COMPARATIVE FINANCIAL PERFORMANCE ANALYSIS OF Nepal Industrial and Commercial Bank and Everest Bank Limited IN THE FRAMEWORK OF CAMELS

By:

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T.U. Registration Number: 6554-92/1746/059

A Thesis Submitted to:

Office of the Dean
Faculty of Management
Tribhuvan University

In partial fulfillment of the requirements of the degree of
Master of Business Studies (M.B.S.)

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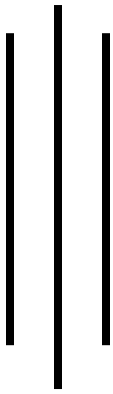

In partial fulfillment of the requirements for the

Degree of

Master of Business Studies (M.B.S.)

Kathmandu, Nepal

March, 2009

RECOMMENDATION

This is to certify that the thesis

Submitted by
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COMPARATIVE FINANCIAL PERFORMANCE ANALYSIS OF NEPAL INDUSTRIAL AND COMMERCIAL BANK AND EVEREST BANK LIMITED IN THE FRAMEWORK OF CAMELS

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

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VIVA-VOCE SHEET

We have conducted the viva –voce examination of the thesis presented

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COMPARATIVE FINANCIAL PERFORMANCE ANALYSIS OF NEPAL INDUSTRIAL AND COMMERCIAL BANK AND EVEREST BANK LIMITED IN THE FRAMEWORK OF CAMELS

And found the thesis to be the original work of the student and written according to the prescribed format. We recommend the thesis to be accepted as partial fulfillment of the requirement for

Master Degree of Business Studies (M.B.S.)

Viva-Voce Committee

Head, Research Department **……**

Member (Thesis Supervisor) …..……..

Member (Thesis Supervisor) …..……..

Member (External Expert) …..……..

DECLARATION

I hereby declare that the work reported in this thesis entitled "**COMPARATIVE FINANCIAL PERFORMANCE ANALYSIS OF NEPAL INDUSTRIAL AND COMMERCIAL BANK AND EVEREST BANK LIMITED IN THE FRAMEWORK OF CAMELS**" submitted to Shanker Dev Campus, Faculty of Management, Tribhuvan University, is my original research work done in the form of partial fulfillment of the requirement for the Degree of Master's in Business Studies (M.B.S.) under the supervision of Dr. K.D. Manandhar and Dhruba Subedi, of Shanker Dev Campus, Tribhuvan University.

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CHAPTER I

INTRODUCTION

1.1 Background of the Study

The study of performance of listed commercial banks and returns to investors occupies an important role in the development of capital market. Development and expansion of capital market are essential for the rapid economic growth of the country. Capital market helps economic development by mobilizing long term capital needed for productive sector. It is vital to long term growth and prosperity of the economy since it provide the channel through which needed funds can be raised.

Bank is a financial institution, which plays significant role in the development of the country. It helps the growth of agriculture trade, commerce and industry of the national economy. The banking sector is largely responsible for collecting household saving it items of different types of deposits and regulating them in the society by lending them in different sector of the economy. The banking sector has now reached even to the most remote areas of the country and has contributed a good deal to the growth of the economy. By lending their resources in small scale industries under intensive banking programmed the banks has contributed to the economic growth of the economy.

Banking institution are inevitable for the resources mobilization and the all round development of the country. They have resources for economic development and they maintain economic confidence of various segments and extend credit to people.

Banking concept existed even in the ancient period, when the gold smiths and reach people used to issue receipt to the common on people against the promise to

safe keeping of their valuable items on the presentation of the receipt, the depositors would get back their gold and valuable after paying a small amount for safe keeping and saving.

This is the main reason for accepting banks since ancient time in some form. Previously gold smiths performed this task but now various types of banks have taken over this task.

Banks refers to any firms that are basically concerned with the transaction of money, however today banks are established for specific purpose. Different types of banks are focus different types of services to their customers. Although the basic principle is the same today different types of the financial institution have been established with different purpose. Such as Merchant bank, overseas bank, clearing bank, the discount house, Trustee saving bank, Mobil serving bank etc.

These banks give different types of services to people. Basically banks performs various types of services like collection of deposits from the public , granting loans to the investors in different sector, overdraft , guarantee against payment , letter of credit discounting bills promissory, selling of shares agency function etc.

When the opinion Finance Company Act 1985 and democratic movement 1989, His majesty's government has formally adopted the economic liberalization policy. This policy has been more emphasis to the private sector and international investors to invest in Nepal, as encouraging factor of sustainable economic growth. The new policy has already resulted that the establishment of finance companies is an encouraging trend. The main objectives of the commercial banks is to collect deposits and to provide loan and also mobilizing scattered saving through various schemes and deploy them in different sector of the economy for the economic development of the country, the aim of the Finance Company Act

1985 is to guide the economic in right direction as giving services where Commercial Banks and other financial institution mentioned where are but available.

The history of the development of financial institutions in Nepal was very long. The first commercial bank is Nepal bank Ltd, established in 1994 B.S. is none government sector.

Then the Nepal Rastra Bank (Central Bank of Nepal) in 2013 B.S. was a significant dimension in the development of banking sector. The second commercial bank is Rastriya Banijaya Bank Ltd., which has established in 2021 B.S., a fully wondered of government bank. Then after other banks were established gradually.

According to Nepal Commerce Bank Ltd. 2031 B.S., a commercial bank is the one which exchanges money, deposits money, accepts deposit grants loan and performs commercial banking function and which is not a bank meant for co-operative agriculture, industries as for such specific purposes.

When the government adopted liberal and market oriented economic policy since mid-1995, Nepal allowed foreign banks on joint the approval from Nepal Rastra bank. These foreign joint venture banks are allowed 50% foreign equity participation. As result first only three JV bank's namely Nepal Arab bank Ltd., Nepal Indo-suez bank Ltd., and Nepal Griendlays Bank Ltd. were established in 2041, 2042 and 2043 B.S. respectively.

The least of licensed commercial banks in Nepal by 2008 are given in Appendix I

1.2 Focus of the Study

Commercial banks play a tremendous role in a development of developing nations, also helps in the economic sector of the country. Typically, commercial bank's main motive is to make profit by providing quality services to the customers in Nepal. There are 25 commercial banks operating in Nepal. Banks' performance is dependent on elements like capital, earning capability of their resources, returns to their shareholders and liquidity situation, etc. NRB has become so critical on requirements to maintenance of capital adequacy ratios, liquidity ratios in the banks' deposit collection and lending activities. As long as the banks are able to maintain the requirements on these aspects they are allowed to carry out their full fledged banking activities. Similarly, the banks' profitability, efficiency have impacts on the investors. Therefore, the focus has been put on assessing the capital adequacy, earning capability and efficiency and liquidity of the sample commercial banks.

The main objectives of this research is to analyze the financial performance through the use of appropriate financial tools, so this research focused mainly to highlight and examine the profit ability position of the selected banks ignoring other aspects of banks transactions.

To highlight the financial portion of the banks, the research is based on the certain financial tools in the CAMEL framework..

1.3 Statement of the Problem

A financial institution's soundness is judged on the basis of capital adequacy, asset quality, management, earning, and liquidity (CAMEL). Some financial institution have very low capital adequacy ratio while some have piled of non-performing assets. Similarly, it appears that financial institutions do not have proper system managing the correctness of credit classification and provision of some

commercial banks. The profitability position of a firm is generally known through financial statements but a major question emerges whether there are adequate to reflect the overall performance of company. The fundamentals problem of this study is to check up the financial health of Nepal Industrial and Commercial Bank Ltd. in the framework of CAMEL. Based on this general problem the following specific problems are set in this study.

- Are the capital maintained by NIC and EBL adequate?
- What are the asset quality of NIC and EBL?
- Are the management of NIC and EBL efficient?
- What is the earning capacity of NIC and EBL?
- What are liquidity position of NIC and EBL?

1.4 Objectives of the Study

The general objective of this study is to make comparative analysis of the financial performance of the two commercial banks, NIC and Everest Bank Ltd. and to recommend, suggestion for the improvement of state of affair. The specific objectives of the study are given below.

- To measure the capital adequacy of NIC and EBL.
- To evaluate the asset quality of NIC and EBL.
- To assess the efficiency of management of NIC and EBL.
- To measure the earning capacity of NIC and EBL.
- To measure the liquidity position of NIC and EBL.

1.5 Significance of the Study

Research it self has own importance because it aims to gain knowledge and to add the new literature to the existing field. The significance of this study lies mainly in filling a research gap on the study of comparative financial performance analysis of with respect to NIC and EBL. This study will contribute significantly to solve

the problem existing in the financial institution and to formulate the policy and strategies to maintain activities effectively. The study is important for commercial banks, researchers, scholars, investors, students, government and many other parties. So, this study will be helpful to those who want to study in further detail and widely in this field. At last, it is expected that the study will add a drop of literature to the field of commercial banks and their comparative financial performance analysis.

1.6 Limitation of the Study

As every study is conducted with in certain limitations the present study is not an exceptional. The study is based on a case study of NIC and EBL, which may not represent the overall scenario of all commercial banks. Basically, the study is limited with in the following factors.

- Out of various commercials banks, the study is conducted on only two banks: NIC and Everest Bank Ltd.
- Most of the data ore of secondary nature and the calculations, conclusions of the study will fully depended on the accuracy of the data provided by the respective organization.
- The study covers the financial performance of the NIC and EBL for the period of only five fiscal years (F/Y 2003/04 to 2007/08)
- The study is simply a partial fulfillment of MBS degree and prepared with in time constraint.
- The focus is given to the quantitative aspects of the two banks. Qualitative factors are not studied.

1.7. Organization of the Study

The study will divide into five chapters.

Chapter I: Introduction: This chapter explains background of the study, Statement of the problem, Objectives of the study, Importance of the study and limitation of the study.

Chapter II: Review of Literature: This chapter is included Conceptual review and Review of related studies. Past studies conducted by foreign and Nepalese scholars in the performance of financial institution have also been presented.

Chapter III: Research Methodology: This chapter includes research design, Justifications for the Selection of the Unit, population and sample, Nature and Source of Data, Data Collection Procedures, Data Processing Data and Analysis Tools

Chapter IV: Data presentation and Analysis: Fourth chapter is Data presentation and analysis. This chapter is included Data presentation, Data analysis and Major finding of the study

Chapter V: Summary, Conclusion and Recommendations: This chapter consists of summary of the study, conclusion of the major findings and recommendations for further improvement.

CHAPTER II
LITERATURE REVIEW

This chapter is included conceptual review, review of research and work papers and review of dissertation. Conceptual review is a most important for every study that provides clear concept on subject of matter for the study. In this section brief explanation of major findings of previous study is undertaken. This chapter is divided into two parts: conceptual review and review of related studies.

2.1 Conceptual Review

This sub-chapter presents the theoretical aspect of the study. It includes the concept of financial performance analysis and concept of CAMEL rating.

2.1.1 Financial Performance Analysis

Financial performance analysis is a process of identifying the financial strength and weakness of the firm by properly establishing the relationship between item of balance sheet and the profit and loss account. It is undertaken to assess the financial strength and weakness of the firm. The analysis is usually based on financial statement prepared by the firm. Financial analysis serves as the basis for decision making. Moreover this analysis is also made to find out whether to use debt or equity funds to finance planned plant expansion. Financial analysis uses data contented in the firm's financial statement supplemented by the statement of cash flows. Furthermore, it summarized the large quantity of financial data and makes qualitative judgment about the firm's financial performance. The primary tools of financial analysis are financial ratios. Financial ratios provide a good technique for assessing financial performance.

Financial statements contain a wealth of information, which if properly analyzed and interpreted, can provide valuable insights into firm's performance and position (Chandra, 1992:6). Analysis of financial statements is of interest to lenders, investors, security analysis, managers and others. It generally begins with the calculations of set of financial ratios designed to reveal the relative strength and weaknesses of a company as compares to other companies in the same industry, and to show whether the firm's position has been improving or deteriorating over time (Western and Copeland, 1991:59). Financial analysis is a process of identifying the financial strengths and weaknesses of the firm by properly establishing relationship between the item of balance sheet and the profit and loss account (Pandey, 1999:26).

2.1.2 Concept of "CAMEL" Rating System

Federal Reserve Bank of New York (1997) has defined the component of CAMEL as rating system which produces a composite rating of an institution's overall condition and performance by assessing five components: Capital Adequacy, Asset Quality, Management Administration, Earning and Liquidity.

CAMEL was originally developed by the FDIC for the purpose of determining when to schedule an on-site examination of bank (Thomson, 1991; Whalen and Thomson, 1988). The FFIEC is revised in January 1997, the UFIRS, which is commonly referred to as the CAMEL rating system. This system was designed by regulatory authorities to quantify the performance and the financial condition of the Banks which it regulates.

The CAMEL rating system is subjective. Benchmarks for each component are provided, but they are guidelines only, and present essential foundations upon which the composite rating is based. They do not eliminate consideration of other pertinent factors by the examiner. The uniform rating system provides the

groundwork for necessary supervisors to be reasonably compared and helps institutions supervised by all three US supervisors to be reasonably compared and evaluated. Ratings are assigned for each component in addition to the overall rating of a financial institution's financial condition. The ratings are assigned on a scale from 1 to5. The CAMEL rating are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding financial institutions' overall financial conditions, although they also reflect available public information.

The most important criteria for determining the appropriateness of Fls to act as financial intermediary are its solvency, profitability and liquidity. In this respect, the BCBS of the bank of international settlements (BIS), since 1988, has recommended using capital adequacy, assets quality, management quality, earnings and liquidity (CAMEL) as criteria for assessing FI.

During an on-site bank exam, supervisors gather private information, such as details on problem loans with which to evaluate a bank's financial condition and to monitor its compliance with laws and regulatory policies. A key product of such an exam is a supervisory rating of the bank's overall condition, commonly referred to as a CAMEL rating. CAMEL rating system is used by the three federal banking supervisors [the Federal Reserve, the FDIC, and the office of the comptroller of the currency (OCC)] and other financial supervisory agencies to provide a convenient summary of bank conditions at the time of an exam. In Nepal, the NRB plays the supervisory role for evaluating financial institution's financial condition through rating the financial institution's in accordance to CAMEL is still in its initial phase.

Composite Rating

The FFIEC press release, USA (1996) describes the composite rating and defines the six components rating. According to the press release, composite ratings are based on a careful evaluation of an institution's managerial, operational, financial and compliance performance. The six key components used to assess an institution's financial condition and operations are: capital adequacy, asset quality, management capability, earnings quality, the adequacy of liquidity and sensitivity to market risk. The rating scale range from 1 to 5, with a rating of 1 indicating: the strongest performance and risk management practices relative to the institution's size, complexity, and risk profile and the level of performance inadequate risk management practices relative to the institution's size, complexity, risk profile and the greatest supervisory concern. The composite ratings are defined in the FFIEC press releases (1996) are as follows.

Composite 1: FIs in this group are in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These FIs are the most capable of withstanding the vagaries of business condition and are resistant to outside influences such as economic instability in their trade area. These FIs are in substantial compliance and risk management practices relative to the institution's size, complexity and profile and give no cause for supervisory concern.

Composite 2: FIs in this group are fundamentally sound. For a FI to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the board of directors' and management's capabilities and willingness to correct. These FIs are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity and risk profile.

