ANALYSIS OF FINANCIAL PERFORMANCE IN THE FRAMEWORK OF CAMEL OF OM FINANCE LIMITED

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RECOMMENDATION

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VIVA-VOCE SHEET

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

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LIST OF ABBREVIATIONS USED

ALLL	: Allowance for Loan and Lease Losses
B.S.	: Bikram Sambat
BAFIO	: Bank and Financial Institutions Ordinance
BCBS	: Basel Committee on Banking Supervision
BIS	: Bank of International Settlements
CAMELS	: Capital, Assets Management, Earnings, Liquidity, Sensitivity
CAR	: Capital Adequacy Ratio
CCAR	: Core Capital Adequacy Ratio
Co.	: Company
CRR	: Cash Reserve Ratio
CV	: Coefficient of Variation
E. Pra.Ni.No.	: Licensed Financial Institutions Directives Number
FDIC	: Federal Deposit Insurance Corporation, USA
FFIEC	: Federal Financial Institutions Examinations Council, USA
EPS	: Earning Per Share
F.Y.	: Fiscal Year
Fig.	: Figure
FISD	: Financial Institution Supervision Department
i.e.	: That is
Ltd.	: Limited
NIM	: Net Interest Margin
NPL	: Non performing Loan
OFL	: Om Finance Limited
PLLL	: Provision for Loan and Lease Losses
RBB	: Rastriya Banijya Bank

ROA	: Return on Assets
ROE	: Return on Equity
Rs.	: Rupee
SCAR	: Supplementary Capital Adequacy Ratio
SD	: Standard Deviation
SEBON	: Securities Board of Nepal
UFIRS	: Uniform Financial Institutions Rating System

CHAPTER ONE

INTRODUCTION

1.1 Background

Nepal is an underdeveloped country. It has been facing many problems in economic development. An organized financial institution like Om Finance Limited has vital role to play mobilizing financial resources. Especially in Kaski District. It has been performing a leading role to the best it's capacity in the promotion of industry, trade and commerce. In the 14th century, Jayasthiti Malla, the ruler of Kantipur, classified the people in 64 classes according to their occupations. Tankadhari was one at the categories of the people who worked as a money lender. Tankadhari invested money to the needy persons by charging some percentage as interest. During the period of Ranodip Singh, Tejarath Adda established in 19th century. Shyam Joshi and Hari Prasad Shrestha, Principle of Bankings insurance (Kathmandu:Taleju Prakashan, 2002)19-20. It was the first step towards the institutional development of banking in Nepal, which granted loan to the people at 5 percent rate against gold, silver and ornaments came in existence. In the beginning, the service was provided to the government service holders repayable in installment basis to their salary. Later, the service was extended to normal people as well. Tejarath was replaced by Nepal Bank Limited. It was established in 1937 A.D. (B.S. 1994.07.30). Therefore B.S. 1994 is called golden period of modern banking in Nepal. Government had responsibility of draw out banking services everywhere in country and also managing financial system in a proper way. Thus Nepal Rastra Bank was established at B.S. 2013.01.14 as a central bank under

Nepal Rastra Bank Act 2012 B.S. Since then, it has been functioning as the government's bank and has contributed to the growth of financial sector, Then many institutions such as Nepal Industrial Development Corporation (1959 A.D.), Rastriya Banijya Bank (1966 A.D.), Agriculture Development Bank (1974 A.D.), were established. Similarly, Nepal Arab Bank Limited, the first Joint venture Commercial Bank was established in 1984 A.D. (B.S. 2041.03.29, rename as Nepal Bank Limited since 1st Jan 2002), Himalayan Bank Limited in 1998 A.D., Everest Bank Limited is 1995 A.D. Then many bank coming in the private sector such as Nepal Bangladesh Bank Limited, Lumbini Bank Limited, Kumari Bank Limited, Laxmi Bank Limited. Nepal Awash Bikash Bitta company Limited is the first finance Company established in 2049 B.S. promoted by RBB, Agriculture Development Bank (ADB) and Nepal Arab Bank Limited. In the same year, Nepal finance and saving Company Limited was established from the private sector. Now there are 59 finance companies in existence. A finance company obtains fund from its own paid-up capital, providing different kinds of financial institutions and lends it to business industry, hire purchase housing and leasing activities. Finance companies are market maker, investigator and user of money market and capital market. Om finance Limited is one of the finance Company established in Pokhara city which is situated at New Road. Om finance Limited started his financial transaction from B.S. 2057.06.01. It started with only 9 employees but now 14 employees are working in the company.

The main objectives of Om finance Limited is to accumulate scattered savings and mobilized it to various planned sectors of economy to support the economic prosperity of the country by then it can provide its services in many ways like

- Collection and mobilization of deposits within the limited specified by NRB.

- Providing term loan to business, industry and trade, serve in the capacity of financial intermediary and also provide guarantee on loan if needed.
- Providing installment or hire Purchase loan.
- To formulate and implement other activities under the rules and regulation provided by NRB.

Performance analysis is the one of the key tools to measure the effectiveness of the institutions. One company used framework for analyzing the health of individual institutions is the CAMEL framework which looks at five major aspects of a financial institutions: Capital Adequacy Assets quality, Management, Earning and Liquidity. Capital adequacy is evaluated in relation to the volume of risk assets, the volume of marginal and inferior quality as sets the banks growth experience, plan and prospects and strength of management. The level of level, distribution and severity of adversely classified assets evaluates assets quality. Earning are evaluated with respect to their ability to cover losses and provide adequate capital protections trends peer group comparisions the quality and compositions of net income and the degree of reliance on interest sensitivity funds. The liquidity of a firm is measured by its ability to satisfy its shortterm obligation as they come due Liquidity refers to the solvency of the firm's overall financial position. Liquidity is evaluated in relation to the volatility of deposits.

1.2 Focus of the Study

Topic itself is very clear about focus of the study Financial performance is the one of the key tools to measure the effectiveness of the institutions. It is a process of identifying the financial strength and weakness of the firm by properly establishing relationship between the items of balance sheet and the profit and loss account.

