CHAPTER 1

INTRODUCTION

1.1 Background

The world has now made itself more & more commercial hence turned its inner shel as a global village. With the introduction of WTO concept in nepal's context we can see the emergence of industrial, commercial & financial race taking pace. Financial services are the backbone of the modern economy. Financial services are crucial for savings and efficient resource allocation which facilitate economic growth. Internationalization can help countries build more robust and efficient financial systems by introducing international practices and standards; by improving quality, efficiency, and breadth of financial services; and by allowing more stable sources of funds. The liberalization of financial sector in Nepal has opened a new horizon of expectancy in banking industry. But the liberalization is not easy game to play, it demands for the expert to drive it. The efficiency of liberalization is based on economic discipline and its adherence. The level of overall development of a country is its social, cultural, or political or whatsoever is characterized by the level of economic growth in it and the crux of the economic growth lies in the development of a well planned and well management banking system. It's not wrong to say that our banking scenario is not in an adult stage but of course in a very infant stage, where bank can be considered as the backbone of a country's overall development, the development of the banking sector is a must.With this scenerio taking place. There comes the role of money in an economy,which is very important. Proper and well- planned management of money directs, determines and enhances the health and productivity of total financial sector and the performance of financial sector affects the growth of the economy. The increase in investment impacts positively in every sector of economy such as employment, production, income, government revenue, international trade etc. What role a bank can play to assist the economic development is the main issue that the banking sectors are facing in Nepal and world wide today. The liberalization of the economy has posed more responsibility and challenges on competitative risks. The existence of bank has its root in the economic development and the bank have a role to play in the fund mobilization to increase the pace of development. Moreover bank plays a pivotal role in the smooth functioning of the financial & industrial sector .

In the mid eightees, the monopoly of two state owned commercial banks & two development banks came to an end. Presently,

20	class A
38	class B
74	class C
12	class D

& some more banks are in the pipeline to commence their business. (The Himalayan Times Friday October 5th, 2007) Banks provide an effective payment and credit system, which facilitates the channeling of funds from the surplus spending units (savers) to the deficit spending units (investors) in the economy. By accepting deposits, the banks promote the habit of thrift and savings among the people. These savings of the people later results in the capital formation, which is the basis of economic progress in the country. The various utility functions performed by the banks are of great economic significance for the economy, which can influence the course and direction of the economic activity within the economy.

Again, loan rates are positively related to the NPL ratio and the provision rate. The market can support infinite amounts of banks when the banks are revenue-maximising. There are some examples of an unnecessarily high number of banks in the market, particularly in developing countries.

“The banking sector is mainly responsible for collecting household savings in terms of different types of deposit and regulating them in the society by lending in different sectors of the economy. The banking sector has now reached most of the rural areas but still there are too many nooks and corners to be reached in order to have the overall development of the banking sector in the economy. By lending their resources in small scale industries under intensive banking program has enabled the banks to share in the economic growth of the economy. Taking into consideration that more than 50% sector of Nepal is yet to be served by the banking services so many Banks being opened in the remote and rulal places of the country. This steps taken by the commercial banks so far is an appreciable efforts led by them wherein they have tried to reach the nooks and corners of the country .

The existence of an ideal commercial banking system regularizes the scattered fund from public. Commercial banks if succeeded in increasing the banking habit of the people, would have great power in multiplying the deposits by way of credit creation and this would be a great creation in national savings. The role of commercial banks in the country like Nepal can be judged like, a farmer to purchase a buffalo, an industry to establish its industrial foundation, an exporter to export in a very high rate and enhance the growth of the economy. The two essential functions of the commercial bank may be summarized as the borrowing and lending of money. The primary function of the commercial banks is just like a broker to and a dealer in money. By discharging this function a commercial banks renders a valuable service to the community by increasing the productive capacity of the country and thereby acceleration the pace of economic development.

Every commercial banks is motivated to maximize profits and wealth maximization through best services and highly innovative and sophisticated banking products. A sound bank is that bank which is able to recover its entire loan with their interest. After the liberalization, banking industry has got a faster pace then any other industry. The hurdle that lies in the smooth functioning of the commercial banks is non recovery of the loans and interest accrued in those loans and advances. Lack in the system of the management of loan leads in the piling up of non recovery of loans sanctioned by the banks. If this piling up of the loans is not reduced with in a time no bank can survive and will certainly loose all its reputation from the market and comes to verge of liquidation. In such circumstances the foreign banks tries to withdraw their investment and country may face absolute crises as it happened in the South East Asia during 1980's. This is definitely not good for both the parties.

In order to save from such situation as mentioned above it is necessary to manage the loans and advances sanctioned by banks properly and they should be closely watched until they are repaid. This watching, reviewing and monitoring process of loan is known as management of loans. In the management of loans the most crucial aspect is to manage the due loans and their recovery. Protecting loans from being default and timely address of defaulted loan comes under the management of Non–Performing Assets. To be secure enough of this particular situation every banks are setting a separate department for NPA management.

Generally speaking performing loans are those that repay principle and interest to the banks. These assets constitute the primary sources of income to the banks. Banks are willing to lend as much as possible. But they have to be careful about the safety if such loans turns bad later. Loans are risky assets, even though bank invest most of its resources in granting loans.

Now a day, the banks are taking different principles for granting loans (i. e, liquidity, profitability, and safety, & security, social responsibility etc.) but the NPA does not decline. An asset is classified as non performing assets, if the borrower does not pay dues in the form of principle and interest.

Prior to the process of libersation, the Banks had their own system of booking of income and also making provisions against loan losses, which were not based on very sound banking principles. There was a need to introduce the concept of non performing advances so as to reflect the true picture of profit, improve the quality of loan assets and health of the Banks. The modern banking concept has laid down different kinds of rule regardless the traditional baking concept. The experience of banking has shown that small portion of the loans extended by the bank in time-to-time basis turns doubtful. So, instead of making full provisions banks according to NRB directives still make 1% of provision to pass loan category. The quality of loan assets, among others parameters is reflected in its recovery of principal and/or interest and other charges. Though the security is also a criteria in certain cases for treating the account as NPA, but the primary criteria is record of recovery.

Loans and advances dominate the asset side of balance sheet of any bank. Similarly, earning from such loans and advances occupy a major space in income statement of the bank. One should be very much clear that most of the bank shrinkage in the world is due to high amount of non –performing assets. Risk of non – payment of loan is known as credit risk or default risk. “Performing loans have multiple benefits to the society while non performing loan erodes even existing capital”. (Dahal and Dahal, 2002: 114)

Monopolistic competition has been frequently used among various competition models in banking as the industry uses horizontal as well as vertical product differentiation (Gehrig, 1996; Matutes and Vives, 1996; 2000). On the other hand, some scholars (Freixas and Rochet, 1997) focused on imperfect information in the industry as there are information gaps among borrowers and lenders which lies at the centre of banking sector dynamics and draws attention to financial intermediaries as an information and communication network when communication possibilities across potential traders are imperfect. In terms of banking behaviour, Klein (1971) and Monti (1972) considered a bank as a firm maximising its net present value of assets, and established a landmark model of banking. Klein (1971) assumed that banks maximise profits in the course of intermediation activity. However, the main challenge in this paper is to show that non performing assets impacts the banking behaviour which affects the industry structure ultimately.

Focus of the Study

Banking sector are the backbone of a country's economy. The motto of the commercial bank is to mobilize the resources by investing the same in a profitable manner. The resources may include capital funds consisting of shareholders equity, money deposited by the people, borrowings and profit capitalization. The competency of any commercial banks is referred as to the utilization of the resources on most profitable manner which is adequate to meet its cost of funds as well as some margin left over as the reward for risk bearing. Bank disburses loans and advances for certain predetermined fixed periods or every loans and advances has its maturity period or expiry date and the borrowers must repay the loans by the maturity period. Some loans are recovered within the maturity but there is no certainty that all the loans are recovered by the maturity date.

A big chunk of resources of the bank are being utilized as loan and advances. As the return from loan floatation is higher than the return from any other activities, commercial banks are concentrating their financial activities for the management of loans and advances. The mushrooming growth of the banks had led them towards cutthroat competition. The sluggish economic condition is a hurdle to the smooth functioning of the bank. But it is happy to note that in such circumstances also banks are still grooming in the step of advancement.

The less share in the credit field had led the bank to be flexible in choosing the the finances. The resources could not be considered utilized properly when the loans provided to the clients could not be regular and if there is cumulative overdue outstanding. Behind this overdue there may be occurrence of multiple reasons. The main reason may be the economic failure which has a far reaching impact. So it is very important that the economy of the country is functionally well. The contributing factor that turns the loan into bad loan are the attitude of the borrower, types and quality of the security taken, and legal hurdles created by the borrower when the recovery action is started. Non – Performing assets may be defined as the bad loans and advances which are not performing well. As per the NRB directives loans are being classified as substandard, doubtful, and bad loans. Nepal Rastra Bank defines defines non performing loans as loans and advances which are due for more than 90 days. In order to protect the Banks from the probable loss on lending that cannot be recovered even after liquidation of security held with banks , some part of profits are set aside which may be called loan loss provision according to aging basis for risk mitigation. The Loan Loss provision is to be made by debiting profit and loss account. Such provision so made affects the profitability of the company. Increase in the loan loss provision means the net profit of the bank will come down by that amount. Increase in the loan loss provision decrease the profit of the bank leading to decrease in dividends to the shareholders. However adequate loan loss provision strengthens the financial health of the banks by controlling credit risk and safeguards the depositor's money leading to overall economic development of the country. This study will also help to find out the relationship of non performing assets on profitability.

The management of the non performing assets led the banks towards the rigorous recovery action, which ultimately may cause auctioning of the security held with the bank's custody. Continuous acceptance of such has added to the volume of non banking asset. The total NPA of Nepalese banking sector is estimated to be 30%. The nationalized two big commercial banks namely Nepal Bank Limited and Rastriya Banijya Bank have non – performing assets to the extent of 50% - 60%. We can see many other commercial in the same list for which the main reason is high volume of non – performing assets. For most banks, loans account half or more of their total assets and about half to two thirds of their revenues. Moreover, risk in banking tends to be concentrated in the loan portfolio. When a bank gets into serious trouble, its problems usually springs from loans that have become uncollectible due to mismanagement, illegal manipulation of loans, misguided lending policies, or an unexpected economic downturn. A detailed analysis of the documentation and collateral for the largest loan, a review of a sample of small loans and an evaluation of the bank's loan policy should be properly monitored to ensure that it is sound and prudent in order to protect the public's funds. Thus it becomes necessary that the funds of the bank, which has been granted as loans, into various sectors be thoroughly inspected to guarantee the protection of the bank against unforeseen risks. Banking sector are the backbone of a country's economy. The motto of the commercial bank is to mobilize the resources by investing the same in a profitable manner. The resources may include capital funds consisting of shareholders equity, money deposited by the people, borrowings and profit capitalization. The competency of any commercial banks is referred as to the utilization of the resources on most profitable manner which is adequate to meet its cost of funds as well as some margin left over as the reward for risk bearing.

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Statement of the problem

As the commercial banks are emerging in high rate.The bank mobilises its deposit by extending its credit portfolio. So, in the process of extending its credit portfolio, there might be any loans that may not perform in the stated good conditions. And if the loan turns into bad loans than the Bank may fall into a big crisis which may result in the collapse of the bank because the bank may loose all the capital and the depositers assets. So, in order to play a safety and longlasting game in this competative international areana, bank must make itself strong internally by making enough caution in the loan management. In loan management there lies the role of non performing asset's management. So, the management of NPA has become a major challenge in the today's banking sector. So, it was found quite interesting and challenging to choose the topic of NPA management. The main aims of commercial banks is to mobilize the funds collected from people and provide prompt services for the people. According to international norms any financial institution whose non – performing loans are more than 5% is considered weak in financial aspects. This study will mainly try to focus on the major grounds like:

- What is the level of gross and net NPA on Nepal SBI Bank?
- What are the major external and internal factors which are significantly responsible for the emergence and increment of NPA?
- How NPA does affects on the profitability of the Bank?
- What are the problems associated with management of NPA? What should be done to mitigate and manage the NPA efficiently?

- What are the factors leading to accumulation of non – performing loan?

Objectives of the study

The **main objectives** of the study is to evaluate the management of NPA of NSBL with various statistical measure. In detail the specific objective of the study are highlighted below:

- To evaluate the position and growth of NPA and its consequences effect on profitability of the Bank.
- To analyse the future trend of NPA for the next five years.
- To study and identify the NPA provisioning is adequate or not as per NRB guidelines.
- To identify major tecniques for NPA management.

Significance of the Study

The problem of non performing loans is faced by every commercial banks. So well management of this aspect is a most for the smooth functioning of the organization. For this problem being a major problem the study and research is definitely going to have some sort of significance for the banking sector. Since very few research had been so far conducted in this particular topic this research is going to add to the literature of NPA management. Basically this study will identify the major areas of NPA. This study will help the commercial banks to timely identify the non performing assets and the major contributing factors causing the NPA and timely identification for the reduction of NPA level. This study will also help for the regulation and administration of the non performing assets. Hence this study will be helpful to banker, researcher, shareholders, depositors, further researchers and students.

Limitation of the Study

The study has the following limitations:

- Only Nepal SBI Bank has been considered for sample study.
- The research is limited to the analysis of non performing assets which the sample banks were holding the period of fy2059/60 to 2063/64 B. S.
- The analysis will be bases on the data depicted from annual reports of the sample bank that are secondary in nature and is assumed that the data depicts the true picture of the banks.

Organization of the study

This research work has been divided into five chapters, namely,

Chapter I: Introduction

Chapter II: Review of literature

Chapter III: Research Methodology

Chapter IV: Data Presentation and Analysis

Chapter V: Summary, Conclusion and recommendation

This research work has been divided into five chapters, namely Introduction, Review of Literature, Research Methodology, Data Presentation and Analysis and finally summary, Conclusion and Recommendation.

The first chapter includes various aspects of this study like background of the study, focus of the study, statement of the problem, objectives of the study, significance of the study and limitations of the study.

The second chapter incorporates review of theoretical and related literature regarding the subject matter.

The third chapter incorporates deals with the research methodology, which consists of research design, sources of data, population and sample along with different statistical and financial tools used in the study.

The fourth chapter includes presentation and analysis of data using different statistical tools and major findings.

The final or fifth chapter includes summary conclusions and recommendations regarding the subject matter.

CHAPTER II

REVIEW OF LITERATURE

"Review of literature is basically stock taking of available literature in one's field of research. It provides the knowledge of the status of their study to researcher. The main purpose of literature review is to fiend out what research studies have been conducted in one's chosen fiend of study, and what remains to be done" (wolf & pant, 2000:30) This chapter mainly reviews the available literature with regards to Non-performing Assets of the commercial Banks of Nepal. In this chapter, review of books and definitions of various logical terms pertinent to the area of study are reviewed and presented. Similarly, a brief pertinent to the related studies and findings as well as review of various articles, Which are relevant to this research study, has been made in this chapter. Since, no previous research and studies were conducted on this chapter, and review of previous studies (Thesis) was not possible. However abstract of the various working paper of IMF & World bank personnel's are presented. Commercial banks are guided by commercial bank act 2031, various prudential norms framed by Nepal Rastra bank and various amendments on it. Non-performing Assets are classified and treated as according to NRB Guidelines. Various prudential norms and guidelines of Nepal Rastra Bank, which are relevant to the study, are presented in this chapter. Therefore, review of literature has been categorized into the following groups. They are:

2.1 Review of Concept on Banking

2.2 Review of Prudential Norms & Regulation of Credit

2.3 Review of textual concepts on Non-performing Asset.

2.4 Review of Previous/ Past Studies

2.5 Review of Concept on Banking

As this study is related with the non performing asset of banking industry of Nepal. It is very necessary to know about banking terminology its evolution, growth, functions and problem. In this section a brief review on concept of banking is done on following sequential manner.