Composite 3: FIs in this group exhibit some degree of supervisory concern in one or more of the component areas. These FIs exhibit a combination of weaknesses that may range from moderate to sever: however, the magnitude of the deficiencies generally will not cause a component to be rated more severely than 4. FIs in this group generally are more vulnerable to outside influences than those institutions rated a composite 1 or 2. Additionally, these FIs may be in significant noncompliance with laws and regulations.

Composite 4: FIs in this group generally exhibit unsafe and unsound practices or conditions. There are serious financial or managerial deficiencies that result in unsatisfactory performance. The problems range from severe to critically deficient. The weaknesses and problems are not being satisfactorily addressed or resolved by the board of directors and management. FIs in this group generally are not capable of withstanding business fluctuations. There may be significant noncompliance with laws and regulations. Risk management practices are generally unacceptable relative to the institution's size, complexity and risk profile. Close supervisory attention is required, which means, in most cases, formal enforcement action is necessary to address the problems. Institution in this group poses a risk to the deposit insurance fund. Failure is a distinct possibility if the problems and weaknesses are not satisfactorily addressed and resolved.

Composite 5: FIs in this group exhibit extremely unsafe and unsound practices or conditions exhibit a critically deficient performance, often contain inadequate risk management practices relative to the institution's size, complexity and risk profile are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the FIs to be viable. Ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

2.1.3 CAMEL Components

Each of the components rating description in the FFIEC press release (1996) is divided into three sections: an introductory paragraph a list of the principal evaluation factors that relate to that component and a brief description of each numerical rating for that component. Some of the evaluation factors are reiterated under one or more of the other components to reinforce the interrelation between components. The listing of evaluation factors for each component rating is in no particular order of importance. The description of the CAMEL components are made as under based on the FFIEC press release (1996).

2.1.3.1 Capital Adequacy

Bank capital performs several important functions. Most importantly they are:
Absorbs Losses: Capital allows institution to continue operating as going concern during periods when operating losses or other adverse financial results are experienced.

Promotes Public Confidence: Capital provides a measure of assurance to the public that an institution will continue to provide financial services even when losses have been incurred, thereby helping to maintain confidence in the banking system and minimize liquidity concerns.

Restricts Excessive Asset Growth: Capital along with minimum capital ratio standard, restrains unjustified asset expansion by requiring that asset growth be funded by a commensurate amount of additional capital.

Provides Protection to Depositors: Placing owners at significant risk of loss, should the institution fail, helps to minimize the potential “moral hazard” and promotes safe and sound banking practices.

Capital is necessary for the bank to operate. While many areas of a bank are important and subject to scrutiny, capital adequacy is the area that triggers the most regulatory of capital adequacy, which are:

- The Tier 1 Risk-Based capital ratio.
- The total risk-based capital ratio.
- The tier 1 leverage ratio.

The capital adequacy of an institution is rated based upon, but not limited to, an assessment of the following evaluation factors:

- Size of the bank.
- Volume of inferior quality assets.
- Bank's growth experience, plans and prospects.
- Access to capital markets.
- Non-ledger assets and sound values not shown on books (real property) at nominal values, charge-offs with firm recovery values, tax adjustments).

The FDIC improvement Act of 1991, which created a link between enforcement actions and the level of capital, held by a bank. This supervisory link is commonly known as prompt Corrective Action (PCA) and aims to resolve banking problems early and at the least cost to the bank insurance fund. PCA has classified the banks as:

Well-Capitalized: To be considered well-capitalized, a bank will meet the following conditions:

- Total risk-based capital is 10 percent or more.
- Tier 1 risk-based capital ratio is 6 percent or more.
- Tier 1 leverage ratio is 5 percent or more.

In addition to these ratio guidelines, to be well capitalized bank can not be subject to an order, a written agreement, a capital directive or a PCA directive.

Adequately Capitalized: to be considered well capitalized, bank will meet the following conditions:

- Total risk-based capital ratio is at least NRB minimum capital adequacy ratio requirement.
- Tier 1 risk-based capital ratio is at least NRB minimum tier 1 capital ratio requirement.
- Tier 1 leverage ratio is at least 4 percent.

Undercapitalized: to be considered undercapitalized, a bank will meet the following conditions:

- Total risk based capital ratio is less than 8 percent.
- Tier 1 risk based capital ratio is less than 4 percent or tier 1 leverage ratio is less than 4 percent.

Significantly Undercapitalized: To be considered significantly undercapitalized a bank will meet the following conditions:

- Total risk based capital ratio is less than 6 percent.
- Tier 1 risk based capital ratio is less than 3 percent
- Tier 1 leverage ratio is less than 3 percent.

BASEL Capital Accord

The BASEL committee on banking supervision (BCBS) is a committee of banking supervisory authorities that was established by central bank governors of the group of ten countries in 1975. it consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United

Kingdom and the united States. It usually meets at the bank for international Settlements (BIS) in BASEL, where it's permanent is located. (BIS, November 2005).

Starting with its publication of "International Convergence of Capital Measurement and Capital Standards" in July 1988, popularly known as BASEL I Capital Accord, BCBS set out a minimum capital requirement of 8 percent for banks. Prior to that, the committee introduced 25 core principles on effective banking supervision. In 1996, the committee incorporated market risk in the 1988 capital accord. With a major revision of the 1988 accord, there followed by the revised publication of the committee's first round of proposals for revising the capital adequacy framework in June 1999 popularly known as BASEL II capital Accord. Since then, it is revised in January 2001, April 2003 and released its final revised framework updated in November 2005. In this accord, the concept and rationale of the three pillars (minimum capital requirements, supervisory review and market discipline) approach was introduced, on which the revised framework is based. In the revised framework, BCBS retains key elements of the 1988 capital adequacy framework, including the general requirement for banks to hold total capital equivalent to at least 8 percent of their risk-weighted assets; the basic structure of the 1996 market risk amendment regarding the treatment of market risk; and definition of eligible capital. (BIS, 2005)

The new BASEL capital accord (BASEL II), shall be applicable to internally active banks all over the world with effect from end of 2006. Implementing the new accord in Nepal has been a challenging task for the supervisors as well as FIs. Hence, certain preparatory homework is needed to Nepalese financial system to implement BASEL II. NRB and FIs need to have coordinated effort efficiency in Nepalese banks and FIs to establish certain baseline for the effective implementation of BASEL II. In this regard, second interaction program was held

in Nepal with the banks executive to make them aware of the new development. The commercial banks so far has shown positive attitude towards the implementation of BASEL II. “New capital accord implementation preparatory core committee” was drafted “NRB’s concept paper on new capital accord”. According to the program of new capital accord implementation, concept paper was forwarded to all the commercial banks for comments and recommendations. A form was also developed so that commercial banks classify their exposures as per the new approach, which was reviewed by the “BASEL- II implementation working group”. NRB has adopted Basel core principles for effective supervision as guideline for supervision of commercial banks. Core principle methodology adopted by BCBS provides a uniform template for both self-assessment and independent assessment. It involves four part qualitative assessment system: compliant, largely compliant, materially non-compliant and non-compliant. For each principle essential and additional criteria are defined. To achieve a “compliant” assessment with a principle, all essential and additional criteria must be met without any significant deficiencies. A “largely compliant” assessment is given if only minor shortcomings are observed, and these are not seen as sufficient to raise serious doubts about the authority’s ability to achieve the objective of that principle. A “materially non-compliant assessment is given when the shortcoming is sufficient to raise doubts about the authority’s ability to achieve compliance, but substantial progress towards compliance has been achieved.

There is no doubt that the new accord though complex carries a lot of virtues and will be a milestone in improving banks internal mechanism and supervisory process and beneficial to the commercials banks.

Capital Adequacy Norms by NRB

NRB has form time to time stipulated minimum capital fund to be maintained by the banks on the basis of risk weighted assets. The total capital fund is sum of core

capital and supplementary capital. According to the NRB unified directives for Banks and non-banks FIs issue number E. pra.Ni.no 01/061/062 (Ashar 2062 BS), the capital funds of a bank comprise the following:

Core Capital: Core capital of a bank includes paid up equity, share premium, non-redeemable preference shares, general reserve and accumulated profit and loss. However, where the amount of goodwill exists, the same shall be deducted for the purpose of calculation of the core capital.

Supplementary Capital: Supplementary capital includes general loan loss provision, exchange fluctuation reserve, assets revaluation reserve, hybrid capital instruments, unsecured subordinated term debt and other free reserves not allocated for specific purpose.

Banking and Financial institution Ordinance (BAFIO) (2061) also assimilates the same things, which were included and explained in NRB Act 2058, in regard of bank capital. NRB Act is effective from 1st Shrawan 2058(July 16th 2001). According to the NRB directive, minimum paid-up capital requirement for establishment of finance company is as under:

- Rs 200 corer to operate all over Nepal

2.1.3.2 Assets Quality

Asset quality is one of the most critical areas in determining the overall condition of the commercial bank. The primary factor effecting overall asset quality is the quality of the loan portfolio and the credit administration program. Loans are usually the largest of the asset items and can also carry the greatest amount of potential risk to the company's capital account. Security can often be a large portion of the assets and also have identifiable risks. Other items which impact a comprehensive review of asset quality are other real estate, other assets, off-

balance sheet items and, to a lesser extent, cash and due from accounts and premises and fixed assets (Koch and Macdonald, 2004).

Management often expends significant time, energy and resources on their asset portfolio, particularly the loan portfolio. Problems within this portfolio can detract from their ability to successfully and profitably manage other areas of the institution. Examiners need be diligent and focused in their review of the various asset quality areas, as they have an important impact on all other facets of commercial banks operations.

Evaluation of Asset Quality

The evaluation of asset should consider the adequacy of the allowance for loan and lease losses (ALLL) and weigh the exposure-party, issuer or borrower default under actual or implied contractual agreements. All other risks that may affect the value or marketability of an institution's assets, including but not limited to, operating, market, reputation, strategic, or compliance risks, should also be considered. Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any systematic weaknesses, as opposed to isolated problems, should be given appropriate consideration. The following is not a complete list of all possible factors that may influence an examiner's assessment; however, all assessment should consider the following:

- ✓ The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices.
- ✓ The level, distribution, severity, trend of problems, classified, on accrual, restructured, l delinquent and non-performing assets for both on-and off – balance sheet transactions.

- ✓ The adequacy of the allowance for loan and lease losses and other asset valuation reserves.
- ✓ The credit risk arising from or reduced by off-balance sheet transactions, such as un-funded commitments, credit derivatives, commercial and standby letters of credit and lines of credit.
- ✓ The diversification and quality of loan and investment portfolios.
- ✓ The extent of securities underwriting activities and exposure to counter-parties in trading activities.
- ✓ The existence of asset concentrations.
- ✓ The adequacy of loan and investment polices, procedures and practices
- ✓ The ability of management to properly administer its assets, including the timely identification and collection of problem assets.
- ✓ The adequacy of internal controls and management information systems.
- ✓ The volume and nature of credit documentation exceptions.

  As with the evaluation of other component ratings, the above factors, among others, should be evaluated not only according to the current level but also considering any ongoing trends. The same level might be looked on more or less favorably depending on any improving or deteriorating trends is one or more factors.

Rating the Asset Quality Factor

The asset quality rating definitions are applied following a through evaluation of existing and potential risks and the mitigation of those risks. The definitions of each rating are as follows:

1. Rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.

2. A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.
3. A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality. The level and severity of classified assets, other weaknesses, and risks require an elevated level of supervisory concern.
4. A rating 4 is assigned to FIs with deficient asset quality or credit administration practices. The levels of risk and problem assets are significant, inadequately controlled, and subject the FI to potential losses that, if left unchecked, may threaten its viability.
5. A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Non-performing Assets (NPAs)

Loans and advances of FIs need to be serviced by either the principal or the interest of the amount borrowed in stipulated time as agreed by the parties at the time of loan settlement. NRB unified directives E.pra.Ni 20/061/62 (Ashar, 2062 BS) for banks and non-bank FIs, defines non performing loans as loan classified as substandard, doubtful and loss or loans which are past due by principal for more than 3 month. Dhungana (2006) in his column states that the details and classification of standards of Non-performing loans may from country to country depend upon their own banking system requirement norms. He further states that unlike Nepal, countries like Korea, Indonesia, Phillipines, India have classified the loan into five categories on which normal and special categories are classified as performing loans whereas sub standard, doubtful and estimated loss categories are

considered as non performing loans. The study conducted by World Bank highlights that all commercial banks of south asian countries except Nepal and srilanka classify loans as non-performing only after it has been in arrear for at least six months (Pernia, 2004). NRB unified directives for banks and non-bank FIs through directive number E.pra.Ni.No 02/061/62 (ashar 2062 BS) classifies NPL, according to international practice, into three categories depending on the temporal position of loan default, Substandard, Doubtful and loss Assets are the categories on the basis of the time barred to repay either interest or the principal. The degree of NPA assets depend 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 pf assets is being perceived and such assets are treated accordingly. However, the treatment of NPAs depends according to countries. No uniform rule seems to apply (Koch and Macdonald, 2004).

Factors Causing NPAs

Dhungana (2006) in his column broadly categorized in to internal and external factors for high level of NPA in Nepalese banking system. The following factors can also be the reason for causing NPA:

1. NPAs may arise due to failure of business for which loan was used. Whatever may be the reasons for failure of business, it obstructs the carrying out timely payments of financial obligations.
2. On the other part of appraising institutions, the defect in appraising projects breed mismatch not only in investment planning but also in receivables due to defective projection of returns. Large positions of NPAs in developing countries arise due to defective and standard credit appraisal system.
3. Monitoring of projects in time provide insurance against of enterprises through rectification of minor flaws that ape ear during the course of operation. Inability of sound monitoring system can also lead to failure of the project.

4. The resources of FIs collected through deposits from people may be misutilised. Recklessness or negligence on the part of the officials while approving the loan will turn in to default.
5. Attitude of the officials that does not amount to sincere corporate culture also leads to breed drawbacks in the payment of dues to FIs.
6. The credit programmers sponsored by the government are regarded as the source of NPAs. For political benefits government, without assessing the financial feasibility of the credit programmer, announces and compels the credits agencies to go along with the declared policies.
7. Moreover, dishonest politicians often want free ride of on the amounts of loan delivered by credit agencies under government designed programmers. Such loans are hardly recoverable. The fact is evidence from the experience in Nepal and India by the manifestation of higher percentage of NPAs found in priority sector loans.
8. Quite often the definition of the NPAs and accounting norms adopted by concerned agencies also amount to higher or lower magnitude of such assets. Each institution may have different norms to declare the assets whether it is not-performing. The income cycle of the project and amount of loan involved, set the installments of loan repayment. The nature of project also determines the level of NAPs.
9. Slow down in economy, global as well as domestic particularly in industrial sector. Contribution to adversely affect the bottom-line of borrower units and their capacity to service the debt (Taore-1999). Recession debars the economic activities to run smoothly which affect the performance of FIs.

Implication of NPAs

Financial crisis emerged from Thailand in south east Asian countries largely is considered to be due to higher level of NPAs existed with the FIs. The situation was grave when the asset stopped to repay loans to credit agencies which was

borrowed from overseas was matured. Investment in domestic market did not provide returns, hence the amount involved turned into non-performing while repayment on due time was the principal reason to result in financial crisis that terminated into economic crisis in south East Asian countries. Financial crisis occurred in Asia had the higher proportion of NPAs emanate from loans which constituted highest share in the total assets of FIs. Countries with higher proportion of loan in the total assets of banks and finance companies became vulnerable while institutions with lower share of loans in the total assets were affected less.

