Nepal. This policy has also targeted to encourage the traditionally operated local commercial banks to enhance their capacity building, competitiveness, and efficiency and modernize their functions to give prompt customer service. As a result of the new commercial banks act and liberalization policy of 1980s, now there are all together 24 private commercial banks includes six joint venture banks and beside the commercial bank there are 38 development banks, 74 finance companies, 18 insurance companies, 1 employees' provident fund, 1 stock exchange, 34 co-operatives and some NGOs (Limited banking activities) operating in Nepal with the objective to encourage efficient banking services to increase foreign investment in the country and to bring healthy competition in the banking sector. The open and liberal policy in the financial sector has helped in establishing many commercial banks and financial institutions in the country.

Banks and the financial companies are the heart of the financial institutions. They hold the deposits of many persons, government establishments and business units. They make funds available through their leading and investing activities to borrow from individuals, business firms, and government establishments. In doing so, they assist both the flow of goods and services from procedures to consumers and financial activities of the government, they provide a large proportion of the medium of exchange, and they are the media through which monetary policy is affected. These facts show that the commercial banking system of the nation is important to the functioning of the economy.

"Commercial banks held dominate share on the major balance sheet components of financial system. Of the total deposits Rs.391152.60 million in mid-July 2007, the commercial banks vital role in the development of the country. By concentrating of finance companies, total deposits collected in 2007 amount are Rs. 181767 million in

which it disburse amount to Rs. 109121.2 million as loan. It constitutes about 12.21 percent of the total deposits. It shows occupied 86.28 percent of total liabilities followed by finance companies 8.82 percent (Rs.34500million), development banks 3.93 percent, micro credit development banks 0.28 percent and others 0.68 percent. Similarly, on the loans and advances the share of commercial banks stood at 79.50 percent, finance companies at 12.21 (Rs.4776million) percent, development banks at 5.27 percent and micro credit development banks at 1.98 percent and others at 1.03 percent. In the same year the share of commercial banks in borrowings, liquid funds and investments of whole financial system constituted 47.75 percent, 86.28 percent and 91.64 percent respectively." (www.nrb.org)

Under the umbrella Act, Nepal Rastra Bank, the central bank of the nation, categories all the financial institutions in four classes A, B, C and D on the basis of issued capital. Commercial banks are classified as 'A' similarly development banks 'B', finance companies 'C' and cooperatives and micro-finances are classified as 'D'. B class development banks can grow to A class commercial banks, similarly C class finance companies can upgrade to B or A. But D class financial institution can not be upgraded.

According to New Directives of NRB, All financial institutions should raise their issued capital by the year 2070 BS as follows:

Class	**Financial Institution**	**Issued Capital**
A.	Bank	Up to NPR.2, 000,000,000.00
B.	Development Bank	Up to NPR.64, 000,000.00
C.	Finance Company	Up to NPR.20, 000,000.00

As per the oxford dictionary, the word finance company means "the company provides money specially hire purchase". Now the Umbrella Act facilitates the finance companies to grow providing enough financial services or widest range of financial services as banks according to their issued capital. The trend of establishing finance companies begun in the year 1992. Nepal Housing Development Finance Co. Ltd. is the pioneer

finance company in Nepal which is established in 08/03/1992 at Naya Baneshwor, Kathmandu. After one year, Nepal Finance and Savings Co. Ltd. established in 06/01/1993 at Kamaladi Kathmandu as the second finance company. Public excited to establish finance company in the year 1993, during which the number of new finance companies was 6. According to establishment date, NIDC Capital Markets Ltd. Kathmandu, National Finance Co. Ltd. Kathmandu, Annapurna Finance Co. Ltd. Chipledhunga, Pokhara are the 3rd, 4th and 5th finance companies respectively. Similarly Nepal Share Markets Ltd., Peoples Finance Ltd., Himalaya Finance & Savings Co. Ltd., United Finance Ltd., Union Finance Co. Ltd., Mercantile Finance Co. Ltd., Kathmandu Finance Ltd. opened respectively.

Nepal Government policy of allowing finance company operating in Nepal is basically to encourage specially the retail banking local traditionally run commercial banks to enhance their bankable capacity through competition, efficiently modernization mechanism via computerization and prompt customer 's service .(Dr. M. K. Shrestha)

1.1.2. Brief Profile of sample Finance Companies

For this study some early established finance companies are taken, which includes Kathmandu Finance Limited, General Finance Limited, and Nepal Housing and Merchant Finance Company.

A. Kathmandu Finance Limited (KFL)

KFL or the Kathmandu Finance Limited (Bitiya Sanstha) is a recognized financial Institution in Nepal and began its operation from 10th April 1994 in Dillibazar, Kathmandu. It has now 33 million issued capitals. Now the ratio of public share and promoter share is 40:60. It's experienced in financial sector, of the main main objective has done lot of good deeds on the field, depositors, lenders and to investors. Company has been able pay dividend annually to its investors in different fiscal year. Its reputation over the country exists while depositors are regularly getting their interest and goodwill through to it. However it has no branch yet, it is taken as established finance company in

Nepal. Due to its better performance it has ranked in ‘Ka’ class among all finance company.

B. Nepal Housing and Merchant Finance Company (NHMFC)

Nepal Housing and Merchant Finance Company was established in 11th April 1995 in Dillibazar, Kathmandu. It has recently launched a branch in Biratnagar Sub-Metropolitan City. It is established in to maintain the economic welfare of the general people facility loan to agriculture, industry and commerce, to provide the banking services to the country and the people. Currently this finance company has Rs.100 million authorized, Rs.22 million issued capital and Rs.22 million paid up capital. Due to its better performance, this financial institution has become an established finance company.

1.2. Focus of the Study

Present situation of Nepalese market is not so good for any kind of business, banking business is totally focus on lending business, which is naturally a risky business, as per present situation finance companies are playing the vital roles in the growth of Nepalese economy. So what kinds of precautions are taken by bank for its survival is very serious subject. As loan is the core area of the commercial banking. It plays the significance impact on the finance companies liquidity and profitability. But the most worry factor in banking industry is the total management of loan. Due to the excessive amount of non-performing assets in finance companies, there is the wide spread suspicion on the performance on the finance companies.

1.3. Statement of the Problem

As financial institutions are becoming main sources of mobilizing the financial resources, the large amount of finance companies’ funds are concentrated on total loan portfolio. Therefore, the success and failure of the finance company largely depend on the total credit risk management of finance companies. In order to analyze the credit risk management of finance company following research problems are formulated.

1. What is the status of credit portfolio of finance company in terms of?
2. What is the credit management status of finance company in general?
3. What are the total compositions of credit of finance company?

4. What is the loan loss provision status that has been established by finance companies?

5. What are the effects on bank's total performance by the recent regulations relating to loan classification and loan loss provisioning?

6. What is the status of non- performing assets of the finance companies?

7. What is the effect that has been caused by non-performing assets of finance companies on their profitability and liquidity managements?

1.4. Objectives of the study

The main objective of the study is to evaluate the credit risk management of finance companies in Nepal. In order to achieve the basic objective, the following other objectives are

- To analyze the portfolio of lending of selected sector of finance companies.
- To evaluate various financial ration of finance companies.
- To determine the impact of deposit in liquidity and its effect on lending practices.
- To evaluate problems and weakness in credit risk management of finance companies.
- To review the prevailing laws rules and regulation enforced by Nepal Rastra Bank and assess its impact on profitability and liquidity of finance companies.
- To offer suitable suggestions based on findings of this study.

1.5. Significant of the study

This study has proposed to measure the efficiency of both finance companies in their credit risk management procedures. This study adds new idea and findings about the concerned finance companies.

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This study no doubt will have importance to various groups but in particular is directed to a certain groups of people/organizations, which are:

- This study will provide importance information to those who are planning to invest in the study will give a clear picture of financial position of the company under study.
- Importance to shareholders.
- Importance to the management bodies of the finance companies for the evaluation of the performance.
- Importance to "outsiders" which are mainly the customers, financing agencies, stock exchanges etc.
- Importance to the government bodies or the policy makers such as the central bank
- Interested outside parties such as- investors, customers (depositors as well as credit takers), and competitors, personnel of the banks, stockbrokers, dealers, and market makers.
- The study will help general public to know about the overall financial position of the KFL and NHMF.

So, this study helps to identify its hidden strength and weakness finance companies as well as regarding financial and credit condition of finance companies. Likely after the completion, this report will be kept in the library, which plays the role of reference to the students making the similar study in future.

1.6. Limitations of the study

The study has been subject of the following limitations.

a) The study has been based on the secondary data provided by Nepal Rastra Bank.

b) The study is based on data and information provided by finance companies.

c) The study has been limited to the viewpoint of the credit risk management.

d) The study covers the time period of 2003/04 to 2007/08

Differences macro indicators of the global as well domestic economy, which has the impact on the total performance of credit management of finance company, have been ignoring.

1.7. Organization of the Study

The present study is organized in such way that the stated objectives can easily be fulfilled. The structure of the study will try to analyze the study in a systematic way. The study report has presented the systematic presentation and finding of the study. The study report is designed in five chapters which are as follows:

Chapter-I: This chapter describes the basic concept and background of the study. It has served orientation for readers to know about the basic information of the research area, various problems of the study, objectives of the study and need or significance of the study. It is oriented for readers for reporting giving them the perspective they need to understand the detailed information about coming chapter.

Chapter-II: The second chapter of the study assures readers that they are familiar with important research that has been carried out in similar areas. It also establishes that the study as a link in a chain of research that is developing and emerging knowledge about concerned field.

Chapter-III: Research methodology refers to the various sequential steps to be adopted by a researcher in studying a problem with certain objectives in view. It describes about the various source of data related with study and various tools and techniques employed for presenting the data.

Chapter-IV: This chapter analysis the data related with study and presents the finding of the study and also comments briefly on them.

Chapter-V: On the basis of the results from data analysis, the researcher concluded about the performance of the concerned organization for better improvement.

CHAPTER - II
REVIEW OF LITERATURE

This chapter presents the conceptual review of credit risk management including different types of risk that exist in finance companies, credit risk management system and credit risk management frame work and techniques. The Central Bank's regulations regarding the risk management has been also discussed. This chapter focuses on the review of literature relevant to understand credit and credit management of finance companies. Several research works have been done in various aspects of finance companies, especially financial performance, investment policy, resource mobilization, lending policy, compliance of NRB directives by banks etc. There are some books, journals, articles, other studies done related with lending and investment aspect of banks. Some of the relevant studies, literatures on lending and investment are reviewed below. This chapter is categorized into two different headings.

- The conceptual Review
- Related Studies

2.1 The Conceptual Review

Finance companies play a supporting role in the economic development of a country. In fact, in the modern industrialization and service oriented era, the availability of finance companies with competitive services is the measure of economic development of a country. While many people believe that banks play only a narrow role in the economy-taking deposits and making loans-the modern banking has had to adopt new roles in order to remain competitive and responsive to public needs. The principal roles that a finance company plays today are

<u>The intermediation role:</u>

Transferring the savings received primarily from the households into credit (loans) for business firms and others in order to make investments in the new building, equipments share of companies and other capital goods.

The Payment role:

Carrying out payments for good and services on behalf of their customers (such as by issuing and clearing cheques, and dispensing currency and coins)

The Guarantor role

Standing behind the customers to pay off the customer's debts when those customers are unable to pay some of guarantees are bid bond and performance bond etc.

The Agency role:

Acting on behalf of the other financial institutions like banks to manage and protect their property or issue and redeem their securities.

The Policy role:

Serving as a medium for government policy in attempting to regulate the growth of the economy and pursue social goal. Some of the vital functions performed by a full banking service institution today are summarized in below:

- The Trust Function
- The Investment Function
- The Credit Function
- The Banking Function
- The Brokerage Function
- The Payment Function
- The Saving Function
- The Insurance Function

"The economy of a country indicates the development of the country. The financial sector plays an important role in the development of the country and mobilization of financial resources. The financial sector consists of bank, co-operative societies, insurance companies, finance companies, capital markets, foreign exchange markets, mutual funds; provident fund etc. Financial sector organizes the scattered domestic financial resource and invests them in different sectors. Economic development depends upon various

factors however, the major are capital formation and proper utilization. The organized financial sector collects the fund mobilizes and invests the fund in the best possible manner" (Peter Rose: III Edition; IRWIN)

Finance companies play an important role in the economic growth of country. Banking, when properly organized, aids and facilitates the growth of trade, industry and living standard of the citizen. In the modern economy, financial institutions are to be considered not as dealers in money but as the leaders of development. "Banks are not just the store houses of the country's wealth but are the reservoirs of resources necessary for economic development. Bank renders valuable services to trade and industries. The economic growth of the country depends on the growth and development of trade and industries. Industrial development can take place only if sufficient money is invested in industries. Banks undertake the stupendous task by mobilizing the saving of the people and lending the same to the traders and industrialist. The bank helps in the uniform development of the different regions in the country" (Radhaswamy & Vasudevan; 521).

The role of financial institutions in every nation of the world is in pursuit of attendant the goal of rapid economic development. Finance companies are the important organ of the financial sector which occupy important place in the framework of the economy. They hold deposit of the people, government and business units. They make funds available through their lending and investing activities to borrowers like individuals, business and government sectors. So, as they provide capital for the development of the large and small industries, trade, business and services they contribute large portion on the economic growth of the nation. Finance companies make sound investments in various sectors in the economy, which boost the quality and quantity of investment as well as achieve its own objectives of profit maximization. Thus, well formulated and sound investment policies co-ordinate and planned efforts accelerate the pace of economic growth.

Credit affects the overall development of the country. The volume of the credit is directly related with the pace of development of the country which would be mobilized through

various financial institutions of the country itself. Lending is the must fundamental function of a finance company. The pace of time has changed the portfolio of banking business from its primary functions to other functions such as merchant banking, credit card business etc. However, still the lending function is the most important function and determines the future of banking institution. The quality of loan, quality of borrower and quality of securities determines the health of any banker. The efficiency of banker lies in how it multiplies the deposit of depositor. Safety of funds, liquidity of funds, purpose, security of loan, profitability, spread of loan portfolio and compliance with national interest are some of the principles that a banker should follow while granting a loan.

The mechanism of a credit creation is used to expand the business. Fluctuation in the credit facilities granted by banks has an important bearing on the level of economic activity. Expansion of banks credit is followed by increase in production, employment, sales and prices. In a developing economy the banks offer more and more credit and increase the resources of the industries, thereby causing faster economic development. Banks play a decisive role in the industrial development of the country. The credit facilities extended by banks must be uniform and rational; otherwise there will be haphazard development of the country. The flow of credit is very much like smooth and uniform throughout the organs of human body, so also credit should flow steadily and evenly through various sectors of the economy. If the credit flow is artificially plugged or arrested, it would be irreparable harm to economy just as clotting of our blood vessels would lead to fatal results

The finance companies take utmost care in analyzing the creditworthiness of the borrowing customer to ensure that the interest and then principal amount on loans are timely recovered without much trouble and seeking legal process for the recovery. A sound lending policy is essential for the good performance of the banks and further to attain economic objectives directed towards acceleration of the development. Lending policy should be carefully analyzed and the banks should be careful, while performing its credit creation function effectively and to minimize the risk factor.

Two essential functions of commercial banks may be best summarized as the borrowing and lending of money. They borrow money by taking all kind of deposits. Then it provides this money to those who are in need of it by granting overdraft to fixed loan or by discounting bills of exchange or promissory notes. Thus, the primary function of a commercial banker is that of a broker and a dealer in money. By discharging this function efficiently, a commercial banker renders a valuable service to the community by increasing the productive capacity of the country and thereby accelerating the pace of economic development.

Besides the lending function, mobilization of funds has also significant important for a finance company. Investment is the secondary means of fund mobilization. The investment in banking scenario refers to placement of its funds to stocks, securities, and Treasury bill of government etc. "Investment in its broad sense means the sacrifice of current dollars for future dollars. Two different attributes are generally involved: time and risk. The sacrifice takes place on the present and is certain, the rewards comes later, if at all, and the magnitude is generally uncertain'' The investment takes place when and where it is mandatory by the law of central bank or of the country and when the bank finds it is beneficial to investing certain securities so as to gain short term profitability and also to maintain the liquidity position intact.

Generally investment refers to buying of shares, stocks and bond of the capital market. In terms of banking investment means purchasing of stocks, securities, treasury bills etc. A finance company should mobilize its deposits and other funds to secured, profitable and marketable sectors so that it can be easily liquidated when necessary. Therefore when loan investments are made it should analyze all the aspects of good lending practices so that it would gain profit on the transaction of loan. Investment policy provides guidelines to handle their investment operation smoothly ensuring maximum return with minimum exposure towards risk.

Finance companies should be careful while performing the credit creation function. Investment policy should ensure minimum risk and maximum profit from lending. A

good investment policy ensures maximum amount of investment to all sectors of the economy with proper utilization and management of funds.

For the finance company's overall strategy and strategic plan at least three critical components is needed they are

a) Business plan
b) Framework for risk management
c) Strategies for corporate control.

These are the basic components provide a solid foundation for managing value and risk.

As with the traditional approach to strategic planning, its focus is just on operating and competing in the financial services industry. The modern strategic approach also includes a framework for risk management and strategic for competing in the market for corporate control. This risk management component fits for the modern idea of the basic business of banking as managing, measuring and accepting risk. The bank objectives are managed by maximizing those items that create value and minimizing or eliminating those that destroy value.

2.1.1. Features of Sound Lending Policy

There are basically five principles for the sound lending policy:

1) Liquidity: - Liquidity refers to that state of position of a bank that pronounces its capacity to meet its entire obligation. In other words, it refers to the capacity of bank to pay cash against deposits. People deposit money at the bank in different accounts with the confidence that the bank will repay their money when they need. To maintain such confidence of the depositors, the bank must keep this point in mind while investing its excess fund in different securities at the time of lending. So that it can meet current or short - term obligation when they become due for payment.

2) Safety and Security: - Bank must take care while investing its fund. It should never invest its fund in those securities, which are too volatile since a small change causes a

great loss. The bank should accept that type of securities, which are commercial, durable, marketable and of high market value. For this purpose, MAST should be followed:

M= Marketability	A= Ascertain ability
S= Stability	T= Transferability

3) Profitability: - Commercial banks invest on those sectors that derive the maximum income. Hence the investment or granting of loan and advances by them are highly influenced by profit margin. Generally the profit of commercial banks depends upon the interest rate of the bank, volume of loan provided, time period of loan and nature of investment on different securities.

4) Suitability: - Bank should always know the purpose of loan demanded by a customer because if the borrower misuse the loan granted by the bank he will never able to repay interest and principal. In order to avoid such circumstances, loans should be allowed to the selected borrowers and it should demand all the essential detailed information about the scheme of project in which the bank is lending for. Bank must keep in mind the overall development plans of the nation and the credit policy of the concerned authority i.e. Central Bank.

5) Diversification: - Diversification reduces the risk of recovery. The bank must not invest the funds in specific sector but to the various sectors so that when something goes wrong in one particular sector other will recover (Joshi, 2004:37-42).

2.1.2 Some Important Terms

In this section of the study, efforts have been made to clarify the meaning of some important terms that are frequently used. They are presented below:

1) Deposits: - Basically deposits mean the amount deposited in a current saving or fixed account of a bank or a financial institution. Deposit is the main sources of a fund that bank usually uses for the generation of profit. Therefore, the efficiency of the banks depends on its ability to attract deposits. Deposit being the borrowed amount from the

depositors or from general public, it constitutes the liability of bank. The deposits of a bank are affected by the various factors. They are as follows:

a) Types of customers.

b) Physical facilities of Bank.

c) Management accessibility of customers.

d) Interest rate paid on deposits.

e) Types and ranges of services offered by the Bank.

f) The prevailing economic condition of the country.

2) Loan and Advances: - This is the primary sources of income and most profitable assets of a bank. A bank is always willing to lend as more as possible since they constitute the larger part of revenue. But bank has to be more careful while providing loans and advances since they may not be realized at short period of time. Sometimes they may turn into bad debts. Fund borrowed from banks are much cheaper than borrowed from unorganized moneylenders. Loans and advances are provided against the personal security of the borrower or against the security of the immovable and moveable properties. Banks provide loans in various forms: overdraft, cash credit, direct loans and discounting bills of exchange. In addition to this, some portion of loan and advances and overdraft includes that amount which is given to the staff of the bank as house loan, vehicle loan, personal loan and other (Joshi, 2004:65).

3) Investment on Government Securities, Shares and Debentures: - Though a commercial bank can earn interest and dividend from the investment on government securities, shares and debentures, it is not the major portion of income. But it is treated as a secondary source of banking business.

4) Investment on Other Company's Shares and Debentures: - Commercial banks invest their excess funds to the shares and debentures of the other company. They generally do so when there is excess of funds than required and there is no alternative opportunity to make investment in the profitable sector. Now a day's commercial banks of Nepal have

purchased shares and debenture of Regional Development Bank, NIDC and other Development Banks etc.

5) Other Uses of Funds: - Commercial banks must maintain the minimum balance with NRB i.e. 6 % for fixed deposits and 8 % for each of current and saving deposit account in local currency. Similarly 3 % cash balance of local cash balance of all local currency accounts must be maintained in the vault of the bank. Again a part of the funds should be used for bank balance in foreign bank and to purchase fixed assets like land, buildings, furniture, computers, stationery etc.

6) Off - Balance Sheet Activities: - Off-balance sheet activities cover the contingent liabilities. These activities are not recognized as assets and liabilities in balance sheet. They are LC, Guarantee, Commission, and Bills for collection etc. These activities are very important, as they are the good source of profit to the bank though they have risk (Joshi, 2004:67).

There is no single important part of sound management than the methods which bank used to manage risk. Banking business is very risky business, there are several types of risk prevailed in the banking industry, but three major area of risk are widely recognized. i.e., credit risk, market risk and operating risk.

2.1.3 Types of risk faced by financial institution

i.) Credit risk

The credit risk is the potential financial loss resulting from the failure of customers to honor fully the terms of a loan or contract. On the other hand, the market risk includes balance sheet risk and trading risk such as potential risk to earning and capital resulting from changes in interest rate, liquidity conditions, impact of foreign exchange rate fluctuations etc. Meanwhile. Operating risk arise from the natural disasters, errors in processing and settlement of transactions safeguarding of assets, system failure, fraud and forgery.

Against the above backdrops, the main attributes of various risks that can be faced by a banker while evaluating a loan proposal may be expressed by the following functional relationship (Shrestha: 2007: pp 15-22).

Credit Risk (CR) = ƒ (BR, FR, Dr, CR, Fr)

Where,

F = function of

BR = Business\operation risk

FR = Financial risk

DR = Default/settlement risk

FR = Fiduciary risk

It is not practically possible to assign a particular coefficient to each of the risk factors stated above as the degree of each varies from case to case.

Business or Operational Risk

It is defined as the potential volatility of the performance of the unit concerned, caused by the very nature and type of business operations involved. The board elements of such risk can be classified as.

- Critical risk
- Operational risk
- Production risk
- Marketing and selling risk
- Labor risk

However, the most important component of this category is the macro system risk associated with the industry 1Witself. The operational economic environment, in general and the fiscal and monetary policies of the government provide as additional dimension to the risk structure.

Financial risk

This risk measures the relative stability of the unit in response to change in its own capital structure, i.e. debt-equity base or exogenous factors in terms of generation of profit. In other words, financial risk depicts whether or not the company would be in a position to generate sufficient profit, after paying debt interest, to finance satisfactory divided besides plugging back adequate quantum into the business.

Default or Settlement risk

The term "Default" mean any failure to meet all or some terms of the lending agreement. Hence, this risk measures the probability of adherence of the borrower to the terms and conditions of the agreement, as it will ultimately be reflected in the repayment capability. This risk indicated the propensity and ability of the entrepreneur to pay back the bank loan.

Cost base risk

This risk indicated the degree of income or profit generated within a unit from a given cost structure. It is a fact as the business develops, cost incurred on various items also increases, and giving rise to incremental income. A developing concern would have incremental income, which shall be more than incremental cost or expenditure. A high value of non- performing assets may not lead to increase profit to the unit.

Fiduciary risk

This risk refers to the eventuality of losses arise out of off balance sheet financial guarantee and other contingent liabilities (e.g. guarantee etc.) of associates substantial risk. Careful analysis is required at the time of credit appraisal.

ii.) Market risk

Market risk is the risk incurred in the trading of assets and liabilities due to changes in interest rates, exchange rates, and other asset prices. So, Market risk is exposure to the uncertain market value of the firm's asset. Major factors affecting Market risk are:

- Liquidity Risk
- Interest Rate Risk

- Foreign Exchange Risk
- Operational Risk

a. Liquidity Risk

Anthony Saunders says" Liquidity risk arises whenever financial institutions' liability holders, such as depositors or insurance policyholders, demand immediate cash for their financial claims". When liability holders demand cash immediately - that is, put their financial claims back to the FI-the FI must either borrow additional funds or sell off assets to meet the demand for the withdrawal of funds. An institution is said to have liquidity if it can easily meet its liability holders' demand for cash either because it has cash on hand or can otherwise raise or borrow cash.

In banking sector, Liquidity risk is created when banks hold different sixes of assets and liabilities. Extreme illiquid assets in bank may result bankruptcy where as excess liquid asset may carry interest rate risk over the period of time. As it is fatal risk, prudent liquidity management is the primary function of banking sector. Liquidity management is also to make sure that expected shortfall amounts are funded at a reasonable cost, ensure excess fund are invested properly with reasonable returns and without carrying any interest rate risk to the bank.

b. Interest Rate Risk

Interest Rate Risk is the incurred by a financial institution when the maturities of its assets and liabilities are mismatched. Interest Rate Risk is probability of decline of earnings, due to the adverse movement of interest rates in various markets. The applicable interest earned on assets and liabilities and hence net interest margin is the function of market variables and it may get changed overnight or over a period of time according to the market situation. Changes in the interest rate can significantly alter net interest income depending on the mismatch of assets and liabilities held by the bank. Changes in interest rates also the market value of bank's equity.

c. Foreign Exchange Risk

Foreign Exchange Risk is the risk that exchange rate changes can affect the value of a bank's assets and liabilities denominated in foreign currencies. The bank is also exposed to foreign exchange risk, which arises from the maturity mismatching of foreign currency positions. In the foreign exchange business, bank also face the risk of default risk of the counter parities or settlement risk. While such type of risk crystallization will not cause principal loss, banks may have to undertake fresh transaction in the cash/spot market to replace the failed transactions. Thus, the bank may incur replacement cost, which depends upon the currency rate movements.

d. Operational Risk

Operational Risk is associated with problems of accurately processing, setting and taking or making delivery to trades in exchange for cash. It also arises in record keeping, processing system failures and compliance with various regulations. The Basel committee on Banking Supervision, Basel September (2000), defines the operational risk as "the risk of loss resulting from inadequate or failed interval processes, [people and system or from external events."