- Origin and Historical growth of banking
- Evolution of Banking in Nepal.
- Concept of Bank
- Concept of Commercial Bank
- Joint Venture Commercial Bank
- Function of Commercial Bank
- Importance of Commercial Bank
- Problems of Banking in Nepal

2.1.1. **Origin and Historical Growth of Banking**

Banking is of ancient origin, though little is known about it before the Middle Ages. The origin of commercial banking can be traceable in the ancient ear of storing Greeks and Mesopotamians as well as Romans, when the practice of storing precious metals and coins at safes and Places and loaning out money to the people on interest was prevalent. The traces of rudimentary banking are found in the Chaldean Egytian and Phoenician history. According to Alfred Marshall, In Greece, the temples of Delphi and other safer places acted as store house for the precious metals before the day of coinage, and private purposes at interest, though they paid none themselves. Private money changers began with the task of reducing many metallic currencies, more of less exactly, to a common unit of value, and went on to accept money on deposit at interest and to lend is out at higher interest permitting meanwhile drafts to be drawn on them (Radhaswami, & Vasudevan, 1979:10-11)

Modern banking made its first appearance in medieval Italy, despite strong Christian prohibitions against Usury (the charging of interest) according to the Canon Law. Florence, Genoa, and Lucca became the centers of finance and trade in Twelfth and Thirteenth Centuries. The first bank called the Bank of Venice' was established in Venice, Italy in 1157 AD to finance the monarch in his wars. Following its establishment, the banks established were the Bank of Barcelona and the Bank of Genoa in 1401 and 1407 respectively. Banking slowly spread to the rest of Europe, and by the late Thirteenth Century, in Barcelona, even the clergy was engaged in banking. The Germans and Swiss rose to pre-eminence in the 1480s. The Bank of Amsterdam was the great bank of the 17th Century and it enjoyed a prestigious position, no less important than is held currently by the Bank of England, for a long time in the sphere of international commerce (Dahal & Dahal, 2002:10).

In England, banking had its origin with the London goldsmiths who, in the 17th Century, began to accept deposits from merchants and others for safe keeping of money and other valuables. Crude money lending and money changing were present during the reign of Elizabeth I (1533 Ad-1603 AD) and the practice developed whereby merchants would deposit money (coins) in the Tower of London , which served as the British mint. In 1640, Charles I expropriated the sum then on deposit (approximately & 200,000). Having learned form this loss, the merchants decided to seek a depository free from the danger of royal confiscation. A natural place was the strong boxes owned by goldsmiths, and these businesses soon commenced the practice of accepting deposits for which they gave a receipt payable to the specific order of the depositor or the bearer. As these receipts (or goldsmith notes) (i.e. claims against deposits) were negotiable, they passed from hand to hand in exchange for goods and services, and became a medium of exchange and a means of payment. From time they would be presented for conversion into coin. This first innovation was the forerunner of the bank note or bank's currency.

Shortly thereafter, as early ass 1680, the practice developed whereby the depositor could write a note requesting that a sum money be paid to a third party or to the bearer. This innovation was the forerunner of the modern check, which is merely an order to a bank requesting that a deposit be transferred to a third person of bearer. The next stage in the development of banking arises when the goldsmith becomes a money-lender. This development was based on discovery or realization of the goldsmiths that is was not necessary to maintain 100 percent reserve against deposit liabilities held with them as it was unlikely that all depositors would ask for their deposits on the same day. The goldsmiths soon realized that, on average, daily withdrawals were equal to daily deposit and only a contingency reserve was required for the periods when withdrawals exceeded deposits. After keeping the contingency reserve, the goldsmiths found it feasible to loan out the remaining deposits by charging interest. Fractional reserve banking must have developed shortly after the goldsmiths entered the banking business, because periodically, they computed balance sheets, or as they called it casting up ye shop" . In this way, the goldsmith-money lender became a banker who started performing the two major functions of a bank, i.e. receiving deposits and advancing loans.

The concept of modern commercial bank came into existence by the emergence of Bank of England in 1694 with a capital of l 1.2 million by a group of wealthy London merchants and financiers. Since, at that time, there was no concept of joint stock company, it was necessary to obtain a special charter from the crown to pool their money in common venture. King William 1H was too pleased to grant a royal charter to Bank of England, because in return a capital subscribed of f 1.2 million was lent to him to finance his war against France. The chapter, also gave the new bank the right to issue notes, payable on demand, upto the amount of the loan to the King.

In spite of the establishment of Bank of England in 1694, the development of modem commercial banking institutions had to wait for another century and four decades until the passage of Banking Act of 1833 which provided freedom for the establishment of Joint stock banks. While banking arose far early and rapidly in some countries than in other, it was only in the 19th century that the modem Joint stock commercial banking system developed in the leading countries of the world. When colonies were established in North and South America old banking services were transferred to the New World.

2.1.2 <u>Concept of Commercial Bank</u>

More often than not, banks and commercial banks are interpreted as being synonym of each other but in reality they are two different areas of study Commercial bank is one of the various types of bank and would need a separate identity before one should go any further on study of commercial banks.

There are several types of banks like commercial bank, central bank, industrial bank, agricultural bank, rural development bank, savings bank, exchange bank, universal bank, co-operative bank, mutual fund, housing bank, equipment bank etc. Commercial banks contribute significantly in the financial system of a country. They pool together the savings of the community and arrange for their productive use. They supply the financial needs of modem business by various means. They accept deposits from the public on the condition that they are repayable on demand or on short notice. Their business is confined to financing the short-term needs of trade and industry such as working capital financing. They cannot finance in fixed assets. They grant loans in the form of cash credits and overdrafts. Apart from financing, the role of commercial banks, in modem time, is more vital in (a) agency services, and (b) general utility services. Under agency services, a commercial bank performs a number of activities on behalf of its customers. A commercial bank undertakes the payment of subscriptions, insurance premium, rent etc. and collection of cheques, bills, salaries, pensions, dividends, interest etc. on behalf of the customers. In addition, it undertakes to buy and sell securities on behalf of its customers. It also arranges to remit money from one place to another by means of cheques, drafts, T.T., SWIFT, etc. Apart from agency services, the commercial bank also renders some useful services known as general utility services which include safekeeping of valuables, providing assistance in foreign trade, issuing credit instruments like letters of credit and travelers' cheques, acceptance bill of exchange, financial advising, offering security brokerage services, etc(Khadka &Singh, 2003 15).

Commercial Bank Act, 2031 BS of Nepal has defined commercial bank as, "An organization which exchanges money, accepts deposits, grants loans and performs commercial banking functions and which is not a bank meant for co-operative, a 'culture, industries or for such specific purpose"(Commercial Bank Act,2031:1).

The name commercial bank was first used to indicate that the loans extended were short-term loans to business, though loans later were extended to consumers, governments and other non-business institutions as well. In general, the assets of by commercial banks tend to be more liquid and carry less risk than the assets held other financial intermediaries.

2.1.2.**Joint Venture Banks**

By nature, Nepalese commercial banks can be classified into two categories viz. domestic commercial banks and commercial banks with foreign collaboration. The commercial banks with foreign collaboration are also called Joint Venture Banks. Joint venture is a general model for foreign direct investment. Joint venture means joining of forces between two and more enterprises for the purpose of carrying out a specific operation. Joint venture is the mode of trading through partnership among the nations and is also a form of negotiations between various groups of industries and traders. If one talks about joint venture, there must be at least two parties and concepts of complementary and synergy. The joint venture concept has become more acceptable and popular than other concepts these days. Hence banks operating in the form of joint venture are known as Joint Venture Banks (JVBs). In common parlance, JVB in Nepal refer to foreign joint venture banks in which foreign parent banks purchase certain percentage of share (not exceeding to 50%) apply their international management and network. But, with a view of giving more liberty to banking sector and attracting more foreign investment in this sector Bank and Financial Institution Ordinance 2060 allowed to take maximum 75 % stake in any joint venture Bank.

In Nepal, to encourage joint venture in banking sector three major reforms were carried out in 1980. The reforms 'include allowing the foreign banks to operate as joint venture, lifting of control on interest rate and introduction of the auctioning of government securities. The government's policy of allowing foreign JVB to operate in Nepal is basically targeted to encourage local traditionally run commercial banks to enhance their banking capacity through competition, efficiency, modernization, mechanization via computerization and prompt customer services.

Joint Venture Banks are registered in Nepal under Company Act 2021 B.S. and operated under the Commercial Bank Act 203 1. They have Joint venture between Nepalese investors and their parent banks. Financial and non-financial institutions as well as private investors have shared the domestic portion of investment. At present, there are 8 JVBs in Nepal. Initially they were established as a Joint venture Bank. The growth of joint venture Banks increases dramatically after the restoration of democracy when the government adopted liberal and market oriented policy. The establishment of joint venture Banks after restoration of democracy in 1990 has been contributing to a gradual development of banking culture i.e. by issuing ATM cards and Credit cards, tele banking, 365 days banking service etc. This has drawn a heavy attention from non-business organization or general public towards commercial banks.

Functions of Commercial Banks

A modem commercial bank performs a variety of functions and services. In this study, functions of commercial banks are grouped under five sub-headings like acceptance of deposits, advancing of loans, agency functions, purchase and sale of foreign exchange, and creation of credit. The fundamental functions, performed by modem commercial banks are discussed below (Valdhya, 2001-.38-42):

Acceptance of Deposits

The bank accepts different types of deposits from the public:

*	Fixed Deposit	-	Money in this account is accepted for a fixed period and cannot be withdrawn before the expiry of that period.
*	Current Deposit	-	The depositor can withdraw money from this account whenever he requires it, so it is also known as demand deposit. Generally the bank grants no interest on this account. On the contrary it can charge a small amount on the customer for the services by it.
*	Saving Deposit	-	Some restrictions are imposed on the depositor under this account. For example, he can withdraw only a specified sum of money in a day or week.
*	Recurring Deposit	-	The purpose of this account is to encourage regular savings by the public, particularly by the fixed income group. Generally money in these accounts is deposited in monthly installments for a fixed period and is repaid to the depositors along with interest on maturity.

*	Call Deposit	-	Call deposit incorporates the characteristics of current and saving deposit. Current in the sense, deposit is withdrawn at call and savings in a sense the deposit earns interest. Interest rate on call deposit is negotiable between the bank and the depositor and hence it is normally not announced in public.

Advancing of Loans:

*	Cash Credit	-	It is running loan acount, normally granted against stock and receivables and is regulated by stock statements and drawing power wherein Credit/Debit transactions are permitted within the sanctionaed limit. The level to which debit balance can be permitted is decided by Drawing Power or Limit whichever is lower. Cash credit is normally granted against security of certain investments like Bonds/Fixed Deposits or some time it is given against personal guarantee.
*	Demand/Term Loan	-	Demand loan is a loan on repayment basis and is not a running account. Demand loan once granted will have a debit for the quantum sanctioned and thereafter only credits for repayment, normally personal in nature, are permitted. it is given with or without security. If given against security, the security will be in the form of fixed assets or fixed deposits and it will never be given

			against stocks. These loans are granted to acquire fixed assets like machinery and construction works.
*	Trust Receipt Loan	-	Trust Receipts Loans are sanctioned as a limit to be utilized against hypothecation of stocks imported under own letters of credit, normally for a period of 90 days. It is in the nature of demand loan, which is liquidated by 2-3 installments and the limit is not cancelled with liquidation but is reinstated. hence this loan is more in the form of working capital loan.
*	Bill/Cheque Purchase/Discounting	-	This is the best form of advance in terms of credit discipline as it is self-liquidating in nature. Any trader/industrialist receives payments by cheques or draws Hundis/Documents on the buyer. These cheques/bills of exchange are discounted by the banks and in turn the banks receive commission.
*	Money at call & Short Notice	-	These loans are generally made to other banks and financial institutions. Such loans are very short period loans and can be called back by the bank at a very short notice of one day to 14 days.

Agency Functions of Banks:

The various agency services rendered by the banks are as follows-

Transfer of funds - The banks help their customers in transferring funds from one place to another through an instrument known as bank draft.

Colleting customers' funds - The bank collects the funds of its customers from other banks and credits them to their accounts.

Purchase and sale of shares and securities for the customers - The bank buys and sells stocks and shares of private companies as well as government securities on behalf of its customers.

Collecting dividends on the shares of the customers - The bank collects dividends as well as interest on the shares and debentures of the customers and credits them to their account.

Payment of insurance premium - The bank pays premium to the insurance company on behalf of its customers.

Trustee and Executor - The bank preserves the wills of the customers and executes them after their deaths.

Acts as correspondent - The bank may also act as a correspondent, agent or a representative of its customers.

Purchase and sale of Foreign Exchange

The bank also carries on the business of buying and selling foreign currencies. Generally exchange of foreign currencies in developed countries is done by Exchange Bank but due to lack of exchange banks in our country this function is done by commercial banks.

Creation of Credit:

Creation of credit is one of the most important functions of commercial banks. In order to earn profits, they accept deposits and advance loans by keeping small cash in reserve for day-to-day transactions. When a bank advances a loan, it opens an account to draw money by cheque according to his needs. By granting a loan, the bank creates credit or deposit

General Utility Services:

Apart from agency services, the bank also renders some useful services known as general utility services. They can be explained as follows:

(a) **Safekeeping of Valuables:**

During the middle Ages, banks began the practice of holding gold, securities and other valuables owned by their customers in secure vaults. A modem bank also receives from its customers, valuables such as securities, 'jewelry, documents of title to goods, etc. for safe custody. The bank acts as the custodian of the valuables belonging to the customers. The bank receives them and returns back when demanded.

(b) **Giving information about its customers**:

Since the bank is closely acquainted with its customers, it can pass on reliable information in respect of their creditworthiness to their parties at other places.

(c) **Assist in Foreign Trade:**

The bank assists the traders engaged in foreign trade of the country. It discounts the bills of exchange drawn by Nepalese exporters on the foreign importers and enables the exporters to receive money in the home currency. Similarly it also accepts the bills drawn by the foreign exporters,

(d) **Making venture capital loans**:

Increasingly, banks have become active in financing the start-up costs of new companies, particularly in high-tech industries. Because of the added Task involved in such loans, this is generally through a venture capital firm that is a subsidiary of a bank holding company, and other investors are often brought in to share the risk.

(e) **Financial Advising:**

Bankers have long been asked for financial advice by their customers, particularly when it comes to the use of credit and the saving or investing of funds. Many banks offer a wide range of financial advisory services, from helping financial planning to consulting to business managers and checking on the credit standing of firms.

(f) **Automated Teller Machine (ATM)**

Nowadays, banks allow customers to deposit and draw money from their accounts through Automated Teller Machine.

(g) **Anywhere Branch Banking Service (ABBS):**

Banks offer account holder of a branch to avail some banking services from other branches which is called Anywhere Branch Banking Service.

(h) **Tele Banking**:

Customers may acquire information like, account balance, exchange rate and may instruct banks to do various jobs over the phone/fax.

(I) **Credit/Debit Card:**

Banks issue credit cards to highly creditworthy customers. Banks also issue debit cards as well. This relieves the customers from carrying cash. Beside these functions, a: commercial bank also finance internal and foreign trade, collects statistics about money, banking, trade and commerce, and underwrite shares and debentures issued by private companies, offer some of the banking services at the door of highly valued customers. It also guarantees to other parties on behalf of its customers to make payment up to a specified sum of money to the beneficiary on demand in case of default by its customer. Further, a commercial bank also facilitates the trading between two parties who live in different countries through letters of credit and guarantees the seller of payment in case the buyer defaults to pay.

2.1.3 Importance of Commercial Bank:,

Commercial banks play an important role to the development of the economy. Their operations stabilize the economic pulse of the economy. The size of their transactions mirrors the economic happenings in the country. For example, the mass failures of commercial banks during the 1930's reflected the phenomenon of severe global depression in the world. They are as indispensable component of accelerated growth in developing economy, In fact banks are the nerve center of economy and the barometer of economic prosperity.