Empirically, it has been seen that Nepal and having lower proportion of loan in respect of total assets provided cushion to make ample provision and therefore were least affected by the financial crisis. On the other hand the south East Asian with relatively higher proportion of loans in the total assets of the FIs fell victim of the shock of regional crisis.

The credit institutions are repelled from further investment after the interest accrual or due principal repayment has stopped. Interest incomes from such assets are reduced to the extent of declared amount as NPAs. As the assets declared NPA emanate from the deposits, it puts the depositors fund at risk. The credit agencies are put to an extra amount of liability by regulatory authorities in the form of provision. The amount required for provision depends on the level of NPAs and their quality. Rising level of NPAs create a psyche of worse environment especially in the financial sector. Depositors are not interested to save. Rather the hard earned savings are diverted to consumptions. Consequently the savings pattern hence investment is affected thereby creating unhealthy atmosphere in the financial sector.

NRB Directives Related to Assets Quality

NRB unified directive for banks & non-bank FIs (Ashar 2062 BS) through directive number E. pra.Ni.No 02/061/62, requires the banks to classify outstanding loans and advances on the basis of aging of principal amount. As per the directive the loans and advances should be classified into the following four categories:

Pass: loans and advances whose principal amount is not past due over for 3 months included in this category. These are classified and defined as performing loans.

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

Doubtful: All loans and advances, which are past due for a period of 6 months to 1 year, included in this category**.**

Loss: All loans and advances which are past due for more than 1 year and have least or thin possibility of recovery or considered unrecoverable shall included in this category. Besides this, any loan whether past due or not, in situations of inadequate security, borrower declared insolvent, no whereabouts of the borrower or misuse of borrowed fund, are to be classified as loss category.

The directive further requires banks to provision for loan loss, on the basis of the outstanding loans and advances and bills purchased classified as above. Loan loss provision set aside for performing loans is defined as General Loan provision and that set aside for non-performing loan as specific loan loss provision.

Loan Class	Loan Loss Provision
Pass	1%
Substandard	25%
Doubtful	50%
Less	100%

With the objectives of lowering the concentration risk of bank loans to a few big borrowers and to increase the access of small and middle size borrowers to the bank loans, NRB through directive number E. pra.Ni.No 30/061/62 limits commercial banks to extend credit to a single borrower or group related borrowers up to 25% of core capital for fund based credit facilities and not more than 50% of its core capital for non fund based credit facilities like letters of credit, guarantees, acceptances, commitments.

The facilities extended against bank's own fixed time deposit, government securities, NRB bonds, counter guarantees of world Bank/Agriculture Development Bank/international A + rated banks (as per list of top 1000 world international banks published by the London based magazine, "The Banker" are excluded from the restriction. likewise advances and facilities to be used for the purpose of importing specified merchandise by the following public corporation are also excluded:

Name of corporation	Merchandise
Nepal oil corporation	Petrol, Diesel, Kerosene, L.P.G.
Nepal Food Corporation	Cereals

2.1.3.3 Management Quality

The capability of the board of directors and management, in their respective roles, to identify, measure, monitors and controls the risks of an institution's activities and to ensure a FI's safe, sound and efficient operation in compliance with applicable laws and regulation is reflected in this rating. Depending on the nature

scope of an institution's activities, management practices may need to address some or all of the following risks: credit, market, operating or transaction, reputation, strategic, compliance, legal, liquidity and other risks. Sound management practices are demonstrated by: active oversight by the board of directors and management; competent personnel; adequate policies processes, and controls taking into consideration the size and sophistication of the institution; maintenance of an appropriate audit program and internal control environment: and effective risk monitoring and management information systems. This rating should reflect the board's and management's ability as it applies to all aspects of banking operations as well as other financial service activities in which the institution is involved (Mishkin and Eakins, 2006). The capability and performance of management and the board of directors is rated based upon, but not limited to, an assessment of the following evaluation factors:

- The level and quality of oversight and support of all institution activities by the board of directors and management.
- The ability of the board of directors and management, in their respective roles to plan for, and respond to, risks that may arise from changing business condition or the initiation of new activities or products.
- The adequacy of and conformance with, appropriate internal policies and controls addressing the operations and risks of significant activities.
- The accuracy, timelines and effectiveness of management information and risk monitoring systems appropriate for the institution's size, complexity and risk profile.
- The adequacy of audits and internal controls to: promote effective operations and reliable financial and regulatory reporting; safeguard assets; and ensure compliance with laws, regulations and internal policies.
- Compliance with and regulations.

- Responsiveness to recommendations from auditors and supervisory authorities.
- Management depth and succession.
- The extent that the board of directors and management is affected by, or susceptible to, dominant influence or concentration of authority.
- Reasonableness of compensation policies and avoidance of self-dealing.
- Demonstrated willingness to serve the legitimate banking needs of the community.
- The overall performance of the institution and its risk profile.

Rating the Management Factors

1. A rating of 1 indicates strong performance by management and board of directors and strong risk management practices relative to the institution's size, complexity and risk profile. All significant risks are consistently and effectively identified, measured, monitored and controlled. Management and the board have demonstrated the ability to promptly and successfully address existing and potential problems and risks.
2. A rating of 2 indicates satisfactory management and board performance and risk management practices relative to the institution's size, complexity and risk profile. Minor weakness may exist, but are not material to the safety and soundness of the institution and are being addressed. In general, significant risks and problems are effectively identified, measured and controlled.
3. A rating of 3 indicates management and board performance that need improvement or risk management practices that are less than satisfactory given the nature of the institution's activities. The capabilities of management or the board of directors may be

insufficient for the type, size or condition of the institution. Problems and significant risks may be inadequately identified, measured, monitored or controlled.

4. A rating of 4 indicates deficient management and board performance or risk management practices that are inadequate considering the nature of an institution's activities. The level of problems and risk exposure is excessive. Problems and significant risks are inadequately identified, measured, monitored or controlled and require immediate action by the board and management to preserve the soundness of the institution. Replacing or strengthening management or the board may be necessary.
5. A rating of 5 indicates critically deficient management and board performance or risk management practices. Management and the board of directors have not demonstrated the ability to correct problems and implement appropriate risk management practices. Problems and significant risks are inadequately identified, measured, monitored or controlled and now threaten the continued viability of the institution. Replacing or strengthening management or the board of directors is necessary.

Researchers construct various financial ratios to capture management quality. Meyer and Pifer (1970) state that "Managerial ability is like Lord Action's elephant difficult to define easy to identify. Over a period of time differences between good and poor management will be systematically reflected by the balance sheet and income data and analysis of such data should enable prediction of failures". Graham and Homer (1988) evaluate the factors that contributed to the failures of 16 national banks in USA and conclude that more than 60 percent of failed banks experienced poor management, measured by such variables as poorly

followed loan policies, inadequate problem loan identification systems and non-existent or poorly followed asset/liability management.

Barr and Siems (1993) provide the only direct measurement of management quality, using data evolvement analysis (DEM) to quantity of management. They concluded that the predictive performance of their failure-prediction model improves markedly with the inclusion of the DEA efficiency variable.

Sinkey (1975) purported that a specific ratio representative of management is difficult to identify, but his view was that many ratios are proxies. Often, researchers (Tam and Kiang, 1992; Espahbodi, 1991; West, 1985) have not attempted to include a variable to represent management quality. Thomson (1991) and Whalen (1991) employed the ratio of overhead expense to total assets as representative of management operating efficiency. As none of the ratios from previous research exhibited significance.

2.1.3.4 Earning Quality

Under the UFIRS, in evaluating the adequacy of FIs earning performance, consideration should be given to:

- The level of earning, including trends and stability.
- The ability and provide for adequate capital through retained earnings.
- The quality and sources of earnings
- The level of expenses in relation to operations.
- The adequacy of the budgeting systems, forecasting processes and management information systems in general.
- The adequacy of provisions to maintain the ALLL and other valuation allowance accounts.

- The earnings exposure to market risk as interest rate, foreign exchange, price risks.

From a bank regulator's standpoint, the essential purpose of bank earnings, both current and accumulated, is to absorb losses and augment capital. Earnings are the initial safeguard against the risks of engaging in the banking business and represent the first line of defense against capital depletion resulting from shrinkage in asset value (Squnders and Cornett, 2004). Earnings performance should also allow the bank to remain competitive by providing the resources required to implement management's strategic initiatives.

Evaluation of Earnings Performance

An analysis of earnings comprise of examiner reviewing each component of the Earnings Analysis Trail and Ratio Analysis. Generally, the analysis of earnings begins with examiner reviewing each component of the earnings analysis trail. The earnings analysis trail provides a means of isolating each major component of the income statement for individual analysis. The earnings analysis trail consists of the following income statement components: net interest income, non-interest income, non-interest expenses, provision for loan and lease losses and income taxes. Each component of the earnings analysis trail is initially reviewed in isolation. Typically, ratios are examined to determine a board level view of the component's performance. The level of progression along the analysis trail will depend on a variety of factors including the level and trend of the ratios, change since the previous examination and the institution's risk profile.

Earning Ratio Analysis

Several key ratios used in the earnings analysis are used as shown below:

- Net income to average assets ratio [return on assets (ROA) ratio]
- Net interest income to average assets ratio.

- Net interest income to average earnings assets ratio.
- Non-interest income to average assets ratio.
- Non-interest expenses to average assets ratio.
- Provision for loan and lease losses (PLLL) to average assets ratio.
- Realized gains/losses on securities to average assets ratios.

Earning quality is the ability of a bank to continue to realize strong earnings performance. It is quite for a bank to register impressive profitability ratios and high volumes of income by assuming an unacceptable degree of risk. An inordinately high ROA is often an indicator that the bank is engaged in higher risk activities. For example, bank management may have taken on loans or other investments that provide the highest return possible, but are not of a quality to assure either continued debt servicing or principal repayment. Seeking higher rates for earning assets with higher credit risk will boost short-term earnings. Eventually, however, earnings may suffer if losses in these higher-risk assets are recognized.

In addition, certain of the bank's adversely classified and non-performing assets, especially those upon which future interest payments are not anticipated, may need to be reflected on a non-accrual basis for income statement purposes. If such assets are not places on a non-accrual status, earnings will be overstated. Similarly, material amounts of troubled debt restructured assets may have an adverse impact on earnings.

An institution's assets quality has a close relationship to the analysis of earnings quality. Poor asset quality may necessitate increasing the PLLL to bring the ALLL to an appropriate level and must be reviewed for impact on earnings quality.

Rating the Earnings Factor

1. Earning rated 1 is strong. Earnings are more than sufficient to support operations and maintain adequate capital and allowance levels after are given to asset quality, growth and other factors affecting the quality, quantity and trend of earnings.
2. Earnings rated 2 would be satisfactory and sufficient support operations and maintain adequate capital and allowances levels after consideration is given to asset quality, growth and other factors affecting the quality, quantity and trend of earnings. Earnings that are relatively static or even experiencing a slight decline, may receive a 2 rating provide the institution's level of e3arnings is adequate in view of the assessment factors listed above.
3. Earnings rated 3 may need to improve. Earnings may not fully support operations and provide for the accretion of capital and allowance levels in relation to the institution's overall condition, growth and other factors affecting the quality, quantity and trend of earnings.
4. A rating of 4 indicates earnings that are deficient. Earnings are insufficient to support operations and maintain appropriate capital and allowances levels. Erratic fluctuations in net income or net interest margin, the development of significant negative trends, nominal or unsustainable earnings, intermittent losses, or a substantive drop in earnings from the previous years may characterize institutions so rated.
5. A rating of 5 indicates earnings that are critically deficient. A FI with earnings rated 5 is experiencing losses that represent a distinct threat to its viability through the erosion of capital.

2.1.3.5 Liquidity

In evaluating the adequacy of a FI's liquidity position, consideration should be given the level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's

size, complexity and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligation in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned change in funding sources, as well as react to change in market conditions that affect the ability to quickly liquidate assets with minimal loss. In addition, funds management practices should ensure that liquidity is not maintained at a high cost or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market conditions. Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

1. The adequacy of liquidity sources compared to present and future needs and the ability of the institution to meet liquidity needs without adversely affecting its operations or condition.
2. The availability of assets readily convertible to cash without undue loss.
3. Access to money markets and other sources of funding.
4. The level of diversification of funding sources, both on and off balance sheet.
5. The degree of reliance on short-term, volatile sources of funds, including borrowings and brokered deposits to fund longer-term assets.
6. The trend and stability of deposits.
7. The ability to securities and sell certain pools of assets.
8. the capability of management to properly identify, measure, monitor and control the institution’s liquidity position, management information systems, and contingency funding plans.

Rating the Liquidity Factors

1. A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institution has reliable access to sufficient

sources of funds on favorable terms to meet present and anticipated liquidity needs.

2. A rating of 2 indicates satisfactory liquidity levels and finds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs. Modest weaknesses may be evident in funds management practice.
3. A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices
4. A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms to meet needs.
5. A rating of 5 indicates liquidity levels or funds management practices so critically deficient that the continued viability of the institution is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Liquidity Management Concepts

There are several principles which the economists have propounded to resolve the conflicts between objectives of liquidity, safety and profitability. These concepts are discussed as under:

The Real Bills Doctrine: the real bills doctrine states that FIs should extend only short-term self-liquidating productive loans to business firms. Self liquidating loans are those meant to finance the production, storage, transportation and distribution. When such goods are ultimately sold, the loans are considered to liquidate themselves automatically. The short-term self liquidating productive loan has three advantages. Firstly, they possess liquidity due to which, they liquidate

themselves automatically. Secondly, there is no risk of running into bad debts since earn income for the banks as they are productive.

The Shiftaility Theory: H.G. Moulton propounded the shiftability theory of bank liquidity. According to view, an asset to be perfectly shiftability must be immediately transferable without capital loss when the need for liquidity arises. But in a general crisis requires that all banks should possess such assets which can be shifted on to the central bank which is the lender of the last resort. This theory has certain elements of truth.

The Anticipated Income Theory: The Anticipated Income Theory was developed by H.V. proch in 1944 based on term loan practices by USA commercial banks. According to this theory; the bank plans for liquidation of long term loans from the anticipated income of the borrower regardless of the nature and character of a borrower's business. The bank puts restrictions on the financial activities of the borrower while granting this loan. Consequently, the bank takes into consideration not only the security but with major consideration the anticipated earnings of the borrower. This is superior to the bills doctrine and the shiftability theory because it fulfills the three objectives of liquidity, safety and profitability.

The Liabilities Management Theory: This theory was developed in the 1960s. According to this theory, there is no need for banks grant self-liquidating loans and keep liquid assets because they can borrow reserve money in the money market in case of need. A bank can acquire reserves by crating additional liabilities against it self, from different sources. These sources includes the issuing of time certificates of deposit, borrowing from the other commercial banks, borrowing from the central bank, raising of capital funds by issuing shares, and by plowing back of profits.

Liquidity Management Techniques

Techniques for liquidity assessment have evolved over the years with the significant changes in the monetary policy operating procedures. Despite the uncertainty in predicting liquidity conditions, econometric models could be used to provide first indicative forecasts, given the estimated structure of inter-relationships based on past information. The treasury or fund manager of any banks and FIs should adopt following techniques for effective liquidity management.