Operational Risk arises from inadequate control systems operational problem and breaches in internal controls, fraud and unforeseen catastrophes leading to unexpected losses for bank. Many of the operational-risk-related functions such as regulatory compliance, finance management, frauds, IT, legal and insurance are carried out by the staff and thus human resources itself becomes a cause for operational risk.

2.1.4 Credit Risk Management

Financial environment is dynamic. In this dynamic financial environment fluctuation in interest rates, exchange rates and commodity and real estate prices are not something new. These fluctuations in economic and financial variables weaken the corporate strategies and performance of bank. Thus it's necessary that banks have a framework of risk management. Effective credit risk management allows a finance company to reduce risk and potential non-performing assets. Once finance companies understand their risks and their costs, they will be able to determine their most profitable business and thus

price product according to the risks. Therefore, the finance companies must have an explicit credit risk strategy by organizational changes, risk measurement techniques and fresh credit processes and systems.

There are five areas that credit risk management should focus on.

a) Credit sanctioning and monitoring process.
b) Approach to collateral
c) Credit risks arise from new business opportunities.
d) Credit exposures relative to capital or total advances.
e) Concentration on correlated risk factors

2.1.4.1 Risk Management Framework

Froot, Scharfstein, (1994:91-102) "A Framework for Risk Management" has suggested that the risk management framework rests on three pillars. They are summarized as follows

Making good investment decisions creates corporate value

For traditional banks this means making good loans and investments and non tradition banks, it means this plus making good investment decisions regarding their nontraditional activities e.g., investment banking, mutual funds, insurance derivatives.

Generating enough cash flow internally is the key to making good investments

Companies that do not generate cash flow internally tend to cut investment more substantially than their competitors do. In banking, generating enough cash flow internally plays a critical role in maintaining a firm's capital adequacy. Adequate capital in turn is a prerequisite for expansion and making good investments. With respect to cost and control, finance companies with inadequate capital are subject to higher deposit insurance premiums greater regulatory scrutiny and possible takeover by outsiders.

Proper and prudent look at major market indicators

Finance should look properly at major market indicator because adverse movements in external factors such as interest rates, and commodity prices can disrupt cash flow, a company's ability to invest can be jeopardized.

2.1.4.2 Credit Risk Management Technique

As the majority of the finance companies' assets are in the form of loan, as the lending function is simple and create the value of the companies. The main danger is the chance of the borrower not to pay the loan amount. So the proper and prudent management of the credit risk is very necessary.

Merton and Morten has suggested three techniques for the managing the credit risk in their article published in the Journal of Banking and Finance (Miller & Merton; 1995: 483-489).

A. Risk based pricing

It has been established that risk based pricing requires lenders to change the rate that compensates for the riskiness of the loan. The pricing procedure needs to be straightforward and not based solely on historical loan loss experience. In practice, loan pricing tends to flow the prime rate plus basis. Because the prime rate is not the lowest rate a bank charges, the credit worthiest customers can negotiate discounts from the prime rate. The discount prime rate is what banks use to attempt to complete with open market instruments such as commercial paper and corporate bonds.

B. Assets Restriction

Banks lenders and other creditors have a claim on the borrower's assets. As long as the market value of assets exceeds the value of liabilities, creditors are protected because proceeds from the sale of assets cover all the claims. Alternatively, as long as positive net worth exists, business firms are not going to turn over to creditor's assets that exceed the value of claims against them. Thus one way for lenders to protect themselves is to try to ensure that the value of assets always exceeds than value of claims. Restriction amount of

debt a borrower takes on and restricting the variability of the value of assets are the basic ways of meeting this objectives. Restricting covenants in loan agreement and the strength of bank customer relationships are practical ways that lenders impose asset restrictions or attempt to establish borrower's incentives for compliance.

C. Monitoring

If lenders have a contractual right to monitor assets value continuously and to seize assets, then loan losses can be minimized either by auditing asset values and seizing assets before shortfalls exists or by requiring the posted value if collateral assets to equal or exceed the promised payments. For private loans, for which finance companies have considerable expertise in organization, monitoring with continuous surveillance is costly.

2.1.5 Regulation relating to loan classification and loan loss provisioning

Finance companies are heavily regulated than its non-bank competitors in the financial service industry. They are subject to follow the updated regulations issued by the regulation authority. As my topic is solely devotes to the credit risk review is just based on the recent regulation relating to the credit that are issued by the Nepal Rastra Bank, the regulating authority of Nepal.

As per directives issued by NRB dated 2058-5-29 loans and advances shall be classified into the following four categories

Performing Loan

According to Nepal Rastra Bank Directives good loans are considered as performing loan.

1. Pass Loan

Pass loan and advance whose principal amount are not past due and past due for a period up to one month shall be included in this category. Those are classified and defined as performing loans. Before, up to three months past due is taken as pass loan.

Non Performing Loan

According to Nepal Rastra Bank Directives sub standard, doubt and bad loans were considered as performing loan.

2. **Sub Standard**

   All loans and advances that are past due for a period of three months to six months shall be included in this category. Those are classified as none performing loans.

3. **Doubtful**

   All loans and advances, which are past due for period of six month to one year, shall be included in this category. Those are classified as none performing loans.

4. **Loss**

   All loans and advances which are past due for a period of more than one year as well as advance which have at least possibility of recovery or considered unrecoverable and those having thin possibility of even partial recovery in future has be included in this category. Those loans and advances are also classified and defined as none performing loans.

But NRB circulates a new circular on above classifications. It mentions only two types of loan i.e. Pass and Loss. All the installment dues and matured loans are Loss loan and remaining are considered as Pass loan.

Banks shall classify the loans every quarter and send the details for the same in the specified format within one month from the end of each quarter to the Nepal Rastra Bank.

Additional arrangement in respect of loss loan

- Even if the loan is not past due loans having any or all of the following discrepancies shall be classified as loss.
- No security at all or security that is not in accordance with the borrower's arrangement with bank.
- The borrower is absconding or cannot be found.
- Purchased or discounted bills are not realized within 90 days from the due date.
- The credit has not been used for the purchase originally intended.

- Owing to non recovery, initiation as to auctioning of the collateral has passed six months and if the recovery process is under litigation
- Loans provided to the borrowers included in the backlist and where the credit information bureau blacklist the borrower.
- As per directives loans and advances are required as per the following timetable in four phases.

Class	For FY 2058/59	For FY 2059/60	For FY 2060/61	For FY 2061/62	For FY 2063/64
Pass	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	Loan not matured and no any past due
Sub-Standard	Loans and advance past due for a period of over 3 month to 1 year	Loans and advance past due for a period of over 3 month to 1 year	Loans and advance past due for a period of over 3 months to 9 month	Loans and advance past due for a period of over 3 month to 6 month	All renewed ,restructured & re-scheduled loans
Doubtful	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 9 months to 2 years	Loans and advances past due for a period of over 6 months to 1 years	
Loss	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 2 years	Loans and advances past due for a period of over 1 years	Installment dues & Loan and advances matured

The loan loss provision

On the basis of the outstanding loans and advances and bills purchase classified as per directives shall be provided as follows

Classification of loan	Loss provision
Pass	1 percent
Substandard	25 percent
Doubtful	50 percent
Loss	100 percent

Installments dues from one year is 100% provision of total principal balance of the loan. Further more recently the NRB circulates all the financial institution to maintain 100% loan loss provision for all the installment dues.

Policy on Accounting of Non-banking Assets

Banks may in the case of non-utilization of loan, recover the outstanding principal and interest by the way of disposing the assets placed as collateral. Situation may arise requiring the banks to accept assets where the offer received for the assets put into auction is unsatisfactory. Under the section 13(1) of commercial banking Act, 2031 such self acquired assets are required to be disposed off with in 7 years. The bank management should be specific as to the valuation policy of assets. Since the assets are not for the purpose of own use and required to be disposed off within the specific time period valuation of such assets shall be equivalent to the outstanding amount of principal and interest such as the outstanding amounts become nil where the amount realize in disposition of the assets at a future date i.e. within seven years, varies the difference amount shall be adjusted to the profit and loss account. However, where in the year of acquisition of the assets, the total outstanding amount of principal and interest is more than the market value of such assets, the assets has to be valued at the market price and the difference amount of outstanding principal, interest and the market value of assets shall be charges off to the profit and loss account in the year of acquisition

itself.(Regulation relating to loan classification and loan loss provisioning before 2058.5.29)

2.1.6. Capital adequacy ratio

Capital adequacy ratio (CAR) is the proportion of Capital Fund or Shareholders equity on the total risk weighted asset of a bank. In other words, it is the capital portion, which is used to finance the asset. The total risk weighted asset, on the other hand, includes both on & off balance sheet items, which has been rated with certain percentage of risk. The risk weight of assets ranges from zero for cash, balance at NRB and investment in government bonds to 100% for loans and advances. The higher risk weighted asset means lower will be the capital adequacy ratio as CAR is the ration between Capital fund and Risk Weighted Asset.

According to unified directive 2005, the capital fund includes two types of capital.

A. Primary Capital

Table -2.1

Primary Capital

1	**Issued Capital**
2	**Share Premium**
3	**Irredeemable Preference Share**
4	**General Reserve Fund**
5	**Retained Earning**
6	**Capital Redemption Reserve**
7	***Net Profit After Tax, Tax,& Bonus(Current Year)***
8	**Capital Adjustment Fund Other Free Reserve**
9	**Other Free Reserve**

B. Supplementary Capital

Supplementary Capital refers to all the reserves bank has made for specific purpose, such as loan loss, foreign exchange loss etc. The Supplementary Capital includes:

Table - 2.2

Supplementary Capital

1	**General Loan Loss Provision (Good Loan)**
2	**Assets Revaluation Reserve**
3	**Hybrid Capital Instrument**
4	**Unsecured Subordinated Term Dept**
5	**Exchange Equalization Reserve**
6	**Additional Loan Loss Provision**
7	**Investment Adjustment Reserve**

C. Capital Fund

Capital Fund includes both the primary and supplementary capital. It can be stated in equation as below:

Capital Fund = Primary Capital + Supplementary Capital

Risk Weighted Assets includes both the on and off balance sheet assets. On balance sheet asset includes three types of risk-weighted asset (i.e. 0%, 20% and 100%). Zero percentage risk weighted assets include cash and bank balance, gold (tradable), investment in NRB and Government Bonds, loan against own bank's fixed deposit receipts, money at call, loan against government bonds, interest receivable on National Saving Bonds. 20% risk weighted asset includes balance with local and foreign banks, loan against other bank's fixed deposits receipts, money at call, loan against internationally rated bank's guarantee and other investment on internationally rated banks. 100% risk weighted assets includes investment on investment on shares and debenture, loans and advances, fixed assets, other investment, all other assets (excluding tax paid and accrued interest receivable).

Off balance sheet assets includes four types of types of risk-weighted asset (i.e. 0%, 20%, 50% and 100%). Bills collection has 0% risk. Letter of credit with maturity period less than 6 months and guarantee against counter guarantee of international rates foreign banks have 20% risk. 50% risk weighted asset includes letter of credit with maturity

period more than 6 months, bid bond, underwriting and performance bond. 100% risk weighted items include advance payment guarantee, financial guarantee, other guarantee, irrevocable loan commitment, contingent liability income tax and acceptance and other contingent liability.

The Capital Adequacy ratio of a bank is calculated as below:

i. Capital Adequacy ratio for Core Capital

$$\text{Capital Adequacy ratio} = \frac{\text{Core Capital}}{\text{Total Risk Weighted assets}}$$

ii Capital Adequacy ratio for Total Capital Fund

$$\text{Capital Adequacy ratio} = \frac{\text{Capital Fund}}{\text{Total Risk Weighted assets}}$$

According to NRB directive 2005, the stator Capital Adequacy Ratio (CAR) for core capital is 6%, where as CAR for total capital fund is 12% for fiscal year 2005/06.

A finance company is a business organization that receives and holds deposits of fund from others, makes loans or extends credits and transfers fund by written order of deposits.

Finance company is a corporation, which accepts demand deposits subject to check and makes short-term loans to business enterprises, hire purchase, regardless of scope of its other retail banking services. A finance company is a dealer in money and substitute for money, such as cheque or bill of exchange. It also provides a variety of retail financial services.

Commercial bank Act 2031 B.S of Nepal has defined that," Commercial bank is a bank which exchanges money, deposits money, accepts deposits, grant loans and performs

commercial banking functions and which is not a bank meant for co-operative, agriculture, industries or for such specific purposes."

According to J. H. Clemens, "Commercial bank should consider the national interest followed by borrower's interest and the interest of the bank itself before investing to the borrowers." To further his view, bank lending must be for such purpose of the borrowers that remain keeping with national policy and banks' overall investment policy. A bank's overall investment:

a) Should be basically of short term characters
b) Should be well spread
c) Should be repayable on demand
d) Must be profitable
e) Must be well in adequate security

Thus commercial banks have to consider policy of the government (I.e. Nepal Rastra Banks instructions), national and their own interest as well. Good investment policy ensure maximum amount of investment to all sectors with proper utilization.

M. Radha Swamy and S. V. Vasudevan in the book" A textbook of Banking (Law Practice and Theory of Banking) have described various aspects of lending. They had outlined principles of good lending. What constitutes good advances and a credit appraisal? Banks follow a cautious policy in the matter of lending and are generally governed by the well known general principals of sound lending as below.

1) Safety: The main business of banking consists of borrowing various types of deposits such as current, saving and fixed and discounting of bills. The safety of such funds should be ensured. If the banker has to ensure safe lending, then the three C's of the borrower are character, capacity and capital. Character of the borrower is important because that determines his willingness to repay the loan.

His capital and capacity to run the loan depends on both his capacity to repay and willingness to repay.

2) Liquidity: As the bankers deposits are subject to the legal obligations of being repayable on demand and at short notice, he must ensure liquidity also while lending so in times of need. He will be able to convert the assets into cash quickly and can sell it without any loss.

3) Profitability: Commercial banks have obtained funds from shareholders and naturally if dividend is to be paid on such shares earning profits can only pay it. However, the banker will not give undue importance to this aspect because a particular customer may offer a higher rate of interest but an advance made to him result in a bad debt. Therefore, for the sake of profitability the other two principles, liquidity and safety cannot be scarified.

4) The purpose of the loan: Bankers should enquire the purpose for which the loan is taken. If an advance is given for productive purpose, in all profitability, it will be repaid. Thus safety is ensured. If an advance is made for speculative purpose, the banker may come to grief.

5) Diversification of Loans: The popular saying is "Do not put all the eggs in the same basket". A banker should try to diversify loans as far as possible, so that he may minimize the risk in lending. If the banker lends only to one industry or only two few big firms or concentrates in a certain geographical area, the risk is greater. He should diversify lending so that the failure of one industry or the few big borrowers may not affect him. Where lending is done only in one area, it may be affected by political upheaval or natural calamities.

What constitutes a Good Bank Advance?

In order to make good advance, banker has to ensure the character of the borrower, nature of the proposition, security, and capacity of the borrower to utilize the credit, source of repayment and profitability of the advance.

1) The character of the Borrower: The banker should thoroughly enquire into the integrity and reliability of the borrower. The local manager already knows much of the information concerning the customer. The success of the loan very much depends on the truth of representation of the facts made by the customer and his capacity to run the scheme to a successful conclusion. This depends on his technical competence managerial skill and experience in particular industry or trade.

2) Collection of credit information: In case of new customer the banker has to collect credit information before deciding to make and advance to the customer. In foreign countries, there are specialized credit agencies that collect information relating to the status and financial standing of businessmen and sell the information to the bankers. Examples of such credit agencies are Seyd. & Co. in England and Dun & Bradstreet in U.S.A in India information is available from the credit Information Bureau functioning in the Reserve Bank of India, which provides such information. Such agencies contributes that information makes easy for loan decision.

3) Nature of the proposition: Banks prefer to advance of short periods, especially for working capital requirements. There are specialized institution to finance for the acquisition of fixed assets and new venture.

4) Security: Banker should rely more on the customer and his proposition. However, it is still risky to lend without security. He can fall back on the security when the customer and his proposition fail. According to George Rae, chairman of the (banker) book were covered by mentioning of adequate security. It is clear that in

respect of such advances you would stand absolutely exempt from the risk of loss, but the moment you being to make expectation to the rule, by granting advances to this client or that without security, you leave the solid ground of safety for the treacherous swamps of banking risks.

5) Capacity of the borrower to utilize the credit: The banker must reasonable, be sure about the capacity and integrity of the customer regarding utilization of credit for the purpose for which it is taken. The customer must have the marginal competence and hard working nature.

6) The amount: Bank should see that the amount of loan required is properly arrived at after taking into account all relevant expenses. Quite often the customer misses such items as taxes, overheads, legal expenses, and bank interest. If the amount stated is insufficient, the proposition will be affected by shortage of funds. If the bank is not in a position to lend the required amount, the customer will have to either go slow with his expansion or seek assistance from the other institutions. Sometimes, the proposition may be financed by more than one bank in consortium basis. In deciding the amount to be advanced banker always ensure that the stake of proprietor in the business is more than now own. If this is not ensured, the customer is likely to be reckless in the utilization of funds.

7) Sources of repayment: The banker should enquire the source from which repayment is promised. Where the request is for funds required as additional working capital, and the borrower promises to repay the advance out of profits over a period, the proposal requires careful consideration, and the banker after calling for full information should ascertain the rate at which the customer can reasonable hope to repay the advance. Before giving advance the banker should ensure that the repayment programmed has been properly drawn up and realistic. The sources from which repayment come must be clear. Banks mostly prefer self-liquidating advances.

8) Profitability of the advances: Interest on advances is the main sources of the banks revenue and the interest charged on advances depend in several factors such as prevailing bank rate, the rate of interest paid on deposits, and the risk involved in the particular advance and any other special consideration.

<u>Steps involved in the Appraisal of credit Risks</u>

Credit appraisal is an art, which every practical banker should master from out of experience can never be reduce to an absolute seen . In spite of several technical aids, such as ratio analysis of financial statements, cash flow and fund flow statements available to the modern banker, the ability to make a correct loan decision very much depends on the shrewd and critical judgment, common sense perspective intelligence and discriminating sense of the lending banker. However, the usual steps involved in the appraisals of credit risk are:-

1. Initial interview with the customer. In the initial interview the banker should ascertain the following:

a. The character , capacity and integrity of the borrower
b. The purpose for which the loan is being requested-whether productive or unproductive
c. Prospects of his proposal whether it will succeed or fail
d. Repayment capacity of the borrower including a consideration of the source of repayment.
e. The collateral that is being offered as security must be investigated as to the following.
    i) Whether it is easily marketable
    ii) Value of the security at present
    iii) Whether the value is likely to be stable or it is the security such that its value fluctuates considerably and
    iv) In case of default in payment, is it easily transferable?

Credit investigation of the customer

For credit investigation of the customer, the banker looks into:

i) Past history of the account

ii) Reports from other bankers and people in the same line of business in the case of new customer

iii) Search of document like memorandum of articles, registration papers, annual report available with the Registrar of joint stock companies

iv) A visit to customers place of business

v) Analysis of Balance sheet and profit and loss Account and funds flow analysis in the case of existing companies

vi) In the case if new companies or new projects of existing companies, there must be a critical appraisal of the projects which includes the following :

1. Examination of technical feasibility
2. Whether project is economically viable
3. The competence of the managerial personnel to successfully complete and run the project
4. Examination of the cash budget to ensure the repayment programmed.

M. Radshawmy in his book "Practical Banking" has explained the term credit appraisal. Credit Appraisal, the process of judging the soundness of credit proposal by carefully assessing the risks involved in extending credit to the proposal submitted by the borrowers. Appraisal involves basically two aspects: determination of the quantum of credit to be given and the safety of such credit .In the past the bankers were mostly guided by the security offered, the character of the borrower and their past experience, if any in relation to the borrower. Now the process of credit appraisal has become sophisticated involving a detailed study of business plans, analysis of balance sheets, profit and loss accounts, cash flow and fund flow-both past and projected. Ratio analysis techniques is used to analyses the balance sheet and profit and loss accounts.

Short-term loans are given essentially to meet the working capital gap, a part of which the borrower has to meet from out of long term sources. The bank manager ensures that the

business plan submitted by the borrower is capable of achievement. The borrower submits the following statement during the loan application.

1) Operating statement showing the gross sales, cost of sales(with all the details), gross profit, operating profit after deducting interest, selling , general and administrative expenses, provision for taxes and interest and net profit after taxes.
2) Position regarding current assets and current liabilities. If the peak requirements of finance are on a date different from the balance sheet date, then information should also be given as on that date.
3) Computation of maximum permissible bank finance for working capital
4) Performa statement of stocks and receivables
5) Analysis of balance sheet with the help of analytical and comparative tools
6) Funds flow statement.

Business plans are based on the several assumptions such as government policy, market factors production constraints relating to power and raw material and changes in production techniques as a result of research and development. These assumptions must be subject to close scrutiny and if they are found to be not reasonable, the business plan must be revised. The manager should scrutinize the peak level balance sheet to determine the maximum credit limits. The peak level position and the credit limits should be revised if the peak level statement is found to be in excess of the norms. Projected year-end balance sheet should be studied to know how the financial position of the borrower would be after the completion of the business plan. Projected funds- flow statement should be studied so as to ensure that the long term sources are not only sufficient to meet the long term requirements, but also leave a balance to meet the working capital requirements.

Term loans:

Term loans are medium and long term credits given for purchase of assets, like land, building and machinery and equipment. The amounts of terms loans are fixed primarily in relation to the total costs of the projects. Recently, there has been a phenomenal expansion in the demand for the term credit from the industry. In spite of the extension of

several special financial institutional started to provide such credit, there is still a credit gap, which the commercial banks can fill because of the resources at their disposal. Banks in the past were cautious in extending term credit as they considered such credit non-liquid and risky. However, a substantial portion of the short term credit is "rolled over" by the commercial banks in this country. The overall financial position of the bank's deposits, it capital funds and the general level of its advances deposits ratio limit the quantum of term lending.

Aspects of Appraisal:

Appraisal of term-loans requires a dynamic approach, involving as it does among others, a projection of future trends of output and scales and estimates of costs return and flow of funds. There are four broad aspects of an appraisal technical feasibility, economic feasibility, financial or commercial feasibility and managerial competence. The scope of appraisal and the emphasis placed on each aspect would depend on the circumstances of each case.

The examination of technical feasibility consists of an assessment of the various requirements of the actual production process with a careful enquiry into the availability, accessibility and quality of the goods and services needed.

The testing of economic feasibility will be with reference to the earning capacity of the project. The appraisal of managerial competence is of importance because in a dynamic economic environment, the ability of an enterprise to forge a head of others depends upon the quality of its management. The repayment prospects of a loan thus vitally depend upon the competence and integrity of the management.

The most important aspect of the term loan appraisal is the financial aspect. The term lending institutions have to ensure that the projects to be handled by them meet the minimum financial criteria:

1) The estimated cost of the project is reasonable and complete and has a chance of materializing

2) The financial arrangement is comprehensive without leaving any gaps and ensures availability of cash as and when needed.
3) The estimates of earning and operating costs are as realistic as circumstances permit.
4) The borrower's repaying capacity as judged form the project operations is demonstrable with a reasonable margin of safety.

The financial analysis considers the cost of the project, cost of production and profitability, performed financial statements, cash flow statement and income statements.

Ratio Analysis:

The banker has to apply ratio analysis to financial statements for three or four years to know the trends or patterns in financial structures and inter-relationship of facts. One of the important ratios is the debt-equity ratio. From the lender's point of view the financial structure should reveal a satisfactory balance of "owned funds" i.e. equity and borrower funds i.e. debt.

Inspection:

The pre-sanction and a follow-up of loan proposals in order to keep a watch on the progress of the projects are of considerable importance. There is an extension of financial appraisal and therefore form a part of the work of lending institution.

Loan Agreement:

On the basis of a thorough financial appraisal, the terms and conditions of the loan are settled. In drawing up their terms of loan, the principal consideration should be that it should ensure financial viability of the borrowing concern and as at the same time allowing a margin of safety to the lending institution. Most of the time lending institution charges a uniform rate of interest on all loans. But it is preferable to have variables rates of interest according to the degree of risk involved.

Security against Term loan:

In the case of term loans, scientific financial assessment is of paramount importance. However in the absence of credit information bureaus, which can give information about the credit worthiness of the borrowers but the consideration of security assumes importance. In India, the security generally accepted by the term lending, institution loan proceeds and non-industrial assets as supplementary security. Assets can be valued on the basis of book value or current market value or replacement value. In valuing the assets it is better to combine one or more of the methods so that the resulting valuation safeguards of the interest of the lender and also works out to be equitable to the borrower. A proper valuation of security requires the assistance of legal experts

Participation Arrangements:

Where the amount of loan is too large for a single lending institution, some form of participation arrangement so the part of different institution would be necessary. Such arrangement can also serve other purpose such as underwriting of shares, issuing guarantees etc.

According to S.P. Singh " The investment (credit)policies of banks are conditional, to great extent , by the national policy framework; every banker has apply his own judgment for arriving at a credit at a credit decision, keeping of course his bank's credit policy also in mind."

He further state" The field of investment is more challenging as it offers relatively greater scope to bankers for judgment and discretion in selecting their loan portfolio. But this higher degree of freedom in the field of credit management is also accompanied by greater risk, particularly during recent years; the credit function has become greater complex."

2.2. Review of related studies

Present section deals about concept or findings of earlier scholars on the concerned field of the study. It helps to develop the study as link in a chain of research that is developing and emerging the knowledge about the related field.

2.2.1. Review of Articles

The effort has been made in this present section to examine and review the some related articles published in different economic journals, Bulletins, magazines and newspapers.

Nepal Rastra Bank (NRB) has issued directives to all commercial banks and financial institutions ensuring transparency during loan disbursement as per provision. All commercial banks as well as all financial institution are now required to disclose the name of loan defaulters in every six months. Until now there was no such legal system of disclosing the loan defaulters' name. The new directives have also barred the financial institution from lending any amount to the blacklisted defaulter and their family members. The credit information bureau (CIB) can black list the firm, company or clear the debt within the stipulated period, as per day set criteria for blacklisting, the CIB would monitor those individuals and companies that have the principle loan of above Rs. one million. If the creditor falls to clear the amount within time, or is found mission the loan among other, the creditor can be blacklisted, ("Central bank tightens blacklisting procedure").