The research is focused on assessing the financial condition and performance of Om Finance Limited by using descriptive and analytical research design. The study encompasses the five components of CAMELS and carried out with annual reports of condition and income more specifically, the study focuses on the trend analysis of capital Adequacy Ratio, Non performing Loan Ratio, Total Expenses to Income Ratio, Earning on Share, Earning Per employee, return on equity, return on assets, net interest margin, earning per share and liquidity with respect to NRB standard and industrial averages during the period of the five years starting from FY 2059/2060 to 2064/2065.

Thus, whole energy and effort concentrate on analysis of financial performance of Om Finance Limited (OFL).

1.3 Statement of Problem

A Bank's financial soundness is judged on the basis of capital adequacy, assets quality, management, earning, liquidity, sensitivity to market risk (CAMELS). Financial institutions invest huge amount. Almost all the government banks in Nepal are running in loss. Though almost all the Private Sector banks are running earning Profit it is very difficult to call them sound if appraised from CAMELS approach. Some financial institutions (F1) have very low capital Adequacy ratio while some institutions have piled of non performing assets. Similarly, it appears that institutions do not have proper system in managing the market risk. Therefore, these institutions do not able to stand/manage the CAMELS. It is impossible to get their goals without CAMELS analysis. There are some problem in relation to institutional performance in CAMEL analysis. The fundamental problem of this study is to investigate into the financial health of Om Finance Limited in the framework of CAMEL. So the following main problem are going to the Study:

1. How the finance is managing their capital adequacy?

2. What is the quality of assets of OFL?
3. How far OFL is managing the expenses with respect to incomes? And what is the position of earning per employee in OFL?
4. What is the trend of earning performance made by the finance?
5. What is the trend of liquidity position in the finance?

1.4 Objectives of The Study

After democracy in 1990 A.D. the government follows and encourages the free and open market. So the financial activities are increased. The government has adopted a policy to provide maximum banking facilities to the country for rapid economic development by a keen competition among different banks including foreign banks and finance companies. The broad objective of the Study is to analyze the financial health of Om finance. However the specific objectives of the study are:

1. To analyze the capital adequacy of the finance.
2. To asses the quality of assets of OFL.
3. To evaluate whether OFL is managing its expenses with respect to incomes and to analyze the position of earning per employee in OFL.
4. To analyze the trend of earning performance made by the finance.
5. To analyze the liquidity position of the finance.

1.5 Significance of the Study

Research itself has its own importance because it aims to gain knowledge and to add the new literature to the existing field. The significance of this study lies mainly in filling a research gap on the study of financial performance analysis of OFL. A Finance Company can play a vital role in economic development of a nation. Analysis of financial performance in the framework of CAMEL has become significant aspect in the field of managements decision making in all financial institutions.

The present study describes some important aspects of liquidity, earning capital adequacy and assets quality. This study will be usable and valuable to the Om finance Limited, other financial institutions, banks and other interested parties. Therefore, it is one important key tools to check the health of every financial institutions. It can provide the key measurement to reduce weakness of institutional performance and financial danger in future. This is an analytical study. Therefore, this study analyzed the effectiveness of institutional performance of OFL. It may be boost better institutional performance financial strong and guides to planning and control.

So, this Study will be helpful to those also who want to study in further details and widely in this field. At last, it is expected that the study will add a drop of literature to the field of financial institutions and their financial performance analysis.

1.6 Delimitation of the Study

As every study is conducted within certain limitations, the present study is not an exceptional. The research is conducted to fulfill the academic requirement of month of Business Studies. Despite due to the unavailability of detail financial data CAMELS component 'S' is missing in this study considering the lack of related literature and concerning materials, these studies assumes following limitations:

1. The study is only confined to financial performance analysis of Om Finance Performance Limited. So all the activities are intended to analyze the financial performance.
2. The study is mainly bases on secondary sources, last six years data are taken into consideration for the study purpose published by OFL.
3. The Study will be performance analysis in the framework of CAMEL of OFL.

1.7 Organization of the Study

This study is organized into five chapters; introduction. Review of Literature, Research methodology, Data Processing and Analysis and Summary, Conclusions and Recommendation. Introduction Chapters included background, focus of the study, statement of the problem, objectives, significance, Delimitations of the Study and Organization of the Study. Similarly, the second Chapters deals with the review of available literature. It includes conceptual review and review of related studies. The third chapter deals on research methodology used for carrying out the study. It consists of research design, population and sample sources data, data collection procedure, data Processing and data analysis tools. In this way, Presentation and analysis of data is included in chapter four. Finally, the summary , conclusion and Recommendations are given in chapter five.

CHAPTER TWO

REVIEW OF LITERATURE

This chapter deals with conceptual review regarding financial performance analysis and CAMEL framework of financial performance analysis. Past studies carried out on financial performance analysis are also incorporated here. This chapter is divided into two section. Section I deals with theoretical review and the II section presents the review of relevant Past Studies.

2.1 Conceptual Review

This sub-chapter presents the theoretical aspect of the study. It covers the historical development of financial system and evolution of finance companies in Nepal, Concept of finance companies, financial product and services and financial performance approaches.

2.1.1 Historical Development of Financial System and Evolution of Finance Companies in Nepal.

Nepal's formal financial system began in 1937 A.D. with the establishment of Nepal Bank Ltd (NBL) which was the first commercial bank in the country. The Nepal Rastra Bank (NRB), the country's central bank, was established in 1956 A.D. Under the NRB Act 1955 A.D> and the Rastriya Banijya Bank (RBB) was set up in 1966 A.D. as the second commercial bank. Under the RBB Act with a view to expand activities in the banking sector and to provide better banking facilities to the people. In the developing stage of financial institution in Nepal, the establishment of Agriculture Development Bank (ADB) was another significant

achievement. It was established in 1968 A.D.under the ADBN Act 1967 A.D. to address the needs of agriculture sector (Shrestha and Bhandari, 2004).