Today, in developing economies, regional balance or reduction in regional disparities with regard to the levels and the rate of development amongst the different regions has all along been one of the principal objectives of planned economic development. In this objective commercial banks can play a very vital role. Firstly, by accepting deposits the banks promote the habit of thrift and saving among the people. These savings of the people later result in capital formation in the economy. Thus, by encouraging savings among the people, the banks promote capital formation, which is the basis of economic progress.

Secondly, business innovations, which are essential prerequisite for economic progress, can only take place when the banks provide adequate and cheap credit to the entrepreneurs.

Thirdly, the banks exercise considerable influence on the level of economic activity through their ability to create money in the economy. An underdeveloped economy is characterized by the existence of a large non-monetized sector, particularly in the backward and inaccessible areas of the country. The existence of this non-monetized sector is a hindrance in the economic development of the country. The banks by opening branches in rural and back-ward areas can promote the process of magnetization in the economy.

Fourthly, in a planned economy, banks make the entire planned productive process by providing funds for all types of production incorporated in the plan, regardless of whether the production is in public sector or in private sector, or whether the production is undertaken by one type of organization or another.

Fifthly, through their lending policy, the banks can influence the course and direction of economic activity within the economy.

Sixthly, creating and developing entrepreneurship in developing and underdeveloped economies is highly recognized aspect of commercial banks.

Lastly, various utility functions performed by banks are of great economic importance for the economy. Such functions as cheap remittance of funds, accepting and discounting of bills of exchange, agency functions such as collection of dividends and interest on behalf of customers are very important for the working of the modem economic history tells that tough the extent may vary from country to country, requirement of economic, development of country heavily relies upon its banking system. During its industrial development period, United Kingdom used bank credit to fulfill its working capital need. In the 19^{th} century, during the industrial revolution period of France and Germany, banks played and important role in industrial finance and hence the growth of the nation. Thus removal of banks from a modem economy is beyond imagination in the current context. Without them, the economy will drag behind to the age of barter system, where no intermediary, no financial assets, no liabilities of any kind, and hence no financial institutions existed. With the establishment of commercial banks, the flood-gates of development promising great hopes for people in life have been opened. In fact the development of a country is not possible without a sound commercial banking system

2.1.4 **Problems of Banking in Nepal**

At present large number of banks are operating in Nepal naturally they are rendering a wide range of services. They are keeping up with the changes taking place in the world. While comparing present banking of Nepal with that of a two decade age we find, we find a sea change.

Major problems of the Nepalese banking industry are presented below (Dahal, December 1.002 -20-2 1)

Strong unorganized sector

Most of the people in Nepal live in rural areas and they are illiterate as well. Banks have opened their branches mainly in urban areas. In the rural areas, people have no option but to knock the door of "Sahu mahajan (Money lenders)" for loans. Money lenders exploit the borrowers by charging higher interest rate, compounding the principal amount. Thus, the private interest rate even by manipulated economic poorer. Unorganized sector is strong in the urban areas as well because banks are not competent to render the efficient services and private banks are not focusing this sector for their business.Inability of banking sector to bring this large chunk of urban areas and rural population to the Banking net is a big problem of banking industry in Nepal. This problem. can be overcome by being efficient and by introducing tailor made services

Weak position and unhealthy competition

A bank is judged on the basis of capital, asset quality, management, earning liquidity and sensitivity to the market (CAMELS). Almost all the government banks are running in loss. Though almost all the private sector banks are showing profit, it is very difficult to call them sound if they appraised from CAMELS approach. Some banks have very low capital adequacy ratio (CAR) while some banks have piled up non performing assets. Similarly, it appears banks do not have proper system in the place for management of market risks The people have been raising question over the correctness of credit classification and provisioning of some banks. Should the suspicion come true, it will prove very costly to the depositors, creditors, and national economy as a whole. It would be prudent to advise to NRB to strictly implement its recently introduced directives so that other banks could avert the happening of NBL, RBB and NIDC. Similarly, there is unhealthy competition among the banks to attract and retain the new and old credit customers respectively. In this regard they have compromised on security aspects ad sanctioned loans to customers beyond customer's real requirement. In the long run it will prove costly to both the borrowers and the Bank. This unhealthy competition between private sector banks of Nepal is one of the sole factor for the inability of developing banking culture in Nepal.

Government interference

RBB, NIDC, ADB and NRB are government banks. Government has large share 'in NBL. Inefficiency of these banks knell the death -toll of the economy. Though these banks are working as per existing acts, it is common to hear government interference in their functioning. The change of government has direct link with the change of management in these banks and the policies thereto. This has made the management the puppet of the government and the management is not sure when they will be kicked. This has seriously damaged their competitive strength and defeated the very purpose of their establishment.

Lack of Credit Rating System

All the banks do not have expert lending officials and loan investments are being made without proper analysis of risks. Since loan is the risky asset proper appraisal of the project is a must. Similarly, shrinkage in the value of investment portfolio erodes capital of the Banks. This problem can be removed by establishing agency for credit rating of the borrowers/securities.

Weakness of NRB

Health of NBL, RBB, NIDC and some other private banks are not good today. Though individual banks are to blame themselves for their sick health, NRB can not be given a clean chit. Being supervisor of the financial institution, NRI3 should have played a proactive role so that current plight of them could be averted. Financial reform being initiated by NRB deserves appreciation but such a one-off costly reforms can be avoided if NRB supervises and monitors financial institutions more effectively on a regular basis. NRB should be ruthless against willful defaulters and their banking coterie to extricate the financial sectors from the morass of non-performing assets. Prudential norms recently introduced are good measures, though late NRB should ensure that the prudential measures are put into practice in letter and spirit. Any let up in its implementation defeats the very purpose of its introduction.

Lack of Research Training- and Development

Nepalese Banks are not serious towards research and development. Sometimes, their loan portfolio is diversified while some times it is concentrated. They are unable to foresee the profitable areas and act accordingly. Moreover, banks in Nepal are copying the products of international marketing, that too very, too late. They do not have vision to activate money market of the country by launching new products that suits our requirement. Advancement in the field of IT has brought about revolution in banking sector elsewhere but in Nepal, it is still like a cry for moon. This scenario is not good for healthy growth of banking.

There are around 20,000 bankers in the country but not a single well managed institution. Some banks have in-house training centre but not well managed. Until staffs are motivated and trained, success of the organization becomes just a day dream Hence, the banks should focus on research training and development .Effective RTD helps Nepalese individuals to assume the highest posts in the Banks. Else, our reliance on foreigners does not increase.

2.2 Evolution of Prudential Norms and Regulation of Credit

In general sense credit regulation means regularization of credit facilities given to the borrower of the banks. Regularization includes sanction of credit, determination of cost of credit, inspection of credit unit and timely recovery of interest and principal on loans and advances. As the spread rate between the lending and borrowing is the main source of income, banks are required to maintain the quality of their lending. Good quality of lending indicates the safeguard of depositors benefit and prosperity of whole banking sector. Credit regulation helps to make the accessibility of credit towards every sector of the economy by blocking exploitation of credit accessibility only by the credit players. In another word credit is the main source of generation of employment and backbone of infrastructure development, to make the balance distribution of credit in every needy sector of the economy and to safeguard the interest of public depositors, regulation of credit is necessary.

Nepal Rastra Bank had started to regulate the banking sector after one decade of its establishment in 2033 B.S. by issuing the various directives with regard to credit, deposit, investment, interest rates and liquidity. The role of Nepalese Banking System has undergone number of changes depending upon the requirement of the economy at the material time. This is because for a long time the Banking System largely represented the regulated financial sector. Banks by virtue of their business operation assume a pivotal position in the economy by holding the savings of the people, creating money supply and serving as a conduit for the central bank to carry out the monetary policy initiatives. By administering the national payment and settlement system and acting as intermediary between the saving and investment community and allocating investment efficiently according to the returns to various sectors in the economy, they perform a central role. So when the government policy thrust changed towards globalization and liberalization, and economic reforms were initiated to change the controlled economy to market based economy, banking system again came in for a major overhaul. It was evident that financial sector reforms had to begin with banking reforms and major reforms were initiated in 1991 to the Banking system.

As part of the reform process, there were other changes, which also have an impact on the traditional role of the Banker in terms of resource mobilization and deployment. These were caused by the entry of private Banks, deregulation of interest rates, depending and widening of capital markets enabling the corporate with good rating to access the capital markets and finally privatization and broad basing the ownerships of some of the public sector banks. While the earlier changes affected the bank's business profile, the last factor made the banks accountable for profits to a new group of stakeholders namely the shareholders. This meant that the banks had to have balance sheets that are transparent and drawn as per the requirements of the best accounting standards practiced in Nepal and elsewhere-raising cap tital abroad meant following global standards. The changing environment has exposed banks to a variety of risks. Banks are also under pressure to increase the volume of their business on account of the spreads, and increasing competition. The gamut of increasing risks appears to be less decipherable with traditional wisdom and the risk management systems are just evolving. Bank's loan portfolio is diverse in terms of the nature and size of the units financed, loan products used, geographical areas covered and delivery points. Lacunae in the country's legal system for enforcement of contracts and recovery of loans compound the Bank's difficulties. The result is an alarming increase in NPA's. But these were changes happening not only in Nepal. World over regulators were seized with the problems of assessing the strengths of banks through various measures. As early as July 1998, regulators from all over the world had agreed and released the agreed framework on international convergence of capital measure and capital standards. Emergence of BASEL committee on international finance sector, prudential norms formulated by the committee were considered as the guidelines for banking sector, development of concept on the recognition of the banks on the basis of the Basel committee report were started to get recognition on the basis of the committee. After the analvsis of CBPASS studv of commercial banks of Nepal various regulating norms that have direct impact on the regulation of banking sector were emerged. Those norms, which were related with the Capital adequacy, operation of credit, are known as credit regulation norms.) i maintenance of capital fund ratio, setting of single obligor limit (SOL), credit concentration risk assessment, classification of loans and advances for the purpose of reduction of credit risk and the provisioning arrangement on classified loans and advances were the main theme of those prudential norms which are covered by the directives framed by Nepal Rastra Bank in connection with the operation of credit of commercial banks. Major points of the prudential norms in order to regulation of credit are presented herein below-,

Prudential Norms Relating to Capital Adequacy

Capital adequacy is the relationship between the capital funds to the total risk weighted assets of the Bank. The higher the CAF, the less levered the Bank and safer from the depositor's point of view because the proportion of shareholders stake to the risk weighted assets is also high. Commercial Banks of Nepal are required to have minimum 6% core capital and 12% total capital fund of total risk weighted assets by mid July 2004.

Prudential Norms Relating to Loan Classifications & Provisioning

Commercial Banks of Nepal are required to classify their loans on the basis of overdue aging schedule and provide on a quarterly basis as follows-

Type	**Criteria**	**Provision Requirement**
Pass Loan	Principal overdue upto 3 months	1%
Substandard Loan	Principal overdue upto 6 months	25%
Doubtful Loan	Principal overdue upto I yrs.	50%
Bad Loan	Principal ovedue above I yr,	100%

<u>Prudential Norms Relating to Single Borrower Limit</u>

Single borrower limit refers to the maximum credit limits that can be extended to a cutomers, firm, company or companies of the same group. The purpose of these norms is to avoid extension of credit facilities to a single borrower or group of interrelated borrowers and to mitigate concentration risk due to extension of loan to single/specific area of economy. Main abstract of these norms are as follows-

Fund based credit facilities:	25% of core capital
Non-fund based credit faculties,	50% of core capital

If the above mentioned limit is not maintained by Banks 30% additional risk weighted is assigned to such credit portfolios.

<u>Prudential Norms Relating to Prudential Credit Facility</u>

This norm is concerned with the restriction of providing credit facilities to directors, shareholders, employees and firms related to them. NRB has brought these norms with a view to discourage the practice of lending to rectors/their family members without proper valuation of the loan proposal/project which causes great loss to the banks. The purpose of these norms is to restrict such practices which take place due to favours/pressure tactics applied by bank's directors/ their family members. It encourages banks to follow the rules, regulations and develop professionalism in decision making. Main abstract of this norms are as follows:

- •Banks are restricted to provide credit facilities to their directors and members of his /her family.
- •Banks can not extent credit facilities to an institutions/enterprise in which the directors or family member has direct financial interest or is a manager, partner, agent or guarantor of such unit.
- •Banks can not extent credit facilities to a firm or company in which a director and his/her familv member hold more than 10% share.
- •Banks are restricted to provide credit facilities to a firm or company on behalf of which a director his/her family member is a guarantor.Banks are restricted to provide credit facilities Promoter, shareholders of promoting group, or shareholders owning more than 1% shares of the bank and to bank's employees,
- Banks are restricted to provide credit facilities to a fin-n or company in which bank's shareholder or employee owning more than 1% of its shares has financial interest, is a partner or guarantor,
- Banks are restricted to provide credit facilities to a firm or company in which Bank's shareholder and employees own more than 10% shares and have voting rights-other than those cases where NRB has permitted the same,
- Banks are restricted to provide credit facilities to a person for whom guarantee has been provided by Bank's employee or by shareholder holding more than I% shares.

- Banks are restricted to provide credit facilities by pledging the property owned by bank's director, his/her family member.

Prudential Norms Relating to Non-Banking Assets

Non- banking assets are those collateral properties which are owned by Banks itself from the name of borrower who are defaulted in the payment of their loan obligation. When a loan becomes NPA and there is not any possibility of being recovery of loan, Banks revaluate the collateral property of that loan and the value is booked as a non banking assets. In other words NBA are those portion of loan which are converted into the fixed assets. "Commercial Banks are required to make following arrangement with regards to NBA which they are holding"(NRB Circular Bai.Bi.Ni.Bi. 115/060-61, 2060-10-29 B.S.).

* Any NBA should be disposed off with in 3 years of their erection.

* If any NBA is not disposed off with in 3 years from their erection following provisioning arrangement should be done.

In First Year	33.33%
In second Year	66.67
In Third Year	100.00%

Review of Various Textual Concepts on Non Performing Asset

NPA are done. In this part various literature available in connection to NPA are studied and presented here in order to make research work easy and understanding for everybody. In this part following aspects of non-performing assets are reviewed in sequential manner.

- Conceptual framework of non-performing assets.

- Loan review and classification.
- Legal provisions regarding NPA Impacts of non-performing assets.
- Identification of NPA.
- Early warning signals of NPA.
- Factors contributing for NPA
- Problems associated with management of NPA.
- Ineffective credit policy
- political pressure to lend to unaccredited worthy borrowers,
- overvaluation of collateral are the major causes of mounting non performing assets.

2.3.1 **Conceptual Framework of Non-Performing Assets**

The notion of non-performing loans or asset is often used as a proxy for asset quality of a particular banks or banking system. "Although there is no uniform definition of non performing assets, in many countries, including most G-10 countries, assets are considered to be non performing when (a) principal or interest is due and unpaid for 90 days or more; or (b) interest payment equal payment equal to 90 days interest or more have been capitalized, refinanced or rolled over "(Cotvaria, Dziobek, Kanaya and Song, WP/00/195, December 2000:11

" Non Performing Asset means an asset or account of borrower, which has been classified by a bank or financial institution as sub-standard, doubtful or loss asset, in accordance with the directions or guidelines relating to asset classification issued by RBI "(Athmanathan and Venkatakrishnan, July 2001 A)

An amount due under any credit facility is treated as "past due" when it has not been paid within -30 days from the due date. Due to the improvement in the payment and settlement systems, recovery climate, upgradation of technology in the banking system, etc., it was decided to dispense with 'past due' concept, with effect from March '31, 2007. Accordingly, as from that date, a Non performing asset (NPA) shell be

1. Interest and /or installment of principal remain overdue for a period of more than 180 days in respect of a Term Loan,

2. The account remains 'out of order' for a period of more than 180 days, in respect of an overdraft/ cash Credit (OD/CC),

3. The bill remains overdue for a period of more than 180 days in the case of bills purchased an

4. Interest and /or installment of principal remain overdue for a period of more than 90 days in respect of a Term Loan,

For getting the real meaning of non-performing assets first of all the meaning of assets should be clearly understood. Assets mean "the property of a persons or a company"(Dictionary of Finance, The Penguin International,1994 8 This indicates that the assets are the property of a company accumulated with the help of sources. Non-performing assets means "An outstanding loans and advances that is not being repaid, i.e. neither payments on neither interest nor principal being made" (Athmanathan and Venkatakrishnan.july 2001: 8). In case of the banks the loans and advances are the assets of the banks. As the banks flow loans from the fund generated through shareholders equity, money deposited by the people and fund having through the borrowings, it expect the repayment of funds with some additional amount that is interest so that it could meet its all kinds of expenses. "when any loans couldn't be repaid in time it directly effects to the performance of the banks) Hence, non-performing assets means that loans and advances, which are non performing well or those, loans and advances which are irregular. In this regard it would be very useful to present cross country definition with regards to non performing assets, which is presented below.