Liquidity Planning: The liquidity planning entails the accurate estimation of liquidity needs and the structuring of the portfolio to meet the expected liquidity needs. To ensure that funds are available to meet the liquidity needs at the lower cost, the treasury manager of the banks and FIs must manage its money position to comply with reserve requirements as well as managing its liquid sources.

Managing the Cash Position: A cash position refers to the amount in the process of collection and currency and demand balances due from other banks and the central bank. Numerous transactions that cause an inflow or outflow of cash during a day continually change the cash position of the banks and FIs. Because cash yields no income, cash holdings must be limited to a minimum. The treasury/ fund manager may invest any excess cash or may acquire additional cash sources from inter bank loans or from discount window at the central bank.

Managing the Liquidity Position: Once the liquidity needs of the banks and FIs have been estimated, the treasury manager must decide how these needs are to be funded. The banks and FIs must choose between two general liquidity management strategies, namely, asset management and liquidity needs. In the liability management, money is borrowed to meet liquidity needs. A combination of these strategies is normally employed. The following guidelines must be kept in

mind by the treasury manager when managing the liquidity position of the banks and FIs:

- The treasury managers should know the timing of large withdrawals from big credit clients or depositors in order to plan.
- The priorities and objectives of liquidity management should be clear and properly communicated.
- The needs and decisions must be evaluated on a continuous basis to invest access liquidity and avoid liquidity shortages.

Controlling Liquidity Risk: To asses how well the banks and FIs are managing its liquidity position, the management should be cautious on the following signals from the marketplace that indicate pending liquidity problems:

- Public confidence in terms of withdrawal of deposits from the banks and FIs.
- Share price behavior, falling share prices indicates perceived liquidity problems.
- Risk premiums on money market borrowings.
- Losses because of the hasty sale of assets for liquidity purposes.
- Inability to meet the demands of new credits customers.
- More frequent and larger borrowings from the central bank.

Considering the aforementioned technique, the treasury manager must also consider the purpose of the liquidity need, the length of time for which funds are needed, the access to liability markets, the costs and characteristics of various liquidity sources and interest rate forecast. It is received that the large banks have better access to liability liquidity sources due to the better quality assets and a broader capital base. The small banks are to rely more on assets for liquidity. Thus, an effective liquidity management is essential to reduce costs.

A liquidity ratio measures an entity's ability to pay its short-term obligations out of liquid assets. Liquidity was generally represented in previous studies with a ratio of cash (with some adjustment for short-term liquid securities) to total assets (Tam and Kiang, 1992; Espahbodi, 1991; Lane et. al., 1986; Martin, 1977; Sinkey, 1975).

NRB Directives Related to Liquidity

NRB had given the institution to the commercials banks since 2023 B.S. to deposit the amount the amount ratio of 8 percent from their deposit liability. In the beginning of 2047 B.S. the increase in the quantity of internal credit was high and began to show negative effect on economy. The deflation grew up to 21 percent. So, high liquidity appeared in economy, hence, control of negative effect that may fall on economy to improve the growth of price rate and improvement of the position of loss of running account and control the capacity of flowing the loan of the commercial banks, was necessary and the NRB bonds. With some signs of improvement of economy, the investment ratio was revised accordingly, since Poush 2049 B.S. since the beginning of 2050 B.S., the economy showed improvement and the rate of deflation fell down to 8.8 percent. With this, the provision of investing in the government securities was removed.

With effective from, 2054, Chaitra 31st, commercial banks were required to maintain liquidity of 8 percent of the total current and saving deposits and 6 percent of the fixed deposits, in addition to 3 percent of total deposit in cash at vault. Since then the NRB reserve requirements have been put into force by NRB effective from 22 July 002 (2059/04/06).

Prevailing directives as to cash reserve ratio requirement

a)	Balance to NRB	1. 7 % of current & savings deposit liabilities. 2. 4.5% of fixed deposit liabilities
b)	Cash to vault	2% Total deposit liabilities.

The compliance of liquidity maintenance, the NRB applies following procedures:

a. The CRR maintained by the banks will be examined on the basis of average weekly balance of deposit liabilities immediately preceding 4th week. A week shall comprise from each Sunday through Saturday.
b. CRR will not be calculated for the week which is fully off.
c. Weekly statement of deposit balances to be submitted to NRB inspection and supervision department within 15 days from the date of end of the week.
d. Weekly average of Monday to Friday of total deposit, cash in vault and NRB balance is calculated by dividing by 5.

Penalty will be levied for failing to maintain the adequate liquidity as above under any of the following conditions.

a. In the case of shortfall in maintenance of NRB balance but cash at vault is exactly 2%.
b. In case of shortfall in NRB balance but cash at vault is more than 2% then up to 1% excess cash of total deposit is added in the balance with NRB then on such shortfall account (after adding up to 1% excess)
c. In case of shortfall in cash in vault as well as shortfall in NRB balance then on total shortfall amount.

The applicable rate of penalty is as follows:

First time shortfall = Equivalent to bank rate/highest refinance rate.

Second time shortfall = Equivalent to 2 times of bank rate

Third time shortfall and all subsequent shortfalls= Equivalent to 3 times of bank rate.

2.2 Review of Related Studies and Papers

The research studies and work papers carried out by different scholars within various geographical region including dissertations conducted by Nepalese scholars are reviewed in this section, which are related with financial performance analysis of commercial bank, Finance company and the other area of the study.

2.2.1 Review of Research and Work Papers

Several academic studies examined whether and to what private supervisory information is useful in the supervisory monitoring of Banks and FIs failure-prediction models. It is very crucial for such analysis to identify variables that reliably predict future bank failure. The studies use variables that reflect asset quality, liquidity, capital adequacy and management quality. Most studies find that capital adequacy, earning ability and asset quality measured by the concentration of certain loan types, help to predict bank failure (Sinkey 1975, Pantalone and Plan 1987, Barr and Siems 1993, and Barker and Holdsworth 1993). Barker and Holdsworth (1993) reported that, on average, capital and income slowly deteriorate while past-due loans and charge offs increase as failure approaches. On the other hand, Heyliger and Holdren (1991) discover that asset quality, measured by the ratios of loan provisions and net charge offs to total loans, do not provide reliable indicators of bank failure. These studies adopted a number of methods, including multiple discriminant analysis, factor analysis, proportional hazard models, and legit analysis.

Jackson (1975), conducted a study on commercial bank regulation structure and performance. The study was carried out to identify the determinants of commercial banks allocation efficiency. Both theoretical and empirical microeconomics

analysis has applied to examine the competitive effects of banking influences. In this paper, the nature of banking was examined; showing that banks are essentially financial intermediaries that are engaged in greater completion than is commonly believed. Many theories of the firm as a bank are presented emphasizing efficiency-distorting force such as liquidity provisions. Almarin Philips's model of complex interaction between banking firms and other influences on observed performance was used to summarize banking theories. For the empirical purpose, data conversing 1644 banks over the period 1969-1971 were collected. Regression analysis was used to measure the relationship among variables. As a conclusion, the study showed that, the relatively desirable banking performance is associated with several traits including bank asset size, non-bank competition, low cash holdings, low labor cost, state non member basic status, multi bank company legislation, national bank status, low time deposits and low equity capitalization. Demand levels and temporal variations also significantly affect the banking performance. Further more, the study showed that the commercial banks regulation, structure and performance are interrelated with each other.

Sinkey (1975), notes bank examiners identify a "substandard" loan component of the net capital ratio as critical to identification of problem banks. In later research, Sinkey (1978) recognized the usefulness of loan default information in utilization of a ratio of provision for loan losses to operating expenses, although he did not find the "substandard" loan component to be significant.

Martins (1977), study set the standard for discrete-response models of bank failure prediction. Whereas most other research focused on a small sample of banks over two three years, Martin used all Fed-supervised institution during a seven year period in the 1970s, yielding over 33,000 observations. In what would become a standard approach, he confronted the data agnostically with 25 financial ratios and ran several different specifications in search of the best fit. He found

that capital ratios, liquidity measures and profitability were most significant determinates of failure over his sample period. Although Martin did not employ direct measures of asset quality, his indirect measures provision expenses and loan concentration- also turned out to be significant.

West (1985), developed a model to predict bank failure, which differed from the majority of research by utilizing FDIC generated information, rather than data from the financial statements. Some evidence resulted to support the contention that a loan quality factor (i.e. non-performing loans) had predictive value in this context for monitoring problem banks through its choice in a stepwise legit analysis.

Hirschhom (1987), used a multi factor market model to predict quarterly stock returns for the 15 largest U.S. banks between 1979 and 1987. He included both contemporaneous CAMEL ratings and lagged CAMEL values were not useful for predicting stock returns, Hirschhom found that contemporaneous CAMEL ratings were predicting stock returns. These results suggest that exam ratings contain useful information, but that most of this information is not private market participants have either independently inferred this information at the time of the exam, or this information has been leaked shortly after the exam was completed.

Shrestha (1990), conducted a research work on portfolio behavior for commercial banks in Nepal. She has analyzed the debt to equity ratios of commercial banks in aggregate and agriculture development bank from 1971 to 1990. She has found that the debt to equity ratio of minimum 8.3% in 1971 and the maximum of 21.44% in 1972 and maximum of 52.74% in 1974. On the basis of these findings, ash concluded that the Nepalese commercial banks are highly leveraged and highly risky. Further, she argued that the capital adequacy ratio explains the strength of the capital base of commercial banks. Higher the capital adequacy

ratio, higher is its internal sources. Lower the value of capital adequacy ratio with regard to the standard value shows that the bank's ability to attract deposit from the surplus units and inter bank funds also be limited.

Tam and Kiang (1992), utilized stepwise legit analysis. The researchers examined a small sample of taxes banks, where result indicated two measures of loan default risk were significant in their prediction of bank failure, provision for loan losses to average loans and net charge-offs to average loans exhibited no predictive value.

Barker and Holdsworth (1993), in respect to predicting bank failure, find evidence that CAMEL ratings are3 useful, even after controlling for a wide range of publicly available information about the condition and performance of banks.

Berger and Davies (1994), evaluate the impact of CAMEL rating changes on the parent holding company's stock price. They separate stock price change into two components: a 'private information' effect (which identifies the public's awareness of new information discovered by examiners) and a 'regulatory discipline' effect (which values the regulators' presumed ability to force a bank to change its behavior). Berger and Davies' empirical results provide only weak evidence of a regulatory discipline effect, but they find a strong private information effect. However, the information effect applies only to CAMEL downgrades, which tend to precede stock price declines. Consistent find no movement in stock prices following a CAMEL upgrade.

Cole and Gunther (1998), examine a similar question and find although CAMEL ratings contain useful information, it decays quickly. For the period between 1988 and 1992, they found that a statistical model using publicly available financial data

is better indicator of bank failure than CAMEL ratings that are more than two quarters old.

Morgan (1998), finds that rating agencies disagree more about banks about other types of firms. As a result, supervisors with direct access to private bank information could generate additional information useful to the financial markets, at least by certifying that a bank's financial condition is accurately reported.

The direct public beneficiaries of private supervisory information, such as that contained in CAMELS ratings, would be depositors and holders of banks' securities. Small depositors are protected from possible bank default by of FDIC insurance. This probably explains the finding by Gilbert and Vaughn (1998) that the public announcement of supervisory enforcement actions, such as prohibitions on paying dividends, did not cause deposit runoffs or dramatic increase in the rates paid on deposits at the affected banks. However, uninsured depositors could be expected to respond more strongly to such information. Jordan, et al., (1999) find that uninsured deposits at banks that are subject of publicly-announced enforcement actions, such as case and desist orders, decline during the quarter the announcement.

As of year end 1998, bank holding companies (BHCs) had roughly $120 billion in outstanding subordinated debt. De Young, et al., (1998) examine whether private supervisory information would be useful in pricing the subordinated debt of large BHCs. The authors use an econometric technique that estimates the private information component of the CAMEL ratings for the BHCs' lead banks and regress it onto subordinated bond prices. They conclude that this aspect of CAMEL ratings adds significant explanatory power to the regression after controlling for publicly available financial information and that it appears to be incorporated into bond prices about six months after an exam. Furthermore, they

find that supervisors are more likely to uncover unfavorable private information while de-emphasizing negative information. These results indicate that supervisors can generate useful information about banks, even if those banks already are monitored by private investors and rating agencies.

Focusing specifically on CAMEL ratings, Berger and Davies (1998) use event study methodology to examine the behavior of BHC stock prices in the eight-week period following an exam of its lead bank. They conclude that CAMEL downgrades reveal unfavorable private information about bank conditions to the stock market. This information may reach the public in several ways, such as through bank financial statements made after a downgrade. These results suggest that bank management may reveal favorable private information in advance, while supervisors in effect force the release of unfavorable information.

Berger, Davies and Flannery (1998), extend this analysis by examining whether the information about BHC conditions gathered by supervisors is different from that used by the financial markets. They find that assessments by supervisors and rating agencies are complementary but different from those by stock market. The authors attribute this differences to the fact that supervisors and rating agencies, as representatives of debt holders, are more interested in default probabilities than the stock market, which focuses on future revenues and profitability. This rationale also could explain the authors' finding that supervisory assessments are much less accurate than market assessments of banks' performances.

On-site bank exams seem to generate additional useful information beyond what is publicly available. However, according to Flannery (1998), the limited available evidence does not support the view that supervisory assessments of bank conditions are uniformly better and timelier than market assessments.

The market for bank equity, which is about eight times larger than that for bank subordinated debt, was valued at more than $910 billion at year-end 1998. Thus, the academic literature on the extent to which private supervisory information affects stock prices is more extensive. For example, Jordan, et al., (1999) find that the stock market views the announcement of formal enforcement actions as informative. That is, such announcements are associated with large negative stock returns for the affected banks. This result holds especially for banks that had not previously manifested serious problems.

Hirtle and Lopez (1999), examine the usefulness of past CAMEL ratings in assessing banks' current conditions. They find that, conditional on current public information, the private supervisory information contained in past CAMEL ratings provides further insight in to bank current conditions, as summarized by current CAMEL ratings. The authors find that, over the period from 1989 to 1995, the private supervisory information gathered during the last on-site exam remains useful with respect to the current condition of a bank for up to 6 to 12 quarters (or 1.5 to 3 years). The overall conclusion drawn from academic is that private supervisory information, as summarized by CAMELS ratings, is clearly useful in the supervisory monitoring of bank conditions.

Kolari et al., (2000), developed models and predicted bank failure, where the models initially included three measures of loan default disclosure along with 25 other financial measures. The loan default measures included allowances for loan losses to total assets, net loan charge-offs to total assets and provision for loan losses to total assets. In the final analysis, the allowances for loan losses to total assets were significant in row of the six predictions. As with many other studies, there was a lack of theory for the choice of variables, as stepwise legit was utilized for the decision of inclusion or elimination.

Dziobek, Hobbs and Marston (2000), analyze the determinants of bank liquidity defined as the degree to which a FI is able to meet its obligations under normal business conditions. Volatility in the depositors (and creditor) base depends on the type of depositors, insurance coverage and maturity; banks that rely on a narrow or highly volatile funding base are more prone to liquidity squeezes. Household deposits are typically more stable than, for instance, the deposits of institutional investors or corporate entities. Deposit concentration (i.e. fewer, larger-size deposits) can also be indicative of volatility. Deposit insurance increase the stability of the deposits it covers, with the important caveat front, foreign financing for instance through commercial credit lines and deposits of nonresidents (either in foreign or domestic currency) can become highly volatile in situations of distress and make the financial system vulnerable to external shocks or adverse developments in the domestic economy. As regards instrument maturity, the longer the time before the liability matures (in terms of remaining maturity), the more stable is the funding ; however, in countries where banks are required to meet early withdrawal requests with only minor penalties, maturity may be less relevant to determining funding stability.