The Nepalese financial sector is composed of banking sector and non-banking sector. Banking sector comprises Nepal Rastra Bank (NRB) and Commercial banks. The non-banking sector includes development banks, finance companies, micro-credit development banks, co-operative financial institutions, non-government organizations (NGOs) performing limited banking activities and other financial institutions such as insurance companies, employee's provident fund, citizen investment trust, postal saving offices and Nepal stock exchange. The July 2007 bulletin published by NRB shows that during the last two and half decades the number of financial institutions has grown significantly. At the beginning of the 1980s when financial sector was not liberalized, there were only two commercial banks and development bank in the country. There were no micro-credit development banks, finance companies. Co-operatives and non-government Organizations (NGOs). After the induction of economic liberalization that impetus in the establishment of new bank and non bank financial institutions. Consequently, by the end of the mid-July 2007 altogether 208 bank and non bank financial institutions licensed by NRB are in operation. Out of them, 20 are "A" class Commercial banks, 38 "B" class development banks, 74 "C" class finance companies, 12 "D" class micro-credit development banks, 17 saving and co-operatives, and 47 NGOs.

Table 2.1

Growth of Financial Institution

Types of Financial institutions	Number of Institutions in Mid-July							
	1980	1985	1990	1995	2000	2005	2006	2007
Commercial Banks	2	3	5	10	13	17	18	20
Development Banks	2	2	2	3	7	26	28	38
Finance Companies				21	45	60	70	74
Micro Credit and Development Banks				4	7	11	11	12
Savomg amd Co-operatives				6	19	20	19	17
NGOs (Performing Ltd Banking Activities)					7	47	47	47
	4	5	7	44	98	181	193	208

Source: Banking and Financial Statistics, NRB no.49, July 2007.

Economic liberalization policy of the government has encourages the establishment and growth of finance companies in Nepal within a short span of time. So, establishment of finance companies are the major outcomes of the economic liberalization. The groundwork for establishing finance companies was initiated in 2042 B.S. with the enactment of finance company Act 2042 B.S. (Shrestha and Bhandari, 2004). Despite the provisions of Act; Private Sectors were completely silent till 2049 B.S. on Shrawan, 2049 B.S. with the major shows of public sectors, named Nepal Housing Development Finance Company Ltd was established under the finance company Act 2042. In the private sectors, Nepal finance and saving company Ltd pioneered in this field and started its transaction since Chaitra 2049 B.S. As per the banking and financial statistics, mid-July 2007, no.49 bulletin, finance companies have been growing rapidly. The total number of finance companies which stood at 70 in mid-July 2006 reached to 74 in mid-July 2007. However, majority of the finance companies are rendering their services in Kathmandu valley. Of the total finance companies, 42 are being operated outside the Kathmandu valley. Thus the mushrooming of finance companies in Nepal is the result of financial liberalization program of the government.

2.1.2 Concept of Finance Companies

Finance Companies are the financial institutions that engage in satisfying individual credit needs, and perform merchant banking functions. In other words, finance Companies are the non-bank financial institutions that tend to meet the various kinds of consumer credit needs. They involve in leasing, project financing housing and other kind of real estate financing (Paudel, Baral, Gautam and Rana, 2006:29)

Finance Companies are the non-bank financial institution which borrow funds so as to profit on the difference between the rates paid on borrowed funds and those charged on loans. However, they act as the borrowing and lending financial institutions with additional financial risk taking management. They came into existence under the Finance Company Act, 2042 and now operating under Bank and Financial institution Act, 2063. They are registered as limited Companies at the office of the Company Registrar. A finance Company can accept time deposits of the maturity of three months to maximum six years (Economic Report, 2004). They can also collect fund by issuing debentures. These companies provide basically three types of loans. Such as hire purchase loan, housing loan and term loan. Some of the finance Companies deals with leasing finance also. Finance Companies make installment loans. They offer attractive rates on time deposits than commercial banks. The Primary function of finance companies is to make loan to both individuals and businesses. These companies are popular among low income and medium class people for financing hire purchases, vehicles, machinery, tools, equipments, durable household goods etc. They can also perform merchant banking activities with prior approval of NRB. They are willing to lend to riskier borrowers than commercial banks. They are free to fix interest rate on both deposits and loans. As per the NRB unified directives for Banks and Non-Bank FIs issue number E. Pra. Ni. No 8/060/61 (Ashar 2062 B.S.), there is no any restriction for finance companies to invest in government securities and

NRB Bonds. But, they have to perform their activities as pescribed by the NRB directives Neupane (1995) stresses that the finance companies in Nepal are established with the slow growth and traditional attitude of commercial banks in mobilizing financial resources, lack of financial innovations and growing interest of the public on Upahar and dhukuti programmes. Sharma (2005) explains finance company being a financial intermediaries accept time deposits and advance loans to individuals, firms, companies or institutions for agriculture as well as non-agriculture purpose in order to increase economic activities. Finance companies are the market maker, investigator and use of money market and capital market (Parajuli, 2002). In the same way Upadhyay (2004) writes that finance companies are those intermediaries, which link the savers and users of capital. They collect small and scattered saving of the individuals and mobilize it in the productive sectors in the form of investment on loan. On the other hand, Shrestha (1995) explains that the finance company is established with a view to provide easy access to fulfill individual credit needs, provide attractive return, incentives and favorable terms on deposits, encourage consumers to strengthen their purchasing power.

2.1.3 Financial Products and Services

Finance companies can accept time deposit at the maturity of minimum three months to maximum six years. Generally, the following types of financial Products are provided by finance companies.

Fixed Deposit: Fixed deposits are also known as time deposits or term deposits. They carry a fixed maturity, a penalty is charged for early withdrawal savers that do not need money for a stipulated period from 3 month to longer periods ranging up to 6 years are encouraged to keep it in fixed deposits. This type of deposit offers higher interest rate than saving account. Longer the maturity period, higher will be the rate of interest.

However, the depositor can take 90 percent loan from the finance companies against the security of fixed deposit receipt.

Saving Deposit: Finance Companies accept saving deposit from individuals and organizations. The main purpose of saving deposit is to encourage the habit of saving among the common people and institutions. Depositors can deposit any amount in their accounts in any time. But they can withdraw their money up to a limited amount in certain period. Prior information is required incase of withdraw beyond the restricted limit. Finance companies are allowed to accept saving deposits not exceeding 2.5 times of their core capital. They provide interest on daily balance basis on saving deposit.