Country	**Definations of Non-Performing Assets**
INDIA	Loans and advances which are due for sixth months
INDONESIA	Loans and advances classified as substandard, doubtful and Bad(over three months overdue)
KOREA	loans overdue over three months plus non accrual loans
MALAYSIA	Loans classified as substandard, doubtful and bad as per banks discretion (principal or interest overdue by three or six months at bank's discretion) -
PHILIPPINES	Substandard, doubtful and loss loan. Loans payable in monthly installments more than three months overdue and loans repayable on other term if one month overdue.
SINGAPORE	Loans classified as substandard and all loans and advances which are overdue more than three months
THAILAND	Substandard, doubtful and bad loans(overdue more than three Months

Source* (Cotvaria L,Dziobek C.,Kanaya A. and Song I.,WP/00/195, December 2000:11

As per the norms currently in force, among other conditions, if interest/ or installment remain unpaid for a period exceeding a quarter, the concerned loan account would be classified as (NPA) In other words, the loan accounts classified as per the circular no.13P.BC.79/21-043-9-3 dated April 27,1992 and circular no.B.B.Bc.59/22/04.943-92 dated Decemberl7,1992 the Reserve Bank of India has identified the non-performing assets as an account of loans and advances where on the balance sheet of

- Term loans interest and principal remains past due for more than 90 days.
- If overdraft and cash credit account remain out of order.
- Bills purchase or discounted remains overdue or unpaid for more than 90 days, or other accounts receivables that remains past due for more than 90 days.

The circular further says a Non-performing Assets is a credit facility in respect of which interest has remains unpaid for 90 days. As per the Nepal Rastra Banks Directives" Non-performing Assets are the classified loans and advances and this includes sub-standard, doubtful and bad loan categorized as defined by NRB directives (NRB Directives 2002, compiled by R.Bajracharya & Company)".

2.3.2 Loan Review and Classification

"The primary guiding factor for recognizing a non -performing assets will be the Interest Income Recognition and Assets classification (IRAC) norms prescribed by NRB"(NRB circular No.Bai. Bya.Pa.64/057/ dated 2057.12.2 B.S. – directives Doubtful loans exhibit all the characteristics of substandard loans; with the added characteristics that collection in full is highly questionable and improbable. Classification of loss is deferred because of specific pending factors that may strengthen the quality of assets. Such factors include merger, acquisition, under the headings of Sub-Standard, Doubtful and Loss loan would be treated as NPAs.With an objective to minimize the possible loss of credits extended by commercial Banks, Nepal Rastra Bank amended the policies relating to loan classification and provisioning by their circular No. 71/058 dated 2058/5/29 (14 Sept.2001). As per the new circular of NRB the Commercial Banks Should classify the principal amount of loans and advances on the basis of aging. Under these new rules the Loans and advances are classified into the following categories.

Pass Loan:

Loans in this category are performing and have sound fundamentals which includes borrowers overall financial conditions, resources and cash flow, credit history and character. They also include the purpose of loan, and types of secondary sources of repayment. Loans and Advances whose principal amount are not past due and past due for a period upto 3 months shall be included in this category. These are classified and defined as Performing Loan or Performing Assets.

Substandard Loan

Loans in this category have well defined weaknesses, where the current sound worth and repayment capacity of borrower is not assured. Orderly repayment of debt is in Jeopardy. All loans and advances that are past due for a period of 3 months to 6 months shall be included under this category.

Doubtful Loan

Doubtful loans exhibits all the characteristics of substandard loans, with the added characteristics that collection in full is highly questionable and improbable. Classification of loss is deferred because of specific pending factors that may strengthen the quality of assets. Such factors includes mergers, acquisition, liquidation procedures, capital injection, perfecting liens on additional collateral, and refinancing plan. All loans and advances, which are past due for a period of 6 months to I year, shall be included in this category.

Loss /Bad Loan

These loans are considered uncollectible and of such little value that their continuance as bankable assets is not warranted. This classification does not mean that the asset has absolutely no recovery or salvage value, but rather than it is not practical or desirable to defer full provision or writing of this basically worthless loan. partial recovery of may be possible in the future. All loans and advances which are past due for a period of more than I year as well as advances which have least possibility of recovery or considered unrecoverable and those having thin possibility of even partial recovery in future shall be included in this category.

"Apart from the above-mentioned classification following additional arrangement in respect of loan classification are in rule"(NRB circular No.Bai. Bya.Pa.64/057/ dated 2057.12.2 B.S. - directives No.2).

1. If it is appropriate in the view of Bank's management, there is no 9 restriction in classifying the loans and advances from low risk category to high-risk category. For instance, loans falling under sub-standard may be classified into Doubtful or Loss loan and loans falling under Doubtful may be classified into Loan loss category.

11 .Loans and advances fully secured by gold, silver, fixed deposit receipt and HMG securities shall be included under pass category. However, where collateral of fixed deposit receipt or HMG securities or NRB Bonds is placed as security against loan for other purpose, such loans has to be classified as per the age up to which they are due.

iii. Even if the loan is not past due, loans having any or all kind of the following discrepancies shall be classified as Loan loss or Bad loan.

- No security at all or security that is not in accordance with the borrowers agreement with the Bank.
- The borrower declared bankrupt.
- The borrower is absconding or not found.
- Purchase or discounted bills are not realized within 90 days from the due date.
- The credit has not been used for the purpose originally intended.
- Owing to non-recovery, initiation as to auctioning of the collateral has passed six months and if the recovery process is under litigation.
- Loans provided to the borrowers include in the Blacklist and where the credit information bureau blacklisted the borrower.

"Loans and advances, which are classified as Substandard, Doubtful, and Bad are Categorized as NPA".

2.3.3 Loan loss Provisioning Regarding NPA

Before to state the loan loss provisioning relting to NPA it is necessary to know about the meaning and implication of loan loss provisioning. "Loan loss provisioning is the vehicle for adjusting the value of loans, so as to reflect loan review and classification" (Cotvaria L,Dziobek C.,Kanaya A. and Song I.,WP/00/195, December 2000:14). For example, when review shows that a loan value has become "doubtful ", a provisions need to be established to reflect the loss of loan value. In some respect, provisioning is similar to the concept of depreciation of the property and equipments of non banks. The cost of provisioning constitutes a normal business expenses and reduce banks net profit.

General provision

"General provision is the provision made for possible or latent losses not yet identified "(Cotvaria, Dziobek, Kanaya and Song,WP/00/195, December 2000:14). This amount of loan loss provisioning can be included in capital in calculation of capital adequacy ratio. General provisioning is the amount set aside to protect from the degradation of pass loan in future

Specific Provision

"Specific Provision are the amount of provisioning set aside for the loans classified as substandard, doubtful and Bad " (Cotvaria, Dziobek, Kanaya and Song I.,Vv'P/00/195, December 2000-14) More clearly specific provisioning can be recognized as provisioning for NPA. This amount could not be included in capital in calculation of capital adequacy ratio and strongly hits to the profitability.Nepal Rastra Bank has made it mandatory to commercial Banks through their directives circular no.71/058 dated 12058.5.09, to make the loan loss provisioning on the basis of the outstanding loans and advances and bills purchases on the following basis:

Types of Loans	Loan Loss Provisioning
Pass	I percent
Substandard	25 percent
Doubtful	50 percent

Loss	100 percent

Apart from the above mentioned arrangement following additional arrangement are provided for the loan loss provisioning.

1. Where the loan is extended only against the personal guarantee statement of the assets, equivalent to the personal guarantee amount not claimed by any other, shall be obtained. Such loans shall be classified as per above and where the loans fall under the category of pass, substandard and Doubtful, in addition to the normal loan loss provision applicable for the category, an additional provision by 20 percentages shall also be provided.

ii. The loan loss provisioning in respect of rescheduled, restructured and swap loans shall be provided at a minimum of 12.50 percent.

Ill. In case of priority sector loan the provisioning are made 1%, 25%, 50% and 100 % to the loan categorized as pass, Substandard, Doubtful and loss/bad respectively. However, in respect of insured loans, the provisioning should be made on the following way:

Types of Loan	**Loan Loss Provisioning**
Pass	0.25 percent
Substandard	6.25 percent
Doubtful	12.50 percent
Loss/Bad	25.00 percent.

2.3.4 **Impacts of Non-performing- Assets**

The primary objective of a Bank like any other commercial organization would be to enhance the profitability from their operation, generate surpluses adequate for ensuring growth and increase shareholders value. In today's competitive scenario profits are the index of the efficiency and banks rating are decided on the basis of banks and investors compare these indices to evaluate the banks. "The capital adequacy norms ensure that banks cannot increase their assets without increasing their capital "(Athmanathan S and Venkatakrishnan R.July 2001-5). Only profitable banks or those that are perceived to have clear edge over the others to generate future profits are likely to be rewarded by the investors with their funds. In the era where capital markets decide allocation of funds among competitive investments, profitability is the key factor for such allocation. Under the circumstances assets that do not earn any income or those assets that are categorized as NPAs affects to the bank in many ways which are described below.

i. Profits

- The resources locked up in NPAs are borrowed at cost and have to earn a minimum return to service this cost but NPAs do not cam any interest and other income Thus, NPAs directly affects to the profitability of the Banks.
- NPAs on the hand do not earn any income but on the other hand drain the income earned by performing assets through the claim of provisioning. ThusNPAs reduces the net profit of the Bank.
- Since they do not earn the interest they bring down the yield on advances and the net interest margin or the spread.
- NPAs have direct impact on return on assets and return on equity, the two main parameters for measuring the profitability of the Bank.
- Return on assets will be effected because while the total assets include the NPAs, they do not contribute to profits, which is the numerator in the ratio.
- Return on equity is also as provisioning eats more and more fi7om operating profits earned.

The performance measures by return on deposits (ROD) suggests profitability of banks decreases as market gets more concentrated which contrasts the traditional view on market power. However, this result should be interpreted in association with the commonly used banking sector rescue programmes to write off bad loans. Nonetheless, profitability is positively associated with interest margins, negatively associated with non-performing loans, and positively associated with capital adequacy as expected.On the other hand, NPLs show a negative relationship with market size, i.e. relative NPL ratios decline as market becomes bigger.

ii. **Impacts on Capital Adequacy**

- The risk weighted on Non-performing assets is hundred percent and capital has to be blocked. These assets do not produce income to sustain the capital blocked by them, which again drains the profits earned on the other performing assets.
- If the Bank is required to provide for the entire outstanding NPAs (not provided so far) it could wipe out half of our net worth and reduce the capital adequacy by half.

iii. Increases other costs

As the income earned on performing assets subsidies NPAs, the ability of the banks to offer their spreads to good customers conies down. This in turn makes the best customer choose other cheaper financing options and the bank's assets portfolio quality deteriorates. This result in future NPA's.The cost of monitoring non-performing assets includes administration costs, legal costs and cost of procuring the resources locked.

iv. Impacts on Capital Market Perception

- NPAs bring down the profits, affect the shareholders value and thus adversely affect the investor's confidence.
- In extreme cases it brings down customer confidence also and increase borrowing costs.
- It also affects the ability of the banks to start other business ventures.

Apart from the major impacts mentioned above Non-Performing assets have other adverse impact on banks activities. They are:

- regulators view increasing NPA seriously and they might prescribe harsher measure.
- Increasing level of NPA means no or less bonus and other benefit which,
- ultimately lowers employee morale and reduces their affiliation with
- organization and decision making capacity.

2.3.5 **Identification of Potential NPAs**

Non-performing assets are not born themselves. They are created and converted during the span of time. "For the proactive management of non-per-forming assets early warning signals of problem loans should be addressed and a proper system should be adopted to spot all the potential NPAs" (Athmanathan and Venkatakrishnan, July 2001:8.) Such potential NPA consists of the following Characteristics,

- Accounts delinquent for 2 quarters or more at the end of any quarter during a financial year and in which cases, the missed payments (Interest and/or principal) are unlikely to be realized before the end of the relative financial year.

- Accounts exhibiting early warning signals of potential credit risks These will include transaction related signals like persistent irregularity in accounts, defaults in repayment obligations, devolvement of LC liabilities/invocation of guarantees, operating losses, etc.
- Accounts below as per Bank's Credit Risk Assessment System (CRA).
- Accounts adversely commented upon, from the standpoint of their quality inspection and Audit Reports and by NRB inspectors/Statutory Auditors. These audits form an essential source of information for recognition and Management of NPAs.

2.3.6 **Early Warning Signals of NPAs.**

Non-performing Assets are converted from good loans during the span of time. NPA shows some early warning signal as they started to be converted from good loans. various early warning signals with respect to various aspects of business organization are presented here (Athmanathan S and Venkatakrishnan R. July 2001

i. **Financial signals**

Following are the financial signal that indicates that the loan is going to be bad in near future.

- Persistent irregularity in account
- Defaults In the repayment of obligation
- Overdue of periodic interest
- Devolvement of LC liabilities/invocation of guarantees
- Lower credit summation in the account.
- Sales transaction not routed via Cash Credit account.

• Declining current ratio.

* Increment in operating and net losses.

• Erosion of total net worth.

• Opening of accounts with other Banks.

ii. **Operational and Physical**

Following are the symptoms related with operational aspects of a unit, which indicates that the unit is not performing well and loans and advances sanctioned to them is going to be bad in very near future.

• Low activity levels (Deterioration in turnover)

• Disorderly diversification /frequent changes in plans

• Overdue receivables

• Return of outward bills unpaid/dishonored cheques

• Low inventory movement

• Non payment of wages/ power bills

• Frequent labor troubles

• <u>Loss of Market credit</u>

a. Court cases against the unit

b. inability to raise supplies on usual credit terms

• <u>Attitudinal. changes</u>

c. Avoids contact with the Banks

d. Non/delayed submission of data and financials

e. fudging of financial statements

f. Dissension amongst partners/promoters

Others

g. Adverse changes in government policies

h. Emergence of new competition /technology

2.3.7 **Factors Responsible for NPAs**

The primary guiding factor for recognition of non- performing assets will be the interest income recognition and Assets classification (ERAC) norms prescribed by NRB. According to the prudential Banking and accounting norms any loans and advances against which neither interest nor principal amount has been settled for a certain period of time is known as NPAs. Any interest amount on behalf of any loan accounts could not be considered as interest income until it is recovered. Such amount of interest is booked on interest suspense account. The portion of interest suspense increases with the increase of non-performing loans. Various factors contribute on the conversion of good loans into bad loans. In the context of Nepali Banking system and environment, they are classified as external factor and internal factor, which are described below.

2.3.7.1 **External Factor**

External factors are those factors, which are not in the control of banks. They consist of various unexpected changes in the social, political, economic and other areas of the country. Following are the main external factors, which are responsible for the conversion of good loans into bad loans.

Overall Non-conducive Industrial Environment/Insecurity

The political and economic situation of the country is one of the major factors, which is responsible for the increasing level of NPAs of Nepalese commercial Banks. At the present context various industries, which are located in rural areas of the country, are not been able to do their work. Slow economic growth rate, security problems of the country causing them to make inefficient to meet their financial obligation. Due to law and order situation of the country they have not been able to function in full fledge and the loans and advances sanctioned to the by the banks is being due and the non performing portion of the loans advances by the bank is increasing. (Banking promotion, Pause 2058: 2 1)

Integrity of the Borrower

Intention of the borrower towards the payment of financial obligation is one of the major factors that lead on the way of Non-performing loans. If the borrower is not positive about the payment of Principal and interest of the loan and advances taken from the financial institution he diverts the funds from the actual purpose, manipulates the financial figures and creates the artificial scarcity of funds delays in payment of principal and interest in expectation of waiver of interest. Thus, principal and interest amount becomes overdue and the loans and advances sanctioned to those borrowers becomes NPA.