Sahajwala and Van den Bergh (2000), based their work paper of Basel committee on banking supervision on a study of a number of new bank monitoring systems currently in use or under development in various G10 countries. Such systems are collectively termed “supervisory risk assessment and early warning systems”. The objective of the paper was to provide an overview of the different approaches taken by bank supervisors and to make a preliminary general assessment of the methods that are being used or developed. The study reveals that supervisory authorities are now clearly moving towards putting in place more formal, structured and risk focused procedures for ongoing banking supervision. Individual approaches and system have been developed and adopted, typically in the 1990s, with a greater focus on risk profiles and risk management capabilities

of individual banking institution and on the generation of timely warning of potential changes to a bank's financial position. These new and modified systems have contributed positively to the supervisory process, and supervisors are working towards refining the systems further in order to improve the systems' accuracy and predictive power.

Gytan and Johnson (2001), have presented their work paper on a review of alternative methodologies for early detection of banking distress. The various methodologies proposed by different researchers, in the paper are aimed to the early identification of financial distress for countries without an important recent history of bank failure, but facing an unstable international environment. They evaluate several indicators, the signal extraction approach, limited dependent estimation and finally duration models. In the Early Warning System (EWS) of systematic banking crises section they reviewed the literature aimed to predict crises of the complete banking system of a country. They also include some methodologies approaches that have been used as early warning systems for currency crises, but have a potential application methods requires a sample in which the events have appeared repeatedly. Since there has not been so may repeated episodes in any given country, the estimation must rely on a sample of different countries that have suffered banking problems. According to them, the literature on indicators and EWS of systems crises can be classified by their methodological approach: 1) Qualitative indicators, 2) Signal Extraction, 3) Limited Dependent Regression, 4) Other models.

Derviz and Podpiera (2004), based their assessment of commercial banking performance on bank ratings and studied with respect to detecting situations with the potential for adverse development towards failure and owing to the costly nature of frequent supervisory examinations. In this paper they studied models of rating downgrades and consider a specific set of indicators that are suitable as

determinants of a bank's rating. The conclusions about the predictors obtained from the analysis of downgrades are applicable in relatively stable banking sector situations. Banks experiencing minor liquidity trouble might raise their interest rates on deposits, but a regulator would have a hard time distinguishing which bank has increased its deposit rate because of liquidity problems and which has done so owing to an increase in its cost of funds caused by some other factor. Therefore, in their approach the cost of funds one of the plausible downgrade indicators was used in the form of the banks "credit spread". In addition to credit spread, they tested the inclusion of the value at risk (VaR) indicator in the form of total asset VaR, as they believed that this type of indicator might play an important role in determining the level of the rating due to its easy computability and data availability to the public. They focused on the capital, assets, management, earning, liquidity, market risk based composite (CAMELS) rating and the Standard and Poors (S&P) ratings. The choice of their sample was determined by the fact that cross section data is probably less appropriate given the specific character of the relatively small banking market in the Czech Republic. The three chosen banks, i.e. Ceska Sporirelna (CS), Komercni Banka (KB) and Ceskoslovenska Obchodni Banka (CSOB), cover a dominant portion of the market, the rest being occupied by small narrowly specialized banks or foreign bank branches. Therefore, they used panel data with three banks and their financial indicators to analyze the change in the CAMES and S&P ratings. They found that the reliable predictors of a bank's S&P rating are credit spread, capital adequacy, and the total loans to total assets ratio. In the case of the CAMELS rating does not yield itself easily to predictions within any horizon with the studies technique. On the contrary, the S&P rating can be relatively precisely predicted one month in advance.

Baral has conducted a research and published his paper in the journal of Nepalese business studies. On health check-up of Commercial Bank in the framework off

CAMEL, a case study of joint venture Banks in Nepal. The paper examined the financial health of joint venture Banks in the CAMEL framework for a period ranging from fiscal year 2001 to 2004. Three joint venture Commercial Banks of Nepal were randomly selected for the study. The study was based on historical data disclosed by annual reports of Commercial Banks. It has covered four fiscal years' data for the purpose of study. The study was based totally on the CAMEL framework (Baral, 2005).

2.2.2 Review of Dissertations

Prior to this, several thesis works have been conducted by various researchers regarding different aspects of commercial banks like financial performance, capital structure, investment policy, interest rate structure and resources mobilization. The excerpts from the findings of some of these research works are presented which are relevant for this study:

Pradhan (1980), conducted a study on investment policy of Nepal Bank Ltd. The objective to that study was to evaluate the lending policy and to find out the ways to encourage the bank lending. This study has covered only five fiscal years BS 2028/29 through BS 2033/34. he used Karl Pearson's coefficient of correlation, ratio analysis and percentage analysis. He concluded with the positive relationship between deposits and loans and advances. But the same was not in a proportion manner, greater increase in deposits led to little increase in the loans and advances. Increase in the interest rate was the main factor for the decrease in loan demand. The bank had investment only 3 percent of its total investment in the priority sector, which was lower than the percentage (7 percent) imposed by NRB.

Shrestha (1990), conducted a research work on profile behavior for commercial banks in Nepal. She has analyzed the debt to equity ratios of commercial banks in aggregate and agriculture development bank from 1971 to 1990. The researcher

has found that the debt to equity ratio in commercial banks minimum of 8.3% in 1971 and the maximum of 1583.3% in 1974. Similarly, the range of debt to equity ratios of ADB/N is minimum of 21.44% in 1972 and maximum of 652.74% in 1990. On the basis of the finding, the researcher concluded that the Nepalese commercial banks are highly leveraged and highly risky. Further, the researcher argued that the capital adequacy ratio explains the strength of the capital base of commercial banks. Higher the capital adequacy ratio, higher is its internal sources, lower value of capital adequacy ratio with regard to the standard value shows that the bank's ability to attract deposit from the surplus units and inter bank funds also be limited.

K.C. (1991), has done a study on dividend policy of joint venture banks in Nepal. The objective of this study was to provide conceptual framework of dividend models and analyze the financial variables affecting the stock value and interpret the implication of paying dividend in dividend valuation models. The study has covered the time span of FY 1984/85 to 1989/90. in this study, various financial ratios have been analyzed with the help of two types of analytical tools-investment and statistical tools. Investment tools consist of dividend payout ratio, earning per share, return on paid-up capital, retention ratio and dividend valuation model. In addition to the coefficient of correlation, the researcher has used financial tools in this study. The researcher concluded that earning per share of all three joint ventures banks (Nepal Arab Bank Ltd, Nepal Indosuez Bank Ltd and Nepal Grindlays Bank Ltd.) were satisfactory and actual capitalization rate was higher then the normal capitalization rate.

Bohara (1992), has done a study on financial performance of Nepal Arab Bank Ltd. (NABIL) and Nepal Indosuez Bank Ltd. (LIBL). The basis objectives of this study were to highlight on the functions and policies of joint ventures banks and to evaluate the comparative financial performance of NABIL. The study has covered

the five fiscal years 1986/87 to 1990/91. in this study financial tools along with statistical tools have been used. Different ratios- liquidity, activity, coverage, leverage, profitability and other indicators like earning per share, dividend per share, market value to book value ratio, have been used to evaluate the performance of NABIL and NIBL. In statistical tool the least square method has been employed. The researcher has, on the basis of different financial indicators, and concluded that performance of NABIL is better than that of NIBL. The researcher further concluded that bank performances could not be judged solely in term of profit as it may have earned profit by maintaining adequate liquidity and safety position. The researcher has recommended to NIBL to extend their banking facilities even in the rural areas by opening up increasing equality base.

Adhikari (1993), conducted a study on evaluation of the financial performance of Nepal Bank Ltd. The study has been limited of FV 2038/ 39 B.S through FY 2046/47 B.S. The main indicators of financial performance used were financial rations current loan to deposit , return on capital, return in net worth, return on total assets, earning per share, dividend per share, pay out and net worth per share vs. market price per share. The researcher concluded that the bank had not managed investment portfolio efficiently. Operational efficiency was not satisfactory. During the study period, except liquidity position not all other financial indicators were satisfactory.

Joshi (1993), conducted a study on commercial banks of Nepal with reference to financial analysis of Rastriya Banijya Bank. The objective of this study was to provide conceptual framework of commercial banks, and to analyze and quantitative performance basis. The study was based on the financial data of FY 2042B.S through 2046B.S. Researcher has used various financial ratios like current. Liquidity, funded debt to total capitalization, and funded debt to equality in this study. The researcher had drawn the conclusion that performance of RBB

was not satisfactory during the study period. Further, the researcher concluded that bank had not been managed in true professional approach but had managed in bureaucratic approach to sustain with political environment rather than commercial environment.

Shakya (1995), performs a study on financial analysis of joint venture banks in Nepal. The objective of this study was to carry out the comparative financial performance evaluation of Nepal Arab Bank Ltd. (NABIL) and Nepal Grindlays Bank Ltd (NGBL). This study has covered the time span of FY 1988/89 through 1993/94. In this study, he has financial ratios viz. liquidity, leveraged, activity, profitability, growth and valuation and statistical tools viz. Karl Person's correlation coefficient, student t-test, simple average and index. The researcher has found that in spite of the increase in loans and deposit of both banks, their performance measured in terms of deposit utilization rate is not satisfactory. Further, the study showed that financial performance of NABIL is better than of NGBL.

Gurung (1995), conducted a research on "A financial study of joint venture banks in Nepal". The objective of this study was to examine the financial strengths and weaknesses of Nepal Grindlays bank ltd. (NGBL) and Nepal Indosuez Bank Ltd. (NIBL). The study has covered the period of seven fiscal years i.e. 1986/87 through 1992/93. in this study, he has used financial ratios viz. current, activity, profitability, capital structure and statistical tool viz. Karl Person's coefficient of correlation. The researcher has, based on different financial indicators; found that performance of NGBL is better than that of NIBL.

Thapa (2001), has conducted her study "A comparative study on investment policy of Nepal Bangladesh bank ltd. And other joint ventures banks". The researcher's main objective of study was to evaluate the liquidity, assets

management efficiency, profitability and risk position on NBBL in comparison NABIL and NGBL and to examine the fund mobilization and investment policy NBBL through off-balance sheet and on-balance sheet activities in comparison to other two banks. Through research, the researcher found that the liquidity position of NBBL is comparatively not better than of NABIL and NGBL. The liquidity ratios are moderately fluctuating which means the bank has not properly formulated stable policy. As per the study, NBBL is not better position regarding its on-balance sheet as well as off-balance sheet activities in compare to NABIL and NGBL and it does not seem to follow and definite policy regarding the management of its assets. The researcher at the last suggested following a specific policy in investment and she further recommended to maintain the optimum level of relationship among deposit and loan and advances, outside assets and net profit and to maintain the adequate recovery rate.

Bhandari (2006), has conducted a study on the financial performance of Himalayan Bank Limited in the framework of CAMEL. The basic objective of this study was to analyze the financial performance of Himalayan Bank Limited through CAMEL. The study has covered the time period of 6 years from fiscal year 1999 to 2004. The researcher has used different financial tools and other statistical tools in the study. The analysis revealed adequate capital of the bank. The non-performing loans through in decreasing trend are still a matter of concern. The bank is still with better ROE however, it is in decreasing trend of net interest margin shows management stock monitoring over the bank's earning assets. The liquid funds to total deposit ratio to above the industrial average ratio. NRB balance and cash in vault to total deposit ratios are below the industrial average ratio during the study period.

Chanda (2006), has conducted a study on financial performance analysis of Nabil Bank Limited in the framework of CAMELS with the objective to analyze the

financial condition of Nabil Bank Limited. It has covered five years data starting from fiscal year 2000/01 to 2004/05. The analysis discovered that the Bank is running with adequate capital and the capital fund of Bank is sound and sufficient to meet the banking operation as per NRB standard. The bank has placed efficient credit management and recovery efforts of good quality loans will increase in future. The management decision related to operation and investments have assisted in future. The management decisions related to operation and investments have assisted in controlling control and recovery the interest spared and cost effective sources of fund. The liquid funds to total deposit ratio is above the industrial average ratio. NRB balance and cash in vault to total deposit ratios are below the industrial average ratio during the study period.

2.3 Research Gap

Various studies have been conducted in the past on financial analysis of commercial banks in the US and other regions were found done. The research paper done in the context of Nepal mainly emphasized a liquidity, profit ability and leverage of the commercial banks. These studies lack micro-level analysis and found applying traditional analysis of financial performance. In the context of Nepalese banking environment, there are few academic researchers found conducted in the frame work of CAMEL but not found the comparative analysis on the commercial banks. So, this research is conducted to know actual comparative financial performance of Nepal Industrial and Commercial (NIC) and Everest Bank Limited in the frame work of CAMEL. Therefore, the comparative study of financial performance of commercial banks will add new dimension toward banking function of commercial banks.

CHAPTER III

RESEARCH METHODOLOGY

This chapter provides the overall framework or plan for the collection, analysis and presentation of data required to fulfill the objective of the study. The main objective of the study is to analyze and evaluate comparative financial performance of Nepal Industrial and Commercial Bank and Everest Bank Limited. To meet the objective, following methodology is applied in the study, which is described as below.

3.1 Research Design

By research design we mean an overall framework or plan for the activities to be undertaken during the course of a research study. The plan is the overall scheme or program of the research. (Wolff and Pant, 1975:92) Therefore, to achieve the desired end of this study descriptive and analytical research design is applied. Descriptive research design seeks to find out the fact by help of sufficient data and information.

3.2 Justifications for the Selection of the Unit

NIC and EBL are the leading commercial bank. Due to the special role play by the company, question arise that what is its actual financial performance. Thus to fulfill the gap, this study is attempt to solve the problem by taking both bank as study unit through convenience sampling techniques.

3.3 Population and Sample

For the purpose of this study commercial banks are taken as population. Till February 2009 there are all together 25 commercial banks established in Nepal. But being a case study of comparative financial performance analysis, Nepal

Industrial and Commercial Bank and Everest Bank Limited are selected as a sample for this study. This sample size represents 12.5% of the total population. For this sampling purpose convenience sampling method is used. The sample of the commercial banks and population are given in Appendix I.

3.4 Nature and Source of Data

The study is based on secondary data. For the purpose of the study, the annual reports of the NIC and EBL are used as the major sources of data. Besides the annual reports of those banks required data and information is collected from the following sources.

- NRB reports and bulletins and its website.
- Various publications dealing in the subject matters of study.
- Various articles published in journals, etc.
- Various research report and Dissertations.
- Nepal Stock Exchange report.

Formal and informal talks with the senior staff of the company were also helpful to obtain the information of the related problem.

3.5 Data Collection Procedures

As stated earlier, the study is mainly based on secondary data. The annual reports and other information of have been obtained from sample banks. NRB directives, banking and financial statistics and other publications are collected from the web site of NRB. Some supplementary data and information, literature review are collected from the Shanker Dev Library, Katmandu Western Regional Library, Pokhara, Central Library, T.U. NRB publication , different journals magazines and other published and unpublished reports documented by the concern authorities.