Due to slowdown in the world economy and deteriorating law and order situation of the country, many sectors of the economy are already sick. When any sector of economy catches cold, bank start sneezing. From this perspective, the banking industry as a whole is not robust. In case of investors having lower income, portfolio management may be limited to small saving income. But on the other hand, portfolio management means to invest funds in various schemes of mutual funds like deposits, shares and debentures for the investors with surplus income. Therefore portfolio management becomes very important both for an individual's as well as institutional investors. Large investors would like to select the best mix of investment assets. (Shrestha," Portfolio management lays the vital role in individual as well as institutional")

The current volume of the total banking deposits is over 1550-fold higher than what used to be some 38 years ago whereas the Gross Domestic Product (GDP) of the country during the same period, price increased just by 62-folds. Central bank static's shows that

the total banking deposit in 1965 used to be just Rs. 129.8 million, but swelled to Rs. 202.13 billion by mid-Jan 2003. similarly, the total loan and advances of the entire banking system in 1960 stood at Rs. 107 million, which was over 82 percent of them total deposit. However, total loans and advances went up to Rs. 127 billion, comparing almost 63 percent of the total deposit, during the period. As a result both deposit and lending of the banking system witnessed increase of over 6-folds and 5 folds to Rs.21 billion respectively by 1990s. As a result of economic expansion and private sector development, the nineties witnessed a quantum jump in both deposit mobilization and lending. The deposit of banking system, by the end of 2002, touched Rs. 154.5 billion, which are 7-folds more than the deposit of the nineties. Loans and advances from the banking system touched Rs. 118 billion by June-end 2000 and the amount was double than what it used to be in 1985. (The Kathmandu Post (2003), "Central bank tightens blacklisting procedures")

In the past report titled 'loan loss provision rises Notably' published in the Kathmandu Post, the reporter has made an endeavor to highlight some facts and figures regarding loan loss provision of commercial banks. 'The banking sector is witnessing a huge surge in loan loss provisioning reserve lately. The increment is primarily a result of a directive issue by Nepal Rastra Bank (NRB) in 2001 that introduced stringent loan provisioning criteria for commercial banks. As per data recently released by the central bank, the total loan loss provision in the country's banking sector increased from amount Rs. 8.73 billion in mid-April 2001 to Rs. 13.18 billion in mid-April 2003. The increment is over 51 percent. As per the latest NRB figures, a remarkable surge has been seen in loan provision of Nepal Bank Ltd (NBL). Against the provision of Rs. 1.7 million in mid-April 2007, the loan provision amount surged to whopping Rs. 7.33 billion in a year"
The reporter further stated that apart from the two technically insolvent government-invested banks, loan provision of other joint venture private banks has also risen significantly and the notable increments seen in the loan loss provisioning amounts due to the eight-point prudential directives that the central bank issued in mid-July to all commercial banks.

The reporter concludes, "The directives laid down stringent guidelines relating to loan loss provisioning to ensure a good health of the overall banking system. The directive requires loans to be provisioned to the extent of cent percent if payment is defaulted for one year. Likewise, the directives require loans to be provisioned to the extent of 25 per cent if payment is defaulted for over three months and 50 per cent if the period of default extends beyond six months. The earlier directive required progressive provisioning of loans, but allowed maximum of three years, unlike the present system of just two year, for loans to be provisioned to the extent of cent percent'.

Binam Ghimire in his article titled "Credit sector reform and NRB" has tried to highlight the effects of change or amendment in NRB directives regarding loan classification and loan loss provisioning. "Although the circumstances leading to financial problem or crisis in many Nepali banks differ in many respects, what is common among most of the banks is the increased size of nonperforming assets (NPAs), to resolve the problem of the losses or likely losses of this nature facing the industry. NRB, as the central bank, has amended several old directives and issued many new circulars in the recent years." (Ghimire, "Credit sector reform and NRB".)

As opinioned by him, since majority of the loans of most of the commercial banks of the country at present fall under substandard, doubtful and even loss categories, loan loss provisioning now compared to previous arrangement would be dramatically higher. The new classification and provisioning norms are much lent able as they help to strengthen banks financially. He added that we also must remember that the old system remained in force from 1991 to 2001, which was probably the most volatile decade of the business operation of the country. He has indicated that loan loss provisioning as a percentage of total credit of April 12, 2001 is 5.2% but as April 13, 2003, it has jumped to 18.39. If only private banks are considered, it is 2.12% of April 2001 where as it is 6.30% as of April 13, 2003. The total increment in LLP is Rs 11,328.11, million and the total increment in credit is only Rs 7976.70. He has also stated that tightening provisioning requirements on NPL is to ensure that banks remain liquid even during economic downturns.

In the conclusion he has mentioned that in the recent years NRB has worked for management and reform of the credit of the financial institution more seriously and NRB has adopted reforms aimed not just at dealing with problems but also at strengthening banking supervision to reduce the likelihood of future crisis, "All prudential directives of NRB in connection of credit sector reform have been made revised after April 2001. To adapt to such changes there can be some difficulties and for a better and harmonized reform NRB should continue to be supportive, proactive and also participative to take opinions of bankers for a change in regulation/policy taking place in the future."

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

As stated by the writer, the definition of NPA differs from country to country. In some of the developing countries of Asia Pacific Economic Cooperation (APEC) forum, a loan is classified as non-performing only after it has been arrear for at least 6 months. Similarly, it is after three months, in India. Loans thus defaulted are classified into different categories having their differing implication on the asset management of financial institution. He also stated that NPAs are classified according to international practice into 3 categories namely substandard, Doubtful and Loss depending upon the temporal position of loan default. "Thus the degree of NPA assets depends solely on the length of time the asset has been in the form of non-obliged by the loaner. The more time it has elapsed the worse condition of asset is being perceived and such assets are treated accordingly. "As per Chhetri's view, failure of business for which loan was used,

defective and below standard credit appraisal system credit program sponsored by Government, slowdown in economy/recession, diversion of fund is some of the factors leading to accumulation of NPAs.

He said that there is serious implication of NPAs, on financial institutions. He further added that the liability of credit institution does not limit to the amount declared as NPA but extends to extra amount that required for provisioning depends upon the level of NPAs and their quality. As per his view, rising level of NPAs create a psyche of worse environment especially in the financial sector. He mentioned that by reviving the activities of the financial institution like waiving interest, rescheduling the loan, writing off the loan, appointing private recovery agent, taking help of tribunals and law of land, etc, NPAs can be reduced.

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

This article of Patrick F. Reidy provides an overview of the credit portfolio management function, structural alternatives, the skill necessary for its effective implementation, and a final word on training and compensation. The focus is on corporate credit portfolios, as these often present the largest concentration challenges though they can be easily modified.

Modern portfolio management of bank assets has fundamentally changed the requirements for individuals using this technique: their backgrounds, their training, and their skills in using available resources. While traditional credit training remains necessary, today's portfolio manager arguments this background with knowledge of

early-warning systems, alternative structures to better set risk/return parameters, and more.

Traditional training focused on the individual loan. Traditional credit training focused on the analysis of a firm's management, operations, and financial structure as the basis for determining a borrower's creditworthiness; now training programs incorporate not only these techniques, but also that elusive element called a bank's credit culture.

In essence, a bank's credit culture was a series of written and unwritten rules about which types of customers, industries and credit profiles were acceptable. This culture ultimately dictated the structure and composition of the bank's total portfolio.

Protection measures against portfolio losses focused on loan loss reserves based on moving-average formulas. Concentration risk was to be avoided, but there were always those special customers for whom exceptions could be made. If the formulas were correct, then overall expected losses in the portfolio would be covered by reserves. But those formulas and expectations were not always so accommodative. As a result, certain concentrations would invariably lead to extraordinary or unexpected losses that were charged to income in the year of their incurrence.

Portfolio management looks at the impact of loans individually, collectively, and comparatively. Modern portfolio management techniques have supplemented these unwritten rules with portfolio analysis and policies that establish limits on exposure by country, by obligor, by industry, and so on. These limits are derived from a specific focus on the technical aspects of this asset classes a segmentation of the credit product and an analysis of the effect of combining credits into portfolios. Credit portfolios can now be evaluated on the basis of fundamental as well as quantitative portfolio analysis. (This is now being further institutionalized in terms of required capital as defined in the updated Basel Capital Accords.)

2.2.1.1 NPL in Nepal and Other Countries

Non- performing loan was the serious problem not only in national banking but also in the international banking. Non-performing loan differs in the various countries such as in 2003; the non-performing loan was 2.3% in U.K., 8.8% in India, 22% in China, 15.5% in Thailand and 2% in Japan (NRB Samachar, 2063:27).

In September 30, 2001 of the Latin American countries, among the 8 corer dollar share capital 7.51 corer dollar was non-performing loans and it was 8 percent of the total loan. The non-performing loan was very high because the two public banks (Nepal Bank limited and Rastriya Banijya Bank) have very huge amount of non-performing loans. Few years ago, the published sources showed that the Nepal bank Limited has 62% of the non-performing and Rastriya Banijya bank has 52 percent of nonperforming loan and these two banks have around 35 Arab rupee non performing loans and responsibility of nonperforming loans per Nepali has one thousand six hundred and fifteen rupees and it occupies 8% more than the per capital income of the year (NRB Samachar, 2063:32).

2.2.1.2 Sources of Major Problems in Credit Risk Management

Effective credit risk management allows a bank to reduce risks and potential NPLs. It also offers other benefits. Once banks understand their risk and their costs, they will be able to determine their most profitable business and thus, credit-risk strategy supported by organizational changes, risk measurement technique and fresh credit process and systems. In the context of Nepal, the sources of major problems in credit risk management are as follows (Ramamurthy, 2004: 3-5):

Financial statement (including audited) do not reflect a “true and fair view” of the business entity due to creative accounting. The audited financial statement as submitted by the customers do not reflect details relating to

- Encumbrances changes on the company’s current/fixed assets plus to whom they are changed.
- Details of group company lending/ borrowings
- Status of income assessment etc.

- Contingent liabilities.
- Accounting policies.
- Delegation of finding authority is based on seriously and not an complexes of the concerned officials
- No exchange of credit information/ lack of transparency among the competition banks giving rise to multiple banking (some customers having facilities with different base) complicating to excessive financing, double financing, division of funds, flight of capital coverage shortfall etc.
- Absence of: Risk based pricing methodologies Customer risk rating methods Facility risk rating models
- Pronounced name lending.
- Collateral based lending instead of need based/ cash flow base lending.
- Over banked center contributing for severe competition and price-cutting.
- Lack of corporate governance
- Permissive banking practice including names, lending, multiple banking etc.
- Macro level scenario of political stability, slow growing economy, small domestic market.
- Ineffective judiciary
- Cross border risk disappearance of promoters
- Inadequacy of low to deal with crime like cheating, misfeasance.

2.2.2 Review of Empirical Studies

"A bank is a government regulated, profit making business that operates in competition with other banks and financial institutions to serve the saving and credit needs of its customers. The primary business of banks is accepting deposit and lending money. Banks accepts deposit for customers who want the safety and convenience of deposit service and the opportunity to earn interest on their excess funds "(Sapkota, 2001:54).

Bhattacharya in his book “Banking Strategy", credit appraisal and lending decision has put the recommendation to Tandon committee. He has prepared this report in 1975,

however these recommendations still deserve great significance in the sector of credit appraisal, the system proposed by the committee enjoying upon the banker are as follow:

a. To assess the need based credit of the borrower on a rational basis.
b. To ensure proper and use of bank credit by keeping a closer watch on the borrower business and thus ensure safety of the banks funds.
c. To improve the financial discipline of the borrower and
d. To develop healthy banker-borrower relationship

The committee examined the existing system of lending and recommended the following broad changes in lending system.

a) The credit needs of borrowers are assessed on the basis of their business plans.
b) Bank credit only be supplementary to the borrowers resources and not in replacement of them, i.e. banks not to finance one hundred percent of borrowers' requirement,
c) Borrowers are required to old inventory and receivables according to norms prescribed by the Reserve Bank of India from time to time.
d) Credit be made available in different components only, depending upon the nature of holding of various current assets.
e) In order to facilitate a close watch on the operations of borrowers, they are required to summit, at regular intervals, data regarding their business and financial operations, both for the past and future period.

The committee including stores and other items uses in the manufacturing process are:

a) Raw material including stores and other items uses in the manufacturing process.
b) Stock in process
c) Finished goods
d) Receivable
e) Spares

"Bank growth and profitability are the result of carefully forecasting funding needs, competitively attracting funds, efficiently borrowing funds and effectively investing, funds in safe but profitable earning assets. Depending on a bank's size and location and on local and national economic conditions, a bank may have adequate, relatively stable sources of low cost funds, or it may have to compete regularly and aggressively for funds at high market prices for an increasing number of banks, the second situation is becoming the norm as more and more banks face increasing pressure to attract adequate funds at reasonable costs (Bhattacharya, 1998: 309).

In the word of S.P. Singh and S. Singh, credit policies of banks are condition to great extent by the national policy framework, every banker has to apply his own judgment for arriving at a credit decision, keeping of course, bankers and credit policy also in mind (Singh and Singh, 1983:34).

H.D. Gross stated lending is the essence of commercial banking; consequently the formulation and implementation of sound lending policies are among the most important responsibilities of bank directors and management. Dell conceived lending policies are essential in a bank to perform its credit creating function effectively and minimize the risk interest in any intention of credit (Gross, 1963:45)

Shrestha (1995) said that the commercial banks should not concentrated on the specific sector but should fulfill the credit need of various sector of the economy including agriculture, industry, commercial and social sector of the economy service sector. The commercial banks should very effective while providing loans. While providing loans, the banks should think on the maximizing the economic growth of the country as well as the profit from providing the loan for the operation of the country.

Functionally, credit is now segmented into four parts.

1. Origination and determination of the required level of customer commitment. The sales/ relationship function in credit portfolio management is often separate from the analysis/underwriting function. This allows for an efficient use of resources for client

development as well as analytical discipline and consistency. The relationship manager determines the commitment level that will maximize relationship income.

2. Fundamental analysis of the individual credit. The underwriting function in credit portfolio management is charged with the more traditional responsibility of individual credit analysis and monitoring. But this function is being driven more and more toward a specialization based on industry, so that the full benefits of analyzing alternative borrowers within an industry can be achieved. The more specialized structure enables CPM to provide key value-added analyses to relationship and product managers in complex customer support for example, merger and acquisition analysis. It also provides for a centralized, efficient use of analytical resources.

3. Portfolio monitoring. Many more tools and information resources exist today than were available in the past for portfolio monitoring. For example:

* Institutions now set various portfolio limits to shape the structure of the desired portfolio.
* Early - warning processes to measure portfolio deterioration have become an integral part of credit risk management.
* For large corporate portfolios, Merton- based models relate information inherent in the equity markets to a firm's debt levels.

* Bond spreads and credit derivative premiums provide a forward-looking credit view for the market that can be compared with a bank's own credit view.

4. The role of credit approval authorities. The credit approval function determines the desired exposure level for the institution's books within the context of pre-established limits by obligor and industry. As a result, credit approval manages expected loss and allocates capital to desirable transactions. CPM, as separate from credit approval, optimizes the use of capital through alterations to the portfolio's profile.

Alternative Structures for CPM

The establishment of **Credit Portfolio Management** is typically an evolutionary process for each banking institution. At start-up, CPM usually takes a defensive role eliminating concentration risk and culling underperforming relationships from the risk/ return point of view. As CPM develops, optimization of the selected portfolio is added to its role, adjusting exposures to take into account the best risk/return structure. The adjustments often use the credit derivatives markets in order not to disturb the primary relationship with the customer. In its advanced form, CPM adds the bank's credit view to its role, with the intention of improving the portfolio's relative value performance among different asset classes.

The state of CPM along this developmental curve often dictates whether it is located inside the wall (subject to the possibility of receiving non public information) or outside the wall (not subject to non public information and free to adjust positions).

Functions of CPM

CPM achieves two principal goals:

1. To match required hold levels with desired hold levels.
2. To optimize the portfolio of assets ultimately held by the bank.

To do this effectively, CPM must perform all or some of the following key functions, depending on the state of the developmental curve discussed above:

* Serve as an analytical and advisory group to the line and to the approval authorities, plus serve as an integral part of critical deal teams.
* Prepare the credit approval package and advocate the transaction to the credit approval authorities.
* Closely monitor obligor risks, returns, and concentrations.
* Evaluate, establish, and effectively use advanced modeling techniques to help determine the potential risk inherent in the portfolio and its asset correlations.

* Manage those same risks through the judicious use of loan sales and synthetic instruments such as credit default swaps and CDOs. (Reidy, RMA journal, (2005) "Corporate credit portfolio management: changing skills requirements".)

2.2.3. Review of Journals

Kamal Subedi titled "Growth in Major Commercial Banks" In an article published in New Business Age, has compared between the first six month of the fiscal year 2002-2003 and 2003-04, which shows that there has been noticeable increase in credit outflow by the commercial banks except of Nepal Bank Ltd (NBL) and Rastriya Banijya Bank (RBB) (the government owned banks) There has been increase in credit – deposit (CD) ratios of all commercial banks except of NBL and RBB in which case it has gone down by 10.41% and 5.99% respectively. It may be because their concentration was only on recovery of the huge Nonperforming Assets (NPA). However, Subedi pointed out that no matter what the size of NPA is and the circumstances are, each bank has to collect the deposit in order to create a lending and to invest in the new ventures. Except RBB all banks have increment in deposit collection.

A decrease in CD ratio (the percentage of the deposit mobilization over the credit) signifies the presence of high liquidity and comparatively lower fund mobilization and vice versa. High liquidity and idle funds will result in lower profits. HBL has the highest growth of 18.47% in CD ratio over the last year. Similarly, NABIL and Everest Bank Ltd. (EBL) have recorded growth rates of 11.83% and 7.45% respectively in their CD ratio. However, this ratio of other commercial banks has declined, largely due to factors external to the banks.

As per the NRB directives, all commercial banks have to maintain loan loss provision according to the size of overdue loans. Nepal Credit and Commerce Bank (NCC) were able to decrease its loan loss provision by 27.63% as compared to the previous year indicating a good recovery of interest as well as principal. In case of Nepal Investment Bank (NIBL), growth in loan loss provision(which in fact decreased by 6.73%) was much less than the growth of the total credit(which in fact decrease by 6.73%) was much less

than the growth of the total credit(which increased by 53%). Similarly, NBL and HBL were able to maintain a healthy composition of loan loss provision (decreased by 9.49% & 0%) and credit (increased by 3.70% and 26.78%), again signifying good results from their loan recovery efforts. In case of remaining banks, the situation is not satisfactory as the growth of loan loss provisions higher than the growth of credit.

A bank's stability depends on the reserve it maintains. NABIL's reserve growth is very good i.e. 1400% on retained earnings and 67.86% on other reserves. Similarly, all other banks have except NCC and BOK made noticeable increment in it. The major yardstick to measure the status of the bank (which is the prime concern of shareholders) is the profitability of the banks- the spread between what the banks has earned and expensed. In this regard, KBL has made the significant growth of 81.25% in profit as compared to the precious year. Similarly Standard Chartered Bank (SCBNL), NABIL, HBL, BOK, EBL, NIBL, NSBI, NIC and NCC have the growth of 7.72%, 6.333%, 43.73%, 29.83%, 61.8%, 62.76%, 29.76%, 37.89% and 4.03% respectively.

Government of Nepal has promulgated ordinance to replace several existing laws related to the banks and financial institutions like Commercial Bank Act 2031, Finance act etc related to financial institution. The major highlight of the ordinance with universal banking that makes all the banks and financial institution governed by a single act making the legal process much efficient and with less confusion and it has protected the rights and welfare of the depositors and investors.

However this ordinance has lots of unclear issues, which has created confusion to the existing banks and financial institutions. The ordinance has classified the financial institution into categories replacing the present terms as commercial, development of finance companies. The act has classified the commercial banks' category, as "ka" category .The positive aspect of this ordinance is that the financial institution which fall under the "Kha" category will also be allowed to carry out several financial activities that were previously allowed to only commercial banks, such as opening current accounts,

issuing drafts and traveler’s cheque, dealing in foreign exchange and issuing letter of credits.

Even the financial institutional, which falls under the category “Ga” are permitted to handle current account, saving account and to some extent, foreign currency transaction. Due to these changes, the consumer will be benefited due to the competition among these banks and financial institutions.

In an article published in New Business Age written by Sudhir Khattri, has analyzed the ordinance pros and cons, in general speaking termed as Umbrella Act. He has expressed his disagreement in the ordinance regarding the qualification of the Board of Directors' composition. The qualification set is out of the total number of directors, two thirds have to be graduates in law, banking and statistics. Another requirement is five years work experience either in banking or public limited companies or in a gazette level government posts. He argues why a science graduate or someone with engineering background cannot be the director, it is not justifiable to question on the capacities of the people with these background i.e. in the past some successful General Manager and Directors in Nepal Industrial Development Corporation (NIDC) were engineers. He further writes that activities like project financing and asset valuation require engineers and similarly that there cannot be any reason for the position of director in banks to be graduates in some specified fields only. For CEO of the “Ka” category, qualification required is masters Degree in the chosen few subject and the term would be of four years. The act however does not mention the renewal of the CEO's term. The Board or AGM of the institution should decide the CEO’s tenure. (Khatri,” One umbrella Act’s pros and cons”. Pp, 18-20.)

Similarly, he points out argument in the requirement of five year work experience. The performance of the public limited companies is so poor that the efficiency of the staff is questionable. In such situation how can one hire someone with the experience in public limited companies? As per the act, it is mandatory to appoint a professional director in the Board chosen from the list of professional experts enlisted by NRB. Such director

will not have voting right. It is questionable that can be contribute significantly towards the development of a bank or financial institution without the voting right?

For the existing banks and other financial institutions a two- year period has been granted to apply for the license. Entirely new Memorandum of Association and Article of Association have to be prepared and a special general meeting of shareholder has to be called. If any institution fails to obtain the license on the said period their license will be seized. However, there is no clear information on whether the institutions can prepare Memorandum of Articles in their own format or are there any prescribed format available or will be made available by the central bank- Nepal Rastra Bank for this purpose.

This ordinance has given the full authority to NRB for monitoring, inspection, supervision etc. NRB is vested with the power to fix interest rates in lending and deposits and the Act also states that NRB can also delegate this authority to the individual banks themselves. However, such delegated authority can be taken by the bank. This makes banking, more risky, it indicates that NRB is interest to take control on fixation of interest rates as when required.

In an article published written by Atma Shrestha in Business Age entitled “Entrepreneur –Friendly Credit Policy” has reviewed the present credit policy with main focus of the credit decision being based on the collateral. He argues that only collateral should not be considered as the basis of the credit decision. (Shrestha, “Entrepreneur- Friendly credit policy”)

Access to finance is vital element for entrepreneurship development in the country. Without it one cannot think of starting business of any sort. It’s mainly due to this reason; most of the students after completing their single mindedly look for employment opportunity. No other option, no matter how lucrative and attractive it would be enters into their mind. It has created huge pressure in the labor market. In the absence of entrepreneurial activities in the country, employment opportunity will be very limited and even qualified and competent people do not get job. The established notion of the

Nepalese bankers that money lent to the wealthy people based on collateral is safe. But is not actually a safe assumption in the face of greater difficulty in loan recovery from these people. Also, this particular segment of market is already over-banked. With the worsening business performance of the Nepalese corporate sector mostly due to the poor management compounded by other factors sluggish economic conditions and political instability, banks must now explore newer market segment for their sustained growth and success. Under this backdrop, Nepalese commercial banks must change their policy and must understand that even the people living in the low and middle level of economic pyramid can potentially be lucrative market. They can ignore them only at their peril, especially at the time when the competition in the market consisting of people at upper level of economic pyramid is very intense and had already saturated. In this context, potential entrepreneurs armed with skills, knowledge and readiness to take plunge in the business world can form a formidable market opportunity for the Nepalese banking industry –only if it can come out of the cocoon of traditional collateral-driven lending approach.

At the time when Nepalese banking industry is confronting with the increasing NPA, it might seem unwise and untimely to suggest that commercial banks extend loan to the potential entrepreneurs without collateral. It is not that they must ignore the collateral altogether while making credit decision. Collateral may be one of the important elements of the credit decisions. But this should not be a pre-condition for any credit decision. Lesson should be learned from the past experience of this credit policy that collateral alone does not ensure quality of credit decision. The fluctuation and stagnancy in the real estate business has further reinforced this view. More important, Nepalese bankers themselves must have to have entrepreneurship spirit which means, they should not hesitate to take educated risk by giving more weight to the entrepreneurship dimension of the credit proposals while making credit decision. The ability of lending is identifying and investing a distinct competitive advantage in the crowded market. However it's essential that any government rules and regulations that inhibit the promotion of entrepreneurship in the country must be abolished.

Entrepreneurship development is one of the important conditions for the economic growth of a country. There must be the sprout of entrepreneurship activities in the country for rapid economic growth and progress. However it does not happen automatically. We must create necessary condition and environment where people with skills, knowledge and hunger to make money by starting their own business can get easy access to capital.

The ordinance relating to banks and financial institutions has been promulgated that has been brought into existence effective February 4, 2004. The Banks and Financial Institutions Ordinance, 2004 has replaced the existing Agricultural Bank Act, 2024, Commercial Bank Act, Development Bank Act, and Nepal Industrial Development Corporation Act and Finance Companies Acts and have bought all such institutions under the preview of a single Act. Though this ordinance came as an achievement in the financial sector reform program, its being a, matter of debate among the various finance experts that the ordinance having six months existence time should be enacted? At this time since there is no parliament in the country and the parliament is authorized to enact permanent law. It is obvious that the financial sector must go through uncertainty in the future. The ordinance, popularly called as Umbrella Act.

In an article “Comments on Umbrella Ordinance 2004” Tirtha Upadhya, president of ICAN has clearly described the ordinance along with his views. The ordinance is comprehensive and prescribes in detail the provision for licensing, incorporation, governance and merger and dissolution procedure for banks and financial institutions (FIs). This is a significant improvement over the existing Acts but apprehension is expressed about the discretionary power that the ordinance has vested on Nepal Rastra Bank(NRB).(Upadhaya, “Comments On Umbrella Ordinance 2004”P16-17)

The ordinance divides into 12 chapters and contains altogether 93 sections.

Chapter 1 defines the various terms used in the ordinance but has conspicuously omitted to define” security” and “collateral” among some important terms. These words have been frequently used in relation to lending activity but in the absence of universally acceptable definition the ongoing anomalies owing to the ambiguity are expected to

continue though it has been clarified that the financial institutions henceforth can lend against personal or corporate guarantees.

Chapter 2 specifies the procedure for establishing a bank or financial institutional and has brought transparency in licensing procedure. The authority has to either issue the license within 120 days of application or notify the reason of refusal within the said period. Further a foreign bank's presence in Nepal either though a joint venture or branch banking is legally mandated. This provision will probably meet the long outstanding demand of the donors and conforms Nepal's entry to WTO. Buying back of its share by a financial institution, a unique provision is legally slated by this ordinance, and that could be considered progressive. But it has failed to explain the objective of such provision and at the same time appears to be restrictive to implement. The ordinance failed to prescribe condition for enhancing the stake of joint venture partner, fresh issue of share to strategic partner, issue under employee's stock option plan and preferential issue that is vital from the investor's perspective.