NRBs Guidelines and Blacklisting Procedure

NRB's guidelines on respect of classification of the loans and advances are another crucial factor that is responsible for the immediate growth of NPA in Nepalese commercial Bank. Various loopholes, which exist in NRBs (guidlines, are responsible for the inefficient supervisions of commercial banks. On the other hand the supervisors from NRB do not reflect all the position on their report and commercial banks hide their actual position of NPA, which is rapidly growing

Existing blacklisting procedure is also somewhat responsible for increase of NPA in Nepalese commercial banks. "In the existing rule a business house holding even a minor investment (10% or above) in a blacklisted entity could find all of its associated businesses blacklisted "(New business Age, July 2003 48). As the private sector of Nepal is dominated by a relatively small number of business houses such provisioning of blacklisting is mostly affecting to all sectors of Nepalese economy and the portion of NPAs of Nepalese Banks is increasing.

Weak Loan Recovery Law and Procedures

Long process in respect of recovery of loans and advances is another factor, which

is responsible or the growth of NPA's in Nepalese commercial Banks. The existing loan recovery act is very complex and lengthy. Provisions of 35 days notice, 7 days notice, cumbersome legal process of auctioning the property and stay order provisioning in appellate court against the auctioning of the property are the main hurdles in recovery of bad loan. Mandatory provision of disposing off NBAs within 3 years encouraging banks to compromise settlement instead of auctioning the property. Lack of loan recovery act and slow and time consuming process on decision making by court are also somehow responsible for emergence of NPAs and their ineffective management. Thus portion of NPA is growing in Nepalese commercial banks being very difficult to reduce them.

Unstable Government Policies & Weak Government Stand on International Politics

Frequent changes in various government policies related to tax, tariff & customs directly hits to the operation and performance of those organizations which comes under the periphery of those rules. Changes in the policies create unexpected liability on behalf of those organizations. As a result they become unable to meet their financial obligation and loans & advances given to them turns into NPA. Similarly, Weak government stand on various bilateral and multilateral treaties and agreements hampers the country's export based industries by imposing various quota system, tax, tariff and custom duties which, in turn converts the loans facilities given to them into NPA. For e.g in Nepal loans and advances sanctioned to vegetable ghee, Zinc oxide, and Acrylic Yam industries is turning into NPA due to adverse impact of Indo-Nepal commercial treaties.

2.3.7.2 **Internal Factors**

Internal factors are those factors, which are emerged fi7om the system of organization itself They could be controlled and mitigated if proper analysis and

care is given in the primary stage of their development. These factors *include the various policies of the organization, personnel executing those policies and other internal environment, which is conducive for the said matter. some of the major contributing internal factors for the growth of NPA are presented herein below.

Credit Policy of the Bank

Main factor, which is responsible for the owth of NPA's, is the credit policy of the commercial Banks. Commercial banks are not formulating their policies in consistent with their objectives. Credit guidelines are not evaluated on the grounds of its adequacy in provisions of managing credit risks and addressing the sufficient procedures in maintaining consistency in credit operation. In sufficient provisions in the guidelines of credit operation leads the banks towards the corruption, which is the main way of turning good loans into bad loans.

Management Inefficiency and Weaknesses

Lack of managerial skill in respect of credit operation is another factor for turning good loans into bad loans. "Over flexibility on the project analysis, lack of competent manpower in credit operation, tendency of over valuation of collateral property, lack of scientific collateral assessment system, insufficient manpower in credit control, lack of regular follow up and inspection to the unit to whom credit is granted are the factors which are responsible for the growth of NPAs in Nepalese commercial Banks"(Banking Promotion, Poush 2056 B.S.: 27) . Lack of technical knows how of various project and insufficient method of project feasibility study are also other factors that are responsible for conversion of good loans into bad.

Financial Indiscipline and Inadequacy

Corrupted manpower in the credit operation, inappropriate system of rating risk and return on any project, manipulation of various Information about the project to whom loan is to be sanctioned, political relationship of credit manpower alsoadversely affects on the quality of good loans.(Banking Promotion, Poush 2057:42).

Lack of Quality Appraisal of Loan Proposal

Every loan proposal are apprised before sanctioning of any loan amount to them. While appraising any loan proposal various things such as credit worthiness of customer, credit information from CEO, personal net worth of guarantors, conduct of other associated business concern with other financial institution, inspection of collateral property are to be done. Any kind of consideration and flexibility on such above mentioned things might hide the actual position of the project, which in turn will be a contributing factor for the conversion of good loans into bad loans. Any loans and advances which were sanctioned without appraising actual cash flow, real internal rate of return, break even point and other environmental factors may be the causes of failure of the project which ultimately a perfect reason for conversion of good loans into bad loans.

Lack of Quality Marketing

Marketing is related to exploring the profitable opportunities and to make an association of business entity with them. In banking industry main concern of marketing is related with finding that entity which has good profitable business opportunity, identifying short term and long term needs of the customers, setting business plan to meet the needs of customer and making an arrangement of lending to them. If marketing is not done properly banks may lend to those entity which don't have any future of their survival and loans and advances availed to them will be converted into NPAS in future course of time.

2.3.8 Problems Associated With Management of NPA

Management of NPA is one of the major concerns of every commercial bank, not only in Nepal but all over the world. Currently in Nepal every Banks are setting a separate department for management of problem loans. Considering the economic situation of the country and other contributing factors in turning of good loans into bad following are the problems encountered in the management of NPAs.

Lack of Asset Management Company

"Asset Management Company could one of the measures for the settlement of problem loans as they helps the banks to remove bad assets from their balance sheet "(Banking Promotion, Poush 2058 B.S.- 25) In the concept of AMC whole of the bad loans of the Banking sector collected in one company and managed from there. This will help the Banks to avoid unnecessary expenses concerning legal opinion, establishing different department for auctioning of collateral property against which those gone loan were given.

Lack of Proper Documentation

Inappropriate documentation during the disbursement of loan is also one of the problem associated with the management of NPAs. Security documents are vital weapons to bring the defaulters in trap. Security documents should be updated with every change in the terms and conditions of lending. Uncompleted documents, omission of signature, date and thumb print on security documents benefits the defaulters in the execution of court proceeding. Thus, documentation plays great role in the management of NPAs.

Requirement of NRB Guidelines and Ineffective CIB

NRB Guidelines with regarding the provision for NBA, which are later product of NPAs is somehow creating difficulties in the management of NPA.As per their new regulations relating to BA Banks are required to maintain provision of 33,66 and 100 percent with in three years if not disposed off. Sometimes court cases stretches more than three years appealing in appellate court and high court against the decision of court. This has lead the banks towards the 'increase management cost of NBA on one hand and reduce the pie of net profit through means of provisioning o the other hand. Similarly, Credit information Bureau is not functioning as it could be. Lack of net working with banks to keep up to date information with regards defaulters and their relatives has lead the bank towards the lending to willful defaulters which in turn increases the level of NPA .

Difficulties in the Court Proceedings :

Cumbersome legal process in the execution of court proceeding with regards to collateral of NPA is also somehow responsible in creation of hurdles in the management of NPAs. Provisions of appealing in appellate and high court have encouraged the defaulters in making the payment of the loans and advances which they availed. Due to the fear of this lengthy and cumbersome legal process bankers are forced to make compromise settlement which in turn reduces the amount of recovery to be done and management of NPA becomes ineffective.

Depreciation of Assets Due to Economic Conditions

Due to the political situation of the country many peoples are migrating to Kathmandu valley thus value of collateral property outside Kathamndu valley is decreasing very few bids comes in the process of auctioning those property. Banks management could not accept those low amount bids and that property which are to be disposed off with in a specified time couldn't be disposed off This will create another problem in the management of NPAs as most of the time spends on auctioning procedure of these property banks personals could not concentrate their time in identification of potential NPAs.

2.4 **Review of Previous Studies**

On this part reviews of various studies related to the research area are done. For the convenience and easy understanding of review of previous studies. this part is presented herein following sequential manner

- Review of International Studies
- Review of Previous Studies in Nepal

2.4.1 **Review of International Studies**

In order to get the idea of analyzing NPA, the researcher has visited several web sites. No actual core studies were found during web search. However, various journals, working papers & Seminar papers from the web sites of IMF, World Bank JFC & Nepal Rastra Bank in course of searching pilot studies were found. In order to gather concepts and conclusions about the various aspects of nonperforming asset the researcher has collected and studied those journals, working papers & Seminar papers. Conclusions drawn from those studies are presented here in below:

2.4.1.1 **Study of Adrian M. Bloern and Corneils N. Gorter**

Adrian M. Bloem and Corneils N. Gorter has classified non-performing assets according to international Statisticals Mannuals and International norms of Banking and Accounting Institution. They analyzed the NPA's on both the standards as mentioned above. Main finding of their study was the income effects of NPA as the NPAs reduce the pie of earning assets.

2.4.1.2 **Study of Luis Cotvaria & Inwon Song**

On Their working paper entitled "Loan Review Provisioning and Macroeconomic Linkages" Luis Cotvaria & Inwon Song analyzed the classification of loans with their respective provisioning effect and trace out the linkages of NPA's with Capital Adequacy Ratio. They find out that provisioning for NPA (Specific Provisioning) could not be included in capital fund but it reduces the portion of net income by eating through means of provisioning for NPA thus, NPA reduces the capital adequacy ratio.

2.4.1.3 **Study of Luc Laeven and Giovanni Majnoni**

Similarly, Luc Laeven and Giovanni Majnoni analyzed the relationship of loan loss provisioning with the loan portfolio of large commercial Banks in different geographical areas of the world Their studies revealed that a sound Bank should show positive association between the amount of loan loss provisioning and the growth of loan portfolio. In their conclusion they are stating that "We find the positive link between earnings provisioning is stronger for countries with higher income level, suggesting that pro cyclical behavior of loan loss provisioning is higher in developed countries than in developing countries"(Laeven L. and Majnoni G., fMF working paper 2003:13).

2.4.1.4 **Study of Alain Laurin and Giovanni Mainom**

On the working paper prepared by Alain Laurin and Giovanni Majnoni presented the findings of World Bank survey of loans classification and provisioning practices in the countries represented on the BASEL principals Liaison Group. Through their working paper they find that differences in provisioning and classifications approaches have made it difficult to compare the banking system weaknesses across different region, making peer pressure and market discipline difficult.

2.4.1.5 **Study of Kav Ellen Herr and Goe mivazaki**

On the study made by Kay Ellen Herr and Goe Miyazaki find out the securitization as a better solution to solve the problems of non performing assets. They analyzed that secunitization would helps the Banks to reduce the levels of non performing assets from their balance sheet and enables them to get tax benefit which would otherwise not been by simple write off of non-performing assets.

2.4.1.6 **Study of Mr. Prashant R. Reddv**

On his Thesis entitled "A comparative study of Non-performing Asset in India in the global context : similarities, dissimilarities and remedial measures" Mr. Prashant R. Reddy analyzed the noticeable improvement in the financial health of Indian Banking Sector as the ratio of gross NPA and net NPA to total credit have been falling from 23-18% and 12.4 % to 14.46% & 6.74 % respectively. On his research he further analsed that "the level of NPA on large industrial sector is very high in India but the overall level of NPA of Indian Banking Sectors seems low and manageable in comparison to china's 28% and Indonesia's 26 %"(Reddy R.P., I.I.M.A. reserch paper,2000)

2.4.2 **Review of Related Studies in Nepal**

Starting from the period of selection of topics and preparing proposal for research work, the researcher has visited various library of the campus under Tribhuvan University and consulted with personals working in the industry under study. The NPA is being burning issue in Nepalese banking industry therefore; the researcher has taken an initiation to study on the topics. Association of study with the researcher's own working field also encourages to take this initiative. Regarding other research studies there are primary data used but here the study has been undergone by using secondary data. Normally, other researches have been conducted comparing two /three or various other commercial banks but in my research one and only Nepal SBI Bank NPA has been anaysed and came to a certain conclusion.

Further the researcher have taken the reference of various NPA research studies conducted in the T.U. But this research work is different from that of the various other research done in NPA management. It can be said different in the following sense.

- In this research work there is only data taken from the secondary methodology whereas many thesis have been found using primary data.
- The five years period has been taken for the study purpose ie,(2059-2064) which is the most recent data, whereas other researches are made of earlier or old data.
- The Sample Bank taken for the study purpose is only one Bank ie, Nepal SBI Bank Ltd. whereas I have found most of the research of comparative study of the

various commercial banks. So, more descriptive and detailed study has been done for the NPA management of Nepal SBI Bank.

CHAPTER III

RESEARCH METHODOLOGY

3.1 Introduction

Research Methodology is a systematic way to solve the research problems. It describes the methods and process applied in the entire aspects of the study. “Research methodology refers to the various sequential steps to be adopted by a researcher in studying a problem with certain object/objects in view"(Kothari, 1990-15)

3.2 Research Design

This study follows both the descriptive and analytical approaches This study is designed to explore the various factors whichever are responsive or the conversion of good loans into bad, to measure the level of non performing assets which the sample bank.

The research covers one of the major commercial bank in Nepal. The research has its basic objective to figure out problem therein and provide them with some recommendation. The literature has been reviewed especially from the past thesis conducted on same aspects of commercial banks. The data for the research are of secondary type.

3.1.1 Sources of Data

The main objective of the study is to find the NPA management of NSBL on the basis of past and present management practice of the bank. So, the data presented in this study are from ***secondary sources***. The annual reports of the bank are the major sources of the data for the study. However, besides the annual reports of the subjected bank the following sources of data shall also be used in the respective corner of the study;

1. NRB Reports
2. Various publications dealing with the subject matter of the study
3. Various articles published in magazines
4. Websites of different institutions

Besides the above, any kind of other sources, such as assertions, interviews, remarks by the specialist of the subject, those are capable in providing valuable data and conclusion, shall be considered in the study.

3.1.2 Data Collecting Procedures

The annual reports of NSBL were obtained from the corporate office of the bank. NRB publications, such as quarterly economic bulletin, banking and financial statistics, economic report, annual reports of NRB etc. have been collected from the website of NRB www.nrb.gov.np.

3.3. Tools and Techniques for Analysis

To analyze and interpret the financial data of sample banks various financial and statistical tools and techniques have been used in the study. It is true that suitable or appropriate tools, according to nature of statement and data make the analysis more effective and significant. For achieving this objective, basically two sorts of tools are used: financial and statistical. Brief discussions of these tools are as follows:

3.3.1 Financial Tools

As this study is related to the analysis of NPA, Financial tools are more useful. They helps to analyze the level and position of sample Banks with respect to NPA. In spite of various financial tools available, the researcher has primarily stressed on ratio analysis assuming the most suitable tools to analyze the level of NPA. "An arithmetical relationship between two figures is known as ratio"(Pandey, 1998 21). Ratio analysis is a powerful tool of analysis as it reflects the position of one variable with respect to other one. Profitability is the major indicator of financial soundness of an organization. NPAs are directly related to the profitability of the bank as they reduce the portion of earning assets and eats parts of income by means of provisioning to them. The absolute NPA figures presented in the financial statements do not provide meaningful understanding of the position of NPA which, they are holding. Any figure conveys meaning only when it is related to some other relevant information. Therefore, the relationship between two figures, expressed mathematically, is known as ratio. Ratio helps to summarize the large quantities of financial data and to make qualitative judgment and conclusions from the analysis of those.

Following Ratio which are relevant to the analysis of NPA are analyzed in this study.