3.6 Data Processing

First of all, necessary data are collected from the published documents and then audited financial statements recorded in master sheet manually. Then, data are entered in to table to work out CAMEL financial ratio and prepare the necessary figures. Finally, different financial tools under CAMEL are worked out with the help of computer programmers.

3.7 Data Analysis Tools

Various financial and statistical tools have been used to measure the comparative financial analysis and to draw inferences on the study area. Graphs, charts and tables as appropriate have also been used to analyze the data. The collected data have been organized, tabulated, processed and analyzed using various statistical and financial tools as described in the following sections.

3.7.1 Financial Tools

This study is based on following financial tools and techniques.

The tools are based in the framework of CAMEL.

Capital Adequacy

a) Core Capital Adequacy Ratio: Core capital adequacy ratio shows the relationship between the total core capital or internal sources and total risk adjusted assets. It is used to measure the adequacy of core capital and financial soundness from very close angle. It is calculated by using following model.

$$\text{CCAR} = \frac{\textit{Core Capital}}{\textit{Total Risk Adjusted Assets}} \times 100$$

Where,

CCAR=Core Capital Adequacy Ratio

Core Capital = paid-up capital + share premium + non-redeemable preference share + general reserve + cumulative profit –goodwill if any

b) Supplementary Capital Adequacy Ratio: Supplementary capital adequacy ratio is the expression of numerical relationship between supplementary capital and total risk adjusted assets. It measures the proportion of supplementary capital in total risk adjusted assets. Further more, it shows the absolute contribution of supplementary capital in capital adequacy. The ratio is used to analyze the supplementary capital adequacy and determined by using the following model

$$\text{SCAR}=\frac{Supplementary\ Capital}{Risk\ Weighted\ Assets} \mid 100$$

Where,

SCAR= Supplementary Capital Adequacy Ratio

Supplementary Capital=Loan loss provision + exchange equalization reserve + assets revaluation reserve + hybrid capital instrument + unsecured subordinate term debt + interest rate fluctuation fund + other free reserves

c) Total Capital Adequacy Ratio: Capital adequacy ratio is the numerical relationship between total fund and risk adjusted assets. It measures the adequacy of capital and financial soundness of finance company. Capital adequacy ratio is used to measure of capital in the finance company. It is worked by using the following model.

$$\text{CAR}=\frac{Total\ \ Capital\ Fund}{Total\ \ Risk\ Adjusted\ Assets} \mid 100$$

Where,

CAR= Capital Adequacy Ratio

Total capital fund= Core capital + Supplementary capital

Total Risk Adjusted Assets= On-balance sheet risk adjusted assets + off balance sheet risk adjusted assets

Assets Quality

a) Non-performing Loan Ratio: The non-performing loan ratio indicates the relationship between non-performing loan and total loan. It measures the proportion of non-performing loan in total loan and advances. The ratio is used to analyze the asset quality and determined by using the given model.

$$\text{Non-performing Loan Ratio} = \frac{Non\ Z\ perfor\ \min g\ Assets}{TOtal\ Loan\ and\ Advance} \mid 100$$

Where,

Non-performing loan= loan not recovered with in the given the time frame either in the form of interest servicing or principal repayment.

b) Loan Loss Ratio: The loan loss ratio is the expression of numerical relationship between loan loss provision and loan and advances. It is used to appraise quality of asset. It measures the proportion of loan loss provision in total and advances. This ratio shows the possibility of loan default. Higher ratio implies higher portion of non-performing loan portfolio. For the purpose of study following is used to determine the loan loss ratio.

$$\text{Loan Loss Ratio} = \frac{Loan\ Loss\ \Pr ovision}{Total\ Loan\ and\ Advances} \mid 100$$

Management Quality

a) Total Expenses to Total Incomes Ratio: The total expenses to total income ratio is the expression of numerical relationship between total expenses and total incomes of the company. It measures the proportion of total expenses in total revenues. A high or increasing ratio of expenses to total revenues can indicate that financial institutions may not be operating efficiently. This can be, but is not necessarily due to management deficiencies. In any case, it is likely to negatively

affect profitability (IMF, 2000). Following is the expression of total expenses to total revenues ratio.

$$\text{Total Expenses to Total Income Ratio} = \frac{Total\ \text{exp}enses}{Total\ Income} \mid 100$$

b) Earning Per Employee: Earning per employee is the numerical relationship between net profits after tax to total number of employee. Low or decreasing earnings per employee can reflect inefficiencies as a result of overstaffing, with similar repercussions in terms of profitability (IMF, 2000). It is calculated by using the following model.

$$\text{Earning Per Employee} = \frac{Net\ \text{Pr}ofit\ After\ Tax}{Number\ of\ \ Employee} \mid 100$$

Earning Quality

a) Return on Assets (ROA): Return on assets is the numerical relationship between net incomes after taxes to total assets of a company. It is primarily an indicator of managerial efficiency; it indicates how capably the management of the company has been converting the institution's assets into net earning (Rose, 1999). It is calculated by using the following model.

$$\text{Return on Assets} = \frac{Net\ Income\ After\ Tax}{Total\ Assets} \mid 100$$

b) Earning Per Share (EPS): earning per share provides a direct measure of the returns flowing to the company's owners-its stockholders- measured relative to the members of shares to the public(Rose, 1999). It gives the strength of the share in the market. Following is the expression of earning per share.

$$\text{Earning Per Share} = \frac{Net\ Income\ to\ Shareholder}{Number\ of\ \ Share}$$

Liquidity Position

a) Total Liquid Fund to Total Deposits Ratio: A total liquid fund to total deposits is the expression of numerical relationship between total liquid funds and total deposits of the company. It measures the proportion of total liquid funds in total deposits. Further more, it shows the overall short-term liquidity position. The higher ratio implies the better liquidity position and lower ratio shows the inefficient liquidity position of the company. It is calculated by using the following model.

$$\text{Total Liquid Fund to Total Deposits Ratio} = \frac{Total\ Liquid\ Fund}{Total\ Deposit} \times 100$$

Where,

Total Liquid Fund= cash in hand + foreign currency in hand + Balance with NRB + balance with domestic bank + balance Held abroad + calls deposits

b) NRB Balance to Total Deposit Ratio: NRB balance to total deposits ratio is the expression of numerical relationship between NRB balance and total deposits of a bank. It measures the proportion of NRB balance in total deposits. It shows whether bank is holding the balance as required by NRB. For the purpose of this study following model is used to determine the NRB balance to total deposits.

$$\text{NRB Balance to Total Deposit Ratio} = \frac{NRB\ Balance}{TOtal\ Deposit} \times 100$$

c) Cash in Vault to Total deposit Ratio: Cash in vault to total deposits ratio indicates the relationship between cash in vault to total deposits. It shows the percentage of total deposit maintained as vault. It is worked out by using the following model.

$$\text{Vault to Total Deposits Ratio} = \frac{Cash\ in Vault}{Total\ Deposit} \times 100$$

Where,

Cash in vault = cash in hand + foreign currency in hand

3.7.2 Statistical Tools

Average: A simple arithmetic average is used to summarize the data as a representation of mean data. A simple arithmetic average is a value obtained by dividing the sum of the values by their numbers (Kothari, 1989). Thus, the average is expressed as:

$$(\bar{X}) = \frac{X}{N}$$

Where,

$\bar{X}$ = Mean of the values

N= Number of pairs of observation

During the analysis of data, mean is calculated by using the statistical formulas average on excel data sheet on computer.

Standard Deviation: Standard deviation is the absolute measure of dispersion of the values and shows the deviation or dispersion in absolute term (Kothari, 1989). It is said that higher the value of standard deviation the higher the variability and vice versa. Karl person introduced the concept of standard deviation in 1983. Here, the standard deviation is used to find out the deviation in absolute term. Standard deviation is determined in following way.

$$\text{S.D.} = \sqrt{\frac{x^2}{n} Z \frac{x}{n}}^2$$

Here,

n= no. of observation

x=individual value

During the analysis of data, standard deviation is calculated by using the statistical formula on SPSS program on computer.

Coefficient of Variation: Coefficient of variation is the relative measure of dispersion based on the standard deviation (Kothari, 1989). It is most commonly used to measure the variation of data and more useful for the comparative study of variability in two or more series or graph or distribution. Symbolically, the coefficient of variation is calculated as:

$$CV = \frac{\pm}{\overline{X}}$$

Here,

± =standard deviation

$\overline{X}$ = mean

CV= Coefficient of variation

Least Square Trend Analysis: Least square trend has been used to find out the trend of ratio (Kothari, 1989). The general equation used for trend is given below:

$$Y = a + bx$$

Where,

Y=Dependent variable

x= Coded time in year (independent variable)

a= Y-intercept

b= Slope of the trend line

In the above model,

$$b = \frac{N.\ \ XY\ \mathrm{Z}\ \ X.\ \ Y}{N.\ \ X^{2}\ \mathrm{Z}(\ \ X)^{2}}$$

$$a = \frac{Y\ \mathrm{Z}b.\ \ X}{N}$$

CHAPTER VI

DATA ANALYSIS AND PRESENTATION

This chapter deals with the presentation of data collected from the different sources. The purpose of this chapter is to study evaluate and analyze the financial performance of Nepal Industrial and Commercial Bank (NIC) and Everest Bank Ltd. in the frame work of CAMEL.

4.1 Capital Adequacy

4.1.1 Core Capital Adequacy Ratio

Table4.1

Core Capital Adequacy Ratio

Year	Bank		
	NIC	EBL	NRB Std(%)
2003/04	11.50	9.58	5.5
2004/05	12.37	8.88	5.5
2005/06	9.94	8.21	6
2006/07	9.21	7.82	5.5
2007/08	10.50	9.03	6
Average	10.61	8.71	
Std. Dev.	1.07	0.62	

Source: Appendix III

Table 4.1 shows CCAR of NIC and EBL for the study period as 11.50, 12.37, 9.94, 9.21 and 10.50 and 9.58, 8.88, 8.21, 7.82 and 9.03 respectively. Similarly, the table also shows the NRB standards required to be maintained by the commercial banks as 5.5 in 2003/04, 2004/05 and 2006/07 and 6 in 2005/06 and

2007/08. From the table it can be seen that the CCAR maintained by both the commercial banks is more than the standards set by the NRB for the study period. The table reveals an average CCAR of NIC and EBL is 10.61 and 8.71 respectively. Based on this, we can say that NIC's capital base is stronger than EBL. The table also gives standard deviation of the sample commercial banks on core capital adequacy ratio. The standard deviation for both the banks is 1.07 and 0.62 respectively. As the standard deviation of NIC is more than that of EBL there is a more variability in the capital base of this bank than EBL.

4.1.2 Supplementary Capital Adequacy Ratio

Table 4.2

Supplementary Capital Adequacy Ratio

Year	Bank		NRB Std NIC*	NRB Std Everest*
	NIC	EBL		
2003/04	0.84	1.50	11.50	9.58
2004/ 05	0.92	4.68	12.37	8.88
2005/06	3.60	4.11	9.94	8.21
2006/07	3.00	3.37	9.21	7.82
2007/08	2.61	2.40	10.50	9.03
Average	2.2	3.21		
Std. dev.	1.12	1.15		

Source: Appendix IV

*NRB standard not more than 100% Core Capital

Table 4.2 shows the SCAR of NIC and EBL for the study period as 0.84, 0.92, 3.60, 3.00 and 2.61 and 1.50, 4.68, 4.11, 3.37 and 2.40 respectively. According to NRB directives, upto 100 percent of the CCAR maintained by the concerned bank for a particular year is the standard SCAR. So, the NRB standard on

Supplementary Capital Adequacy for NIC and EBL for the study period is 11.50, 12.37, 9.94, 9.21 and 10.50 and 9.58, 8.88, 8.21, 7.82 and 9.03 respectively. As the SCAR of NIC and EBL for the study period is less than the CCAR of those banks for the respective year, their capital base is adequate. The table shows an average supplementary capital adequacy ration of NIC and EBL as 2.2 and 3.21 respectively. Similarly, it discloses the standard deviation of both the banks as 1.12 and 1.15 respectively. Based the average SCAR, EBL's capital base is stronger than that of NIC. Since standard deviation of SCAR of EBL is higher than that of NIC, the variability in its SCAR is higher than that of NIC meaning that more risky in terms of SCAR.

4.1.3 Total Capital Adequacy Ratio

Table 4.3

Capital Adequacy Ratio

Year	Bank		NRB Std (%)
	NIC	EBL	
2003/04	11.86	11.07	11
2004/05	13.29	13.57	11
2005/06	13.54	12.32	11
2006/07	12.20	11.19	11
2007/08	13.11	11.44	11
Mean	12.80	11.92	
S. D.	0.65	0.93	

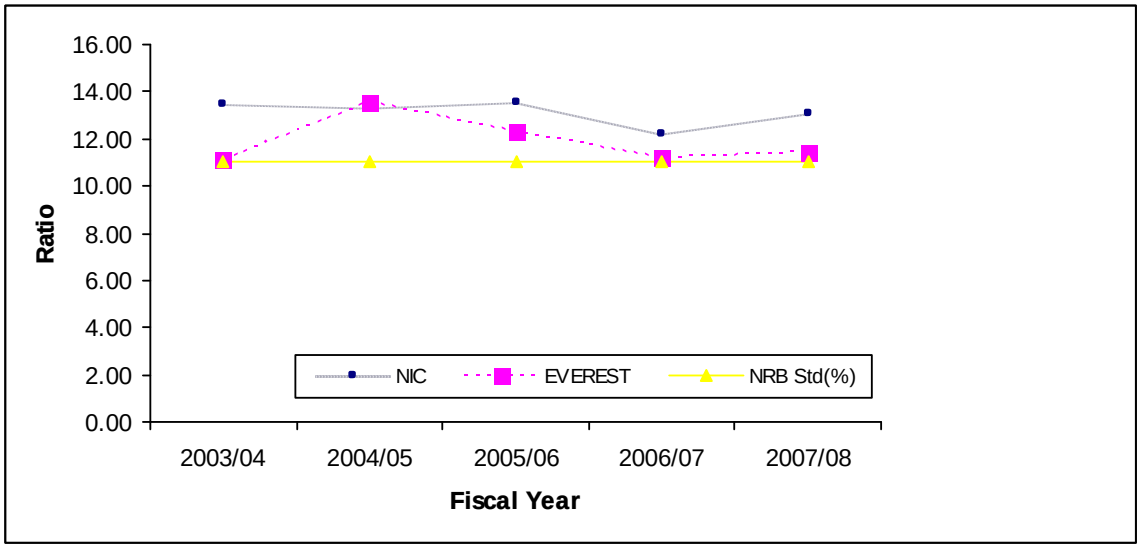
Source: Appendix V

Table 4.3 shows Total Capital Adequacy Ratio of NIC, EBL for the study period. The ratio of NIC and EBL is 11.86, 13.29, 13.54, 12.20 and 13.11 and 11.07, 13.57, 12.32, 11.19 and 11.44 respectively. The NRB standard on the Total

Capital Adequacy for the commercial banks is 11 for the said period. The data reveals that the ratio maintained by both the commercial banks is more than the NRB standards on the same. The table also discloses mean CAR of NIC and EBL as 12.80 and 11.92 respectively. It also discloses S.D. of both the banks as 0.65 and 0.93 respectively. Based on mean CAR, we can say that the capital base of NIC is stronger than EBL. The value on S.D. concludes that there is a greater variability in CAR of EBL than that of NIC.