Recurring Deposit: Various type of recurring deposit schemes are introduced by finance companies. This scheme was developed to encourage the economical among the people of fixed regular earnings. In this scheme, the depositor is required to deposit the fixed amount in each installment and repaid the total amount with interest at maturity.

Finance Companies advance loans to individuals, firms, companies and institution. They provide different types of loans which are as follows:

Hire Purchase Loan: Under this type of loan, finance companies provide loan for the purchase of vehicle, machines, equipments and tools, durable household goods and other movable property. The loan will be provided in installment basis and the interest rate will be depending on the situation. The repayment of this type of loan will be in installment with interest.

Housing Loan: Under this type of loan, finance companies provide loan for the purchase of land, constructions of house for individuals and warehouse. The interest rate will be up and down according to economic situation. It is issued in installment basis and repayment will also be in installment with interest.

Term loan: Under this type of loan, finance companies provide loan for the expansion of trade and industry, further education, health, tourism, agriculture, water resources, irrigation etc.

Loan Against Fixed Deposit: Under this type of loan, only the person or organization that have certain amount on fixed deposit in the company will get loan. Only the fixed depositors can get the loan up to 90 percent of fixed deposit amount. The company charges Pays 2 percent interest in this type of loan.

According to the NRB unified directives for Banks and Non-Bank F1s issue number E.Pra. Ni. No 15/061/62 (Ashar 2062 B.S.), finance companies are free to fix interest rates on both the deposits they take and the loan they provide. So, the rate of interest on both the deposits and loans will vary from one finance company to another. Other financial services provided by finance companies are issue of shares and underwriting, act as financial guarantee, collect share applications, purchase and sale of government bonds.

2.1.4 Bank and Financial Institutions Act, 2063

Bank and Financial activities are governed by rules and regulations which are reviewed from time to time to reflect the changing economic environment. Previously, Finance Company Act, 2042 used to govern finance companies in Nepal. Due to the absence of Parliament, Bank and Financial Institutions ordinance (BAFIO) came into existence in February 4, 2004. The ordinance is renewed in every six months. BAFIO governs all types of financial institutions. It aims to ensure reliable and quality banking and financial intermediation services through healthy competition among banks and financial institutions safeguard and promote the interest of the depositors and people at large in the overall banking and financial system of the country. The ordinance repeals and replaces all existing Acts relating to commercial banks. Nepal Industrial Development Bank, other

Development Banks and Finance Companies and brings all such institutions under one single Act which is known as Umbrella Act. As per the Umbrella Act, banks and financial institutions are to be classified as A, B, C and D class on the basis of minimum paid up Capital. Accordingly, Commercial banks are in the 'A' class and they are labeled as banks. Similarly, development banks, finance companies, and micro credit development banks are categorized into 'B', 'C' and 'D' class respectively and they are called Financial institutions (BAFIO, 2004). By mid-July 2006, there are 18 commercial bank of class 'A', 29 Development banks of class 'B', 70 finance companies of class 'C', 11 micro credit development banks of class 'D'. Besides this, there are 19 saving and credit co-operative and 47 NGOs undertaking limited banking functions after obtaining permission from the NRB.

For the proper and smooth operation of bank and financial institutions, an Umbrella Act named as Bank and financial Institution Act, 2063 has recently been enacted, which is effective since 16th of Shrawan, 2063. As per the Act, well performing bank or financial institution may be upgraded if it has met capital requirement, has been in profit for the last 5 years in a row, total non-performing assets has remained within the NRB prescribed limit and all the prescribed conditions have been met. Similarly, NRB can downgrade any bank or financial institutions from 'A' to 'B' or 'B' to 'C' class if its status of performance is found to have turned totally other way around against as prescribed. Subject to this Act, class 'C' licensed institution may conduct the following types of financial transactions:

a. Accept deposits with or without interest and refund such deposits, subject to the limit prescribed by the NRB.
b. Supply credits other than hypothecation credit as prescribed.
c. Supply credits for businesses relating to hire-purchase, leasing and housing, as well as for service enterprises.
d. Engage in merchant banking business.

e. Write off credit subject to the bye-rules framed by the Board.
f. Supply credit on the basis of co-financing by Joining hands with other licensed institutions according to the agreement concluded for the purpose so as to divide the collateral.
g. Supply credit against the guarantee provided by any bank or financial institution.
h. Obtain credits by pledging its movable or immovable asset as collateral.
i. Supply a fresh credit in a lump sum or in installment against the security of the same movable or immovable assets which have already been pledged with it or with any other licensed institution, to the extent covered by the total value of such security.
j. Properly manage, sell or lease out its assets.
k. Issue, accept, pay, discount or deal in bills of exchange, promissory notes, cheques, travelers' cheques, drafts or other financial instruments.
l. Deal in Indian currency.
m. Supply credits not exceeding the amount prescribed by the Rastra Bank to ensure the economic upliftment of the destitute class, low income families, victims of natural calamities and inhabitants of any area of the country with the provision of individual or collective guarantee.
n. Exchange with the Rastra Bank or any other licensed institution Particulars, information or notices regarding debtors or customers who have obtained credits or any other facility from it or any other licensed institution.
o. Supply installment or hire-purchase credit to any individual, firm, company or institution for vehicles, machinery, tools, equipment, durable household goods or similar other movable property.

p. Supply credit to any individual, firm, company or institution for the purchase or construction of residential houses or go downs, or for the purchase of lands for the construction of such residential houses or go downs.

q. Supply credit (leasing-finance) to any individual, firm, company or institution for taking up vehicles, machinery, tools, equipment, durable household goods or similar other movable property on lease, or provide such movable property on lease.

r. Prescribe conditions according to need in order to protect its interests while supplying credit to any individual or institution or carrying out any Hans action with him/her/it.

s. Operate projects such as those relating to purchase of lands and construction of buildings for land development and residential purposes, and sell or manage such lands and buildings, or make arrangements for doing so.

t. Perform such other functions as are prescribed by the Rastra Bank.