Chapter 3 deals with the constitution and Board of Directors and appointment of CEO. Henceforth, in addition to directors appointed by the shareholders, meetings, the FIs must have one independent director in its Board appointed from amongst the names in a roster maintained by NRB. Also, the academic qualification of remaining directors has been prescribed that requires that 2/3 rd of all directors must possess required academic qualification and experience but it has failed to ensure that people of requisite qualification are elected by the general meeting. Similarly, academic qualification for a position of CEO is also prescribed and his/her tenure is limited to four years. But the intention for limiting the tenure paid executive remains unexplained. It might prevent young and dynamic person from taking this leadership position. Further, the authority and responsibility specified are not commensurate to the position of a CEO. As the law does not guarantee vesting of executive authority on CEO, it might inconsistent with the principle of divesting management from investor to professional managers.

Chapter 4 places restriction on using bank of FIs name or carrying out financial transaction by institution other that those licensed by NRB as per the ordinance.

Chapter 5 deals with capital adequacy, reserves and provisioning for NPA's but the more it has tried to be transparent, the more it has vested discretionary powers with NRB. To protect the interest of depositors, the prime concern of legislatures in drafting the law should be continued maintenance of adequate capital and such an important matter should not be left to the discretion of NRB. The lesson should be learnt from the past experiences where NRB's leniency sent two largest banks technically bankrupt. In this regard, it may be pertinent to remind why the Basel Committee recommendation on capital adequacy (that is universally acceptable) is not created to meet the capital gap within specified time. Such an obligation is vital for protecting the depositors' interest. As such obligation has been the case with the two largest banks (i.e. Nepal Bank Ltd. And Rastriya Banijya Bank) and a few other private sector banks in Nepal, continued flouting with NPA's has eaten away not only their equity but the depositors' money as well.

Chapter 6 prescribes the financial transactions that bank's at FIs are empowered to undertake. It has attempted to include all types if traditional financial transaction either to undertaken by a bank or FIs but has failed to visualize the requirement of a modern banking like debt securitization swap and hedge transactions and dealing in other financial derivates. The finance company will be benefited with this ordinance as they are now authorized to accept interest free deposit. Regulatory, inspection and supervision responsibility with regard to FIs continue to remain with NRB. The new provision has enlarged the scope of NRB's regulatory role. Banks set up with foreign shareholding will now be required to submit to NRB the inspection reports prepared by their headquarters. Severe penalty including suspension of Board or taking over the management of FIs has been prescribed if the result of NRB inspection indicates non-compliance with its directives or if the FIs are found to be guilty of engaging in activities that are detrimental to the interest of the shareholders or the depositors**.**

Chapter 7 The deregulated interest rate regime appears to be drifting away as the ordinance has empowered NRB to intervene in rate fixation but it does not specify the conditions that would oblige NRB to do so. Looking at the current rate of interest offered on deposit on FIs that has gone below the inflation rate, NRB intervention could bring relief to thousands of small depositors especially old, disabled and pensioners whose lifetime saving is at stake.

Loan disbursement and its recovery procedures are covered under **Chapter 8** that re-established the NRB's authority to regulate lending and minimize the chances of loan going to and unscrupulous borrower or diversion of the funds. The ordinance has specifically provided for the compulsory registration of all charges on assets pledge as collateral but the agency responsible for such registration (other than real estate) is not identified. The authority of FIs in loan recovery has been extended and it may now reach to other assets of the borrower in case the security of loan falls short or becomes inadequate. The hitherto requirement of disposal of non-banking assets within seven year has been done away with. It may result in accumulation of significant unproductive assets in FIs balance sheet. The role of loan Recovery Tribunal has been undermined and no role is envisaged for Asset Management Company that is in the offing.

In Chapter 9 The role of the auditor of FIs has been extended and it goes beyond the scope of expertise of accounting profession. Auditors shall require among others, to certify whether FIs have acted (or failed to act) to protect the interest of depositors or investors and whether the business of FIs has been conducted satisfactory. Basis of such opinion is not outlines and accordingly it will serve or purpose other than becoming a ritual.

Chapter 10 deals with merger that permits FIs merge with other FIs only. This is a new provision but does not prescribe the circumstances when such merger will be permitted. The missing part on merger is the safeguard of interest of minority shareholders. It does not entitle shareholder opposed to the merger to ask for compulsory acquisition that is vital for promoting foreign investment.

Chapter 11 prescribe penalty for various offences that could be both civil, and criminal. **Chapter 12** has laid down procedure for voluntary winding up FIs arbitration and miscellaneous administration and operational procedures. The client confidentiality is guaranteed but with so many restrictive sub-clauses it is doubtful if the objective would ever be met. Similarly depositor's right is clearly protected by reiterating that there would be no other claimant on deposit kept with FIs other than the depositor himself or his nominee but with such right. The state may interfere in one or other pretext defeating the intension of law and lessening the confidence in the banking system

For the first time, the law has taken recognize of international terrorism and NRB is empowered to suspend operation of account related to organization or individual associated with such activities. But it has omitted any anti-money laundering provision. Probably, a separate Act is being envisaged to deal with such transactions.

In conclusion, it could be said that the ordinance is comprehensive and deals with significant aspect of operation of FIs. However, attempts should be made to limit NRB's discretionary power by framing transparent, prudent and unambiguous policies and regulations. Further work would be necessary to integrate the country's financial sector with international financial sector with international financial market and effort should be directed to encourage adoption of international bet practices like International Financial Reporting standards (IFRS), International standards on Auditing (ISA), Bassel Committee Recommendation etc.

Dr. Champak Prasad Pokharel in the article entitled "Financial sector Reform and New Challenges", Agricultural Credit Publication stresses that highest liquidity makes financial institution un-bankable by creating unnecessary burden of bearing the cost of capital. Dr. Pokharel expresses that most of the financial institutions are lying on uneconomic situation due to ineffectiveness of portfolio management on the one hand and deficiencies of efficient modern management on the other as far for the betterment of financial possibility in portfolio projects, like health , residential buildings, communication, tea gardening etc.

Dr. Pokharel further suggests that commercial banks need to make strong strategy urgently with shifting the money from fixed deposit to saving reducing the interest between deposit and interest spread in both sectors. He highlights that fixed deposit has been increasing in the ratio of 0.44 to 0.95 from 1990 -1999.

2.3 Review of Thesis

The financial institutions especially CBs have to identity new area of investment to increase loans and advances in reducing the liquidity position.

With the rapid growth in the number of banks and financial institution, deposit insurance scheme is a must. The principle reasons for introducing such deposit insurance should be one of the social justice rather than economic justification in order to protect the interest of the small depositors. In this condition, this scheme should be expedited to implement (Karki, 2000: 26-30).

Rewat Bahadur Karki has summarizes some of the challenge through his article ,"The financial sector is facing major challenges of high NPL of the banking sector, which comes around 18% of the total loan but it the loan classification is made according to least international practice, it is assumed to exceed 30% credit demand is being met largely by non-institutional source i.e. private money lender, merchant trade, individual and land lord at very high rate of interest, which is 2-3 times higher then of institutional source, this shows that the unorganized financial sector is playing a major role in Nepalese economy. The liquidity has a major role in Nepalese economy. The liquidity position of the banking sector is rated as high as 24%, but the productive sector of the economy is starved by credit crunch. This has created a paradoxical situation in banking sector. He has given some suggestions to improve the Nepalese financial sector:

Pradhan (2053) in his study entitled "Deposit mobilization, its problem and prospects". He has presented a short glimpse on investment in different sector, its problem and prospects through his article. On his article, he said that, "Deposit is the life blood of any financial institution, be it commercial bank, finance company, co-operative or non government organization". He has added, In consideration of ten commercial banks,

nearly three dozen of finance companies, the latest figure does produce a strong feeling that a serious review must be of problem and prospects of deposit sector. Besides few joint venture banks, other organizations rely heavily on the business deposits receiving and credit disbursement.

In the light of this Mr. Pradhan has pointed out following problems of deposits mobilization in Nepalese perspective:

- Due to lack of education, most of Nepalese people do not go for saving in institutional manner. However, they are very much used of saving, be it in the form of cash, ornament or kind. Their reluctance to deal with institutions system are governed by their lower level of understanding about financial organization, process requirement, office hour withdrawals system availability of depositing facilities and so on.
- Due to the lesser office hour of banking system people prefers for holding the cash in the personal possession.
- Unavailability of the institutional services in the rural areas.
- No more mobilization and improvement of the employment of deposits in the loan sectors.

Mr. Pradhan has not only pointed out the problems but also suggested for the prosperity of deposit mobilization. They are given as:

a) By cultivating the habit of using the formal sector for transactions must be a priority and continuous educational programme.
b) By adding service hour system will definitely be an appropriate step.
c) By providing sufficient institutional service in due rural areas. If deposit mobilization, materialize, that should be taken as major achievement as this generated fund can be used somewhere by the bank. NRB could endorse this deposit collection by continuing to subsidize overhead cost far little longer period. A full scale of field office system could be taken back and modes manpower strength deputed to cut down overhead cost.

d) NRB could also organize training program to develop skilled manpower.

e) By spreading co-operative to the rural areas mini banking services are to be launched.

f) The scheme of mobilizing the deposit in the form of free personal accident insurance, deposit insurance may be fruitful. Not only waiting far potential customer it is better to reach to the potential depositors.

At last, Mr. Pradhan mentioned deposit mobilization carried out effectively is in the interest of depositors, society, financial sectors and the nation. Lower level of deposit rising allows squeezed level of loan delivery leaving more room to informal sectors. That is why higher priority to deposit mobilization has all the relevance.

Competition between joint venture banks made them to collect large amount as deposit. In the same way, Nepal's two joint venture banks NABIL and HBL are positioned among 500 biggest bank of Asia region. This evaluation is based on the total assets, loan investment, net income and profit and investment on shares (Kantipur, 2001).

Regmi (2004) conducted a thesis "A study on credit practices of joint venture commercial banks with reference to Nepal SBI Bank Ltd. And Nepal Bangladesh Bank Ltd."

The basic objectives of this thesis are:

- To determine impact of deposit in liquidity and its effect on lending practices.
- To know the volume of contribution made by both bank in lending.
- To examine lending efficiency and its contribution in profit.
- To analyze trend of deposit utilization towards loan and advances and net profit and their projection for next five years.

The major findings of this study are:

1. In terms of liquidity ratio, current ratio of NSBL is higher than that of NBBL. The ratio of liquid fund to current liability of NSBL is higher than NBBL. This shows that NBBL has less consistency than NSBL. The ratio of cash and bank balance to

deposit of NSBL is higher than that of NBBL. Cash and bank balance to interest-sensitive deposit measures the liquidity risk arising from fluctuation of interest rate in the market. The ratio of cash and bank balance to interest sensitive deposit of NSBL is higher than NSBL. NSBL has poor position due to high volume of interest sensitive liability in deposit mix.

2. The ratio of loans and advances to total assets of NBBL is higher than NSBL. Likewise mean ratio of loans and advances to total deposit of NBBL is higher than NSBL. The mean ratio of investment to loans and advances and investment of NSBL is higher than that of NBBL. Likewise the ratio of total investment to total deposit of NSBL is higher than that of NBBL.
3. The ratio of credit to government enterprises to total credit of NBBL is higher than that of NSBL. The mean ratio of credit tot bills paid and discount to total credit ratio o NBBL is higher than that of NSBL. NSBL has contributed 95.91% in private sector loan, 2.51% in government sector loan and 1.56% in bills paid and discounts. Likewise NBBL has contributed 90.83% in private sector loan, 4.29% in government sector loan and 4.84% in bills paid and discounts.
4. Among the various measurement of profitability ratio return on equity (ROE) and earning per share (EPS) reflects the relative measure of profitability. The performance of NBBL is better than NSBL. Return 0on equity and earning per share of NBBL are higher than that of NSBL in all years.
5. Co-efficient of correlation between deposit and loans & advances of both banks have positive value. Also co-efficient of correlation between total income and loans & advances of both bank have positive relation. Coefficient of correlation between net profit and loans & advances of NSBL is negative as other variables like increase in interest suspense and loan loss provision affects net profit. Coefficient of correlation between net profit and loans & advances of NBBL is positive.
6. Trend analysis of total deposit of NSBL and NBBL are found in increasing trend. The increment ratio on deposit of NSBL is lower in comparison to NBBL.

This study is mainly focused on the lending practices and the volume of credit in comparison to the deposits. Therefore, the major gap in this research is study of the risk

involved in the lending practices or the study of credit risk. Therefore, further study on the risk involved in creating credit can be made.

Kafle (2005) in his study entitled "Non-performing loans of Nepalese commercial banks." The researchers mean objective of the study was to know the problems of the non-performing loans and its effect in the ROA and ROE of the Nepalese commercial banks and to find out whether the Nepalese commercial banks are following the NRB directives regarding loan loss provision for non-performing loan or hot.

Through the research he has found that the no banks have been following NRB's directives regarding the loan loss provision. He also conclude that the return on assets (ROA) and return on equity (ROE) of the bank deposed upon the NPLs. The high degree of negative correlation between NPL and ROA and the NPL and ROE clearly indicates that there is inverse relation between them. He has recommended that for the smooth operation of the commercial banks, the NPLs should be controlled for this bank should provide necessary training regarding loan management to the manpower's. In order to remove, the NPLs, banks should take enough collateral so that banks can recover its loan amount. For the loan loss provision as per the NRB directive and to reduce the NPL, the bank management should be effective and the NRB's monitoring and regulation is necessary.

Shrestha (2005) on "A study of Non performing Loan & loan loss provision of Commercial Bank, A case study of NABIL, SCB and NBL" has made study about a part of credit risk associated with those banks. The main objectives of her study were:

- To find out the proportion of non-performing loan in the selected commercial banks.
- To find out the factors leading to accumulation of non performing loan in commercial banks
- To study and analyze the guidelines and provisions pertaining to loan classification and loan loss provisioning.
- To find out the relationship between loan and loan loss provision in the selected commercial bank.

- To study and the impact of loan loss provision on the profitability of the commercial banks.

The major finding in her study was that the NBL has the highest portion of the loan in total asset followed by NABIL and SCBNL. She concludes that the SCBL shows the risk-averse attitude. Likewise the non-performing loan to total loan is found highest in NBL, NABIL and SCBNL. Likewise the Loan Loss Provision is also highest in NBL where as the SCBL has the least Loan Loss Provision.

Likewise, the NBL has the highest portion of Loss loan followed by NABIL and SCBL. This study is more concentrated on non-performing loans; however, there exists lots of areas in credit risk management where further research is called for. In context of credit risk, collateral risk, concentration risk, organization risk management system can be studied.

Surit Sharma (2006) took following objective in his study of "Loan management of Joint Venture Banks".

- To analyze the effectiveness of lending policy of the selected sample banks.
- To measure the performance in quality, efficiency

To meet the above objective, the sources of data of commercial bank are analyzed by using financial tools such as ratio analysis, frequency, mean, standard deviation are used. Among many joint venture banks the researcher took two banks EBL and NBBL with five years data.

In findings, the current ratios of these banks are considerable and considerable but mean liquid fund to total deposit ratios are fewer consistencies and are not above 1 which shows the minimum deposit mobilization. Likewise, assets to total liabilities ratios are also fluctuating.

Similarly, loan and advances to total deposit ratio, mean ratio of loan and advance and investment to total deposit ratio shows the deposit mobilization in income generating sector are being nearly equal to 1. Loan and advances to shareholders equity ratio shows

how well the investment made by investor. These ratios of both banks are above 10 and are fewer consistencies.

In conclusion, the overall performance of Nepal Bangladesh Bank Limited is satisfactory then Everest Bank Limited. The liquidity position of NBBL is better than that of EBL. As loans and advances of NBBL is increasing trend deposit is also increasing trend during the study period. There is increasing trend in profit of NBBL shows that improvement in performance and success of the firm. Purpose wise loan classification show that the NBBL and EBL banks have given priority to industrial and commercial sector lending, as well as priority and deprived sector lending. NBBL has higher lending portion in these sectors than EBL. From the selected bank NBBL has performed well in increasing growth ratio of deposit, loans and advances, investment and profit.

NBBL has good lending procedure, preliminary screening is done of all the loan application, credit appraisal and financial position of the business and cash flows of the proposal is given high importance, which is essential criterion for loan approval. There is proper control mechanism like delegation of authority, follow up visits and books of accounts inspection of the client, which results in good performance of the bank. The banks follow NRB guidelines of loans classification and provisioning which makes strong financial position of the bank instead of holding high volume of non-performing assets. After comparatively study of NBL and EBL banking performance, it can be concluded that NBL has better performance than that of EBL.

Bishal (2006) took following objective in his study of "Lending policy of Joint Venture Banks". The main objective of his study is to analyze the fund mobilizing policy adopted by NABIL and Himalayan Bank Limited. The specific objectives of the study are as follows:

- To measure the relationship of total deposits with total investment, loan and advances and net profit.
- To evaluate the comparative growth ratio on total investment, loans and advances, total deposits and net profit of HBL and NABIL Bank Limited.

- To evaluate financial and investment efficiency, profitability and liquidity position of HBL and NABIL Bank Limited.
- To analyze the sources and uses of funds of HBL and NABIL Bank Limited.

To achieve the objectives of the study, descriptive an analytical research design has been used for secondary data. Some statistical and financial tools have also been applied to examine facts and descriptive techniques have been adopted to evaluate funds mobilizing performance of HBL and compare to NABIL Bank Limited.

In findings, the mean ratio of cash and bank balance to total deposits and investment on government securities of HBL is more consistent and that of NABIL. The average study of cash and bank balance to current assets ratio, investment on government securities, the mean ratio of loan and advances to total deposits, the mean ratio of investment on government securities to total working fund, return on loan and advances and return on working funds HBL is more consistent than that of NABIL. The mean ratio of total interest paid to total working fund, liquid funds, correlation coefficient between deposit and total investment, between deposit and loan and advances, growth rate of loan and advances and liquidity risk ratio of HBL is higher than NABIL. But the capital fund, yearly growth rate of net profit of NABIL is better in comparison to HBL. The total deposits to total investment ratio of HBL and NABIL are in increasing trend. There is significant difference between mean ratios of loan and advances to total deposits and total investment to total deposit of HBL and NABIL.

From the above analysis, it can be concluded that the liquidity position of NABIL was not satisfactory whereas HBL is comparatively better than that of NABIL. NABIL has made enough investment in government securities than HBL but weak position in mobilizing the collected deposits as loan and advances and NABIL.

NABIL seems stronger in earning interest from working fund than HBL and it has also been successful to collect its working fund from less expensive sources. Growth rate of NABIL on loan and advances and total investment are too weak in comparison to HBL. HBL borrowing is an indication that the internal fund management than NABIL.

Deposits and total investment, deposits and loan and advances of HBL and NABIL indicate high degree of positive correlation. In most of the cases it has been found that loan and advances and investment decision depends upon other variables. So the calculation of probable error also supports significant relationship. By considering the trend values also, HBL seems to be more successful than NABIL to utilize its total collected deposits in investment, deposit utilization trend in relation to loan and advances. In case of testing of hypothesis it can be concluded that there is significant difference between mean ratio of loan and advances to total deposits of HBL and NABIL and there is no difference between mean ratios of total investment to their total deposits.

S. Shrestha (2008) on her research "A study on the credit risk management of Nepalese Commercial Banks" aims following objective taking Kumari Bank and Machhapuchre Bank.

- To examine the credit risk position of the selected commercial banks in Nepal
- To analyze the credit risk management system and practices of KBL and MBL
- To evaluate the organizational structure of KBL and MBL to manage the credit risk.

From the analyses of credit risks, following major findings have been obtained:

1. From the analysis of primary data, it is found that the majority of the respondents of both banks have favored with the bank's single sector, which is up to 10 % of total loan. However, the sector wise lending analysis portrays that KBL and MBL have extended up to 19.88 % and 30.12% of loan in a single sector respectively in FY 2005/06. Similarly, the exposure on the single sector of KBL and MBL exceeds 10 % of total loan in 3 and 5 sectors respectively. The single sector loan to core capital shows that the ratio crossed 100% in 2 sectors of both KBL and MBL. In regard to concentration risk, KBL has more risk in manufacturing and others sector where as MBL has more risk on manufacturing and Whole seller and sectors as the single sector credit to core capital ratio in these sectors is more than 100 %. MBL has very high loan concentration on manufacturing sector of 199.35% of the core capital. From the personal interview of the key respondents it was found that both banks have been

extending credit in those highly concentrated sectors after getting approval from the board of director. This clarifies that concentration risk is the main source of credit risk for KBL and MBL.

2. Similarly, lack of systematic and thorough credit processing is also the major source of credit risk in these banks. The problems in credit processing include lack of thorough credit assessment, absence of testing and validation of new lending techniques, subjective decision-making by senior management**,** lack of effective credit review process, failure to monitor borrowers or collateral values, and failure of banks to take sufficient account of business cycle effects etc. Likewise the market-sensitive and Liquidity-sensitive exposures also increase the credit risk of these banks. Similarly, it is found that both banks have their own rating system of the credit client and the sectors. Both banks have ranked 1st to the manufacturing sector where as the Agriculture sector has been ranked the last on the basis of priority. KBL has chosen others sector and real estate business in 2nd and 3rd position respectively, where as the MBL has just opposite preference in these sectors.
3. Likewise, KBL has ranked Character, Collateral and Capacity of borrower first, second and third criterion for granting credit where as MBL ranked Character, Capacity and Capital first, second and third priority respectively. The hypothesis test on the preference of the bank's staff also proves that there is no significant difference between observed and expected frequency of ranking.
4. Lending analysis against various collaterals: it has been found that both the banks have lent highest amount of loan against the movable/ immovable property. The average lending over 5 years period of KBL and MBL against movable/ immovable property is Rs. 2,987 million and 2,673 million respectively. Similarly, the lending against others securities (i.e. other than prescribed by NRB) is second position for both banks, whereas the lending against guarantee of local banks and finance companies is in third position. However, MBL has also granted loan without any collateral. The average amount of loan without collateral is Rs. 3 million annually, which is in the 6th place on ranking. On the contrary, KBL has not granted any loan without backing any collateral.

In conclusion, the major banking risks include credit risk, market risk (i.e. liquidity risk, interest risk, operation risk etc). Among these risks, credit risk has the major impact on banking (i.e. more than 60 %). Because of the credit risk, the Non Performing Loan (NPL) of bank will increase. With the increase in NPL, the loan loss provisioning will also increase simultaneously leading to decrease in profit. The decrease in profit results in low dividend to shareholder and bonus to employees.

To remain alert and prepare plans and policies to tackle unpredictable factors such as violence riots, natural disaster, technology and employees, fault and fraud of customers and outsiders are the challenges for these commercial banks.

For proper management of the credit risk, both banks have their own set of policies and practices, which is in consistence with NRB guidelines. For credit risk management, both banks have Credit Policies Guidelines (CPG). Similarly, NPL is regularly monitored by both the banks on regular basis and provisioning is done on quarterly basis by categorizing the loan as per NRB guidelines. Similarly, sector wise and security wise lending is being analyzed by these banks on monthly basis. Organizational structure of these banks is frequently restructured for proper credit risk management as per requirement.

For minimizing the loss arising due to occurrence of the credit risks, capital adequacy have been maintained by these banks within the standard prescribed by NRB. However, the trend of Capital Adequacy ratio of these banks suggests that both the banks need to increase their capital fund, which is possible mainly by issuing shares, debentures or preference share.

Though both the banks have their own set of procedures for assessing various risks and their management, problems are still prevalent in these banks. In credit risk, single sector loan concentration is the main problem in both the banks. In MBL, the major problem is a high amount of lending in manufacturing sector, lending without collateral, non-performing loan & organizational structure for handing credit risk. In KBL, with the increase in total loan, NPL is also increasing. So, proper adjustment is needed for managing the NPL.

CHAPTER - III
RESEARCH METHODOLOGY

Research in common parlance refers to a search for knowledge. This chapter focuses on the research methodology understand credit and credit management of finance companies. The Webster international Dictionary gives a very inclusive definition of research as "a careful critical inquiry or examination in seeking facts and principles diligent investigation in order to ascertain something."

This chapter deals with the research methodology employed in the entire aspect of the study. Research methodology is the process of arriving at solution of the problem through planned and systematic dealing with the collection, analysis and interpretation of facts and figures. In other words, research methodology refers to the various methods of practices applied by the researcher in the entire aspect of the study. This chapter includes the research design, population and sample, nature and sources of data and analysis of data.

3.1 Research Design

A Research Design is the arrangement of condition for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure. (Kothari, 1992:25). Research design is the plan, structure and strategy of investigation conceived so as to obtain answers to the research question and to control variances. To achieve the objectives of the study, descriptive an analytical research design has been used. Some statistical and financial tools have also been applied to examine facts and descriptive techniques have been adapted to credit risk management of financial companies in Nepal especially reference to Kathmandu finance limited and Nepal housing and merchant finance limited. The study is based on secondary data. So the descriptive and analytical research designs have been used.

3.2 Population and Sample

The method of selecting for study a small portion of the population to draw conclusion about characteristics of the population is known as sampling. Sampling may be defined as the selection of part of the population on the basis of which a judgment or inference about the universe is made. There are a lot of mushrooming financial institute, Which are regarded as a population of the study. But it is not possible to cover the entire financial institute under the study. There are altogether 78 finance companies are operating in Nepal. So, only two finance company have been taken as sample i.e.

- Kathmandu finance

- Nepal housing and merchant finance limited

3.3 Nature and Sources of data

The study is mainly conducted on secondary data relating to the study of credit risk management of financial companies in Nepal especially reference to Kathmandu finance limited and Nepal housing and merchant finance limited. For the purpose of the study, various related books, booklets, magazine, journals, newspaper and thesis made in this field have been referred. Besides necessary suggestions are taken from various experts

3.4 Data Collecting Procedures

The annual reports of the concerned banks were obtained from their head office and their websites. The main source of data are annual report of concern financial institute. NRB publication, such as Banking and Financial Statistics Economic Reports, Annual Reports of NRB etc .has been collected from the personal visit of concerned department of NRB at Baluwatar. Besides, a details review materials are collected from the library of Shanker Dev Campus and central library of T.U.

3.5 Tools and Techniques used

"The analysis of data consists of organizing, tabulating, and performing statistical analysis" (Wolf and Pant: 127)

In this study, various financial and statistical tools have been used to achieve the objective of the study. According to the pattern of data available, the analysis of data will be done. The various tools applied in this study have been briefly presented as under:

- Financial tools
- Statistical tools

3.6 Financial Tools

Financial performance is analyzed through the use of two important tools. The financial tool is one of the most important tool, which includes ratio analysis and the other one financial statement analysis have been used in this study. Financial tools are used to examine the financial strength and weakness of bank. Although there are many financial ratios, only selected ratios are used in this study.

3.6.1 Analysis of Financial Rations

The techniques of ratio analysis in of considerable significance in studying the financial stability, liquidity, profitability and the quality of management of the business and industrial concerns, the important ratios that are studied for this purpose are given below.