Figure 4.1

Capital Adequacy Ratio of NIC and EBL Comparing with NRB Standard



In the figure 4.1, the graphs represent Total Capital Adequacy Ratio of sample commercial banks and NRB standard on the same for the study period. The graphs representing Total Capital Adequacy Ratio of NIC and EBL are above the graph for NRB standard on the same. Therefore, we can say that the capital base of those banks is adequate.

The line representing CAR for NIC is above the same line for EBL. Therefore, we can say that the capital base of NIC is stronger than the EBL.

4.2 Asset Quality

4.2.1 Non-Performing Loan to Total Loan and Advances

Table 4.4

Non-performing Loan Ratio

Year	Bank	
	NIC	EBL
2003/04	6.45	1.72
2004/05	3.94	1.63
2005/06	2.70	1.27
2006/07	1.13	0.80
2007/08	0.87	0.68
Mean	3.02	1.22
C.V.	0.68	0.35

Source: AppendixVI

Table 4.4 shows that NPL ratios of NIC for the study period to be 6.45, 3.94, 2.70, 1.13 and 0.87. Similarly, same ratio of EBL for the study period is 1.72, 1.63, 1.27, 0.80, 0.68. The NPL ratio of both the banks is in decreasing trend. The table also reveals mean NPL of NIC and EBL as 3.02 and 1.22 respectively. The table also reveals CV of both the banks as 0.68 and 0.35 respectively. Form the mean NPL, we can say that the asset quality of EBL is sound. Similarly, from the CV of NPL, we can say that the loan and advances of EBL is less risky.

Figure 4.2

Comparing Non-Performing Loan Ratio of NIC and EBL

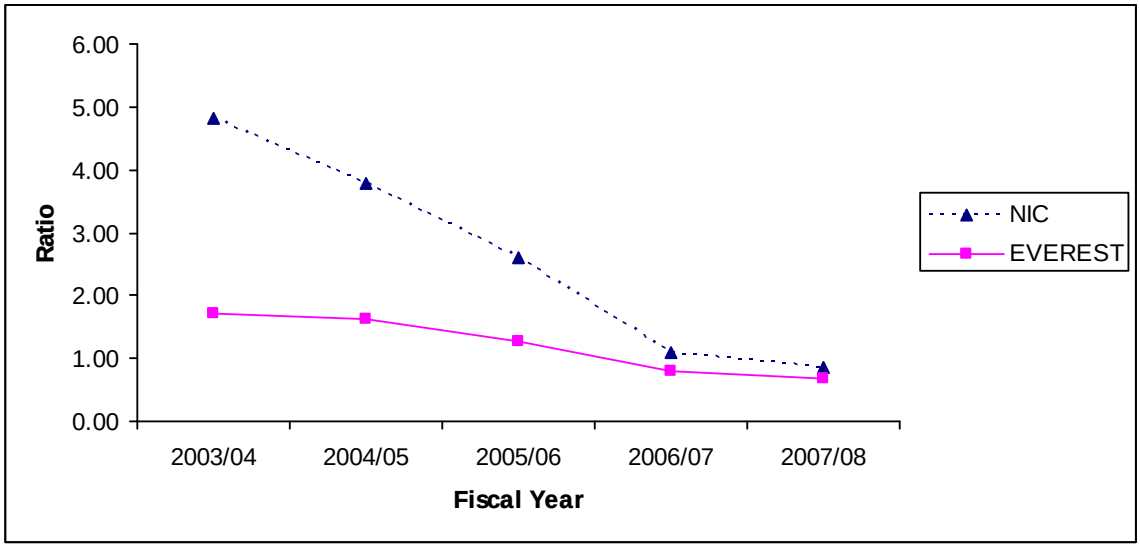


Figure 4.2 is the graphic presentation of NPL ratios of the sample commercial banks for the study period. The curve representing NPL of EBL is below the curve of NIC. Therefore, we can conclude that the loan and advances of EBL is sound compare to NIC.

4.2.2 Loan Loss Provision to Total Loan and Advances

Table 4.5

Loan Loss Ratio

	Bank	
Year	NIC	EBL
2003/04	4.53	3.47
2004/05	4.19	3.56
2005/06	3.70	3.30
2006/07	2.09	2.97
2007/08	1.78	2.64
Mean	3.26	3.19
CV	0.34	0.11

Source: Appendix VII

Table 4.5 exhibits that the loan loss ratio of NIC for the study period is 4.53, 4.19, 3.70, 2.09 and 1.78. Similarly, the same ratio of EBL for the study period is 3.47, 3.56, 3.30, 2.97 and 2.64. The ratio for NIC is decreasing because of reduced amount of loan loss provision required for the amount of loan investment by the banks in the study period. The ratio of EBL, too, is decreasing except in the year 2004/05. The table shows mean LLR of NIC and EBL as 3.26 and 3.19 respectively. The table also shows CV of NIC and EBL as 0.34 and 0.11 respectively. The value on mean LLR reveals that the quality of loans issued by the EBL is good compare to NIC. As the CV of EBL is less than that of NIC, we can conclude that the loans of EBL is less risky than that of NIC.

Figure 4.3

Trend of Loan Loss Ratio of NIC Bank

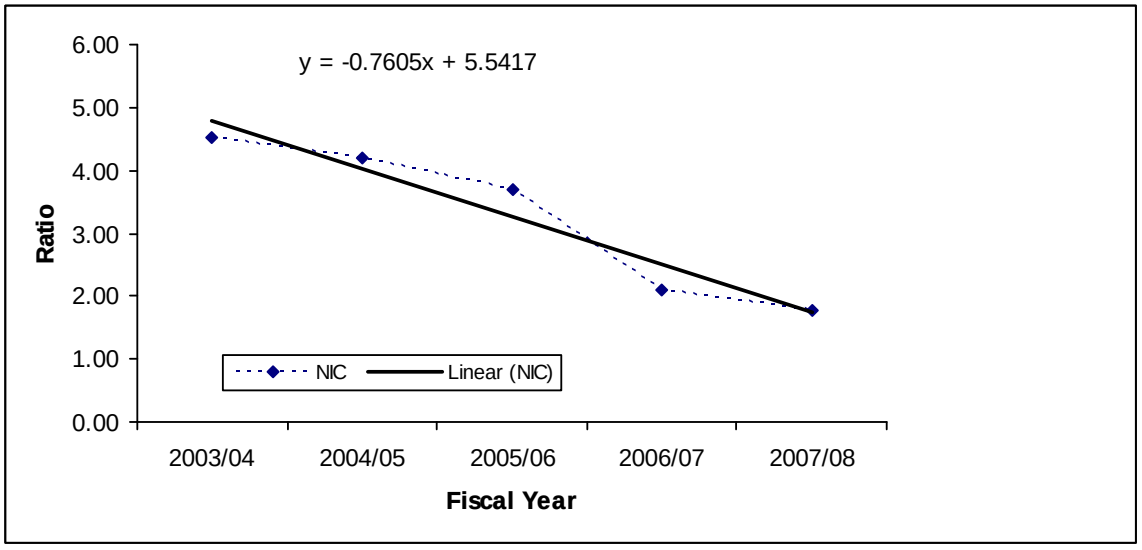
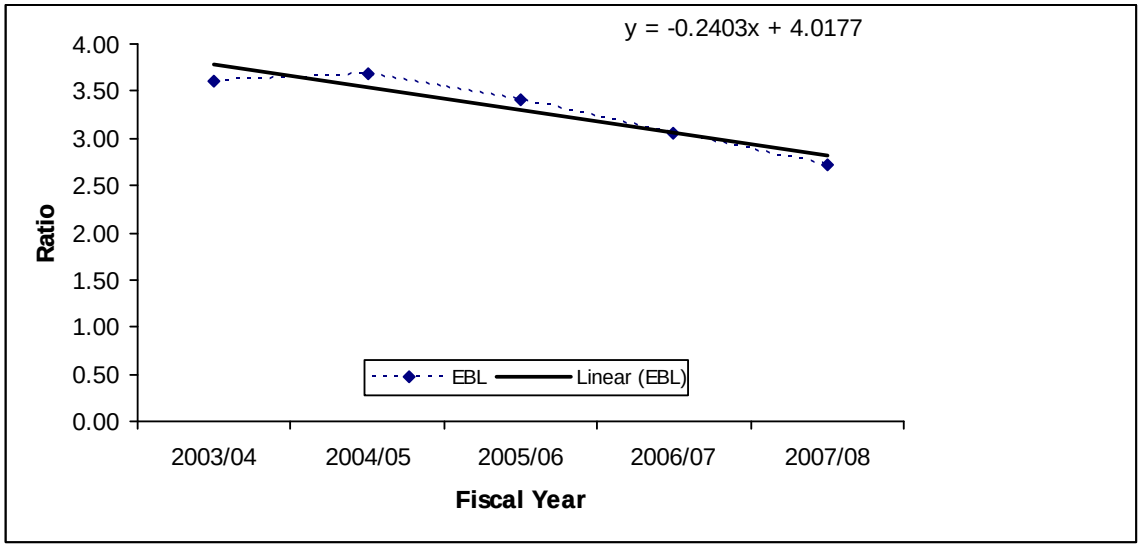


Figure 4.4

Trend of Loan Loss Ratio of EBL



Figures 4.3 and 4.4 shows the observed value of loan loss ratio along with least square trend line. The ratio is downward during the study period. The slope of the trend line determined by the least square method is negative which indicates the trend of loan loss ratio is decreasing over the study period.

4.3 Management Efficiency

4. 3.1 Total Expenses to Total Revenue Ratio

Table 4.6

Total Expenses to Total Revenue Ratio

	Bank	
Year	NIC	EBL
2003/04	73.94	81.71
2004/05	78.29	80.12
2005/06	85.49	77.75
2006/07	82.91	78.38
2007/08	77.52	74.81
Mean	79.63	78.55
CV	0.05	0.03

Source: Appendix VIII

Table 4.6 shows ratio on total expenses to total revenue of NIC and EBL as 73.94, 78.29, 85.49, 82.91 and 77.52 and 81.71, 80.12, 77.75, 78.38 and 74.81 respectively for the study period. The data reveals that ratio of NIC is increasing over 2003/04 to 2005/06 then decreasing thereafter. Table reveals mean expense to revenue ratio of NIC and EBL as 79.63 and 78.55 respectively. The table also shows CV of both the banks as 0.05 and 0.03 respectively. Mean ratio on expense to revenue of NIC is greater than that of EBL which indicates larger portion of the income is expensed. Similarly, the CV of NIC is greater than EBL meaning that greater variability in its ratio. It means the management of NIC seems less efficient.

4.3.2 Earning Per Employee

Table 4.7

Earning per Employee(Rs)

Year	Bank	
	NIC	EBL
2003/04	667160.26	574266.73
2004/05	724558.82	654531.56
2005/06	581853.46	775460.58
2006/07	838492.33	754222.09
2007/08	1047663.97	1004941.23
Mean	771.95	754.70
S.D.	161.13	144.03

Source: Appendix IX

Table 4.7 shows the mean earning per employee of NIC and EBL as 771.95 and 754.70 respectively. The table also shows the S.D. of both the banks as 161.13 and

144.03 respectively. The value on mean earning per employee of NIC is greater than EBL which indicates better management performance of the bank compare to its competitor. Since the S.D. of earning per employee of NIC is greater than that of EBL, there is more risk in per employee earning of the NIC compare to its competitor.

4.4 Earning Performance

4. 4.1 Return on Assets (ROA)

Table 4.8

Return on Assets Ratio

Year	Bank	
	NIC	EBL
2003/04	1.68	1.49
2004/05	1.51	1.46
2005/06	0.93	1.49
2006/07	1.36	1.38
2007/08	1.60	1.66
Mean	1.41	1.50
C.V.	0.19	0.06

Source: Appendix X

Table 4.8 shows mean ROA ratio of NIC and EBL as 1.41 and 1.50 respectively. The table also shows CV of ROA ratio of NIC and EBL as 0.19 and 0.06 respectively. The mean value of ROA ratio reveals that the return on assets of EBL is better than that of NIC. Similarly, the value on CV reveals that less variability in the return on assets of EBL compare to NIC. Therefore, EBL seems to be less risky than NIC.

4.4.2 Earning Per Share (EPS)

Table 4.9

Earning per Share (Rs.)

	Bank	
Year	NIC	EVEREST
2003/04	18.68	45.58
2004/05	22.75	54.22
2005/06	16.10	62.78
2006/07	24.01	78.42
2007/08	25.75	91.82
Mean	21.46	66.56
C.V.	3.55	16.56

Source: Appendix XI

Table 4.9 shows EPS of NIC for the study period 18.68, 22.75, 16.10, 24.01 and 25.75. Similarly, the same of EBL for the study period is 45.58, 54.22, 62.78, 78.42 and 91.81. The EPS of NIC is increasing year by year over the study period except in 2005/06. The table shows that the EPS of EBL is increasing year by year over the study period despite the increase in the number of shareholders. This increase in EPS is due to the increase in the bank's net profit over the study period.

Further, the table shows mean EPS of NIC and EBL as 21.46 and 66.56 respectively. It also shows the CV of the banks as 3.55 and 16.56 respectively. EBL's higher mean value on EPS compare to NIC indicates that it's earning performance is better than NIC. The CV of EBL indicates greater variability in its EPS than NIC's. With this we can say that there is more risk in EBL than in NIC.