2.1.5 Approaches to Supervision

Effective supervision is prerequisite for growth and stability of financial system. The supervision facilitates the detection of frauds, malpractices, abuses of power by management and undesirable trends and imprudent practices such as deterioration in the quality of loan portfolio and insider lending. Due to the fast growth of financial institutions, a separate department for supervision of financial institution was established in 1998, which was named as Financial institution supervision Department (FISD). So at Present all the commercial banks are supervised by Bank supervision Department and all other financial institutions are supervised by the FISD (NRB Annual Report, 2001/02). The FISD carry out on-site examination of financial institution by sending examination team to the institutions. The most common supervisory tools used by the regulatory

agencies in promoting safety and soundness are on-site supervision and off-site supervision. Both on-site and off-site supervision (inspection reports) helps to discourage the unnecessary delays.

On-site supervision: The on-site supervision is a regular full scope corporate level examination. Supervisors rely principally on regular on-site examinations to assess the condition of financial institutions. On-site examination is the most effective tools for constraining financial institution's risk. On-site inspection is performed on the basis of on-site inspection manuals. The manual covers the areas of capital adequacy, loan portfolio management, treasury operation, management information system, and internal control system and information technology. This manual provides guidelines to examiners for preparation of inspection report.

Generally 15 days before, the concerned financial institutions are informed to prepare the necessary documents by the FISD Then only on-site examination is done. After the completion of on-site inspection, CAMELS rating of financial institutions are done by the supervisors (NRB Annual Report, 061/62). So, the on-site examination rating like CAMELS are useful in the analysis of the firm at the examination. NRB has made on-site inspection to 29 Finance Companies, 15 development banks, 3 cooperative societies and 7 NGOs during the period of mid-April 2005 to mid-march 2006. Besides this, monitoring visits were also carried out in 3 development banks, 3 finance companies, and 1 cooperative society (monetary policy, 2005/06).

Off-Site Supervision: An off-site supervisory approach undertakes an assessment of the soundness of financial institutions based exclusively on an analysis of information obtained from statutory returns submitted by the institutions than actual on-site field examination. Then monitors the financial health of supervised institutions and analyzed the reports and conditions. The off-site review and analysis deal with capital, liquidity,

which can be quantified, but is less well suited to qualitative issues such as management strength and operational risks. Besides, off-site supervision is taken as early warning system to identify potential problems in financial institutions as well as for the compliance of applicable provisions. This support and strengthen quality of on-site examination

2.1.6 Financial Performance Approaches

Every business entity should be able to enhance their competitive strength through achieving the financial goals. Financial institutions strength is usually thought of both in quantitative terms, namely a firm's intrinsic financial condition as reflected in its capital, reserves, asset quality, earnings and liquidity, and in qualitative terms, as evidenced in the underlying quality and effectiveness of management, internal controls, and risk management policies and practices. The soundness of institutions is found on a strong balance sheet and strong management.

Innovation, deregulation and globalizations in banking sector, banks today are under great pressure to perform-to meet the objectives of their stockholder, employees, depositors, and borrowing customers, while somehow keeping government regulators satisfied that the bank's policies, loans, and investments are found. As banking organizations have grown in recent years, more and more of them have been forced to turn to the money and capital markets to raise funds by selling stocks, bonds and short-term instruments. This development has placed management under great pressure to set and meet banking performance goals. Bankers have been called upon to continually re-evaluate their loan and deposit policies, review their plans for expansion and growth, and asses their returns and risk in light of this new competitive environment. In addition, there is the added problem of bank failures. Many of these failures have been associated with management mistakes, outright fraud, and a more volatile and uncertain economy that demands new standards for bank management.

Financial statements contain a wealth of information, which if properly analyzed and interpreted, can provide valuable insights into firm's performance and position (Chandra, 1992). Analysis of financial statements is of interest to lenders, investors, security analysis, managers, and others. It generally begins with the calculations of a set of financial ratios designed to reveal the relative strength, and weaknesses of a company as compared to other companies in the same industry, and to show whether the firm's position has been improving or deteriorating over time (Weston and Copeland, 1991). Financial analysis is a process of identifying the financial strengths and weaknesses of the firm by properly establishing relationship between the item of balance sheet and profit and the loss account (Pandey, 1999). There are many approaches for measuring the performance of financial institution focuses on balance sheet. They are ROA, ROE, RAROC and CAMEL (Koch and Macdonald, 2004). Among them, CAMEL-style method of analysis has been considered in this study. Within this framework, the financial condition and performance of Om finance Limited (OFL) has been assessed.

Return on Assess (ROA) Approach: The rate of return on assess is one of the most common performance measurement approaches of financial institutions. If measures the ability of management to utilize the real and financial resources of the firm to generate returns. Further it examines the profitability of a concern in terms of the relationship between profit earned and assets employed in the firm. It shows the effectiveness of the utilization of assets. It is primarily an indicator of managerial efficiency; it indicates how capably the management of the firm has been converting the institutions assets into net earnings (Rose, 2002). The return on assets provides information on how efficiently a firm is being run. The higher the firms return on assets the berth it is doing in operation and vice versa.

Return On Equity (ROE) Approach: The return on equity is also one of the popular performance measurement approaches of financial institutions. Equity holders of company are concerned about how much the company is earning on their equity investment. This information is provided by the return on equity. It measures the rate of return on Share holders, investment. It is the aggregate returns to stockholders before dividends. The higher the return the better, as company can add more to retained earnings and pay more in cash dividends when profits are higher (koch and Macdonald, 2004). It measures the rate of return flowing to the firm's shareholders. It indicates how well the firm has utilized the resources of the owners.