3.3.1.1 Gross NPA Ratio

This ratio reflects the position of total non performing assets out of the total loans and advances of an organization. Gross NPA is the sum total of substandard, doubtful and bad loan as described and categorized by NRB directives. Gross NPAs are analysed with respect to total assets, total loans and advances.

$$\text{Gross NPA as \% of Total Assets} = \frac{\text{Non performing Assets}}{\text{Total assets}} * 100$$

$$\text{Gross NPA as \% of Total Loans} = \frac{\text{Non performing Assets}}{\text{Total Loans \& Advances}} * 100$$

3.3.1.2 **Net NPA Ratio**

This Ratio reflects the position of those loans and advances to which there is no cushion in order to protect from future degradation of loans.Net NPA is obtained by subtracting the amount of loan loss provisioning for NPAs from the amount of gross NPA. Gross NPAs are analysed with respect to total assets, total loans and advances.

$$\text{Gross NPA as \% of Total Assets} = \frac{\text{Net NPAs}}{\text{Total assets}} \times 100$$

$$\text{Gross NPA as \% of Total Loans} = \frac{\text{Net NPAs}}{\text{Total Loans \& Advances}} \times 100$$

3.3.1.3 **<u>Ratio of Loan loss Provisioning to NPA</u>**

This Ratio analysis the portion of those non performing assets which are secured by means of provisioning. Higher this ratio indicates that the bank is in safe position with regards to further degradation of quality of loans. Higher this ratio is good for banking industry. This ratio is analysed by using the formula given below:

$$\text{\% of NPA secured by provisioning} = \frac{\text{Loan Loss Provisioning}}{\text{Non-performing assets}} * 100$$

3.3.1.4 **Ratio of net NPA to gross NPA**

This is the very important ratio in analysis of NPA. As net NPA is the amount of loans and advances against which there is no provision is maintained. This ratio helps to analyze that among the total NPAs how much are not protected by means of provisioning. Higher of this ratio is considered dangerous from the viewpoint of further -provisioning in coming future. For the convenience of study this ratio is analysed by using the following formula-.

$$\text{Net NPA as \% of gross NPA} = \frac{\text{Net NPA}}{\text{Gross NPA}} * 100$$

Apart from the ratios as mentioned above different graph charts were also used to analyze and present the primary data collected from respondents. The so collected are tabulated, analyzed and interpreted accordingly to explore the objectives set by researcher.

3.3.2 **Statistical Tools**

Although various statistical tools were available to analyze the data, the researcher has selected following statistical tools which are most suitable and commonly used to obtain the desired objectives of the study.

3.5.2.1 **Arithmetic Mean or Average (X)**

An average is the value, which represents a group of values. It depicts the characteristic of the whole group. It is an envoy of the entire mass of homogeneous data. Generally the average value lies somewhere in between the two extremes, i.e. the largest and the smallest items. It is calculated as follows:

$$\text{Arithmetic Mean } (\text{-}X) = \frac{XI + X2 + X3 \ldots\ldots\ldots\ldots\ldots + Xn}{N}$$

or, $$X = \frac{\sum X}{N}$$

Where,

$\sum X$= Sum of the sizes of the items

N= Number of items

3.3.2.2 **Standard Deviation (CV)**

Karl Pearson first introduced the concept of standard deviation in 1983. "Standard deviation is the positive square root of the arithmetic average of the squares of all the deviations measured from the arithmetic average of the series. The standard deviation measures the absolute dispersion of a distribution. The greater the amount of dispersion the greater the standard derivation, i.e. greater will be the magnitude of the deviations of the values for their mean. A small standard deviation means a high degree of uniformity of the observation as well as homogeneity of a series. Standard Deviation is denoted by a Greek letter (Sigma) and is calculated as follows"(Gupta S.C., 1998 :380).

3.3.2.3 **Coefficient of Variation (C.V.)**

It is the measurement of the relative dispersion developed by Karl Pearson. It is used to compare the variability of two or more series. The series with higher coefficient of variation is said to be more variable, less consistent, less uniform, more stable and more homogeneous. On the contrary the series with less coefficient of variation is said to be less variable, more consistent, more uniform, more stable and more homogenous. It is denoted by C.V. and is obtained by dividing the standard
deviation by arithmetic mean. Thus

$$\text{Coefficient of Variation (C.V.)} \quad \frac{\text{S.D. x 100}}{\text{Mean}} = \frac{\exists \text{ x 100}}{X}$$

Where,

$\exists$ = Standard Deviation

X = Mean

3.3.2.4 **Trend - Percentage Method (Index Number)**

In financial analysis the direction of change over a period of years is of crucial importance. For trend analysis, the use of index number is generally advocated. The procedure followed is to assign the number 100 to items of the base year and to calculate percentage changes in each item of other years in relation to the base year. This procedure may be called as Trend - Percentage method (Joshi P.R.,2001 .173).

There are various phenomena, which change with the passage of time. An index number is a statistical device assigned to measure the relative change in the level of phenomena (variable or group of variables) with respect to time, geographical location or other characteristics. So index number is a device for measuring changes in the magnitude of the phenomena from time to time or even from place to place. The careful study of relative changes that have taken place in the past helps to forecast the future trend and tendencies.

Index number or Trend - percentage method is used in this study to evaluate trends of non- performing assets.

3.3.2.5 **Correlation Analysis**

The correlation coefficient analysis refers to the tool used in measuring the closeness of the relationship between variables. The term correlation (co -variation) indicates the relationship between two such variables in which with changes in the values of one variable, the values of the other variables also changes. If two or more quantities vary in sympathy so that the movements in the one tend to be accompanied by corresponding movements in the other they are said to be correlated. Correlation also means that between two series or groups of data there exists some casual connection. "The correlation analysis attempts to determine the degree of relationship between variables, when the relationship is of a quantitative nature, the appropriate statistical tool for discovering and measuring the relationship is known as correlation"(Joshi P.R., 2001 - 163). Correlation Coefficient is used in the study to determine the relationship of NPA with profitability indicators such as ROL, ROE, ROA, Provisioning, Interest Suspense and loan portfolio.

Interpretation of Correlation Coefficient (r)

When r =1, there is positively perfect correlation between the two variables.When r = -1, there is negatively perfect correlation between the two variables. When r = 0, the variables are uncorrelated. Nearer the value of r to + 1, closer will be the relationship between two variable and nearer the value of r to 0, lesser will be the relationship. One very convenient and useful way of interpreting the value of coefficient of correlation between two variables is to use square of coefficient of correlation, which is called coefficient of determination. The coefficient of determination thus equals r2. If the value of r = 0.9, r2will be 0.81 and this would mean that 81% of the variation in the dependent variable has been explained by the independent variable. It is much easier to understand the meaning of r2 than r and therefore, the coefficient of determination should be preferred in presenting the result of correlation analysis.

CHAPTER IV

PRESENTATION AND ANALYSIS OF DATA

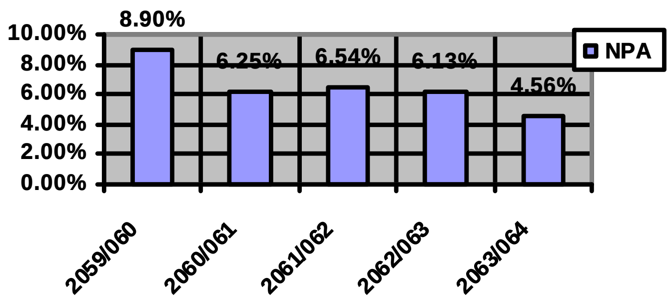
In this chapter, data collected from secondary sources are presented and analysed by using various financial and statistical tools and techniques. In this chapter the researcher aims to draw conclusion regarding position of NPA of sample bank. Various factor contributing for NPA, impacts of NPA on profitability and other suggestive measures for the management and mitigation of NPA.

4.1 COMPARATIVE STUDY OF NPA ON INDUSTRY AVERAGE AND NEPAL SBI BANK LTD.

Here NPA of Nepal SBI bank Ltd., for five consecutive year from fiscal year 2059 - 2064 has been presented.

INDUSTRY AVERAGE for NPA in the year 2064: 8.47%

Year	2059/2060	2060/2061	2061/2062	2062/2063	2063/2064
NPA	8.90%	6.25%	6.54%	6.13%	4.56%



As we can see that the NPA trend of Nepal SBI Bank Ltd. is decreasing. In the year 2059/060 the NPA has rose to 8.90% and in the year 2060/061 the NPA level has rose to 6.25% but has shown a good fall. That may be because of rigorous follow up in the process of converting good loans into bad loans. Again in the year 2061/062 the NPA level has mounted a small growth of 6.54%, again in the year 2062/063 it showed a tiny fall of 6.13% and again in the year 2063/064 the NPA has declined with a good speed of 4.56%. So, with subjective analysis the 2063/065 NPA level of Nepal SBI Bank, we can say that Nepal SBI Bank's NPA is under the industry average. But still Nepal SBI Bank still need to have a rigorous follow up in order to lower down the NPA level to the most minimal level.

<u>TOTAL ASSETS, TOTAL DEPOSIT AND TOTAL LENDING AND NPA 'S OF NSBL.</u>

Fiscal Year	Total Assets	Total Deposit	Total Lending	Total NPA
2059/60	7,56,63,26,661	14,46,94,881	4,468,719,748	426,947,082
2060/61	8,440,405,808	7,198,327,428	5,143,662,078	345,821,458
2061/62	10,345,373,370	8,654,774,214	6,213,878,776	441,017,011
2062/63	13,035,839,124	11,002,040,633	7,626,736,137	505,336,919
2063/64	13,901,200,559	11,445,286,030	9,460,450,701	458,755,741

<u>Table.4.1</u>

<u>NPA Ratio Analysis of NSBL</u>

Nepal SBI Bank is a reputed joint venture bank. It has completed fifteen successful years of operation. Here data collected from various sources of the bank are resented and analysed.

SN	Particulars	2059/060	2060/061	2061/062	2062/063	2063/064
1	% performing to TA	57.74%	61.44%	60.88%	59.35%	69.10%
2	% performing to total lending	91.10%	93.75%	93.46%	93.87%	95.44%
3	% performing to total deposit	66.98%	72.04%	72.77%	70.32%	83.93%
4	% non performing to shareholder's equity.	74.92%	55.19%	64.00%	51.44%	39.43%

Table no. 4.2 (sources Annual report, Nepal SBI Bank Ltd.,)

As we can see that in the fiscal year 2059/061 the percentage of performing loan to total assets was 57.74% which gradually increases in the subsequent years, which is of course a good signal for the betterment of the Bank, because when the total performing assets increases the bank's worth also increases. But we can see that in the fiscal year 2062/063 the performing to total assets falls a little bit which shows that the bank is not able to control and supervise its lending properly or in the best possible manner. It also indicate that the Bank could not be able to analyse the creditworthiness of the borrower who were unable to repay its lending within the stated period. We can see that the percentage of performing to total deposits also increases in a good speed, which is also equally good signal for the welfare of the bank. Similarly, we can see that the ratio of non performing assets to the shareholders equity was high in the earlier year ie, 2059/061 but in the later year we can see that it is decreases which shows that the bank is not able to keep a balance in the level of NPA which is growing with the growth of the loan portfolio of the bank. So, bank must keep an sharp eye on the management of the NPA which must be brought in the optimum level to reap all the benefit of the bank's effort.

Analysis of Net NPA

Net NPA is the total of those non performing assets where there is no cushion maintained for possible losses on the value of loans. In other words net NPA is the value of loans after subtracting specific provisioning from gross amount of NPA. Net NPA reflects the actual position of bad loans on the total loan portfolio. Net NPA are also analysed with respect to total assets and total Loans.

Net NPA level of NSBL (amounts in lacs)

F/Y	**2059/060**	**2060/061**	**2061/062**	**2062/063**	**2063/064**
Total Assets	7566.33	8440.41	10345.37	13035.84	13901.20
Total lending	4795.71	5531.74	6739.06	8214.31	10065.28
Total NPA	426.95	345.82	441.02	505.34	458.75
Provisionig for NPA	327.12	388.17	525.47	614.72	604.60
Ratio of Net NPA as % of Total Assets	2.50%	0.57%	0.23%	0.06%	0.09%
Ratio of Net NPA as % of Total Lending	44.28%	13.94%	5.30%	1.53%	2.64%

Table 4.3

NPA Ratio Analysis of NSBL:

NPA analysis is one of the major aspects of this research as one of the main objectives of this study is to analyse the level of NPA on the sample Bank ie, Nepal SBI Bank Ltd.

While analyzing the NPA, two categories of NPA are analysed. They are gross NPA and net NPA. All necessary calculations are done by using the programme spss 10.00.

4.1 Analysis of NPA

Gross NPAs, in addition to the amount of net NPAs also include the provisions held by the Bank, the amount of recoveries but not appropriated in the accounts for various reasons, due to which the amount of gross NPAs will be more than the amount of net NPAs. Gross NPA is the sum total of those loans and advances which are due for more than 90 days. More specifically they are the sum total of loans and advances categorized as substandard, doubtful, and bad loans according to NRB directives. Since, NPA are the part of Banks assets they are analysed with respect to total assets and loans.

Net NPA as a % of TA (Rs. In Million)

Fiscal Years	Net NPA	Total Assets	Ratio
2059/060	189.05	7566.33	2.50%
2060/061	48.21	8440.41	0.57%
2061/062	23.38	10345.37	0.23%
2062/063	7.74	13035.84	0.06%
2063/064	12.10	13901.20	0.09%
Mean			0.69%
S.D.			1.03%
C.V.			149.93%

Table.4.4

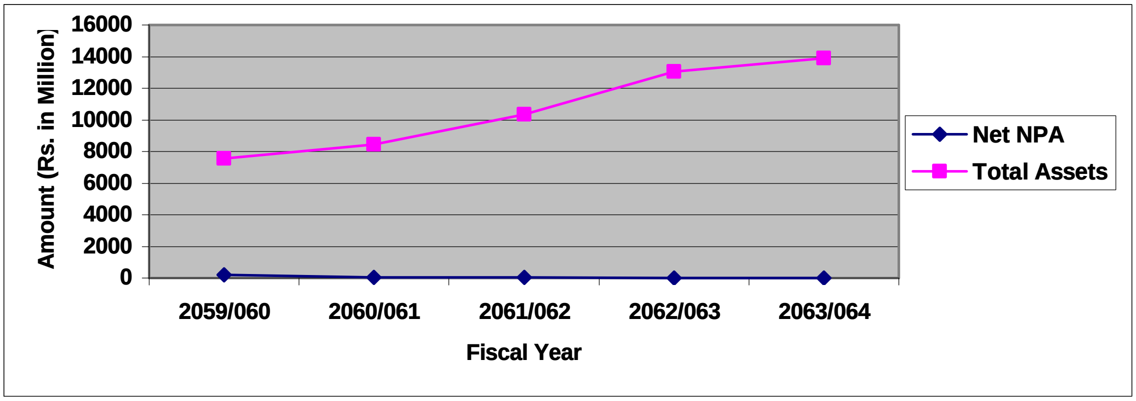


Figure 1

By analyzing the table presented above it is found that the NSBL is holding high NPA with respect to total assets. It seems not very much fluctuating in the period of study. We can see that the standard deviation and coefficient of variation of NPA with respect to total loans are 0.69%, 1.03% and 149.93% respectively. By analyzing this figure we can conclude that NPA of NSBL with respect to total Assets are in steady growing and very less fluctuating.

Calculation of Correlation Between Net NPA as a % of TA of NSBI

Coefficient of Correlation between Net NPA and Total Assets measures the degree of relationship between them. Hence total Assets is independent variable (y) and total NPA is dependent variable (x). As the Total NPA totally depends upon the Assets of the Banks and its effective measures to utilize it in the best possible way. The computation of ‘r’ between these two variables helps us to justify whether total assets is significantly correlated with net NPA or not.