Figure 4.5

Trend of EPS (NIC)

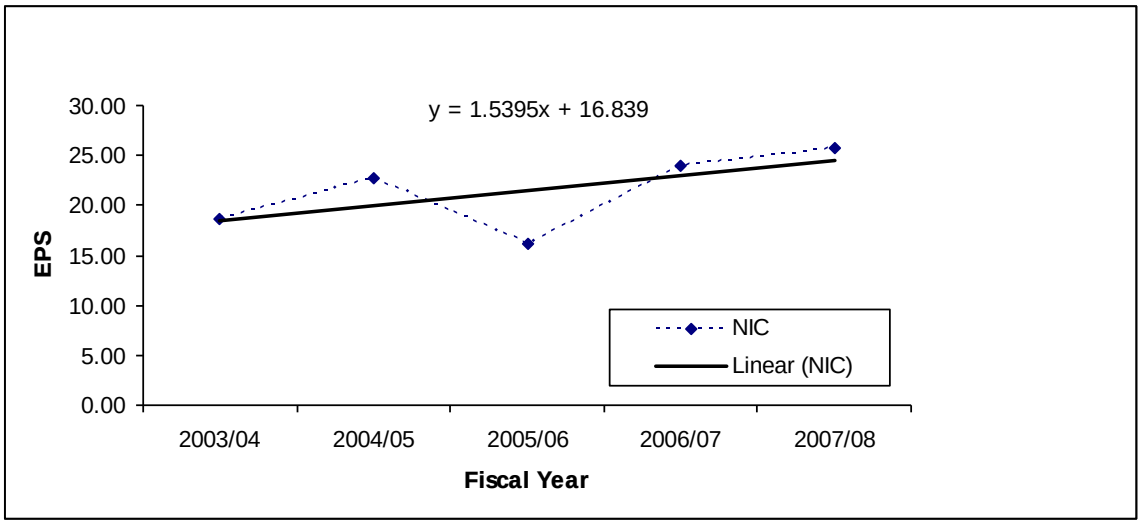


Figure 4.6

Trend of EBL's EPS

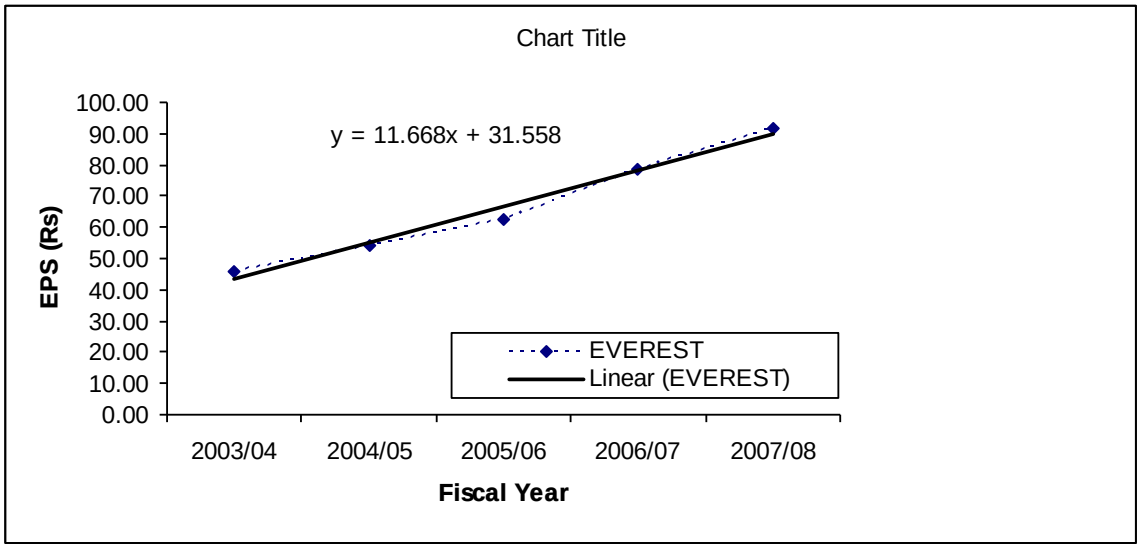


Figure 4.5 and 4.6 show the EPS trend of NIC and EBL over the study period. The least square trend line shows the slope of 1.5395 for NIC meaning that the EPS increases with 1.5 times over the study period. The slope of 11.668 for EBL shown by the least square trend line depicts that the EPS of the bank is growing by

11.67 times over the study period. Since the EPS growth rate of EBL is greater than that of NIC, EBL's earning performance is better than the NIC's.

4.5 Liquidity Position

4.5.1 Liquid Assets to Total Deposit Ratio

Table 4.10

Liquid Assets to Total Deposit Ratio

	Bank	
Year	NIC	EBL
2003/04	16.32	10.16
2004/05	17.63	16.04
2005/06	12.58	11.74
2006/07	7.58	13.15
2007/08	10.34	12.57
Mean	12.89	12.73
S.D.	3.72	1.94
C.V.	0.29	0.15

Source: Appendix XII

Table 4.10 shows liquid assets to total deposit of sample banks for FY 2003/04 to 2007/08. As shown by the table, ratio of NIC is 16.32,17.63,12.58,7.58 and 10.34 over the study period. As depicted in the table, the ratio of EBL is 10.16,16.04, 11.74,13.15 and 12.57. Mean and CV of NIC on the liquid asset to total deposit appeared as12.89 and 0.29 respectively. The mean and CV of EBL on the liquid asset to total deposit appeared as 12.73 and 0.15 respectively. The mean ratio of NIC bank is higher i.e. 12.89 than that of EBL i.e.12.73 which indicates that NIC is more competent in paying deposit and it can keep more liquidity to serve the

depositors than EBL. According to C.V. analysis, it can be determined that the ratio of NIC also varied than that of EBL. But this may be the reason for lower earning of NIC, it is because NIC bank is keeping idle cash and bank balance more than required.

4.5.2 NRB Balance to Total Deposit Ratio

Table 4.11

NRB Balance to Total Deposit Ratio

Year	Bank		NRB standard (%) *
	NIC	EBL	
2003/04	12.50	5.48	6
2004/05	13.42	7.72	5
2005/06	5.20	8.26	5
2006/07	2.61	6.48	5
2007/08	4.85	4.51	5.5

Source: Appendix XIII

Table 4.11 shows NRB Balance to Total Deposit Ratio of NIC for the study period as 12.50, 13.52, 5.20, 2.61 and 4.85 respectively. The table also shows the ratio of EBL as 5.48, 7.72, 8.26, 6.48 and 4.51 over the study period. NRB standard on NRB balance to total deposit for the period is 6,5,5,5 and 5.5. From this it can be concluded that NIC has been maintaining NRB standard except in 2006/07 and 2006/07 and EBL has been maintaining NRB standard except in 2003/04 and 2007/08.

4.5.3 Cash in Vault to Total Deposit Ratio

Table 4.12

Cash in Vault to Total Deposit Ratio

Year	Bank	
	NIC	EBL
2003/04	2.25	2.29
2004/05	2.46	2.55
2005/06	2.95	2.95
2006/07	2.55	6.48
2007/08	3.04	6.42
Mean	2.65	4.14
C.V.	0.11	0.46

Source: Appendix XIV

Table 4.12 exposed that the ratios of NIC as 2.25, 2.46, 2.95, 2.55 and 3.04 in the corresponding years of the study period. Mean and CV appeared 2.65 and 0.11 respectively. In EBL, the ratios remained 2.29, 2.55, 2.95, 6.48, and 6.42 in the corresponding years .Mean and CV of the ratios seemed 4.14 and 0.46 respectively.

The greater average in EBL indicates that EBL is in stronger liquidity position than NIC. According to CV it can be determined that the ratio of EBL also varied than that of NIC.

4.6 Major Findings of the Study

This section lists major findings obtained from the analysis of the data presented for the study purpose. Conclusions drawn from the study are presented in the next chapter entitled “Summary, Conclusion and Recommendations”.

4.6.1 Capital Adequacy in Commercial Banks

Performance of the sample commercial banks is intended to measure with tools: CCAR, SCAR and TCAR suggested under CAMEL model. The mean CCAR of NIC is found to be 10.61 whereas the same for EBL be 8.71. Standard deviation of CCAR of NIC and EBL is found to be 1.07 and 0.62 respectively. The mean SCAR of NIC is found to be 2.2 whereas the same found to 3.21 for EBL. The standard deviation of SCAR of NIC and EBL found to be 1.12 and 1.15 respectively. The mean TCAR of NIC is found to be 12.80 whereas the same found to 11.92 for EBL. The standard deviation of TCAR of NIC and EBL found to be 0.65 and 0.93 respectively.

4.6.2 Asset Quality of Commercial Banks

Performance of sample commercial banks is intended to measure on the basis of NPL ratio and Loan Loss ratio which are the proxy to the quality of assets. Mean NPL ratio of NIC and EBL is found to be 3.02 and 1.22 respectively. Coefficient of variation of NPL of NIC and EBL is found to be 0.68 and 0.35 respectively. The mean Loan Loss ratio of 3.26 and 3.19 is found for NIC and EBL respectively. Similarly, the CV of 0.34 and 0.11 is found for NIC and EBL respectively.

4.6.3 Management Efficiency of Commercial Banks

Performance of sample commercial banks is intended to measure by tools: total expense to total revenue and earning per employee under CAMEL. Mean ratio on expense to revenue for NIC and EBL is found to be 79.63 and 78.55 respectively. Coefficient of variation on the ratio of expense to revenue of NIC and EBL is found to be 0.05 and 0.03 respectively. Mean ratio of earning per employee for NIC and EBL is found to be 771.95 and 754.70 respectively. Standard deviation of earning per employee of NIC and EBL is found to be 161.13 and 144.03 respectively.

4.6.4 Earning Performance of Commercial Banks

The performance of sample commercial banks is intended to measure with the use of CAMEL tool: ROA and EPS. Mean ROA ratio of NIC and EBL is found to be 1.41 and 1.50 respectively. Coefficient of variation of NPL of NIC and EBL is found to be 0.19 and 0.06 respectively. The mean EPS of 21.46 and 66.56 is found for NIC and EBL respectively. Similarly, the CV of 3.55 and 16.56 is found for NIC and EBL respectively.

4.6.5 Liquidity Position in Commercial Banks

The performance of commercial banks is intended to measure with the use of liquid asset to total deposit, NRB balance to total deposit and cash-in-vault to total deposit ratios. Mean and CV of ratio of liquid asset to total deposit of NIC is found to be 12.89 and 0.29 respectively. Similarly, the mean and CV on the same for EBL is found to be 12.73 and 0.15 respectively. NIC has maintained the NRB to total deposit ratio except FY 2006/07 and 2007/08. EBL has maintained the ratio of NRB to total deposit except FY 2007/08. The mean and CV of NIC's ratio on cash-in-vault to total deposit are found as 2.65 and 0.11 respectively. The mean and CV of EBL's ratio on NRB balance to total deposit are found as 4.14 and 0.46 respectively.

CHAPTER - V

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter is divided into three sections. The first section is summary, which describes the whole research in a summarized form. The second section is conclusion. It lists the conclusions drawn from the analysis of the data for the study. The third section is recommendations. It includes necessary suggestions given to the authorities concerned for the consideration to implementation.

5.1 Summary

This study was carried out as academic requirements for MBS degree on the topic of "Comparative Financial Performance Analysis of NIC and EBL in the Framework of CAMELS." The study was started with the objective to find out the fact about financial performance of NIC and EBL. The analysis of financial statement is done to obtain a better insight in to firm's position and performance. CAMEL is a technique of health checking of financial institutions. Financial institution's financial soundness is judged on the basis of capital adequacy, asset quality, management quality, earning quality and liquidity position. Almost, all the government Banks in Nepal are running at loss. Though almost private sector's Banks are earning profit. It is very to difficult to call them sound if appraised from CAMEL approach.

FIs are introducing complex and innovative products, they are exposed to many risks and therefore more amplified as well as diversified the functions performed by the FI supervision department. A key product of supervision is a rating of the FI's overall condition, commonly related to as a CAMEL rating. CAMEL rating system is used by the three federal banking supervisors [The Federal Reserve, FDIC and Office of the controller of the Currency (OCC)] and other financial

supervisory agencies to provide a convenient summary of FI conditions at the time of exam. Various studies have been conducted in the past on the financial analysis of commercial banks in the US and other regions were found done. In context of Nepalese banking environment, there are only few researchers conducted in the framework of CAMEL (Baral, 2005, Bhandari, 2006, Chanda. 2006, Koirala, 2007). The study analyze the level, trend and comparative analysis of capital adequacy, non-performing loans, loan loss provision, management quality ratios, earning capacity and liquidity position components of the NIC and EBL during of 5 years period FY 2003/04 to FY 2006/08. During the research the areas that formed part of the research review were outline of sample banks concept of financial performance analysis, concept of CAMEL rating system and component evaluation system, Basel capital accord, NRB guidelines. Besides these, review of research paper, work paper dissertations and related reports were reviewed.

The research was conducted with in the framework of descriptive and analytical research design. For the study purpose, NIC and EBL was chosen as a study unit applying convenience sampling as technique out of 25 commercial banks. The required data and information were collected from secondary sources. Financial ratios, simple mathematical and statistical tools have applied to get the meaningful result of the collected data in this research work.

The analysis of data and results are presented clearly and simultaneously using suitable tables and graphs. In summary following conclusion are drawn by the analysis of data.

5.2 Conclusions

Based on the findings of the study following conclusions have been drawn:

- The performance of NIC is stronger as measured by CAR but has a higher risk compared to EBL. Based on SCAR, EBL's capital base is stronger than

that of NIC. But there is a greater element of risk in EBL's capital as compared to NIC's. The capital base of NIC is stronger than that of EBL as measured by TCAR. The findings suggest that performance of commercial banks can not be determined by a single tool of CAR.

- On the basis of ratios on NPL and loan loss provision, the quality of EBL's asset is better than that of NIC. Loans advanced by EBL are secured as compared to NIC.
- The management of NIC, as measured by expense to revenue ratio, is less efficient compared to EBL. The management of NIC is more efficient than EBL as measured by earning per employee. Differing efficiency results of commercial banks are found on the basis of efficiency ratios.
- EBL is able to gain more benefits from its assets as compared to NIC. Similarly, the shares of EBL are earning more than that of NIC. A greater variation is seen in the per share earnings of EBL than in NIC.
- Liquidity Position in Commercial Banks: The performance of sample commercial banks is measured with CAMEL tools: Liquid Assets to Total Deposit Ratio, NRB Balance to Total Deposit Ratio and Cash in Vault to Total Deposits. The liquidity position of NIC, as measured by liquid assets to total deposit, is strong compare to EBL. But there is a greater element of risk in the liquidity position of NIC as compared to EBL.
- EBL has maintained the ratio of NRB to total deposit except last year whereas NIC has maintained the ratio except fourth and last year. NIC is able to maintain more efficient liquidity position than EBL in terms of cash in vault to total deposit.

5.3 Recommendations

Based on findings and conclusions, following recommendations have been provided:

- NIC is maintaining strong capital base which is in consistent with the NRB directives. Capital base is an important source to give an impression to general public that their deposit is secured with the bank which enables it to collect more deposits for further investment thereby to earn more returns. Therefore, the NIC's management is advised to maintain the same spirit. Ratios on NPL and Loan Loss of NIC suggest that the loans advanced by this bank are not so secured. Therefore, the management of NIC is advised to focus on the administration of credit extension including scrutinizing and monitoring of borrowers. The ratio on total expenses to total revenue suggest that the greater portion of the bank's revenue is expensed thereby reducing the residuals (earnings) to its shareholders. The bank's management is advised to implement effective budgetary control on the costs. The ratios on ROA and EPS suggest that the bank's asset is earning less as compared to its competitor. The bank's management is advised to identify the causes of inability/or inflexibility in their assets, to identify and plan the investment opportunities and invest accordingly so that it can earn more profits for its owners. The bank has maintained effective liquidity position except in terms of NRB balance to total deposit in some periods. Inability to maintain the required balance may pose restrictions on the bank by the NRB which will adversely affect the operations of the bank and lose public faith on the bank. The bank's management is advised to maintain the balance with the NRB.
- EBL has been able to maintain strong capital base as prescribed by the regulatory authority. Its asset quality is also found to be sound. The management of the EBL is advised to maintain the spirit. Earning per employee of EBL could be enhanced in order to maximize the return. The bank's management is advised to provide

training programs so that their enhanced skill will generate more productivity to the bank. The bank's management is also advised to assess on the need of staff and consider on laying-off excess ones. The bank has maintained effective liquidity position except in terms of NRB balance to total deposit in some periods. Inability to maintain the required balance may pose restrictions on the bank by the NRB which will adversely affect the operations of the bank and lose public faith on the bank. The bank's management is advised to maintain the balance with the NRB.

- NRB being regulator of the commercial banks has a pivotal role in bank's performance, protection of shareholders' interest and general public's deposits. It has to establish effective mechanisms of monitoring and exercise them. It also has a role to formulate economic policies like, interest rates, monetary policy, liquidity policy, etc. in order to boost economic activities and control inflation, in the country. Therefore, the NRB is advised to be effective in monitoring of the commercial banks so that protection of shareholder and public interest is ensured. Both the banks have failed to maintain the requirements on balance with the NRB in some years over the study period. The NRB is advised to be effective in monitoring this requirement.