Risk Adjusted Return On Capital (RAROC)

Approach: Risk adjusted return on capital is an effective tool for measuring risk-adjusted financial performance. In the 1990s Banker's just popularized a method of evaluating loans known as RAROC. Today, many banks and financial institutions employ RAROC to measure managerial performance (Gup and Kolari, 2005). It is a risk-adjusted framework for profitability measurement and profitability management. It is defined as the ratio of risk-adjusted return to economic capital-Economic Capital is attributed on the basis of three risk factors: market risk, credit risk and operational risk. The use of risk-based capital strengthens the risk management discipline within business lines, as the methodologies employed quantify the level of risk within each business line and attribute capital accordingly. Using this method, income is adjusted for risk. Typically, income is adjusted for expected losses. It provides a uniform view of profitability across businesses (Strategic Business Units/ divisions)

Return on Risk Adjusted Capital (RORAC): Return on risk adjusted capital is also a popular method of measuring risk adjusted profit of any financial institutions. Using this method, capital is adjusted for risk. Typically, capital is adjusted for a maximum potential loss based on the

probability of future returns or volatile of earnings. Today, many large banks and financial institutions evaluate their line of business profitability and risk via RAROC or RORAC system (Koch and Macdonald, 2004).

CAMELS Approach: CAMELS is and ideal rating system, practiced worldwide by central banks and rating agencies, to evaluate and analyze safety and soundness of a financial institution. The acronym CAMELS refers to six components namely capital adequacy, assets Quality, Management Quality, Earning Quality, Liquidity and sensitivity to Market Risks. It has proved an effective internal supervisory tool for evaluating the soundness of financial institutions on a uniform basis and for identifying those institutions requiring special supervisory attention or concern. Since January 1, 1997 the rating become CAMELS with the addition of a market sensitivity rating (Koch and Macdonald, 2004). Under such framework, individual components are typically evaluated on a rating scale. These individual rating are then aggregated to arrive at a composite ranking of the institutions, which usually reflects differential emphasis on individual components, and not a simple average.

2.1.7 Concept of "CAMELS" Bank Rating System.

Federal Reserve Bank of New York (1997) has defined the component of CAMEL as rating system which produces a composite rating of an institutions overall condition and performance by assessing five components: Capital Adequacy, Asset quality, management administration, Earnings, and Liquidity, the CAMEL was later updated with inclusion of sixth component, sensitivity to market risk, now is referred to as the CAMELS rating system. In 1997, the rating became CAMELS with the addition of a market sensitivity rating. Nepal Rastra Bank (NRB) has used the CAMELS methodology since 2062/2063 for analysis and rating the soundness of banks and financial institutions. This analysis methodology may not capture the full range of governance risks in a bank and financial

institution. Rating agencies have also followed a similar framework for rating banks and financial institutions. The rating methodologies employed by central banks, rating agencies creditors and investors do not appear to include explicity the analysis of governance risks. SEBON journal (September, 2004) points out that a key factor contributing to bank failure in Asia, was due to lack of adequate bank governance systems and it may be worthwhile to expand the rating methodology to include governance as a key risk factor. The CAMELSG refers to seven component namely capital Adequacy, Assets Quality, Management Quality, Earnings Quality, Liquidity, Sensitivity to market Risks and Governance.

CAMEL was originally developed by the Federal Deposits Insurance Cooperation (FDIC) for the purpose of determining when to schedule an on-site examination of a bank (Thomson, 1991, Whalen and Thomson, 1998). The FFIEC is revised in January 1997, the UFIRS, which is commonly referred to as the CAMEL rating system. This system was designed by regulatory authorities to quantity the performance and the financial condition of the banks which it regulates.

The CAMELS rating system is subjective. Benchmarks for each component are provided. But they are guidelines only, and present essential foundations upon which the composite rating is based. They do not eliminate consideration of other pertinent factors by the examiner. The uniform rating system provides the groundwork for necessary supervisory response and helps institutions supervised the groundwork for necessary supervisory response compared and evaluated. Ratings are assigned for each component in addition to the overall rating of bank's financial condition. The ratings are assigned on a scale from 1 to 5. The CAMELS rating are commonly viewed as summary measures of the private supervisory information gathered by examiners regarding banks' overall financial conditions, although they also reflect available public information. In Nepal, the NRB plays the supervisory role for evaluating

bank's financial condition though rating the banks' in accordance to CAMELS is still initial phase.

Composite Rating

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

Composite 1: FIs in this group are sound in every respect and generally have components rated 1 or 2. Any weaknesses are minor and can be handled in a routine manner by the board of directors and management. These FIs are the most capable of with standing the vagaries of business conditions and are resistant to outside influences such as economic instability in their trade area. These FIs are in substantial compliance with laws and regulations. As a result, these F1s exhibit the strongest performance and risk management practices relative to the institutions size, complexity, and risk profile and give no cause for supervisory concern.

Composite 2: FIs in this group are fundamentally sound. For a FI to receive this rating, generally no component rating should be more severe than 3. Only moderate weaknesses are present and are well within the

board of directors' and management's capabilities and willingness to correct. These FIs are in substantial compliance with laws and regulations. Overall risk management practices are satisfactory relative to the institution's size, complexity, and risk profile.

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

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

Composite 5: FIs in this group exhibit extremely unsafe and unsound practices or conditions exhibit a critically deficient performance; often

contain inadequate risk management practices relative to the institution's size, complexity, and risk profile; and are of the greatest supervisory concern. The volume and severity of problems are beyond management's ability or willingness to control or correct. Immediate outside financial or other assistance is needed in order for the FI to be viable ongoing supervisory attention is necessary. Institutions in this group pose a significant risk to the deposit insurance fund and failure is highly probable.

2.1.8 CAMEL Components

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

2.1.8.1 Capital Adequacy

The capital Component (C) signals the institutions ability to maintain capital commensurate with the nature and extent of all types of risk and the ability of management to identify, measure, monitor, and control these risks (Koch and Macdonald, 2004). The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital.

Capital is a source of financial support to protect an institution against unexpected losses, and is, therefore, a key contributor to the safety and soundness of the firm. So, finance companies have to make decision about the amount of capital they need to hold mainly for three reasons.

First, capital helps prevents company failure, a situation in which the company cannot satisfy its obligation to pay its depositors and other creditors and so goes out of business. Second, the amount of capital affects returns for the owner (equity holders) of the company. And third; a minimum amount of firm capital is required by regulatory authorities. Thus, capital provides a cushion against the risk of failure. The level of capital plays a key role in the evaluation of any financial institution. Any FI should have adequate capital to support the stability and sustainability of its operation (Mishkin and Eakins, 2006).