Net NPA as a % of TL

F/Y	Net NPA	Total Assets	
2059/060	189.05	7566.33	
2060/061	48.21	8440.41	
2061/062	23.38	10345.37	
2062/063	7.74	13035.84	
2063/064	12.10	13901.20	
R			-0.7609
R^2			0.5789
P.E.			0.1270
6P.E.			0.7621

Table 4.5

Coefficient of Correlation between Net NPA and Total Assets:

Table 4.5 shows that the coefficient of correlation between net NPA and total Assets of NSBL is –0.7609, which means it, is negatively correlated. Whereas coefficient of variation between net NPA and total Assets is 0.5789, which indicates that only 5.7% of the total variation in dependent variable that is net NPA has been explained by independent variable (Y) that is total Assets. Moreover by considering the value of ‘r’ it has been found that the value of 6PE is greater than the value if ‘r’ which shows that there is no significant relationship between total NPA and total Assets.

Net NPA as a % of TL (Rs. In Million)

Fiscal Years	Net NPA	Total Loan	Ratio
2059/060	189.05	4795.71	3.94%
2060/061	48.21	5531.74	0.87%
2061/062	23.38	6739.06	0.35%
2062/063	7.74	8241.31	0.09%

2063/064	12.10	10065.28	0.12%
Mean			1.07%
S.D.			1.63%
C.V.			151.91%

Table. 4.6

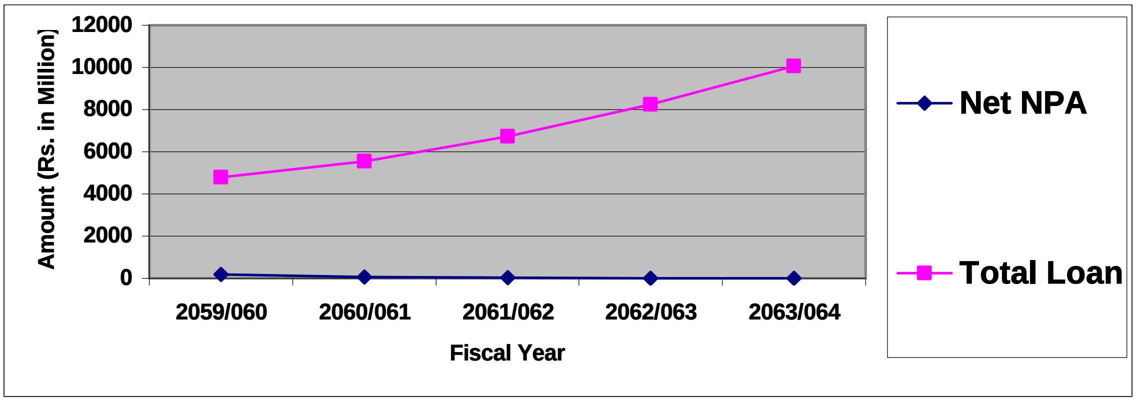


Figure 2

By analyzing the table presented above it is found that the NSBL is holding high NPA with respect to total lending. It seems not very much fluctuating in the period of study. We can see that the standard deviation and coefficient of variation of NPA with respect to total loans are 6.48%, 1.56% and 24.07% respectively. By analyzing this figure we can conclude that NPA of NSBL with respect to total loans are in steady growing and very less fluctuating.

iv. **Calculation of Correlation Between Net NPA as a % of TL of SBI Bank**

F/Y	Net NPA	Total Loan	
2059/060	189.05	4795.71	
2060/061	48.21	5531.74	
2061/062	23.38	6739.06	
2062/063	7.74	8241.31	
2063/064	12.10	10065.28	
R			-0.7260

R^2	0.5270
P.E.	0.1427
6P.E.	0.8560

Table 4.7

Above table shows that the coefficient of correlation between net NPA and total lending of NSBL is –0.7260, which means it, is negatively correlated. Whereas coefficient of variation between net NPA and total lendings is 05270, which indicates that only 5.3% of the total variation in dependent variable that is net NPA has been explained by independent variable (Y) that is total lending. Moreover by considering the value of 'r' it has been found that the value of 6PE is greater than the value if 'r' which shows that there is no significant relationship between total NPA and total lending.

Analysis of NPA with respect to total Loan Loss Provision:

Loan loss provision is a vehicle to adjust in the loss arising out from the gone loan. Higher amount of provisioning indicates that the Bank is maintaining sufficient cushion for the loss that could arise in the future. Analysis of NPA with respect to provisioning reflects the position of future loss that could be arising from the future degradation of loan.

Loan Loss Provision as % of NPA (Rs. In Million)

Fiscal Years	Loan Loss Provision	Total NPA	Ratio
2059/060	327.12	426.95	76.62%
2060/061	388.17	345.82	112.25%
2061/062	525.47	441.02	119.15%

2062/063	614.72	505.34	121.64%
2063/064	604.60	458.75	131.79%
Mean			112.29%
S.D.			21.14%
C.V.			18.83%

Table 4.8

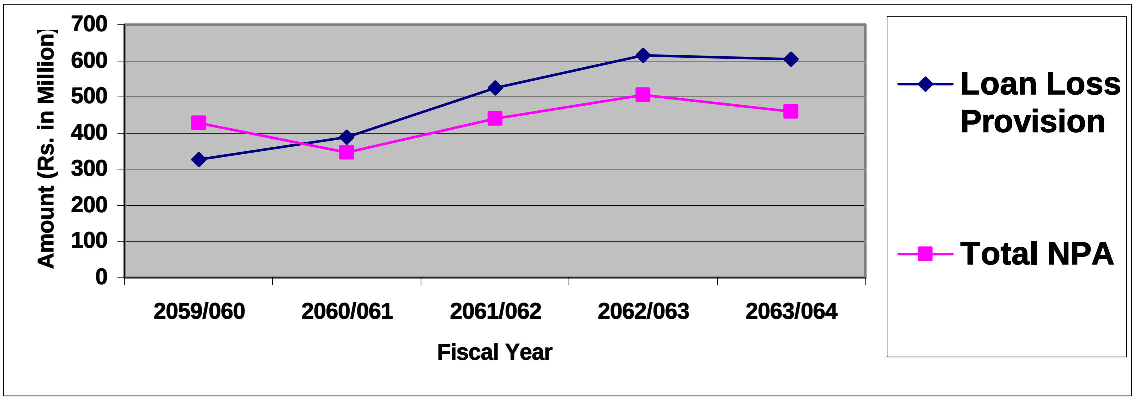


Figure 3

Amount of loan loss provisioning over the total NPA of NSBL are ranging from 76.62% to 119.15% during the period of study, Mean, S.D, and C. V of loan loss provisioning to NPA are found 12.29%, 21.41% and 18.83% respectively. These statistical figures impels us to conclude that 112.29% of total NPA of NSBL are secured by loan loss provisioning during the period of study and there is moderate fluctuation in the growth of loan loss provisioning with respect to portion of non performing assets which they are holding in their portfolio.

Coefficient of Correlation between NPA and loan loss provision:

Coefficient of Correlation between NPA and loan loss provision measures the degree of relationship between two of them. Here total NPA is an independent variable (x) and loan loss provisioning is dependent variable (Y). The computation of ‘r’ between these two variables helps us to justify whether loan loss provisioning are significantly used or not.

ii. **Calculation of Correlation Between Loan Loss Provision as % of NPA of Nepal SBI Bank**

F/Y	Loan Loss Provision	Total NPA	
2059/060	327.12	426.95	
2060/061	388.17	345.82	
2061/062	525.47	441.02	
2062/063	614.72	505.34	
2063/064	604.60	458.75	
R			0.7339
R^2			0.5386
P.E.			0.1392
6P.E.			0.8351

Table 4.9

Above table reveals that, the coefficient of correlation between NPA and loan loss provisioning of NSBL is 0.7339. It indicates that there is possible relation between these two variables. The value of coefficient of determination (r2) is 0.5386 which indicates that there is only 53.86% of the variation in dependent variable has been explained by independent variable. Moreover by considering probable error, we can say that there is no significant relationship between net NPA and loan loss provisioning because the value of r is less than six times of PE.

Analysis of Net NPA with respect to Gross NPA:

This is very important ratio in analysis of NPA. As net NPA is the amount of loans and advances against which there is no provision is maintained. This ratio helps us to analysis that among the total NPA how much are not protected by means of provisioning. Higher the ratio is considered dangerous from the viewpoint of further provisioning in coming future.

The analysis between net NPA and gross NPA defines how much if any lacks provisioning.

Net NPA as a % of Gross NPA (Rs. In Million)

Fiscal Years	Net NPA	Gross NPA	Ratio
2059/060	189.05	426.95	44.28%
2060/061	48.21	345.82	13.94%
2061/062	23.38	441.02	5.30%
2062/063	7.74	505.34	1.53%
2063/064	12.10	458.75	2.64%
Mean			13.54%
S.D.			17.86%
C.V.			131.93%

Table 4.10

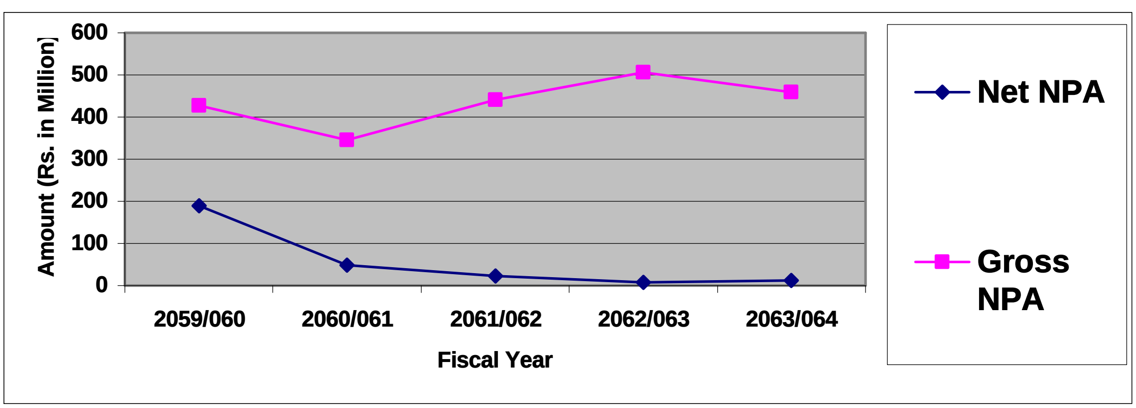


Figure 5

Portion of net NPA out of gross NPA of NSBL during the period of the study are ranging the period of the study are ranging from 1.53% to 44.28%. Average, S.D, and coefficient of variation of net NPA with respect to Gross NPA are 13.54%, 17.86% and 131.93%.

The statistical figure suggest that on average 13.54 % of NPA of NSBL are secured by means of provisioning. Net NPA with respect to total NPA are moderately fluctuating during the period.

Net NPA and gross NPA

Coefficient of correlation between gross NPA and net NPA measures the degree of relationship between two of them. Here net NPA is dependent variable and gross NPA is independent variable (Y). The computation of 'r' between these two variable help us to justify whether net NPA is significantly correlated with gross NPA or not.

ii. Calculation of Correlation Between Net NPA as a % of Gross NPA

of SBI Bank

F/Y	Net NPA	Gross NPA	
2059/060	189.05	426.95	
2060/061	48.21	345.82	
2061/062	23.38	441.02	
2062/063	7.74	505.34	
2063/064	12.10	458.75	
R			-0.2831
R^2			0.0802
P.E.			0.2775
6P.E.			1.6648

Table 4.11

Above table shows that the coefficient of correlation between net NPA and gross NPA is -0.2831 which shows that there is negative correlation between the variables. Considering the coefficient of determination, the value is 0.0802 which indicates that only 8% of the variation in dependent variable (net NPA) has been explained by independent variable (gross NPA). Moreover by considering the value of' 'r' it has been found that the value of 6PE which shows that there is no significant relationship between gross NPA and net NPA.

v. **Calculation of Correlation Between NPA as a % ROA of NSBL Bank**

Here, the coefficient of correlation between NPA and return on assets measures the degree of relationship between two of them.Here for calculation, NPA has been taken as independent variable (x) and ROA as dependent variable (y). computation of correlation of coefficient ie. r,r2 and p.Er and six times probable error 6p.Er

F/Y	NPA	ROA	
2059/060	426.95	0.0064	
2060/061	345.82	0.0072	
2061/062	441.02	0.0055	
2062/063	505.34	0.0090	
2063/064	458.75	0.0183	
R			0.3138
R^2			0.0985
P.E.			0.2719
6P.E.			1.6316

Table 4.12

Above figures reavels that the coefficient of correlation between NPA and ROA is 0.3138 which means only there is positive relationship between the variables.The coefficient of determination (r2) of these two variables are found to be 0.0985 which means that only 9.8%of the variation in the dependent variable (ROA) has been explained by the independent variable (NPA).Considering the value of ‘r’ and comparing it with six times P.Er, it has been found that the value of ‘r’is less than the value of 6 P Er. ie, 0.3138Ψ1.6316, which indicates that there is no significant relationship between NPA and ROA.of NSBL.

vi. **Calculation of Correlation Between NPA as a % ROL of NSBL Bank**

Here, the coefficient of correlation between NPA and return on lendings measures the degree of relationship between two of them.Here for calculation, NPA has been taken as independent variable (x) and ROl as dependent variable (y). computation of correlation of coefficient ie. r,r2 and p.Er and six times probable error 6p.Er

F/Y	**NPA**	**ROL**	
2059/060	426.95	0.0109	
2060/061	345.82	0.0118	
2061/062	441.02	0.0923	
2062/063	505.34	0.0153	
2063/064	458.75	0.0269	
R			0.1290
R^2			0.0166
P.E.			0.2966
6P.E.			1.7798

Table 4.13

Above figures reavels that the coefficient of correlation between NPA and ROL is 0.1290 which means only there is positive relationship between the variables.The coefficient of determination (r2) of these two variables are found to be 0.0166 which means that only

1.6 %of the variation in the dependent variable (ROL) has been explained by the independent variable (NPA).Considering the value of ‘r’ and comparing it with six times P.Er, it has been found that the value of ‘r’is less than the value of 6 P Er. ie, 0.1290Ψ1.779, which indicates that there is no significant relationship between NPA and ROL.of NSBL.

4.5 Trend Analysis:

By this calculation, an attempt has been made to analyse the total NPA level of NSBL for the study period. ie, 2059/060 to 2064/065.An attempt has been made to analyse the total loan and advance of NSBL for the period of study of 2059-2064 and to forcast the total NPA of NSBL for next five years ie, 2059-2064 by making trend analysis.

Trend Value of NPA of NSBL (Rs. In Million)

Fiscal Year (t)	Total NPA (y)	x = (t-2062)	X^2	Xy
2059/060	189.05	-2	4	-378.1
2060/061	48.21	-1	1	-48.21
2061/062	23.38	0	0	0
2062/063	7.74	1	1	7.74
2063/064	12.10	2	4	24.2
N = 5	280.48	0	10	-394.37

Table 4.14

$$a = \frac{y}{N} = \frac{280.48}{5} = 56.096$$

$$b = \frac{xy}{x^2} = \frac{-394.37}{10} = -39.437$$

The Equation of the Straight Line Trend is;

$$Y_c = a + bx$$

$$Y_c = 56.096 + (-39.437)x$$

Year	x = (t-2003)	Trend Value 56.096 + (-39.437)x
2059/060	-2	134.97
2060/061	-1	95.533
2061/062	0	56.096
2062/063	1	16.659
2063/064	2	-22.778
2064/065	3	-62.215
2065/066	4	-101.652
2066/067	5	-141.089
2067/068	6	-180.526
2068/069	7	-219.963

Table 4.15

From the above table, we analyse can that the expected amount of NPA are in decreasing trends. As we can see that in the year 2059/060 the NPA is highest and then after the rate of goes on decreasing. In the year 2061/061, it lowers down to 95.53 and in the year 2061/062 it lowers down to 16.569. And from the year 2063/064 the expected value of NPA of NSBL starts decreasing in the high rate. The Year 2063/064 has 22.778 NPA values which indicates that the Bank will be able to get over the bad loans very well. As now every Banks has made their strategic plan to reduce NPA to the minimum level. So NSBL may also use different tools and techniques which will help to lower down the NPA level. In the same way in other subsequent years also, we can see that the NPA level is lowering down and down which is of course a very good sign for Bank's growth and prosperity as the bank can get higher profit with low level of NPA. Such phenomenon not only gives short term benefit but also long lasting advantage to the Bank.