3.6.2 Ratio Analysis

Ratio analysis is a technique of analysis and interpretation of financial statement. To evaluate the performances of an organization by creating the ratios from the figure of different accounts consisting in balance sheet and income statement is known as ratio analysis. Five types of ratios have been analyzed in this study, which are related to fund mobilization of the banks. They are presented below:

3.6.2.1 Liquidity Ratio

Liquidity ratio measures the ability of the firm to meet its current obligations. A commercial bank must maintain its satisfactory liquidity position to meet the credit need of the community. Liquidity provides honor strength health and prosperity to an organization. It is extremely essential for an organization to meet its obligations as they

become due. A firm should ensure that it has not lack of liquidity and also that it is not too much highly liquid.

i) Cash and Bank Balance to Total Deposits Ratio: - Cash and bank balance is said to be first line defense of every bank. The ratio between the cash and bank balance and total deposit measures the ability of a bank to meet the unanticipated call on all types of deposit. Higher the ratio greater will be the ability to meet the sudden demand of deposit. But every ratio is not desirable since bank has to pay interest on deposit. This also maximizes the cost of fund to the bank.

$$Cash\ and\ Bank\ Balance\ to\ Total\ Deposits\ Ratio \text{X} \frac{Cashand\ Bank\ Balance}{Total\ Deposits}$$

Where**,**

Cash and bank balance is composed up of cash on hand including foreign cheques and other cash item; balance with domestic banks and aboard. Deposits include current, saving, fixed money at short call notice and other types of deposits.

ii) Cash and Bank Balance to Current Assets Ratio: - This ratio shows the bank's liquidity capacity on the basis of cash and bank balance that is the most liquid assets. High the ratio indicates the bank's ability to meet the daily cash requirements of their customer deposits and vice versa. But the high ratio is not preferred as the bank has to pay more interest on deposit and will increase the cost of fund. Low ratio is also very dangerous, as the bank may not be able to make the payment against the cheques presented by the customers. We have,

$$Cash\ and\ Bank\ Balance\ to\ Current\ Assets\ Ratio\ \text{X} \frac{Cashand\ Bank\ Balance}{Current\ Assets}$$

iii) Investment on Government Securities to Current Assets Ratio: - This ratio is used to find out the percentage of current assets invested on government securities, treasury bills and development bonds. We can find out as:

$$Inv. on\ Gvt. securities\ to\ Current\ Asset\ Ratio\ \text{X} \frac{Investment on\ Govt. Securities}{Current\ Assets}$$

Where,

Investment on Government Securities involves treasury bills and development bonds etc.

3.6.2.2. Assets Management Ratio:

"A set of ratio which measure how efficiently a firm is managing its assets and whether or not the level of those assets is properly related to the level of operation. In this study this ratio is used to indicate how effectively the selected banks have arranged and invest their limited resources. The assets management ratios measure how effectively the firm is managing its assets. These ratios are designed to answer this question; does the total amount of each type of assets as reported on the balance sheet seem reasonable or not? If a firm has excessive investments in assets, then its capital cost will be unduly high and its stock price will be suffer" (Brigham, 1989).

i) Loan and Advances to Total Deposits Ratio: - This ratio is calculated to find out how successfully the selected banks are utilizing their collections or deposits on loan and advances for the purpose of earning profit. We have,

$$Loan\ and\ Advances\ to\ Total\ Deposits\ Ratio\ \text{X} \frac{Loan\ and\ Advances}{Total\ Deposits}$$

ii) Total Investment to Total Deposits Ratio: - Investment is one of the major sources of earning profit. It shows how properly firm's deposit has been invested on government securities and shares and debentures of other companies.

$$Total\ Investment\ to\ Total\ Deposits\ Ratio\ \text{X} \frac{Total\ Investment}{Total\ Deposits}$$

iii) Loan and Advances to Total Working Fund Ratio: - This ratio shows the ability of selected banks in terms of earning high profit from loan and advances. Loan and

advances to working fund ratio can be calculated by dividing loan and advances amount by total working fund.

$$Loan\ and\ Advances\ to\ Total\ Working\ Fund\ Ratio\ \mathrm{X}\frac{Loan\ and\ Advance}{Total\ Working\ Fund}$$

iv) Investment on Government Securities to Total Working Fund Ratio: - Investment on government securities to working fund ratio shows how much part of total investment is there on government securities in percentage, it is calculated for this purpose by following formula:

$$Investment\ on\ Govt.\ Securities\ to\ TWF\ Ratio\ \mathrm{X}\frac{Investment on\ Govt.Securities}{Total\ Working\ Fund}$$

v) Investment on Shares and Debentures to Total working Fund Ratio: Investment on shares and debentures to total working fund ratio shows the investment of banks on the shares and debentures of other companies in terms of total working fund. This ratio can be obtained dividing on shares and debentures by total working fund. It is calculated as:

$$Investment\ on\ Shares\ and\ debn.\ to\ TWF\ Ratio\ \mathrm{X}\frac{Investment on\ Shareand\ Debenture}{Total\ Working\ Fund}$$

3.6.2.3 Profitability Ratio: - This ratio is related to profit of the banks is essential for the survival of the bank, so it is regarded as the engine that drives the banks and indicates economics progress. It calculated to measure the overall efficiency of the banks.

i) Return on Loan and Advances Ratio: - Return on loan and advances ratio shows how efficiently the banks have utilized their resources to earn good return from provided loan and advances. This ratio is computed as,

$$Return\ on\ Loan\ and\ Advances\ Ratio\ \mathrm{X}\frac{Net\ \mathrm{Pr}ofit / Loss}{Loan\ and\ Advances}$$

ii) Return on Total Working Fund Ratio: - Return on total working fund ratio measures the profit earning capacity by utilizing available resources i.e. total assets. Return will be higher if the bank's working fund is well managed and efficiently utilized. Maximizing taxes, this in the legal options available will also improve the return. We have,

$$\textit{Return on Total Working Fund Ratio} \; \mathrm{X} \frac{\textit{Net Profit}}{\textit{Total Working Fund}}$$

iii) Total Interest Earned to Total Working Fund Ratio: - This ratio reflects the extent to which the banks are successful in mobilizing these total assets to acquire income as interest. This ratio actually reveals the earning capacity of commercial banks by mobilizing its working fund. Higher the ratio higher will be the income as interest. We have,

$$\textit{Total Interest Earned to TWF Ratio} \; \mathrm{X} \frac{\textit{Total Interest Earned}}{\textit{Total Working Fund}}$$

iv) Total Interest paid to Total working Fund Ratio: - This ratio measures the percentage of total interest expenses on total working fund and vice-versa. This ratio is calculated as,

$$\text{Total Interest paid to Total Working Fund Ratio} \; \mathrm{X} \frac{\textit{Total Interest Paid}}{\textit{Total Working Fund}}$$

3.6.2.4 Risk Ratios: - Commonly, risk means chance or possibility of loss, uncertainty which lies in the business transaction of investment management. When a firm wants to bear risk and uncertainty, profitability and effectiveness of the firm is increased. This ratio checks the degree of risk involved in the various financial operations. For this study following risk ratios are used to analyze and interprets the financial data and investment policy.

i) Liquidity Risk Ratio: - The liquidity risk of the bank defines its liquidity need for deposit. The cash and bank balance are the most liquid assets and they are considered as banks liquidity sources and deposit as the liquidity needs. The ratio of cash and bank balance to total deposit is an indicator of bank's liquidity of need. This ratio is low if funds are kept idle as cash balance but this reduces profitability, when the banks makes loan, its profitability increase and also the risk. Thus, higher liquidity ratio indicates less profitable return and vice-versa. This ratio is calculated as below:

$$Liquidity\ Risk\ Ratio = \frac{Cash\ and\ Bank\ Balance}{Total\ Deposit}$$

ii) Credit Risk Ratio: - Bank utilizes its collected funds in providing credit to different sectors. There is risk of default or non-repayment of loan. While making investment, bank examines the credit risk involved in the project. Generally credit risk ratio shows proportion of non-performing assets in the total investment plus loan and advances of a bank it is computed as:

$$Credit\ Risk\ Ratio = \frac{Total\ Investment\ \Gamma\ Loan\ and\ Advances}{Total\ Assets}$$

3.6.2.5 Growth Ratio: - The growth ratio represents how well the commercial banks are maintaining their economics and financial position. Higher the ratio batter performance of the bank and vice-versa. Under this topic four types of growth ratio are studied, that are directly related to the fund mobilization of commercial banks. The following ratios are calculated by using the formula of growth rate:

i) Growth ratio of total deposits
ii) Growth ratio of total investment
iii) Growth ratio of loans and advances
iv) Growth ratio of net profit

3.7 Statistical Tools

Under this heading some statistical tool such as coefficient of correlation analysis between different variables, trend analysis of deposit, loan and advances, net profit and EPS are used to achieve the objective of the study.

3.7.1 Average/Mean

An average is a single value related from a group of values to represent them in someway, a value, which is supposed to stand for whole group of which it is a part, as typical of all the values in the group. There are various types of averages. Arithmetic mean (AM, Simple & Weighted), median, mode, geometric mean, harmonic mean are the major types of averages. The most popular and widely used measure representing the entire data by one value is the AM. The value of the AM is obtained by adding together all the items and by dividing this total by the number of items.

Mathematically:

Arithmetic Mean (AM) is given by,

$$\bar{X} \; \mathrm{X} \frac{X}{n}$$

Where, $\bar{X}$ = Arithmetic mean

x = Sum of all the values of the variable X

n = Number of observations

3.7.2 Coefficient of variation

The coefficient of variation reflects the relation between standard deviation and mean. The relative measure of dispersion based on the standard deviations known as coefficient of variation. The coefficient of dispersion based on standard deviation multiplied by 100 is known as the CV. It is used for comparing variability of two distributions; the CV is defined as,

$$CV = \frac{\dagger}{\bar{X}} \; \varepsilon \; 100$$

Greater the CV, the more variable or conversely less consistent, less uniform, less

stainable and homogenous than the consistent more uniform, more stable and homogenous. This nature of CV uses that actual size of working capital.

3.7.3 Coefficient of correlation (r)

Correlation analysis is the statistical tools that we can use to describe the degree to which one variable is liner related to another. Coefficient of correlation is the measurement of the degree of relationship between two casually related sets of figure whether positive or negative. Its values lie somewhere ranging between - 1 to +1. If the both variables are constantly changing in the similar direction, the value of coefficient will be –1, two variables take place in opposite defection. The correlation is said to be perfect negative. In this study, simple correlation is use to examine the relationship of different factors with working capital and other variable.

$$\text{Coefficient of correlation (r)} = \frac{\text{CoVariance of X \& Y}}{\dagger_X \ \dagger_Y}$$

i) Coefficient of Correlation between Deposit and Loan & Advances.

Deposit have played a very important role in performance of commercial banks and similarly loan & advances are important to mobile the collected deposits. Coefficient of Correlation between deposit and loan & advances measures the degree of relationship between the two variables. In this analysis, deposit is independent variable (X) and loan & advances is dependent variables(Y). The main objectives of computing 'r' between these two variables are to justify whether deposits are significantly used on loan & advances in a proper way or not.

The following table shows the value of 'r', 'r$^{2'}$ probable Error (P.Er) and P.Er between deposit and loan & advances for the study period 2002/03 to 2006/07.

ii) Coefficient of Correlation between Deposit and Total Investment

Coefficient of correlation between deposit and total investment measures the degree of relation between these two variables. Here deposit is independent variable (x) and total investment is dependent variable(y). The purpose of computing coefficient of correlation

between deposit and total investment is to find whether deposit is significantly used as Investment or not.

3.7.4 Trend Analysis

The easiest way to evaluate the performance of a firm is to compare its current ratios with past ratios. When financial ratios over a period of time are compared it is known as the trend analysis. It gives an indication of the direction of change and reflects whether the firm's financial performance has improved, deteriorated or remain constant over time. The projections are based on the following assumptions:

The least square method to trend analysis has been used in measuring the trend analysis. This method is widely used in practice. The straight line trend of a seires of data is represented by the following formula.

$Y = a + bx$

Here,

Y is the dependent variable, a is y intercept or value of y when x=0, b is the slope of the trend line or amount of change that comes in y for a unit change in x.

CHAPTER – IV
DATA PRESENTATION AND ANALYSIS

4.1 Introduction

This chapter deals with the presentation, analysis and interpretation of relevant data KFL and NHMF in order to fulfill the objectives of this study. To obtain best result, the data have been analyzed according to the research methodology as mentioned in third chapter. The purpose of this chapter is to introduce the mechanics of data analysis and interpretation. With the help of this analysis, efforts have been made to highlight the credit risk management of finance company as well as other cases or problems of KFL and NHMF can be visualized. For analysis, different types of analytical methods and tools such as financial analysis and statistical analysis are used.

4.2 Financial Statement Analysis

Financial analysis is done by applying various financial tools in order to clear picture on the viability of the project. The financial analysis is done to ascertain the liquidity, profitability, leverage, debt servicing and interest servicing ability of the firm. The concept of financial statement analysis has been already discussed in previous chapter. Here, we study and analyze the data by using accounting tools.

4.2.1 Ratio Analysis

Ratio is the relationship between two figures. They provide two important facts about the management: the return on investment and the soundness of the company's financial position. A single ratio will not depict a true picture of the unit. Hence a combination of ratios must be analyzed to drive a true picture. Ratio analysis has been already discussed in previous chapter. Here, different ratios of KFL and NHMF will be calculated, analyzed and interpreted.

4.2.1.1 Liquidity Ratio:

Liquidity refers to the ability of a firm to meet its short- term or current obligations. So liquidity ratios are used to measure the ability of a firm to meet its short-term obligations.

Inadequate liquidity can lead to unexpected cash short falls that must be covered at excessive costs reducing profitability. In the worst case, inadequate liquidity can lead to the liquidity insolvency of the institution. To find -out the ability of the bank to meet their short-term obligations, which are likely to mature in the short period, the following ratios are developed under the liquidity ratios to identify the liquidity position.

(a) Cash and Bank Balance to Total Deposits Ratio

This ratio measures the bank's ability of withdrawal of fund immediately by their depositors. A higher ratio represents a greater ability to cover their deposits and vice-versa. The large ratio shows the idle cash and bank balance in banks while small ratio shows the utilization of deposit from banking perspective.

$$\textit{Cash and Bank Balance to Total Deposits Ratio}\,\mathrm{X}\,\frac{\text{Cash and Bank Balance}}{\text{Total Deposit}}$$

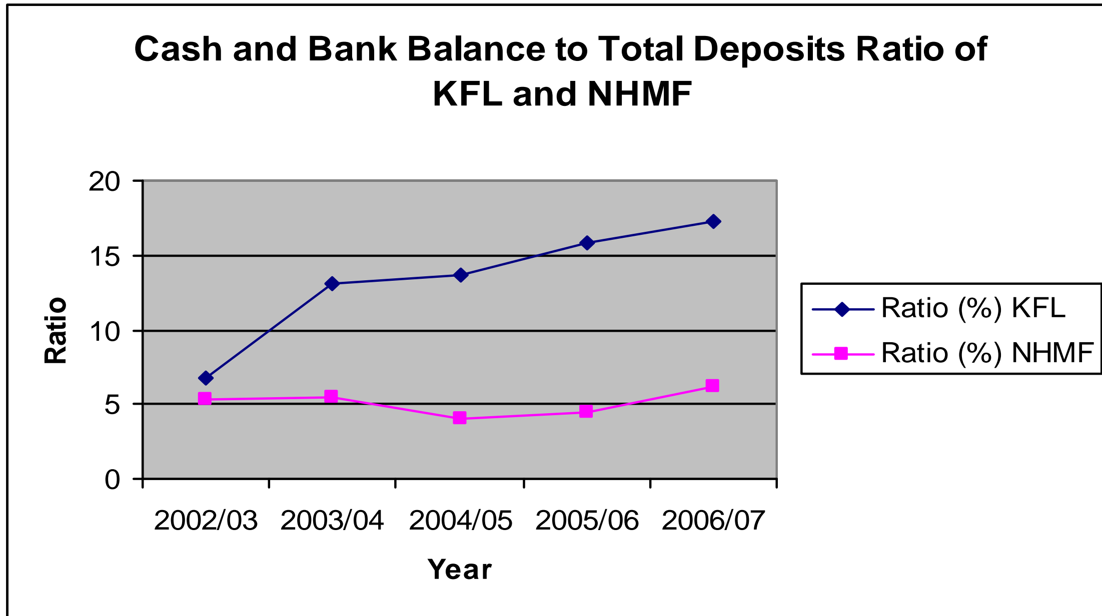
Table: 4.1

Cash and Bank Balance to Total Deposits Ratio

Year	**Ratio (%)**	
	KFL	**NHMF**
2002/03	6.81	5.27
2003/04	13.04	5.51
2004/05	13.71	3.97
2005/06	15.87	4.39
2006/07	17.31	6.20
Mean	13.35	5.07

Appendix: - 1 & 2

Figure: 4.1



From the Table No 4.1 analysis, cash and bank balance to total deposits ratio of the KFL is in increasing trend whereas ratio of NHMF is in decreasing trend in 2004/05 and in other year these are in increasing trend. The higher ratio of KFL and NHMF are 17.31% and 6.20% respectively in the same year i.e. 2006//07.The average ratio of KFL is greater than that of NHMF (i.e. 13.35%>5.07%). It signifies that KFL has sound liquid fund to make immediate payment to the depositors but KFL has excess liquidity rather than that of NHMF because of poor investment opportunities.

(b) Cash and Bank Balance to Current Assets Ratio

This ratio reflects the proportion of cash and bank balance out of total current assets. It can be calculated as follows:

$$\textit{Cash and Bank Balance to Current Assets ratio} = \frac{\textit{Cash and Bank Balance}}{\textit{Current Assets}}$$

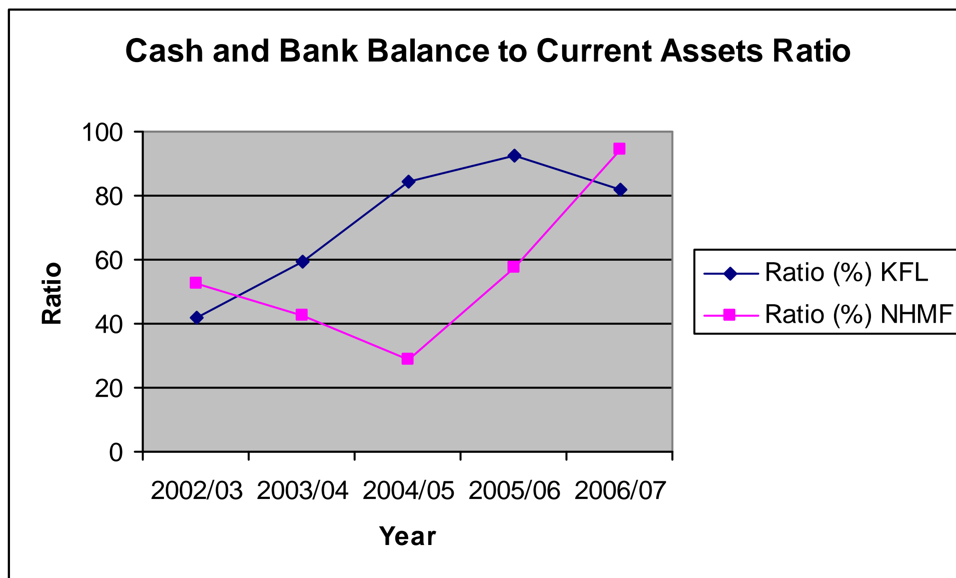
Table: 4.2

Cash and Bank Balance to Current Assets Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	42.01	52.56
2003/04	59.18	42.80
2004/05	84.14	28.74
2005/06	92.44	57.48
2006/07	82.17	94.09
Mean	71.99	55.14

Appendix: - 1 & 2

Figure No. 4.2



Above table and figure No 4.2, shows that the cash and bank balance to current assets ratio of KFL increasing trend except in 2006/07 and NHMF are in fluctuating trend. The highest ratio of KFL is 92.44% in year 2005/2006 and lowest ratio 42.01% in year 2002/2003. The mean ratio is 71.99% .Similarly, the highest ratio of NHMF is 94.09% in 2006/2007 and lowest ratio is 28.74% in 2004/2005.The mean ratio of NHMF is 55.14%. While observing the data, we notice that KFL has higher mean ratio. it means KFL has slightly sound liquid assets than that of NHMF.

(c) Investment on Government Securities to Current Assets Ratio

Government Securities can be easily sold in the market or they can be converted into cash. The main purpose of this ratio is to examine that portion of commercial banks current assets that has been invested into different government securities. This ratio is calculated by dividing investment on government securities by current assets.

$$\text{Investment on Govt. Securities to Current Assets} = \frac{\text{Investment on Gov. Securities}}{\text{Current Assets}}$$

Table: 4.3

Investment on Government Securities to Current Assets Ratio

Year	Ratio (%)	
	KFL	NHMF
2002/03	4.50	61.98
2003/04	3.23	42.26
2004/05	0	33.50
2005/06	0	22.37
2006/07	0	23.38
Mean	1.55	36.70

Appendix: - 1 & 2

Figure: 4.3

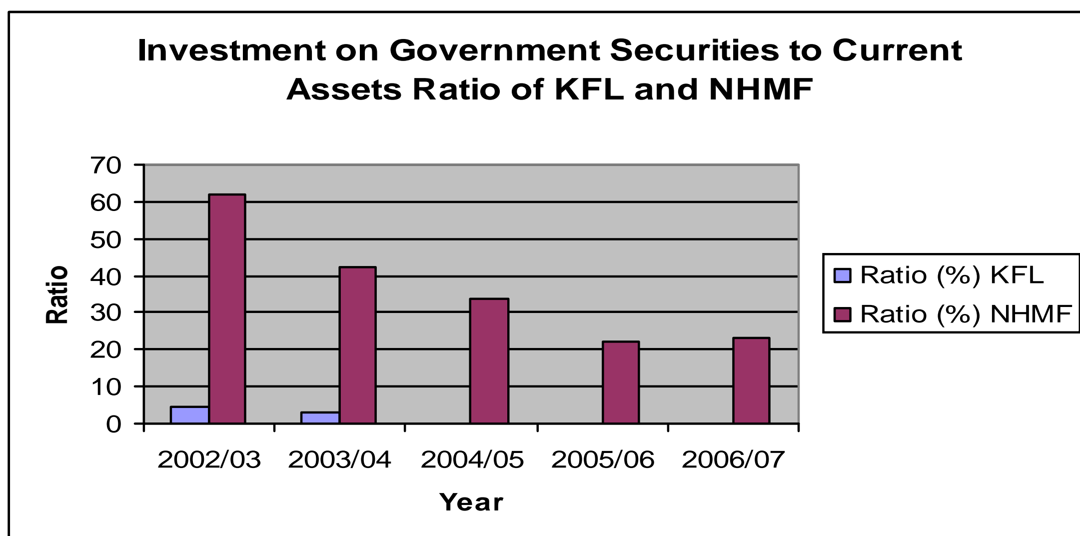


Table and figure No 4.3 shows that the investment on government treasury bills to current assets of KFL is in decreasing trend in 2nd year and in all subsequent year these are zero whereas these ratio are in decreasing trend in all year except 2006/07 of NHMF. The highest ratio of KFL is 4.5% and NHMF is 61.98% in 2002/03. And the lowest ratio of KFL and NHMF are 0% and 22.37% in 2005/06 respectively.

From the table we notice that mean ratio of KFL and NHMF are 1.55% and 36.70%. Respectively. NHMF has higher ratio in every year and mean too. It means NHMF has invested more money in risk free assets than that of KFL. In another word KFL has emphases on more loans and advances and other short term investment than investment in govt. securities.

4.2.1.2 Assets Management Ratio

Assets management ratio measures the efficiency of the bank and finance company to manage its assets in profitable and satisfactory manner. A commercial bank must manage its assets properly to earn high profit. Under this chapter following ratio are studied:

(a) Loan and Advances to Total Deposits Ratio

The ratio measures the extent to which the banks are successful to mobilize their total deposits on loan and advances. We have,

$$Loan\ and\ Advances\ to\ Total\ Deposits\ Ratio = \frac{Loan\ and\ Advances}{Total\ Deposit}$$

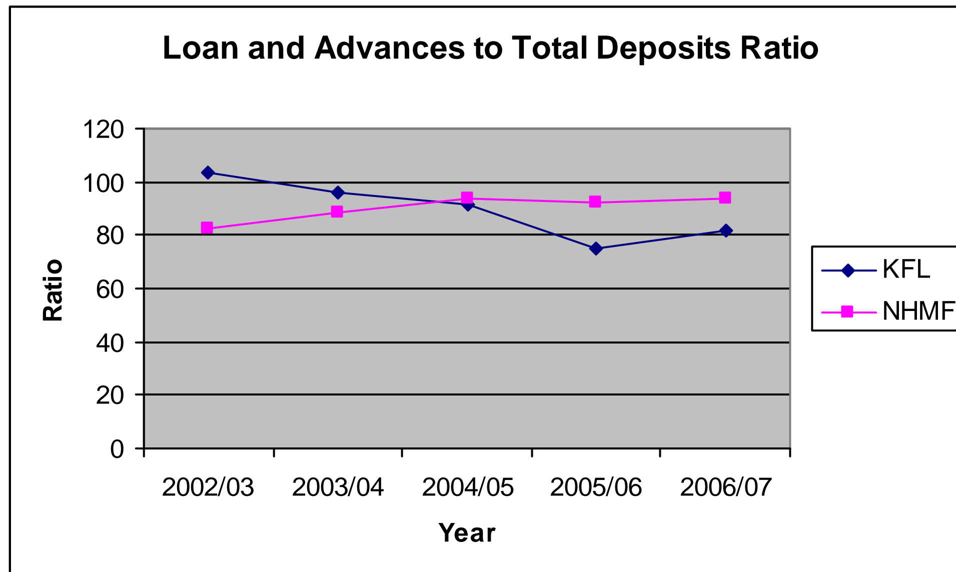
Table: 4.4

Loan and Advances to Total Deposits Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	103.47	82.65
2003/04	96.32	88.29
2004/05	91.30	93.76
2005/06	75.22	92.28
2006/07	81.41	93.87
Mean	89.54	90.17

Source: Appendix: - 1 & 2

Figure: 4.4



A high ratio of loan and advances indicates better mobilization of collected deposits and vice versa. But it should be noted that too high ratio might not be better from liquidity point of view. The Table No 4.4 table shows that these two finance company have mobilized their collected deposits in variable trend. In average KFL has mobilized 89.54% of its collected deposit in loan and advances that is slightly less than that of

NHMF. According to NRB directives above 70% to 90% of loan and advances to total deposit ratio is able to better mobilization of collected deposit. So all of the year both KFL and NHMF has met the NRB requirement or it has properly utilized its deposit to provide loan.