Capital Adequacy is a measure of a firm's capital as a percentage of its risk weighted assets, such as the loans it has provided and the securities it holds. Thus, this parameter indicates whether a particular institution has enough capital to absorb unexpected losses. This is required to maintain depositor confidence and preventing the institution from going bankrupt. If its capital is sufficient other financial, managerial and operational weakness can usually be absorbed.

Bank Capital performs several important functions. Most importantly they are:

Absorbs Losses: Capital allows institutions to continue operating as going concerns during periods when operating losses or other adverse financial results are experienced.

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

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

Provides Protection of Depositors: Pricing owners at significant risk of loss should the institution fail, helps to minimize the potential "Moral hazard" and promotes safe and sound banking practices

Capital is necessary for the bank operate. While many areas of a bank are important and subject to scrutiny, capital adequacy is the area that triggers the most regulatory action. This action is largely based on the three major ratios used in the assessment of capital adequacy, which are:

- The Tier 1 Risk-Based Capital Ratio.
- The Total Risk-Based Capital Ratio.
- The Tier 1 Leverage Ratio.

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

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

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

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

- Total risk-based capital ratios is 10 percent or more.
- Tier 1 risk-based capital ratios is 6 percent or more, and

- Tier 1 leverage ratios is 5 percent or more.

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

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

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

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

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

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

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

Rating Capital Component

1. A rating of 1 indicates a strong capital level relative to the institution's risk profile.
2. A rating of 2 indicates a satisfactory capital level relative to the FI's risk profile.
3. A rating of 3 indicates a less than satisfactory level of capital that does not fully support the institution's risk profile. The rating indicates a need for improvement, even if the institution's risk

profile. The rating indicated a need for improvement, even if the institution's capital level exceeds minimum regulatory and statutory requirement.

4. A rating of 4 indicates a deficient level of capital. In light of the institution's risk profile, viability of the institution may be threatened Assistance from Shareholder or other external sources of financial support may be required.
5. A rating of 5 indicates a critically deficient level of capital such that the institution's viability is threatened. Immediate assistance from shareholders or other external sources of financial support is required.

A FI is expected to maintain capital commensurate with the nature and extent of risks to the institutions and ability of management to identify, measure, monitor, and control these risks. The effect of credit, market, and other risks on the institution's financial condition should be considered when evaluating the adequacy of capital. The types and quantity of risk inherent in an institution's activities will determine the extent to which it may be necessary to maintain capital at levels above required regulatory minimums to properly reflect the potentially adverse consequences that these risks may have on the institution's capital.

BASEL Capital Accord

The Basel committee on Banking super vision (BCBS) is a committee of banking Supervisory authorities that was established by the central bank governors of the group of ten countries in 1975. In consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, the Netherlands, Spain, Sweden, Switzerland, the United Kingdom, and the United States. It usually meets at the Bank for International settlements

(BIS) in Basel where its permanent secretariat is located (BIS, November 2005)

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

The new Basel Capital accord (Basel II), shall be applicable to internally active banks all over the world with effect from end of 2006. Implementing the new accord in Nepal has been a challenging task for the supervisors as well as FIs. Hence, certain preparatory homework is needed to Nepalese financial system to implement BASEL II. The Basel-II has been introduced basically for the protection of depositor's interest by preserving the integrity of capital of Banks. Only "A" class financial institutions, licensed to conduct banking business in Nepal are subject to this capital framework (www.nrb.org.np). NRB and FIs need to have

coordinated effort efficiently in Nepalese banks and FIs to establish certain baseline for the effective implementation of BASEL II. In this regard, second interaction program was held in Nepal with the banks executives to make them aware of the new development. The commercial banks so far has shown positive attitude towards the implementation of Basel II. "New Capital Accord Implementation Preparatory Care Committee" was drafted "NRB's Concept paper on New Capital Accord". According to the Program of New Capital Accord Implementation, Concept paper was forwarded to all the commercial banks for comments and recommendations. A form was also developed so that commercial banks classify their exposures as per the new approach, which was reviewed by the "Basel II implementation working group". NRB has adopted Basel Core Principles for effective supervision as guideline for supervision of commercial banks. Core Principle methodology adopted by BCBS provides a uniform template for both self-assessment and independent assessment. It involves four part qualitative assessment system: Compliant, largely compliant, materially non-compliant, and non-compliant. For each principle essential and additional criteria are defined. To achieve a "Compliant" assessment With a principle, all essential and additional criteria must be met without any significant deficiencies. A "largely Compliant" assessment is given if only minor short comings are observed, and these are not seen as sufficient to raise serious doubts about the authority's ability to achieve the objective of that principle. A " materially non-compliant assessment is give when the shortcoming are sufficient to raise doubts about the authority's ability to achieve compliance, but substantial progress has been made A " non-compliant" assessment is given when no substantial progress towards compliance has achieved.

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

Implementing the new Basel accord in Nepal has been a challenging task for the supervisors as well as financial institutions. The supervisory capacity building, market discipline, issue of poor governance in to the Industry, poor governance in to the market, poor data base, lack of credit rating agencies and lack of adequate, accurate and reliable financial data are some of the challenges ahead for effective implementation of Basel-II. So, NRB and financial institutions need to have coordinated effort efficiently in Nepalese Banks and financial institutions to establish certain baseline for the effective implementation of Basel-II (www.nrb.org.np)

Capital Adequacy Norms by NRB

NRB has from time to time stipulated minimum capital fund to be maintained by the banks based on risk-weighted assets. The total capital fund is the sum of core capital and supplementary capital. According to the NRB unified directives for Banks and non-banks F1s issue number (2062 B.S.), the capital funds of a bank comprise the following:

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

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

Banking and Financial Institutions Ordinance (BAFIO, 2061) also assimilates the same things, which were included and explained in NRB Act 2058, in regard of bank capital. NRB Act is effective from first Shrawan 2058 (16 July 2001). According to the NRB directive, minimum

paid-up capital requirement for establishment of commercial banks is as under:

i. Rs. 250 million to operate all over Nepal except Kathmandu valley.
ii. Rs. 1000 million to operate all over Nepal.
iii. All existing Commercial banks are required raise capital base to Rs. 100 million by mid July, 2009 through minimum 10 percent Paid-up capital increment every year.