4.6 NRB guidelines and NSBL set standard for NPA for five years (2059-2064)

Year	LOAN CATEGORY							
	PASS		SUBSTANDARD		DOUBTFUL		BAD	
	Insured	Uninsured	Insured	uninsured	insured	insured	Insured	uninsured
2059	NA	2%	NA	26%	NA	50%	NA	100%
2060	0.26%	1%	6.25%	25%	12.5%	59%	25%	100%
2061	0.25%	1%	6.25%	25%	13%	50%	25%	102%
2062	0.25%	1%	6.25%	25%	13%	50%	25%	100%
2063	0.38%	1%	6.25%	25%	NA	50%	25%	100%
2064	0.43%	1%	6.25%	25%	20.42%	50%	31.15%	100%

Table 4.16

In the above table, I have compared the Nepal Rastra Bank established standard of NPA provisioning, with Nepal SBI Bank’s five consecutive year’s (2059-2064) NPA provisioning. For more comparative study let us see the NRB’s standard NPA provisioning guideline table for NPA.

LOAN CATEGORY	% PROVISIONING
Pass loan	1%
Substandard loan	25%
Doubtful loan	50%
Loss loan	100%

Table 4.17

The table above is the NRB’s guideline about the loan loss provisioning. As there should be rigorous follow up, proper planning and monitoring if any loan goes doubtful, substandard or bad. So, every bank should follow the guidelines made by NRB so as to save themselves from the future losses arising out from the non performing loans. As we can see that there are two categories in the provisioning of loan loss. The insured and the uninsured category.

LOAN CATEGORY	**% PROVISIONING (under insured category)**
Pass loan	0.25%
Substandard loan	6.25%
Doubtful loan	12.50%
Loss loan	25.00%

Table 4.18

Since,2059 there is provision of registering the loans under deprived sector under DICGC viz, deposit Insurance credit guarantee corporation. Under this scheme 1% premium p.a. of the total loan amount. And incase of default, we compensate 75% from the DICGC. So, under this sector, only one fourth of the total loan amount must be provisioned. That is the reason for less percentage of provision figure in the five years from 2059-2064.

So, from the above detail analysis report, we can say that Nepal SBI Bank has well maintained the NPA provisioning in the five consecutive years. As we can see that, in some years there is provisioning above the standard that may be because of the immediate crisis that may arose from any loan files. So, above the standard provisioning is just to make more secure the loan losses.

Major Findings of the Study:

In this part major findings of the study are presented. All these findings are based on the data analysed and presented above. Major findings of this study are presented below.

Findings of NSBL:

While analyzing the NPA's of NSBL, it is found that the NPA's of NSBL are found slowly increasing and with the increase in the loan portfolio. NSBl has increasing amount of gross NPA but moderate amount of net NPA. More than 70% of NPA's are secured by loan loss provisioning. Net NPA with respect to NPA are nearly 55%. Here we can see that there lies positive relationship between NPA and ROA and NPA and ROL. Total loans, Total NPA, Loan Loss Provisioning are increasing during the period of the study. Correlation of NPA with total loan portfolio, loan loss provisioning is also very high but positively in the same direction. While negative correlation of NPA with ROA and ROL explains that the NPA gives adverse impacts on the growth of these profitability indicators.

Findings of Comparative Study of NPA Industry average and NSBL's NPA:

From the comparative study done with the Nepal SBI Bank Ltd., and NPA industry average it has been found that Nepal SBI bank Ltd., has maintained under industry average. The industry average is 8.47% where as Nepal SBI bank Ltd., has maintained NPA quite lower than that. So, there is somewhat relief in this context but still according to the international norm the NPA level should not exceed 5%.

Findings from Correlation Analysis:

- The coefficient of correlation between net NPA and total assets shows negative correlation. The value of 'r^2' in this case is higher than 6.P.E which indicates that the variable have significant relation between them.

- The coefficient of correlation between net NPA and total Lending shows negative correlation. The value of 'r^2' in this case is higher than 6.P.E which indicates that the variable have significant relation between them.
- The coefficient of correlation between net NPA and total Loan Loss Provision shows positive correlation. The value of 'r^2' in this case is less than 6.P.E which indicates that the variable is no significant relation between them.
- The coefficient of correlation between net NPA and gross NPA shows positive correlation. The value of 'r^2' in this case is less than 6.P.E which indicates that the variable is no significant relation between them.
- The coefficient of correlation between net NPA and ROA shows positive correlation. The value of 'r^2' in this case is less than 6.P.E which indicates that the variable is no significant relation between them.
- The coefficient of correlation between net NPA and ROL shows positive correlation. The value of 'r^2' in this case is less than 6.P.E which indicates that the variable have significant relation between them.

Findings from Trend Analysis of NPA of NSBL

The trend analysis of NPA for the next five years reveals that the trend value of NPA level has gone up in the earlier year ie, 2059/060 and gradually it starts decreasing and in the later year the NPA level has been seen in negative which reveals that if the bank takes some good steps in the management of NPA than finally the Bank can get over the crisis swallowing down the profit by provisioning done for NPA.

Findings from comparative analysis of NRB standard for Loan Loss Provisioning and NSBL's Standard.

When studying the Nepal SBI Bank Ltd.,NPA provisioning, it was found that the bank has well maintained provisioning as per Nepal Rastra Bank guidelines.As NSBL has registered itself on DICGC so the provisioning in that case have to be done only 1/4 of the loan amount. And after detail study of this case it has been found that NSBL has maintained well provisioning of NPA under different category very well.

CHAPTER V

SUMMARY CONCLUSION AND RECOMMENDATION

This chapter is the final chapter if the study which consists of the summary of the four earlier chapters. This chapters briefly explains the findings of the study, tries to fetch the out a conclusion of the study and attempts to offer various factors that contribute for the growth of NPAs in Nepelese commercial Banks. As mentioned in the objectives of the study this chapter also summarises the problems area with regards to management of NPA and various impacts of NPA on profitability.

5.1.1 Summary:

Banking industry is one of the most influential and significant industry in any nation. Banking development pulls the economic development of the nation and uplift of living standard of the people. Hence, no doubt banks today have become more necessary and useful than ever. Despite that Banks, today are under more pressure because of competition of non banking financial service firms. Banks have extended their function as well as their branches however there effort are not enough. Hence, Banks have to be very alert and initiative and make strategies which can bring highest profit and capture largest market share. Banks mobiles their funds in loan and advances and investment in different sectors. The most challenging job of any Bank is to make good profit and credit portfolio, which defines the optimum level of NPA level. The ways techniques and methods that describes how to manage the NPA in the given environment is called management of NPA by commercial Bank.

Hence, this study deals with the NPA management of NSBL. This study is based on five consecutive years study with the help of published data of the Bank. To acquire the result of the study different financial and statistical tools and techniques have been used. The financial tools mainly consists of the trend analysis, correlation analysis etc,. These tools put up light in the study and helps to highlight the NPA scenerio of the Nepal NSBL bank Ltd.,

The NPA level of Nepal SBI Bank ltd., is below industry average. So, NSBL is not that risk proned in the view of NPA, but still it needs to have a rigorous follow up to lower down the NPA level to a minimal level.

Nepal SBI Bank has maintained a good position regarding the NPA provisioning as , it adheres all the guidelines given by Nepal Rastra Bank. So, we can say that it has done commendable effort to lower the NPA level. Although the loan portfolio has increased but the NPA seems declining, which is of course a good sign. But still according to international practices, NPA should not be more than 5%, so, keeping this things in consideration, NSBL should take some effective procedures to bring down the NPA level to a minimal level.

This study has been undertaken to analyse as well as explore the various factors contributing for NPAs and their impact on profitability of Nepal SBI Bank. This is done by studying the various figures and factors related to NPAs in terms of their impact on profitability position, their contribution in the growth of NPA and problem area in their effective management. The financial statements of the last five years has been examined for the subject analysis. To analyse the impacts of NPAs are sorted, tabulated, interpreted and correlated by using appropriate tools and tequnices. Since the study is based on historical data the research design designated is historical and of explanatory type.

The study has been divided in the five chapters, they are introduction, review of literature, research methodology, presentation, analysis and interpretation of data and finally, summary, research findings, conclusion and recommendation.

In the first chapter, the general introduction of commercial Banks and their activity with regards to economic upliftment of the country, focus of the study problem identify for the study are presented. Similarly, the objectives of this research study research methodology and significance of the study are also highlighted in this chapter.

In the second chapter conceptual of banking, conceptual review of various terminology related to NPA, review of related research and study etc, have been briefly defined so as to facilitate in the analysis part of the study. For this regard, the various banking related acts, NRB directives, government policies and present scenerio in the area of banking are also reviewed in this chapter.

The third chapter, the data required for the study and the extracts from the secondary data are presented, analysed and interpreted by using various tools and techniques which are useful to analyse the NPA's in the NSBL under study.

In the fourth chapter, the data required for the study are presentated, analysed and interpretated by using various tools and techniques of the financial management, accounts and statistics to present the result relating to this study.

In the fifth and final chapter consists of the summary of the four earlier chapters. This chapter briefly explains the findings of the study, tries to fetch out a conclusion of the study and attempts to offer various suggestions and recommendations for the proper management of NPA of the NSBL.

Conclusion

In this part conclusions which could be derived from the study are presented. Major conclusion of findings of the study are cited below. These conclusions not only leads on the way meet the objectives of the study but also gives the idea of NPAs of NSBL.

Subjectively talking about the factors that convert good loans into bad loans are political and economic situation of the country, intentions of the borrowers are found more crucial in this phenomenon. Whereas the internal factors are concerned the loop holes in the credit policy of the bank and faults in the credit apprisal system, insufficient control and monitoring system are also equally found responsible in converting good loans into bad loans. Further Stringent NRB guidelines, proper documentations, instability persisting in the country are also contributing in this procedures.

The study also outforces the various factors important for mitigation and management of NPA's.

- Implementation of effective credit control mechanism and monitoring system
- Improvement in credit policy of the Bank
- Good governance system
- Proper and quality delivery of credit services.

While analyzing the NPA's of the NSBL it is found that NSBL should take extensive care for the management of NPA, as we can see that there is fluctuation in the growth of NPA, but with the increase of credit portfolio there is growth of NPA. Gross and net NPA reveals that there is further possibility of turning good loans into bad loans. This could be adverse situation for the Bank to increase the profitability in the future. Although NSBL seems to have some sort of measure to lower the NPA, still the effort is not sufficient. There is high degree of negative correlation between NPA and ROA and ROL, which reveals us to conclude that profitability of NSBL is highly associated with the management of quality of their loan portfolio. Small change or increment in the level of NPA of the bank may highly reduce their profitability in the future.

And here a detail study has been done to evaluate whether NSBL has provisioned as per NRB guidelines or not. So, from that study it has been found that NSBL has done NPA provisioning as per the NRB guidelines very well.

Recommendations

Based on the major findings of this study, some recommendations have been made so as to overcome issues of non performing assets of the banking sector of Nepal.

As the emergence of NPA forces a bank branch to take the income from loan accounts to profit and loss account only if there is actual recovery instead of on accrual basis as is the case with the other accounts. While the bank branches have to pay interest to depositors or to the head office for the funds, they are not able to generate the income from NPA accounts. As a result while there is no decline in the expenditure, the income comes down and results in lower profit or losses.

The growing loan portfolio and NPA is very high. Since the main function of Bank is to lend the loans and advances NSBL should try to increase the loan portfolio. There is high degree of negative correlation exists between NPA and ROA and ROL, this may be due to the large portion of income covered by interest income. So, NSBL should focus on expansion of non fund based business. NSBL must try to improve the quality of their loan portfolio Formulation of NPA management committee and reviewing of its performance on monthly basis may bring some colour in the NPA management.

NPA of NSBL is more than the international norm of 5%. NSBL should take a strict follow up regarding minimization of NPA. But the NPA of NSBL is found to be below the average standard, still in this competitive scenario NPA should really be lowered down to be internationally fit and sound.

As the NPA level of Nepal SBI Bank Ltd, is not very low comparing with the industry average it needs to go for some rigorous follow up of the existing NPA and try to adopt some permanent policies and guidelines which prevents a good loan being a bad loan.

From the analysis and subjective analysis it is found that external factors are more contributing for the growth of NPA in any banks. Though the entire adverse situation related to loan recovery could not be avoided but they can be reduced and mitigated. Credit information system of the bank should be very effective so that the history of the borrower could be find out and lending decision should be made by analyzing the past history with other organization. All banking organization should come under their own one umbrella so that they can raise voices against any adverse changes in government policy and procedures.

Internal factors are in control of the organization itself. Every Banks should try to establish the system of self checking and control in credit department. This can be done by restructuring of department into different sub department as marketing, appraisal and sanctioning, disbursement and credit administration. Credit personnel should be trained in order to avoid the mistake of faulty appraisal of loan proposal.

Collateral appraisal system should be made strong by using independent but recognized valuators.

NPA Department should work in an aggressive manner to have well management of NPA.

Credit officer should also have subjective judgment regarding the appraisal of any loan proposal well in order to evaluate the capacity of the borrower.

As our economy is in declining phase at such circumstances, credit risk or possibility of loan default is high, so loan loss provision should be made strict, baddebt classification standards should be imposed and credit limitation to single borrower should be revived and decreased.

Since some of the problem of NPA arises from improper documentation. Banks should establish a legal department with responsibility of checking and executing of security documents to avoid the problems of improper documentation in time of case filling against defaulters. Apart from this Bank should be careful about the NRB guidelines and other legal procedures that might be obstacle in the management of NPA. They should try to make credit information effective, prompt and on line available so that the quality of credit delivery and appraisal could be made easy and prompt. All Banks should make initiation towards the establishment of Asset Management Company (AMC) so that the bad loans of the Bank could be removed from their Balance sheet.

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ANNEXURE A : ORGANISATION UNDER STUDY

Nepal SBI Bank Ltd.,(NSBL) is the first Nepal-Indo joint venture bank in the country sponsored by three institutional promoters, namely, State Bank of India, Karmachari Sanchaya Kosh (Employees Provident Fund) and Agricultural Development Bank through a memorandum of understanding signed on the 17th July 1992, NSBL started its operation since 8th July, 1993. The Bank was registered on 2050/01/16 (28.04.2008) by the Department of Industry, HMG/N under the company Act 2021and commercial Bank act 2031. The Bank thereafter received certificate of commencement of business on the 30th June, 1993 and the license from Nepal Rastra Bank on the 6th July 1993. NSBL having its formal inauguration on 7th July 1993,commenced its operations on 2050/03/24 (8th July 1993). As per Articles and Memorandum of Association of the Bank, the capital structure of the Bank at present is as under:

Authorised Capital	1,00,00,000 shares of Rs. 100.00 each	Rs.100,00,000,000.00
Issued Capital	50,00,000 shares of Rs. 100.00 each	Rs. 50,00,00,000.00
Paid Up Capital	64,77,984 shares of Rs. 100.00 each	Rs. 64,77,98,400.00

ii. Shareholders Pattern:

State Bank of India	-	50.80%
Karmachari Sanchaya Kosh (EPF)	-	15.24%
Agricultural Development Bank	-	5.08%
General Public of Nepal	-	28.88%

It has been providing services through its 20 Branches and 5 extension Counters. The services provided by NSBL includes deposits, remittances, various types of loan facilities, Letter of credit, Bank Guarantee, retail financing,(housing, vehicle, mortgage, mortgage plus, education etc), 365 days Banking at some branches, evening counters, debit visa card, Bharat Yatra Card,etc.

As Nepal SBI Bank has already set up its standard place in the nepelese Banking Industry. Sooner it will make itself known more exclusively. In Recent days the Nepal SBI Bank Ltd. is going to operate its different branches in the most remote places of Nepal in order to reach the nook and corners of the country in total.