(b) Total Investment to Total Deposits Ratio

This ratio measures the extent to which the banks are able to mobilize their deposit on investment in various securities. A high ratio indicates the success in mobilizing deposit in securities and vice versa. We have,

$$\text{Total Investments to Total Deposits Ratio} = \frac{\textit{Total Investment}}{\textit{Total Deposit}}$$

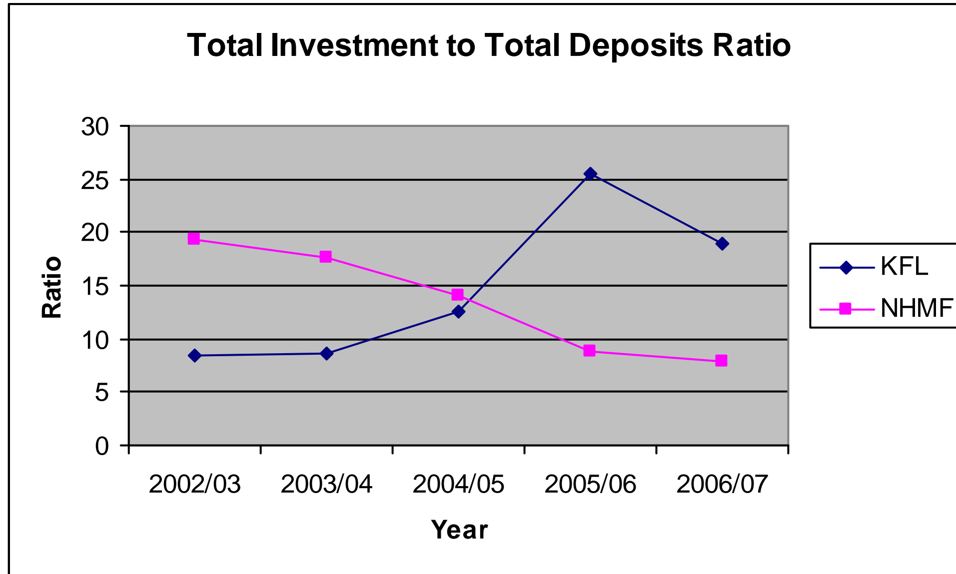
Table: 4.5

Total Investment to Total Deposits Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	8.42	19.25
2003/04	8.63	17.69
2004/05	12.57	14.03
2005/06	25.59	8.80
2006/07	19.03	7.96
Mean	14.85	13.55

Appendix: - 1 & 2

Figure: 4.5



From the Table No 4.5, it is observed that the investment to total deposit ratio of KFL are increased except in 2006/07 whereas of NHMF is in decreasing trend The mean of the ratio of KFL and NHMF are 14.85% and 13.55% respectively so KFL has higher ratio. It signifies KFL has successfully allocated its deposit in investment portfolio in comparison with NHMF.

(c) Loan and Advances to Total Working Fund Ratio

This ratio reflects the extent to which the commercial banks are success in mobilizing their assets on loan and advances for the purpose of income generation. A high ratio indicates better mobilization of fund on loan and advances and vice versa. We have,

$$Loan\ and\ Advances\ to\ TWF\ Ratio = \frac{Total\ Loan\ and\ Advances}{Total\ Working\ Fund}$$

Table: 4.6

Loan and Advances to Total Working Fund Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	76.17	68.03
2003/04	68.45	71.86
2004/05	73.24	78.45
2005/06	61.36	80.45
2006/07	66.00	80.90
Mean	69.04	75.94

Source: Appendix: - 1 & 2

Figure: 4.6

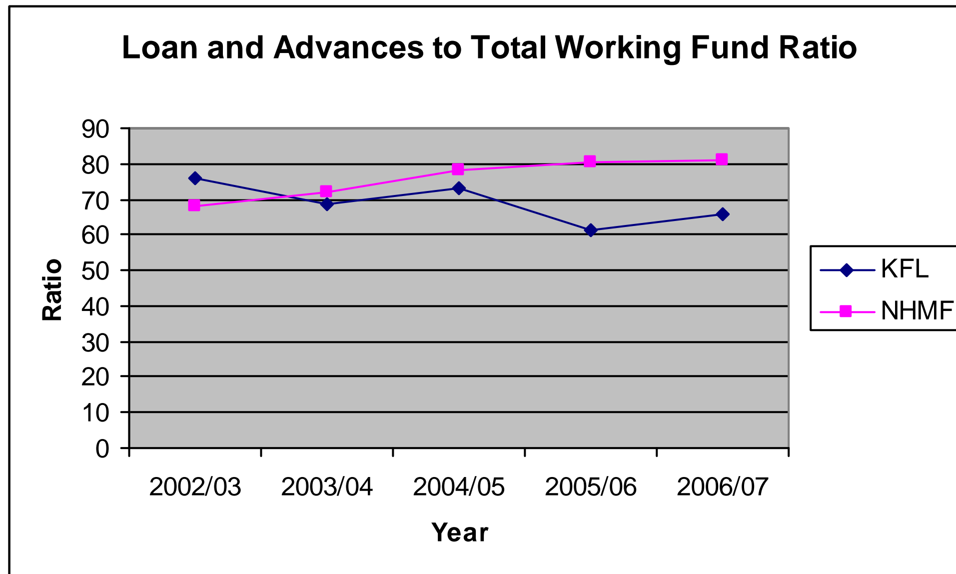


Table and figure 4.6 shows that loan and advances to total assets ratio of KFL is in fluctuating trend whereas ratio of NHMF is in increasing trend While observing their ratios; NHMF is better mobilizing of fund as loan and advances and it seems quite successful in generating higher ratio in each year.

The mean of KFL and NHMF are 69.04% and 75.94% respectively. So NHMF has higher ratio than that of KFL. It reveals that in total assets, NHMF has high proportion of loan and advances.

(d) Investment on Government Securities to Total Working Fund Ratio

The main purpose of this ratio is to examine that portion of banks and finance total working fund that has been invested into different government securities. This ratio is calculated by dividing investment on government securities by total working fund.

$$\text{Invt. on Govt. Securities to Total Working Fund} = \frac{Total\ Investment\ on\ Govt.Securities}{Total\ Working\ Fund}$$

Table: 4.7

Investment on Govt. Securities to Total Working Fund Ratio

Year	Ratio (%)	
	KFL	NHMF
2002/03	0.54	5.11
2003/04	0.51	4.43
2004/05	0	3.87
2005/06	0	1.49
2006/07	0	1.33
Mean	0.21	3.25

Appendix: - 1 & 2

Figure: 4.7

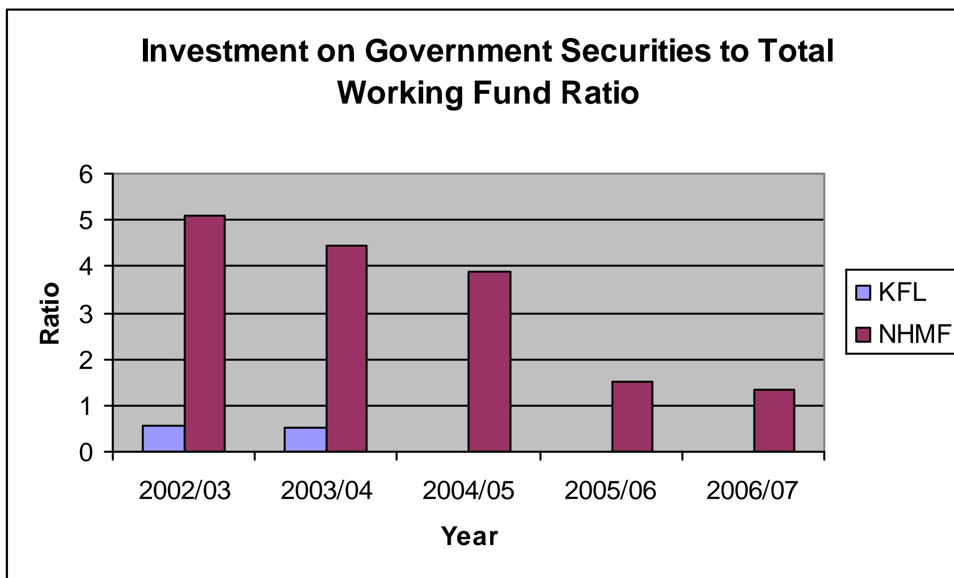


table and figure No 4.7 shows that the investment on government treasury bills to total working fund of KFL is in decreasing trend in 2nd year and in all subsequent year these are zero whereas these ratio are in decreasing trend in all year except of NHMF. The highest ratio of KFL is 0.54% and NHMF is 5.11% in 2002/03. And the lowest ratio of KFL and NHMF are 0% and 1.33% in 2006/07 respectively.

From the table we notice that mean ratio of KFL and NHMF are 0.21% and 3.25%. Respectively. NHMF has higher ratio in every year and mean too. It means NHMF has invested more money in risk free assets out of its total assets than that of KFL. In another word KFL has emphases on more loans and advances and other short term investment than investment in govt. securities.

(e) Investment on Shares and Debentures to Total Working Fund Ratio

The main purpose of this ratio is to examine that portion of commercial banks and finance's total working fund that has been invested into investment on share and debentures. This ratio is calculated by dividing investment on share and debenture by total working fund.

$$Invt.\ on\ Shares\ and\ Debenture\ to\ TWF\ Ratio = \frac{Inv. on\ Shares\ and\ Debentures}{Total\ Working\ Fund}$$

Table: 4.8

Investment on Shares and Debentures to Total Working Fund Ratio

Year	Ratio (%)	
	KFL	NHMF
2002/03	1.52	0.64
2003/04	1.43	0.36
2004/05	0.56	0.14
2005/06	0.41	0.13
2006/07	0.40	0.40
Mean	0.86	0.33

Appendix: - 1 & 2

Figure: 4.8

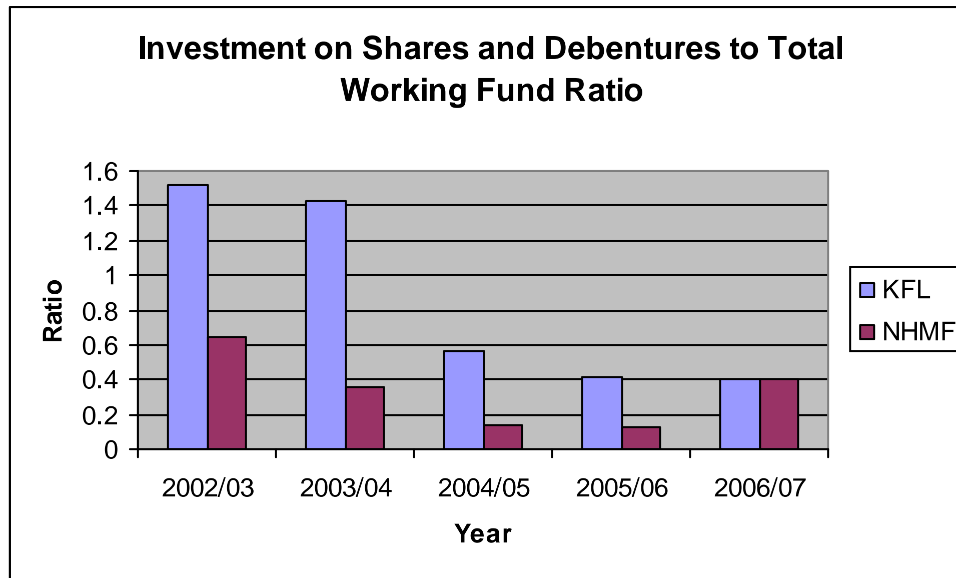


Table and figure No 4.8 shows that the investment on share and debenture to total working fund of KFL is in decreasing trend whereas these ratios are in decreasing trend in all year except in 2006/07 of NHMF. The highest ratio of KFL is 1.52% and NHMF is 0.64% in 2002/03. And the lowest ratio of KFL is 0.40% in 2006/07 and of NHMF is 0.13%2005/06.

From the table we notice that mean ratio of KFL and NHMF are 0.86% and 0.33%. Respectively. KFL has higher ratio in every year and mean too. It means KFL has invested more money in risky assets out of its total assets than that of NHMF. In another word NHMF has emphases on more govt. securities rather than investment on share and debenture.

4.2.1.3 Profitability Ratios

(a) Return on Loan and Advances Ratio

Return on loan and advances ratio measures the earning capacity of a commercial bank on its deposit mobilized on loan and advances higher the ratio greater will be the return and vice versa. It is calculated as follow:

$$\text{Return on Loan and Advances Ratio} = \frac{Net\ Profit / Loss}{Loan\ and\ Advances}$$

Table: 4.9

Return on Loan and Advances Ratio

Year	Ratio (%)	
	KFL	NHMF
2002/03	2.73	1.93
2003/04	0.35	1.26
2004/05	2.38	2.15
2005/06	3.78	1.28
2006/07	2.56	2.92
Mean	2.36	1.91

Appendix: - 1 & 2

Figure: 4.9

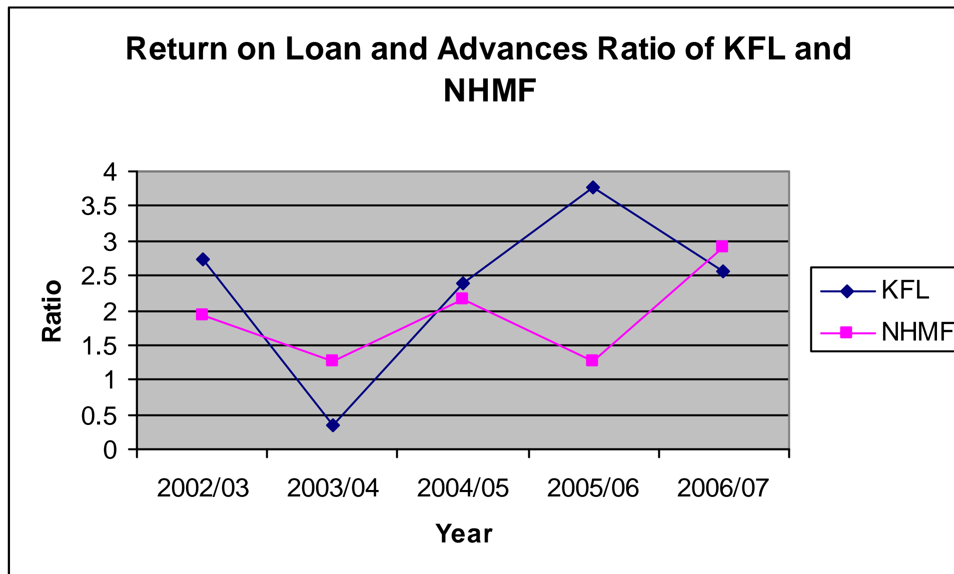


table and figure No 4.9 shows that return on loan and advances ratio of KFL and NHMF are in fluctuating trend. The highest ratio of KFL is 2.73% in the year 2002/ 2003 and lowest ratio 0.35% in year 2003/2004. The mean ratio is 2.36%. This shows the normal earning capacity of KFL in loan and advances. Whereas highest ratio of SCBNL is 2.92%

in year 2006/2007 and lowest ratio is 1.26% in 2003/2004.The mean ratio is 1.91% of NHMF.

From the table we notice that KFL has higher mean ratio. So it seems successful by generating higher ratio. It can be concluded that KFL has better utilized the loan and advance for the profit generation in comparison with NHMF.

(b) Return on Total Working Fund Ratio

Return on total working fund ratio measures the earning capacity of a commercial bank on its deposit mobilized on total working fund, higher the ratio greater will be the return and vice versa. It is calculated as follow:

$$Return\ on\ Total\ Working\ Funds\ Ratio = \frac{Net\ Profit / Loss}{Total\ Working\ Fund}$$

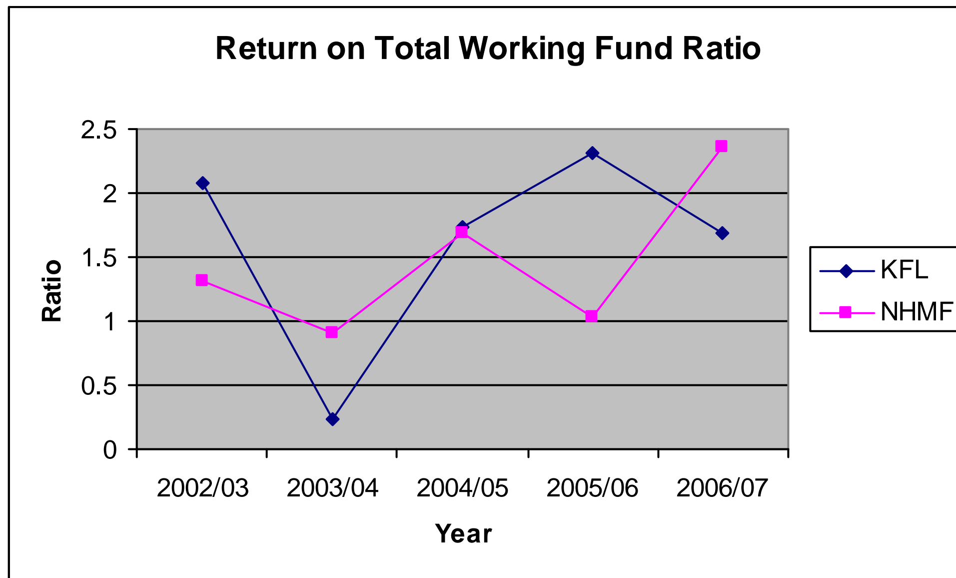
Table: 4.10

Return on Total Working Fund Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	2.08	1.32
2003/04	0.24	0.90
2004/05	1.74	1.69
2005/06	2.32	1.03
2006/07	1.69	2.36
Mean	1.61	1.46

Appendix: - 1 & 2

Figure: 4.10



From the table No 4.10, we notice that ROA of both companies are in fluctuating trend how ever KFL seems successful in managing and utilizing the available assets in order to generate revenue since its ROA ratio is higher than that of NHMF(i.e. 1.61%>1.46%)of total assets in an average.

(c) **Total Interest Earned to Total Working Fund Ratio**

This ratio actually reveals the earning capacity of commercial banks by mobilizing its working fund. Higher the ratio higher will be the income as interest. It is calculated as follow:

$$\text{Total Interest Earned to Total Working Funds Ratio} = \frac{\textit{Total Interest Earned}}{\textit{Total Working Fund}}$$

Table: 4.11

Total Interest Earned to Total Working Fund Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	12.38	11.98
2003/04	11.14	10.04
2004/05	13.00	9.66
2005/06	11.04	10.41
2006/07	12.15	10.24
Mean	11.94	10.46

Appendix: - 1 & 2

Figure: 4.11

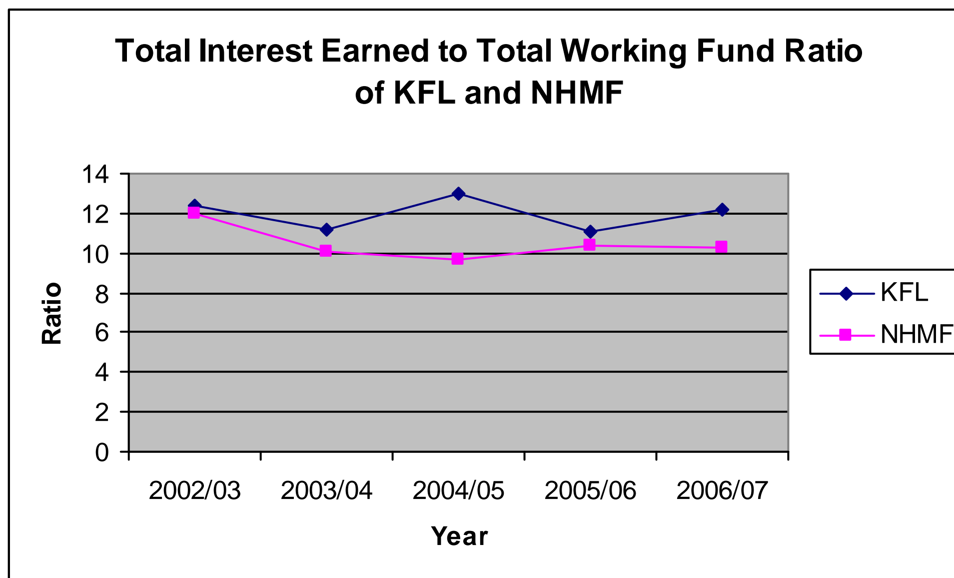


Table and figure No 4.11 shows that both banks have fluctuating trend of ratio. However, KFL seems more conscious about managing its assets in order to earn more interest ratio because it has higher ratio in each year and average ratio is also higher. KFL has 11.94% average ratio whereas NHMF shows 10.46% average ratio. The mean ratio of KFL is more than that of NHMF. In comparison, KFL seems effective in earning interest to some extent although it has lower earning of interest income but it must break the decreasing trend in coming year.

(d) Total Interest paid to Total Working Fund Ratio

This ratio actually reveals the paying capacity of commercial banks by mobilizing its working fund. Higher the ratio higher will be the paying capacity of interest. It is calculated as follow:

$$\text{Total Interest Paid to Total Working Funds Ratio} = \frac{\textit{Total Interest Paid}}{\textit{Total Working Fund}}$$

Table: 4.12

Total Interest Paid to Total Working Fund Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	7.10	7.32
2003/04	6.49	6.21
2004/05	6.73	5.74
2005/06	6.03	5.60
2006/07	6.81	5.85
Mean	6.63	6.14

Appendix: - 1 & 2

Figure: 4.12

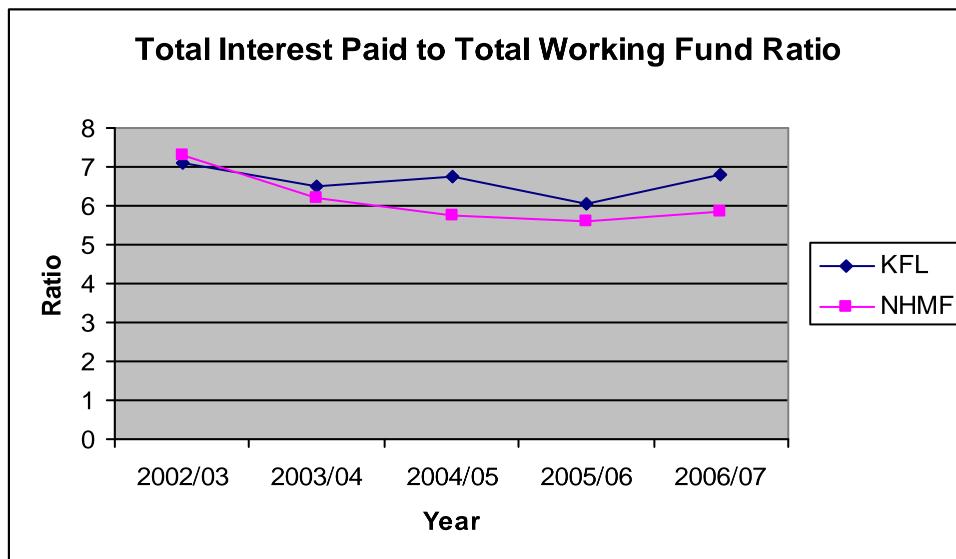


Table and figure No 4.12 shows that KFL has fluctuating trend of ratio whereas NHMF has decreasing trend of ratio except in 2006/07. Due to the higher ratio in each year and average too of KFL, it seems less conscious about borrowing cheaper fund

4.2.1.4 Measurement of Risk

For this study, following risk ratios are used to analyze and interpret the financial data and investment policy.

(a) Liquidity Risk Ratio

Liquidity risk means its liquidity need for deposits. The ratio is calculated by dividing cash and bank balance by total deposits.

$$\text{Liquidity Risk Ratio} = \frac{\textit{Cash and Bank Balance}}{\textit{Total Deposit}}$$

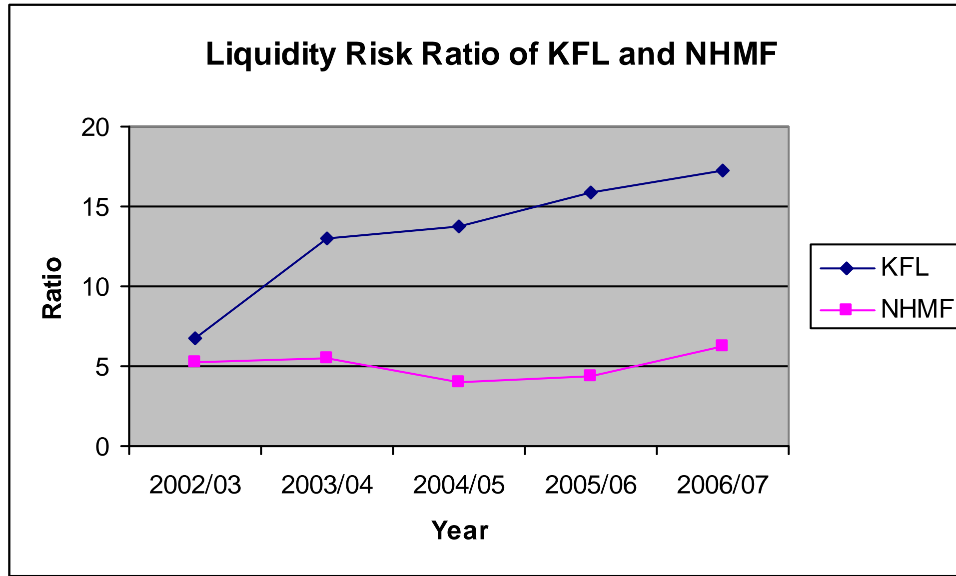
Table: 4.13

Liquidity Risk Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	6.81	5.27
2003/04	13.04	5.51
2004/05	13.71	3.97
2005/06	15.87	4.39
2006/07	17.31	6.20
Mean	13.35	5.07

Appendix: - 1 & 2

Figure: 4.13



The Table and Figure No 4.13 above analysis, cash and bank balance to total deposits ratio of the KFL is in increasing trend whereas ratio of NHMF is in decreasing trend in 2004/05 and in other year these are in increasing trend. The higher ratio of KFL and NHMF are 17.31% and 6.20% respectively in the same year i.e. 2006//07.The average ratio of KFL is greater than that of NHMF (i.e. 13.35%>5.07%). It signifies that KFL has sound liquid fund to make immediate payment to the depositors but KFL has excess liquidity rather than that of NHMF because of poor investment opportunities.

(b) Credit Risk Ratio

In general, credit risk ratio shows the proportion of non-performing assets in the total investment plus loan and advances of a bank. It is computed as,

$$\text{Credit Risk Ratio} = \frac{Total\ Investment\ \Gamma\ Total\ \ loan\ \ and\ Advances}{Total\ Assets}$$

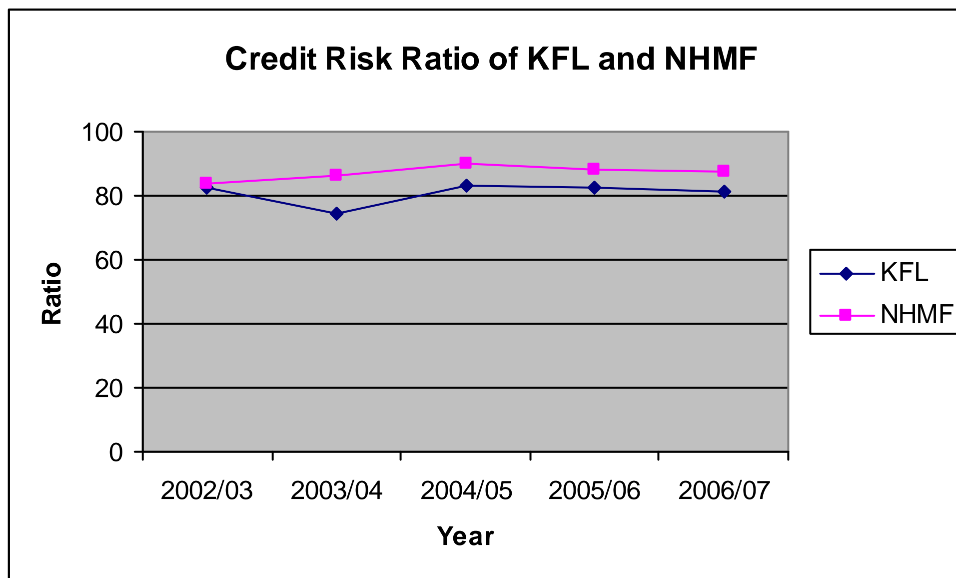
Table: 4.14

Credit Risk Ratio

Year	Ratio (%)	
	KFL	**NHMF**
2002/03	82.37	83.87
2003/04	74.58	86.26
2004/05	83.32	90.19
2005/06	82.24	88.12
2006/07	81.43	87.76
Mean	80.79	87.24

Appendix: - 1 & 2

Figure: 4.14



The Table No.4.14 shows that KFL and NHMF have the credit risk ratio in fluctuating trend. KFL has highest and lowest ratio of 83.32% and 74.58% in the year 2004/05 and 2003/04 respectively. And NHMF has the highest and lowest ratio of 90.19% and 83.85% in the year 2004/05 and 2002/03 respectively. The mean ratio of KFL is lower than that of NHMF (i.e.80.79 %< 87.24%). Growth Ratios

Growth ratio denotes that how well the banks are preserving their economic or financial position. To calculate, check and analyze the expansion and growth of the selected bank the following ratios are calculated:

4.2.1.5 Growth Ratio

(a) Growth Ratio of Total Deposits

To measure such growth percentage and analysis the following formula are used:

$$\text{Growth Percentage} = \frac{\text{Ending Value - Beginning Values}}{\text{Beginning Value}} | 100$$

Table: 4.15

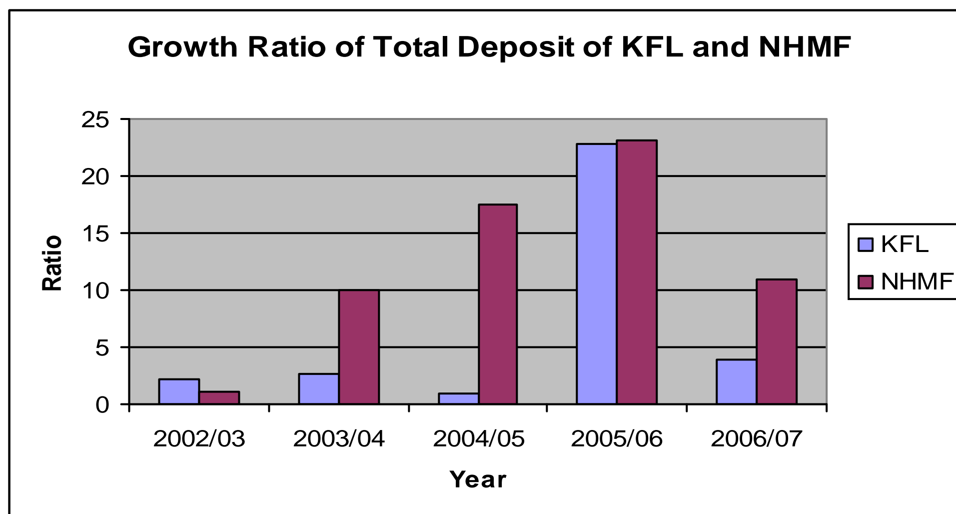
Growth Ratio of Total Deposits

(Rs in thousand)

Banks	Year and deposit					Growth Rate %
	2002/03	2003/04	2004/05	2005/06	2006/07	
KFL	2.15	2.59	0.95	22.83	3.84	**6.47**
NHMF	1.08	9.97	17.49	23.13	10.90	**12.51**

Appendix: - 1 & 2

Figure: 4.15



The Table No 4.15 shows that KFL has fluctuating trend and NHMF has increasing trend of total deposits except in 2006/07. The growth ratio of KFL and NHMF are 6.47% and 12.51% respectively. The growth ratio of NHMF seems to be higher than that of KFL.

(b) Growth Ratio of Loan and Advances

To measure such growth percentage and analysis the following formula are used:

$$\text{Growth Percentage} = \frac{\text{Ending Value - Beginning Values}}{\text{Beginning Value}} | 100$$

Table: 4.16

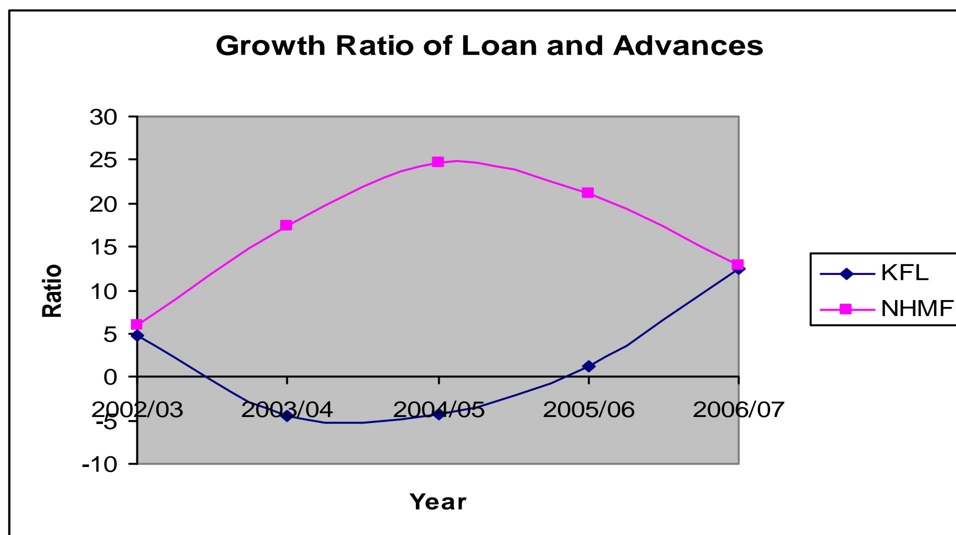
Growth Ratio of Loan and Advances

(Rs in thousand)

Banks	Year and Loan and advances					Growth Rate %
	2002/03	**2003/04**	**2004/05**	**2005/06**	**2006/07**	
KFL	4.82	-4.51	-4.30	1.20	12.38	**1.92**
NHMF	6.02	17.47	24.77	21.20	12.81	**14.04**

Appendix: - 1 & 2

Figure: 4.16



The above analysis shows that NHMF has higher growth rate than that of KFL (i.e. 14.04%>1.92%). KFL has decreasing trend and NHMF has increasing trend in first three years and in decreasing trend in last two years growth rate of loans and advances.

(c) Growth Ratio of Total Investment

To measure such growth percentage and analysis the following formula are used:

$$\text{Growth Percentage} = \frac{\text{Ending Value - Beginning Values}}{\text{Beginning Value}} \times 100$$

Table: 17

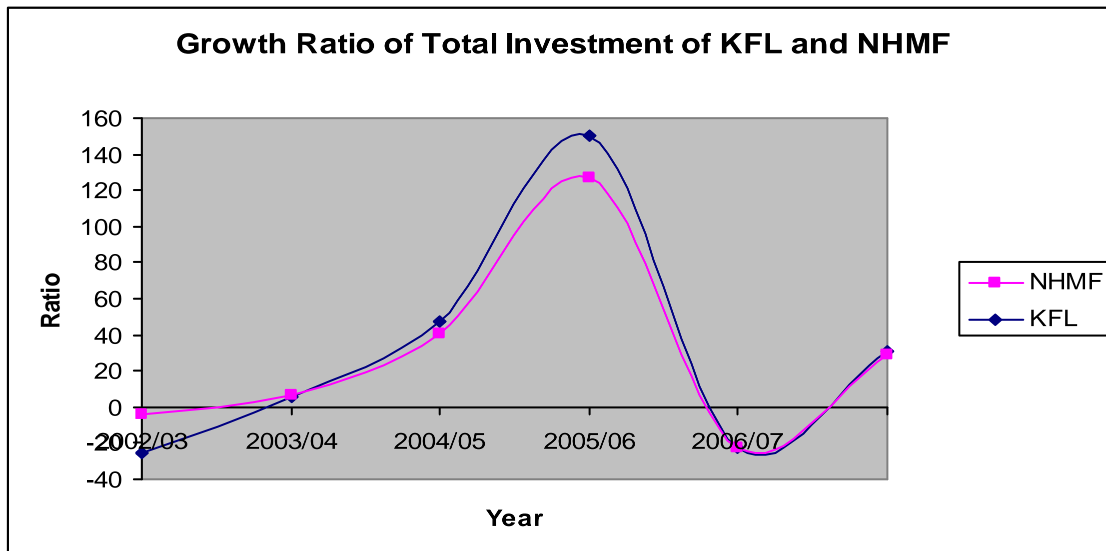
Growth Ratio of Total Investment

(Rs in thousand)

Banks	Year and Total investment					Growth Rate %
	2002/03	**2003/04**	**2004/05**	**2005/06**	**2006/07**	
KFL	-25.82	5.15	47.10	149.97	-22.76	**30.73**
NHMF	21.37745	1.087853	-6.82788	-22.8039	0.360456	**-1.36**

Appendix: - 1 & 2

Figure: 4.17



The growth rate of total investment of KFL seems to be higher than that of NHMF i.e. 30.73%>-1.36%. KFL has negative trend in 1st & last period and in increasing trend in remaining years but NHMF has decreasing and negative trend of growth ratio of investment.

(d) Growth Ratio of Net Profit

To measure such growth percentage and analysis the following formula are used:

$$\text{Growth Percentage} = \frac{\text{Ending Value - Beginning Values}}{\text{Beginning Value}} \times 100$$

Table: 4.18

Growth Ratio of Net Profit

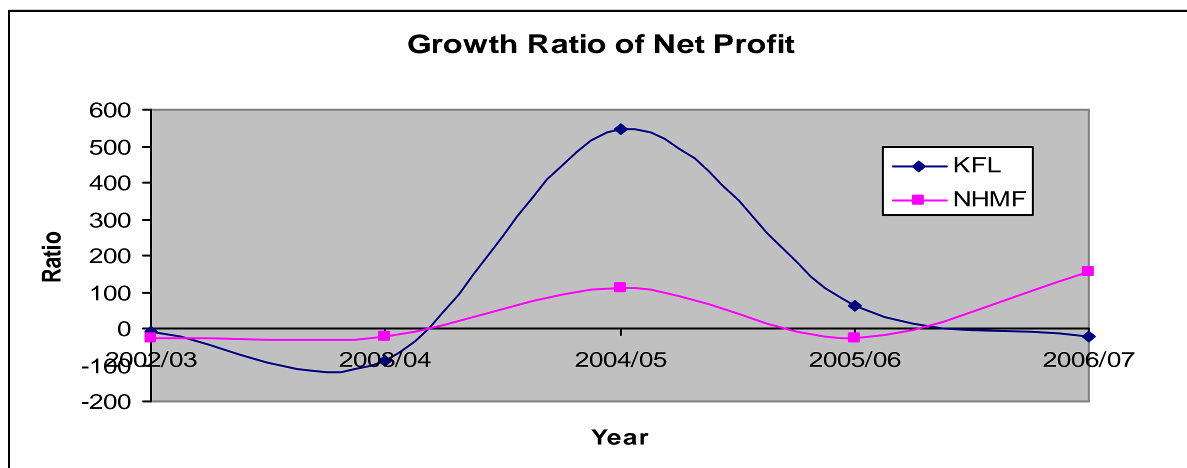
(Rs in thousand)

Banks	Year and Net profit					Growth Rate %
	2002/03	2003/04	2004/05	2005/06	2006/07	
KFL	-8.64931	-87.7253	548.7365	60.7123	-23.6727	**97.8**
NHMF	-27.4558	-23.503	113.1471	-27.9109	157.1611	**38.29**

Appendix: - 1 & 2

From table no 4.18 we can conclude that KFL has growth rate of 97.8% and NHMF has the growth rate of 38.288%. It seems that KFL has higher growth rate than that of NHMF. Both banks followed a fluctuating trend on the growth ratio of net profit.

Figure: 4.18



4.3. Relationship between Total Deposits and Total Investment

The following table describes the relationship between total deposits and total investment of KFL and NHMF of five years study period. In this case, total deposits are independent variables say (X) and total investment is dependent variable say (Y).

Table: 4.19

Relationship between Total Deposits and Total Investment

Name of Bank	Base of Evaluation			
	r	**R^2**	**P.E.**	**6 x P.E.**
KFL	0.929	0.863	0.0413	0.248
NHMF	-0.962	0.925	0.023	0.136

Source: From SPSS Data Editor

The Table No 4.19 shows that coefficient of correlation between deposits and investment of KFL is 0.929 i.e. high degree of positive correlation between these two variables. And the value of coefficient of determination (R^2) is also 0.863 which means 86.3% of investment decision depend upon deposit and only 13.7% investment is depend upon other variables. Similarly probable error is 0.0413 and 6 x P. E. is 0.248 which shows that R^2 is highly greater than 6 x P. E. Therefore it reveals that relationship between deposits and investment is significant i.e. correlation is certain.

Likewise, in case of NHMF, coefficient of correlation between investment and deposit (r) is -0.962 that means there is a high degree of Negative correlation between two variables. The value of coefficient of determination (R^2) is also 0.023 which means only 2.3% of investment decision depend upon deposit and rest 97.7% investment is depend upon other variables. Similarly probable error is 0.023 and 6 x P. E. is 0.136 which shows that R^2 is just greater than 6 x P. E. Therefore it reveals that relationship between deposit and investment is significant i.e. correlation is certain.

4.4 Relationship between Total Deposits and Loans and Advances

The following table describes the relationship between total deposits and loan and advances of KFL and NHMF with comparatively under five-year period. In this case, total deposits are independent variable say (X) and loan and advances is dependent variable say (Y).

Table: 4.20

Relationship between Total Deposits and Loans and Advances

Name of Bank	Base of Evaluation			
	r	**R^2**	**P.E.**	**6 x P.E.**
KFL	0.305	0.093	0.274	1.64
NHMF	0.996	0.992	0.0024	0.015

Source: From SPSS Data Editor

From the Table 4.20 we can find that the coefficient of correlation between deposits and loan and advances of KFL and NHMF are 0.305 and 0.996 respectively. This shows the positive relationship between these two variables i.e. loan and advances and deposits of both banks. By considering coefficient of determination (R^2), the value of R^2 is 0.093 incase of KFL and 0.992 incase of NHMF.

The value of R^2 of KFL is 0.093, which means only 9.3% of loan and advances decision is determined by deposit and rest 90.7% loan and advances depend upon other variables. The value of R^2 of NHMF is 0.992, which means that 99.2% of loan and advances is determined by deposit and only 0.8% loan and advances depend upon other variables.

In view of the probable error of KFL and NHMF, the value of R^2 of KFL is less than the 6 times of P.E. (i.e. 1.64>0.093) which indicates there is significant relationship between deposits and loan and advances. Similarly value of R^2 of NHMF greater then the 6 times of P.E.(i.e. 0.992>0.015) insignificant relationship between deposit and loan and advances

4.3 Trend Analysis

4.3.1 Trend Analysis:

Here, trend analyses of various Ratios are projected for the five years. The measure of trend analysis shows the behavior of given variables in series of time. This trend analysis is carried out to see average performance of the Finance companies for next five years. Sample of trend analysis are as follows

- Loan and advance to Total Deposit

-Total Investment to Total Deposit Ratio

- Return on Loan and Advance Ratio

a) Trend Analysis of Loan and advance to Total Deposit:

In this topic an effort has been made to analyze the trend of loan and advances to total deposits ratio of KFL and NHMF with comparatively of five years study period and projection of next five years. The following table describes the trend values of loan and advances to total deposits ratio of KFL and NHMF.

$Y = a + b x$

Where,

Y = dependent variable, a =Y- intercept, b = slope of trend line or annual growth rate,

X = deviation from some convenient time periods.

The following graph helps to show the trend lines of total deposit for the projected five years. The equations are

$Yc = 89.54 - 6.522x$ of KFL

$Yc = 90.177 + 2.643x$ of NHMF

Table No 4.21

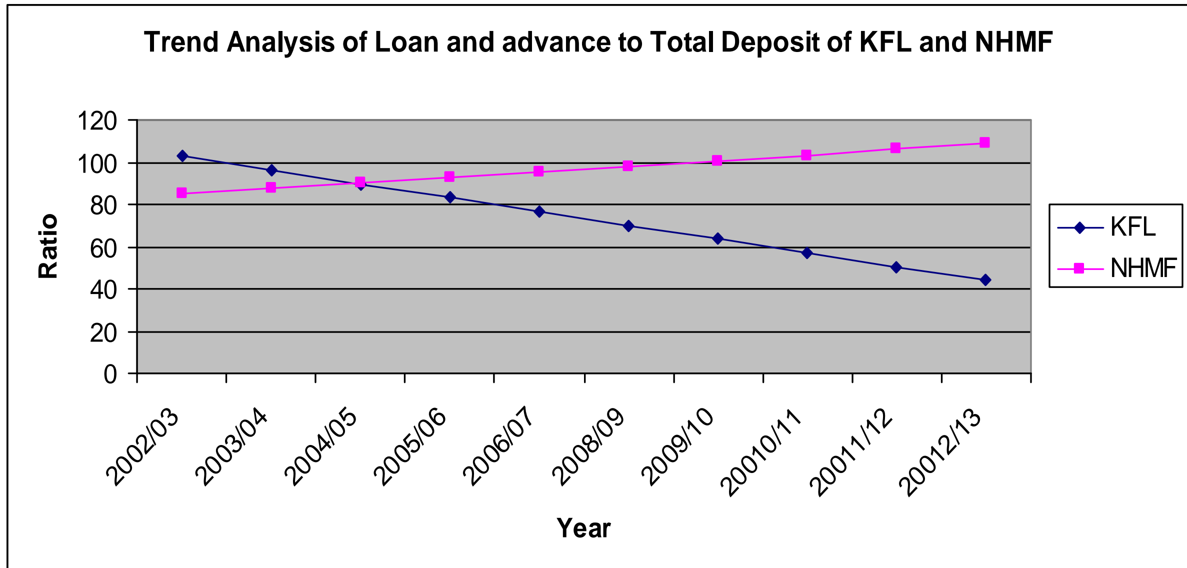
Trend Analysis of Loan and advance to Total Deposit

Year	KFL	NHMF
2002/03	102.584	84.884
2003/04	96.062	87.527
2004/05	89.54	90.17
2005/06	83.018	92.813
2006/07	76.496	95.456
2008/09	69.974	98.099
2009/10	63.452	100.742
20010/11	56.93	103.385
20011/12	50.408	106.028
20012/13	43.886	108.671

Source: annul report of KFL & NHMF

Appendix -3

Figure No 4.19



Above Figure No 4.19 show that Trend of Loan and advance to Total Deposit of KFL is decreasing. Its means total deposits are not utilize efficiently. The Trend of Loan and

advance to Total Deposit of NHMF are slightly increasing up warding. It mean total deposit utilizing in loan and advance so trend of NHMF has smooth and regular up warding position.

b) Total Investment to Total Deposit Ratio

The heading analyze the trend of total investment to total deposits ratio of KFL and NHMF with comparatively under five years study period and projects the trend of coming five years. The following table describes the trend values of total investment to total deposits ratio of KFL in comparison to NHMF for ten years.The following graph helps to show the trend lines of total deposit for the projected five years. The equations are

$Yc = 14.848 + 3.818x$ of KFL

$Yc = 13.54 - 3.147 X$ of NHMF

Table No 4.22

Trend Analysis of Total Investment to Total Deposit Ratio

Year	KFL	NHMF
2002/03	7.212	19.84
2003/04	11.03	16.693
2004/05	14.848	13.546
2005/06	18.666	10.399
2006/07	22.484	7.252
2008/09	26.302	4.105
2009/10	30.12	0.958
20010/11	33.938	-2.189
20011/12	37.756	-5.336
20012/13	41.574	-8.483

Source: Annul report of KFL and NHMF

Appendix - 4

Figure No 4.20

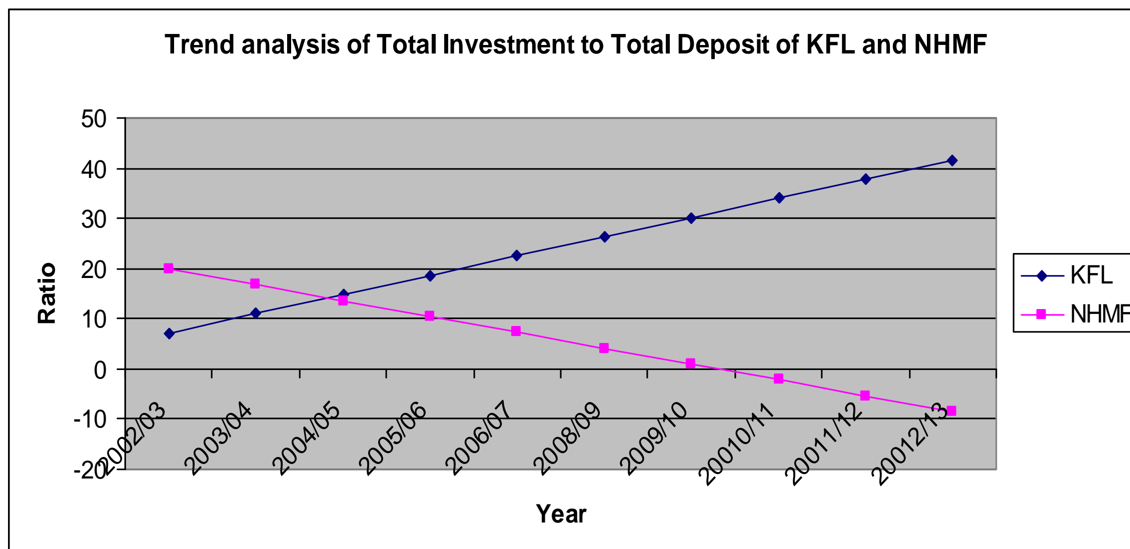


Figure No 4.20 shows that the trend of total investment to total deposit of KFL is slightly increasing trend. Its mean total deposit utilized on total investment. The trend of total investment to total deposit ratio of NHMF is decreasing trend it indicate that the income from total investment to total deposit is decreasing trends.

c) Trend Analysis of Return on loan and advance ratio:

The headings analyze the trend Return on loan and advance ratio of KFL and NHMF with comparatively under five years study period and projects the trend of coming five years. The following table describes the trend values of the trend Return on loan and advance ratio of KFL in comparison to NHMF for ten years.

The following graph helps to show the trend lines of total deposit for the projected five years. The equations are

$Yc = Yc = 2.36+2142.8x$ of KFL

$Yc = 1.908 + 0.2 X$ of NHMF

Table No 4.23

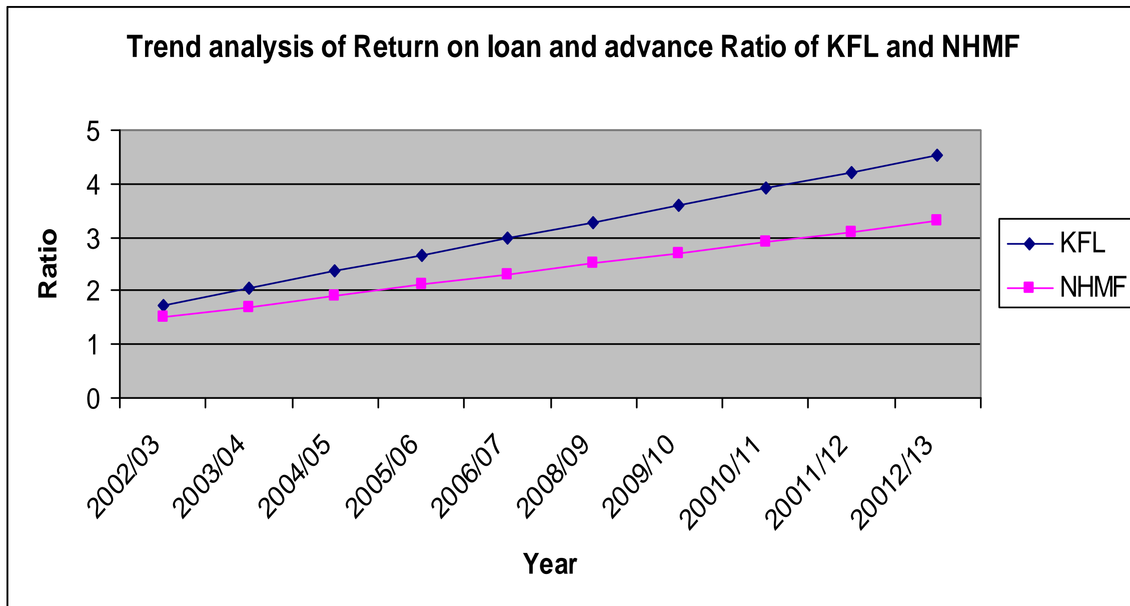
Trend Analysis of return on loan and advance ratio

Return on Loan and Advance Ratio		
Year	**KFL**	**NHMF**
2002/03	1.742	1.508
2003/04	2.051	1.708
2004/05	2.36	1.908
2005/06	2.669	2.108
2006/07	2.978	2.308
2008/09	3.287	2.508
2009/10	3.596	2.708
20010/11	3.905	2.908
20011/12	4.214	3.108
20012/13	4.523	3.308

Source: Annul report of KFL & NHMF

Appendix - 5

Figure No 4.21



The Table and figure No 4.21 shows that the trend of return on loan and advance ratio of KFL is highly increasing trend. It means return from loan and advance is little higher than the NHMF. The trend of return on loan and advance ratio of NHMF has smooth and regular up ward increasing trend. Hence return from loan and advance of both finance companies is positive and increasing trend.

4.4 Major Findings of the Study

From the analysis of the data collected from various sources following findings have been made.

1) The mean ratio of cash and bank balance to total deposits of KFL is higher than NHMF. It means the liquidity position of KFL is higher than NHMF. It shows the higher position regarding the meeting of demand of its customer on their deposit at any time than NHMF.
2) The average study of cash and bank balance to current assets ratio of KFL is higher than NHMF. It shows that NHMF has taken more risk to meet the daily requirement of its customer's deposit than KFL.
3) NHMF has invested more portions of current assets on government securities than KFL according to average study. It means NABIL is more sensitive in investment in productive sector than KFL. It means NHMF has invested more money in risk free assets than that of KFL. In another word KFL has emphases on more loans and advances and other short term investment than investment in govt. securities.
4) In average KFL has mobilized 89.54% of its collected deposit in loan and advances that is slightly less than that of NHMF. According to NRB directives above 70% to 90% of loan and advances to total deposit ratio is able to better mobilization of collected deposit. So all of the year both KFL and NHMF has met the NRB requirement or it has properly utilized its deposit to provide loan.
5) The mean ratio of the total investment to total deposit KFL and NHMF are 14.85% and 13.55% respectively so KFL has higher ratio. It signifies KFL has successfully allocated its deposit in investment portfolio in comparison with NHMF.

6) loan and advances to total assets ratio of KFL is in fluctuating trend whereas ratio of NHMF is in increasing trend While observing their ratios; NHMF is better mobilizing of fund as loan and advances and it seems quite successful in generating higher ratio in each year.
7) Mean ratio of investment on govt securities to total working fund of KFL and NHMF are 0.21% and 3.25%. Respectively. NHMF has higher ratio in every year and mean too. It means NHMF has invested more money in risk free assets out of its total assets than that of KFL. In another word KFL has emphases on more loans and advances and other short term investment than investment in govt. securities.
8) Mean ratio of investment on share and debenture on working fund of KFL and NHMF are 0.86% and 0.33%. Respectively. KFL has higher ratio in every year and mean too. It means KFL has invested more money in risky assets out of its total assets than that of NHMF. In another word NHMF has emphases on more govt securities rather than investment on share and debenture.
9) KFL has higher mean ratio of return on loan and advances. So it seems successful by generating higher ratio. It can be concluded that KFL has better utilized the loan and advance for the profit generation in comparison with NHMF.
10) ROA of both companies are in fluctuating trend how ever KFL seems successful in managing and utilizing the available assets in order to generate revenue since its ROA ratio is higher than that of NHMF(i.e. 1.61%>1.46%)of total assets in an average.
11) KFL seems more conscious about managing its assets in order to earn more interest ratio because it has higher ratio in each year and average ratio is also higher. KFL has 11.94% average ratio whereas NHMF shows 10.46% average ratio. The mean ratio of KFL is more than that of NHMF. In comparison, KFL seems effective in earning interest to some extent although it has lower earning of interest income but it must break the decreasing trend in coming year.
12) KFL has fluctuating trend of interest paid to working fund ratio whereas NHMF has decreasing trend of ratio except in 2006/07. Due to the higher ratio in each

year and average too of KFL, it seems less conscious about borrowing cheaper fund

13) The mean ratio of liquidity risk of KFL is higher than NHMF. It means KFL has sound liquid fund to make immediate payment to the depositors but KFL has excess liquidity rather than that of NHMF because of poor investment opportunities.
14) In case of credit risk ratio, KFL has the lower risk than NHMF.
15) The growth ratio on deposit of NHMF seems to be higher than that of KFL. The growth ratio of KFL and NHMF are 6.47% and 12.51% respectively.
16) The above analysis shows that NHMF has higher growth rate of loan and advances than that of KFL (i.e. 14.04%>1.92%).
17) NHMF seems weak in increasing total investment in comparison to KFL. The growth rate of NHMF is -1.36% but KFL is 30.73%.
18) The yearly growth rate of net profit of KFL is better in comparison to NHMF. NHMF has the growth rate of 38.29% and KFL has 97.80%.
19) KFL has the higher degree of correlation coefficient between deposit and investment than NHMF. It states that KFL is in better position in the mobilization of deposits as investment in comparison to NHMF. There is significant relationship between correlation of coefficient of deposit and investment of KFL and but insignificant relationship between correlation of coefficient of deposit and investment of NHMF.
20) Correlation coefficient between deposit and loan and advances of KFL is lower than NHMF. It indicates that NHMF is successfully mobilizing its deposits as loan and advances. There is significant relationship between correlation coefficient of deposits and loan and advances KFL and NHMF.
21) The Trend of Loan and advance to Total Deposit of KFL is decreasing. Its means total deposits are not utilize efficiently. The Trend of Loan and advance to Total Deposit of NHMF are slightly increasing up warding. It mean total deposit utilizing in loan and advance so trend of NHMF has smooth and regular up warding position.

22) The trend of total investment to total deposit of KFL is slightly increasing trend. Its mean total deposit utilized on total investment. The trend of total investment to total deposit ratio of NHMF is decreasing trend it indicate that the income from total investment to total deposit is decreasing trends.
23) The trend of return on loan and advance ratio of KFL is highly increasing trend. It means return from loan and advance is little higher than the NHMF. The trend of return on loan and advance ratio of NHMF has smooth and regular up ward increasing trend. Hence return from loan and advance of both finance companies is positive and increasing trend.

CHAPTER - V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Summary

Today's modern age there is very much competition in financial sector but less opportunity to make investment. In this condition, bank and finance companies can take initiation in search of new opportunities, so that they can survive in the competitive market and earn profit. But investment is a very risky job. For a purposeful, safe, profitable investment finance company most follows sound investment and fund mobilizing policy.

Generally fund mobilizing means cash flow in the different sectors at profit motive. In the broadest sense it means, the sacrifice of certain current value for future value or possibly uncertain value. This research focuses on the comparative study of fund mobilization of two finances companies; KFL and NHMF Limited. The study focuses whether it is backward or forward in investing its fund efficiently in the business, industry and commerce. In this study KFL is compared with the NHMF Limited on their future fund mobilizing activities by collecting seven years data from the year 2002//03 to 2006/07. Both companies have good position in the market with new banking system and their activities.

Fund mobilizing is always related with risks and returns. It is appropriate to state that the objective is to make a lot of money by recognizing the possible losses. Fund mobilizing policy also involves the identification of the potential categories of financial assets for consideration in the ultimate portfolio.

The main objective of the study is to analyze the fund mobilizing policy adopted by KFL and NHMF Limited. The specific objectives of the study are: a) To measure the relationship of total deposits with total investment, loan and advances and net profit, b) To evaluate the comparative growth ratio on total investment, loans and advances, total deposits and net profit of KFL and NHMF Limited, c) To evaluate financial and

investment efficiency, profitability and liquidity position of KFL and NHMF Limited To achieve the objectives of the study, descriptive an analytical research design has been used. Some statistical and financial tools have also been applied to examine facts and descriptive techniques have been adopted to evaluate funds mobilizing performance of KFL and compare it with NHMF Limited. The study is based on secondary data. So the descriptive and analytical research designs have been used. In this study only two finances companies have been taken as sample. All the finance companies in Nepal are the population of the study. The samples taken are Katmandu finance Limited and Nepal housing and merchant Ltd.

The research is based on secondary source of data. The data relating to the investment, deposit, loan and advances, assets and profit are directly obtained from the balance sheet and Profit and Loss A/C of the concerned companies annual reports. Supplementary data and information are collected from number of institution and authoritative sources like Nepal Rastra Bank, Security Exchange Board, Nepal Stock Exchange Ltd., Ministry of Finance, Budget speech of different fiscal years, economic survey and National Planning Commission etc. To achieve the objectives of the study various financial and statistical tools have been used. After collecting the data from the different sources, it is analyzed by using financial tools and statistical tools. Findings are drawn by applying various financial tools namely liquidity ratio, assets management ratio, profitability ratio, growth ratio and risk ratio. In the same way, statistical tools have been used namely mean, coefficient of correlation and least square method trend.

5.2 Conclusion

From the analysis of the liquidity position of KFL and NHMF, liquidity position of KFL is higher than NHMF. It shows the higher position regarding the meeting of demand of its customer on their deposit at any time than NHMF but KFL has excess liquidity rather than that of NHMF because of poor investment opportunities. NHMF has taken more risk to meet the daily requirement of its customer's deposit than KFL as it has lower cash and bank balance to current ratio. NHMF has made enough investment in government

securities than KFL. In another word KFL has emphases on more loans and advances and other short term investment than investment in govt. securities.

In view of assets management side of two companies, it can be concluded that KFL is in slightly weak position in mobilizing the collected deposits as loan and advances. However in all year both companies have met the NRB requirement in regarding utilization of deposit to provide loan. KFL has successfully allocated its deposit in investment portfolio in comparison with NHMF. NHMF has invested more money in risk free assets out of its total assets than that of KFL has invested more money in risky assets out of its total assets than that of NHMF. In another word NHMF has emphases on more govt. securities rather than investment on share and debenture.

From the viewpoint of profitability, KFL has higher mean ratio of return on loan and advances. So it seems successful by generating higher ratio. It can be concluded that KFL has better utilized the loan and advance for the profit generation in comparison with NHMF. KFL seems successful in managing and utilizing the available assets in order to generate revenue since its ROA ratio is higher than that of NHMF. KFL seems effective in earning interest to some extent although it has lower earning of interest Due to the higher ratio in each year and average too of KFL, it seems less conscious about borrowing cheaper fund. In case of credit risk ratio, KFL has the lower risk than NHMF.

From the growth ratio of total deposits, it can be concluded that NHMF has more collection capacity than NABIL. Growth rate of NHMF on loan and advances is better in comparison to HBL. Growth rate of total investment of KFL seems good than HBL similarly KFL has better position than that of NHMF with respect to growth rate of net profit. Correlation coefficient between deposits and total investment and deposits and loan and advances of KFL and NHMF indicates the positive relationship or there is high degree of positive correlation. In most of the cases it has been found that loan and advances and investment decision depends upon other variables. From the calculation of probable error it can be concluded that the relationship between deposits and investment and loan and advances and deposits of both companies is significant.

By considering the trend values, Trend of Loan and advance to Total Deposit of KFL is decreasing. Its means total deposits are not utilize efficiently. The Trend of Loan and advance to Total Deposit of NHMF are slightly increasing up warding. It means total deposit utilizing as loan and advance of NHMF has smooth and regular up warding position. Trend of total investment to total deposit of KFL is slightly increasing trend. The trend of total investment to total deposit ratio of NHMF is decreasing trend. Trend of return on loan and advance ratio of KFL is highly increasing trend. It means return from loan and advance is little higher than the NHMF. The trend of return on loan and advance ratio of NHMF has smooth and regular up ward increasing trend. Hence return from loan and advance of both finance companies is positive and increasing trend.

5.3 Recommendations

Based on above findings and conclusion the following recommendations have been made.

- The ratio of cash and bank balance to total deposits and current assets of KFL is higher than NHMF. It means NHMF should increase its liquidity position on the other hand KFL has higher idle cash and bank balance. It may decrease over all profit of bank. So KFL is recommended to activate its idle cash and bank balance in productive sector.
- Banks are suggested not to be surrounded and limited within the interest and status of big clients like multinational companies, manufacturer and exporter. The banks have to preserve the banking and saving habits of the low-income people of the kingdom. Because the main source of the collecting deposits of commercial banks are from public sector. It is also recommended to collect more funds as deposits through different schemes from different level of public, through assortment of deposit schemes and facilities like housing schemes, education loan, vehicle loan, and deposit for housewife etc.
- From the analysis, KFL has not invested more funds in government securities in comparison to NHMF. The bank has higher cash and bank balance than NHMF. Therefore, it is recommended to invest in government securities instead of

keeping idle and is not considered good from profitability point of view. Investment on those securities issued by government is free of risk, highly liquid and highly saleable in the marketplace.

- The recovery of the loan is most challenging job for banks. Increasing in non-performing assets leads to failure of commercial bank in recovery of loan. Therefore it has been recommended that KFL and NHMF should follow liberal lending policy when sanction of loan and advances have been done with adequate guarantee and should implement sound collection policy with proper identification of creditworthiness of customers, continual follow up and legal procedure if required.
- NHMF is recommended to increase their investment on shares and debentures on different sectors to earn more interest and dividend income to increase its net profit. KFL seems less conscious about borrowing cheaper fund. So it should give more priority on this matter.
- Both companies have earned more income from interest income which is not good for long term view. So both have to increase their revenue through other banking activity for long-term survival and to avoid bad debt risk.
- KFL has successfully allocated its deposit in investment portfolio in comparison with NHMF. So NHMF should successfully allocate its deposit in invest portfolio.
- Both banks should be careful in increasing profit of the bank to maintain the confidence of shareholders, depositors and all its customers. NHMF profitability position is not better than that of KFL. So, NHMF is strongly recommended to utilize risky assets and shareholders fund to gain high amount of profit.
- NRB has given directives to financial institution to invest their certain percentage of investment in deprive and priority sector. Both companies have earned profit from profitable and private sector. So, they are recommended to strictly follow up the directives issued by NRB and should make investment on public utilities sector like health, sanitation, education, drinking water, agriculture etc.

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Appendix - 1

Katmandu Finance Limited (KFL)

Liquidity Ratio:

(1) Cash reserve ratio:

(in thousand)

Year	Cash and bank balance	Total deposit	Cash reserve ratio (in %)
2002/2003	16337	239779	6.81
2003/2004	32066	245981	13.04
2004/2005	34036	248324	13.71
2005/2006	48398	305008	15.87
2006/2007	54832	316730	17.31
Mean			**13.35**

(2) Cash and bank balance to current assets ratio

(In thousand)

Year	Cash and bank balance	Current assets	Cash and bank balance to current assets ratio (in %)
2002/2003	16337	38884	42.01
2003/2004	32066	54186	59.18
2004/2005	34036	40452	84.14
2005/2006	48398	52357	92.44
2006/2007	54832	66734	82.17
Mean			**71.99**

(3) Investment on Govt. securities to current assets ratio:

(in thousand)

Year	Investment on Govt. securities	Current assets	Investment on Govt. securities to current assets ratio (in %)
2002/2003	1750	38884	4.50
2003/2004	1750	54186	3.23
2004/2005	0	40452	0
2005/2006	0	52357	0
2006/2007	0	66734	0
Mean			**1.55**

Assets Management Ratio:

(1)Loan and Advance to total deposit:

(in thousand)

Year	Loan and advances	Total deposit	Loan and advance to total deposit (in %)
2002/2003	248104	239779	103.47
2003/2004	236917	245981	96.32
2004/2005	226720	248324	91.30
2005/2006	229436	305008	75.22
2006/2007	257846	316730	81.41
Mean			**89.54**

(2)Total investment to total deposit:

(in thousand)

Year	Total investment	Total deposit	Total investment to total deposit (in %)
2002/2003	20186	239779	8.42
2003/2004	21226	245981	8.63
2004/2005	31223	248324	12.57
2005/2006	78049	305008	25.59
2006/2007	60284	316730	19.03
Mean			**14.85**

(3) Loan and advance to total working fund:

(in thousand)

Year	Loan and advances	Total working fund	Loan and advance to total working fund (in %)
2002/2003	248104	325718	76.17
2003/2004	236917	346138	68.45
2004/2005	226720	309578	73.24
2005/2006	229436	373885	61.36
2006/2007	257846	390663	66.00
Mean			**69.04**

(4) Investment to govt. securities to total working fund:

(in thousand)

Year	Investment to govt. securities	total working fund	Investment to govt. securities to total working fund (in %)
2002/2003	1750	325718	0.54
2003/2004	1750	346138	0.51
2004/2005	0	309578	0
2005/2006	0	373885	0
2006/2007	0	390663	0
Mean			**0.21**

(5) Investment on share and debenture to total working fund:

(in thousand)

Year	Investment on share and debenture	total working fund	Investment on share and debenture to total working fund ratio (in %)
2002/2003	4936	325718	1.52
2003/2004	4936	346138	1.43
2004/2005	1723	309578	0.56

2005/2006	1549	373885	0.41
2006/2007	1549	390663	0.40
Mean			**0.86**

Profitability Ratio:

(1) Return on loan and advance:

(in thousand)

Year	Net profit	Loan and advances	Return on loan and advances ratio (in %)
2002/2003	6770	248104	2.73
2003/2004	831	236917	0.35
2004/2005	5391	226720	2.38
2005/2006	8664	229436	3.78
2006/2007	6613	257846	2.56
Mean			**2.36**

(2) Return on total working fund ratio:

(in thousand)

Year	Net profit	Total working fund	Return on total working fund ratio (in %)
2002/2003	6770	325718	2.08
2003/2004	831	346138	0.24
2004/2005	5391	309578	1.74
2005/2006	8664	373885	2.32

2006/2007	6613	390663	1.69
Mean			**1.61**

(3) Total interest income to total working fund ratio:

(in thousand)

Year	Interest income	Total working fund	Return on loan and advances ratio (in %)
2002/2003	40315	325718	12.38
2003/2004	38548	346138	11.14
2004/2005	40257	309578	13.00
2005/2006	41267	373885	11.04
2006/2007	47459	390663	12.15
Mean			**11.94**

(4) Total interest paid to Total working fund ratio:

(in thousand)

Year	Interest paid	Total working fund	Interest paid to total working fund (in %)
2002/2003	23142	325718	7.10
2003/2004	22448	346138	6.49
2004/2005	20840	309578	6.73
2005/2006	22533	373885	6.03

2006/2007	26619	390663	6.81
Mean			**6.63**

Credit Risk Ratio:

(in thousand)

Year	Total investment	Loan and advance	Total assets	Credit risk ratio(in%)
2002/2003	20186	248104	325718	82.37
2003/2004	21226	236917	346138	74.58
2004/2005	31223	226720	309578	83.32
2005/2006	78049	229436	373885	82.24
2006/2007	60284	257846	390663	81.43
Mean				**80.79**

Appendix - 2

Nepal Housing and Merchant Finance Ltd. (NHMF)

Liquidity Ratio:

(1) Cash reserve ratio:

(in thousand)

Year	Cash and bank balance	Total deposit	Cash reserve ratio (in %)
2003/2004	24216	459920	5.27
2004/2005	27856	505766	5.51
2005/2006	23598	594204	3.97
2006/2007	32120	731670	4.39
2007/2008	50296	811421	6.20
Mean			**5.07**

(2) Cash and bank balance to current assets ratio

(in thousand)

Year	Cash and bank balance	Current assets	Cash and bank balance to current assets ratio (in %)
2003/2004	24216	46076	52.56
2004/2005	27856	65078	42.80
2005/2006	23598	82098	28.74
2006/2007	32120	55876	57.48
2007/2008	50296	53456	94.09
Mean			**55.14**

(3) Investment on Govt. securities to current assets ratio:

(in thousand)

Year	Investment on Govt. securities	Current assets	Investment on Govt. securities to current assets ratio (in %)
2003/2004	28556	46076	61.98
2004/2005	27500	65078	42.26
2005/2006	27500	82098	33.50
2006/2007	12500	55876	22.37
2007/2008	12500	53456	23.38
Mean			**36.70**

Assets Management Ratio:

(1) Loan and Advance to total deposit:

(in thousand)

Year	Loan and advances	Total deposit	Loan and advance

			to total deposit (in %)
2003/2004	380104	459920	82.65
2004/2005	446521	505766	88.29
2005/2006	557109	594204	93.76
2006/2007	675197	731670	92.28
2007/2008	761720	811421	93.87
Mean			**90.17**

(2) Total investment to total deposit:

(in thousand)

Year	Total investment	Total deposit	Total investment to total deposit (in %)
2003/2004	88523	459920	19.25
2004/2005	89486	505766	17.69
2005/2006	83376	594204	14.03
2006/2007	64363	731670	8.80
2007/2008	64595	811421	7.96
Mean			**13.55**

(3) Loan and advance to total working fund:

(in thousand)

Year	Loan and advances	Total working fund	Loan and advance to total working fund (in %)
2003/2004	380104	558747	68.03
2004/2005	446521	621397	71.86
2005/2006	557109	710128	78.45
2006/2007	675197	839301	80.45
2007/2008	761720	941514	80.90
Mean			**75.94**

(4) Investment to govt. securities to total working fund:

(in thousand)

Year	Investment to govt. securities	total working fund	Investment to govt. securities to total working fund (in %)
2003/2004	28556	558747	5.11
2004/2005	27500	621397	4.43
2005/2006	27500	710128	3.87
2006/2007	12500	839301	1.49

2007/2008	12500	941514	1.33
Mean			**3.25**

(5) Investment on share and debenture to total working fund:

(in thousand)

Year	Investment on share and debenture	total working fund	Investment on share and debenture to total working fund ratio (in %)
2003/2004	3590	558747	0.64
2004/2005	2208	621397	0.36
2005/2006	1025	710128	0.14
2006/2007	1067	839301	0.13
2007/2008	3787	941514	0.40
Mean			**0.33**

Profitability Ratio:

(5) Return on loan and advance:

(in thousand)

Year	Net profit	Loan and advances	Return on loan and advances ratio (in %)
2003/2004	7348	380104	1.93
2004/2005	5621	446521	1.26

2005/2006	11981	557109	2.15
2006/2007	8637	675197	1.28
2007/2008	22211	761720	2.92
Mean			**1.91**

(6) Return on total working fund ratio:

(in thousand)

Year	Net profit	Total working fund	Return on total working fund ratio (in %)
2003/2004	7348	558747	1.32
2004/2005	5621	621397	0.90
2005/2006	11981	710128	1.69
2006/2007	8637	839301	1.03
2007/2008	22211	941514	2.36
Mean			**1.46**

(7) Total interest income to total working fund ratio:

(in thousand)

Year	Interest income	Total working fund	Return on loan and advances ratio (in %)
2003/2004	66958	558747	11.98
2004/2005	62380	621397	10.04

2005/2006	68593	710128	9.66
2006/2007	87380	839301	10.41
2007/2008	96376	941514	10.24
Mean			**10.46**

(8) Total interest paid to Total working fund ratio:

(in thousand)

Year	Interest paid	Total working fund	Interest paid to total working fund (in %)
2003/2004	40873	558747	7.32
2004/2005	38568	621397	6.21
2005/2006	40772	710128	5.74
2006/2007	46978	839301	5.60
2007/2008	55049	941514	5.85
Mean			**6.14**

Credit Risk Ratio:

(in thousand)

Year	Total investment	Loan and advance	Total assets	Credit risk ratio (in %)

2003/2004	88523	380104	558747	83.87
2004/2005	89486	446521	621397	86.26
2005/2006	83376	557109	710128	90.19
2006/2007	64363	675197	839301	88.12
2007/2008	64595	761720	941514	87.76
Mean				**87.24**

Appendix - 3

Calculation of KFL

Year	loan and advance to total deposit(Y)	X=x-2004/5	X^2	XY
2002/03	103.47	-2	4	-206.9
2003/04	96.32	-1	1	-96.32
2004/05	91.3	0	0	0
2005/06	75.22	1	1	75.22
2006/07	81.41	2	4	162.82
Total(n)=5	Y = 447.72	**X** = 0	X^2 =10	**XY** - 65.22

Source: Annul report of KFL

Let trend line be

Y = a + b x……………………. (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $b = \frac{SXY}{SX^2}$

$= \frac{447.72}{5} = 89.54$ $= \frac{Z65.22}{10} = -6.522$

Substituting these values of a and b in eq (I) we get the required trend line

Yc = 89.54 - 6.522x

Calculation of NHMF

Year	Loan and Advance to Total Deposit(Y)	X=x-2004/5	X^2	XY
2002/03	82.65	-2	4	-165.3
2003/04	88.29	-1	1	-88.29
2004/05	93.76	0	0	0
2005/06	92.28	1	1	92.28
2006/07	93.87	2	4	187.74
Total(n)=5	**Y** = 450.85	**X** = 0	X^2 = 10	XY = 26.43

Source: Annul report of NHMF

Let trend line be

Y = a + b x……………………. (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $b = \frac{SXY}{SX^2}$

$= \frac{450.85}{5}$ $= \frac{26.43}{10}$

= 90.177 = 2.643

Substituting these values of a and b in eq^n (I) we get the required trend line

Yc = 90.177 + 2.643x

Appendix - 4

Calculation of KFL

Year	total investment to total deposit(Y)	X=x-2004/5	X^2	XY
2002/03	8.42	-2	4	-16.84
2003/04	8.63	-1	1	-8.63
2004/05	12.57	0	0	0
2005/06	25.59	1	1	25.59
2006/07	19.03	2	4	38.06
Total(n)=5	74.24	0	10	38.18

Let trend line be

Y = a + b x…………………….. (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $b = \frac{SXY}{SX^2}$

$= \frac{74.24}{5} = 14.848$ $= \frac{38.18}{10} = 3.818$

Substituting these values of a and b in eq. (I) we get the required trend line

Yc = 14.848 + 3.818x

Yc = 2.36+0.309X

Calculation of NHMF

Year	Total Investment to Total Deposit(Y)	X=x-2004/5	X^2	XY
2002/03	19.25	-2	4	-38.5
2003/04	17.69	-1	1	-17.69
2004/05	14.03	0	0	0
2005/06	8.8	1	1	8.8
2006/07	7.96	2	4	15.92
Total(n)=5	67.73	0	10	-31.47

Let trend line be

Y = a + b x……………………. (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $b = \frac{SXY}{SX^2}$

$= \frac{67.73}{5}$

$= 13.546$ $= \frac{Z31.47}{10}$

$= -3.147$

Yc = 13.54 - 3.147 X

Appendix - 5

Calculation of KFL

Year	Return on loan and advance ratio	X=x-2004/5	X^2	XY
2002/03	2.73	-2	4	-5.46
2003/04	0.35	-1	1	-0.35
2004/05	2.38	0	0	0
2005/06	3.78	1	1	3.78
2006/07	2.56	2	4	5.12
Total(n) = 5	11.8	0	10	3.09

Source: Annul report of KFL

Let trend line be

Y = a + b x……………………. (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $b = \frac{SXY}{SX^2}$

$= \frac{11.5}{5}$ $= \frac{3.09}{10}$

= 2.36 = 0.309

Substituting these values of a and b in eq. (I) we get the required trend line

Yc = 2.36+2142.8x

Calculation of NHMF

Year	Return on Loan and Advance Ratio	X=x-2004/5	X^2	XY
2002/03	1.93	-2	4	-3.86
2003/04	1.26	-1	1	-1.26
2004/05	2.15	0	0	0
2005/06	1.28	1	1	1.28
2006/07	2.92	2	4	5.84
Total(n)=5	9.54	0	10	2

Source: Annul report of NHMF

Let trend line be

Y = a + b x…………………… (I)

Where x = X - Middle year

Here,

$a = \frac{SY}{N}$ $\qquad$ $b = \frac{SXY}{SX^2}$

$= \frac{9.54}{5}$ $\qquad$ $= \frac{2}{10}$

$= 1.908$ $\qquad$ $= 0.2$

Substituting these values of a and b in eq. (I) we get the required trend line

$Yc = 1.908 + 0.2\ X$