Generally, the capital measurement tool is basically represented by a ratio of primary capital to assets (Estrella, et al; 1986; Martin, 1977). Estrella et al (2000) utilized three measures of capital were relatively good explanatory power over short time horizons, while risk weighted ratios provided relatively better explanatory power over short time horizons. Eeeher at al, (1996), Thomson (1991), Whalen (1991) and Sinkey (1978) employed an analogous ratio definition, but with a refinement to adjust for loan losses, which theoretically would account for some portion of related risk in the asset portfolio (Cantor, 2001).

2.1.8.2 Assets Quality

Assets Quality is one of the most critical areas in determining the overall condition of a bank. The asset quality component reflects the amount of existing credit risk associated with the loan and investment portfolio as well as off-balance sheet activities (Koch and Macdonald, 2004). Asset quality refers to the degree of financial strength and risk in a financial institution's assets, typically loans and investment. The assets of the firm are assessed to evaluate the market or realizable values of the firm's assets, particularly the loan portfolio. This aspect reviews the quality of the loan portfolio and the investment with due consideration to the provisions made by the firm. It also reviews the activities of firm management in terms of the development and implementation of various policies and the enactment of system of controls.

The Primary factor effecting overall asset quality is the quality of the loan portfolio and the credit administration program. Loans are usually the larges items of the asset and can carry the greatest amount of potential risk to the bank's capital account. Securities can often be a large portion of the assets and have identifiable risks. Other items which impact a comprehensive review of asset quality are other real estate, other assets, off-balance sheet items and, to a lesser extent, cash and due from accounts, and premises and fixed assets.

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

Evaluation of Asset Quality

A Comprehensive evaluation of asset quality is the most important components in assessing the current condition and future viability of the financial institution. The ability of management to identify, measure, monitor, and control credit risk is also reflected here. The evaluation of asset quality should consider the adequacy of the Allowance for Loan and Lease Losses (ALLL) and weight the exposure to counter-party, issuer, or borrower default under actual or implied contractual agreements. All other risks that may effect the value or marketability of an institution's assets, including, but no limited to, operating, market, reputation, strategic, or compliance risks, has to be considered. Prior to assigning an asset quality rating, several factors should be considered. The factors should be reviewed within the context of any local and regional conditions that might affect bank performance. In addition, any systemic weaknesses, as opposed to isolated problems, should be given appropriate consideration. The following is not a complete list of all possible factors that may influence an

examiners assessment; however, all assessments should consider the following:

- The adequacy of underwriting standards, soundness of credit administration practices, and appropriateness of risk identification practices,
- The level, distribution, severity, and trend of problem, classified on accrual, restructured, delinquent, and non-performing assets for both on and off-balance sheet transaction.
- The adequacy of the allowance for loan and lease losses and other asset valuation reserves,
- The credit risk arising from or reduced by off-balance sheet transactions, such as un-funded commitments, credit derivatives, commercial and standby letters of credit, and lines of credit,
- The extent of securities underwriting activities and exposure to counter parties in trading activities.
- The existence of asset concentrations,
- The adequacy of loan and investment policies, procedures, and Practices.
- The ability of management to properly administer its assets, including the timely identification and collection of problem assets,
- The adequacy of internal controls and management information systems,
- The volume and nature of credit documentation exceptions.

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

Rating the Asset Quality Factor

The Asset Quality Rating definitions are applied following through evaluation of existing and potential risks and the mitigation of those risks. The definitions of each rating are as follows:

1. A rating of 1 indicates strong asset quality and credit administration practices. Identified weaknesses are minor in nature and risk exposure is modest in relation to capital protection and management's abilities. Asset quality in such institutions is of minimal supervisory concern.
2. A rating of 2 indicates satisfactory asset quality and credit administration practices. The level and severity of classifications and other weaknesses warrant a limited level of supervisory attention. Risk exposure is commensurate with capital protection and management's abilities.
3. A rating of 3 is assigned when asset quality or credit administration practices are less than satisfactory. Trends may be stable or indicate deterioration in asset quality. The level and severity of classified assets, other weaknesses, and risk require an elevated, level of supervisory concern.
4. A rating of 4 is assigned to FIs with deficient asset quality or credit administration practices. The level of risk and problem assets are significant, inadequately controlled, and subject the FI to potential losses that, if left unchecked, may threaten its viability.
5. A rating of 5 represents critically deficient asset quality or credit administration practices that present an imminent threat to the institution's viability.

Non-performing Assets (NPAs)

Either loan or advance of FIs needs to be serviced by the principal or the interest of the amount borrowed in stipulated time as agreed by the

parties at the time of loan settlement NRB unified directives (2062 BS.) for Banks and Non-Banks FIs, defines Non Performing loans as loans classified as substandard, Doubtful and Loss or Loans which are past due by principal for more than 3 months. Dhungana (2006) states that the details and classification of standards of Non Performing Loans may vary from country to country depending upon the own banking system requirement norms. He further states that unlike Nepal, countries like Korea, Indonesia, Philippines, India have classified the loan into five categories on which normal and special categories are classified as performing loans whereas sub standard, doubtful and estimated loss categories and considered as Non Performing Loans. The Study Conducted by World Bank highlights that all commercial banks of South Asian countries except Nepal and Sri-Lanka classify loans as non-performing only after it has been arrear for at least six months (Pernia, 2004). NRB unified directives for Banks and Non-Banks F1s through (2062 B.S.) classifies NPL, according to international Practice, into three categories depending on the temporal position of loan default. Substandard, Doubtful and Loss Assets are the categories on the basis of the time based to repay either interest or the principal. The degree of NPA assets depend solely on the length of time the asset has been in the form of non-obliged by the loanee. The more time it has elapsed the worse condition of assets is being perceived and such assets are treated accordingly. However, the treatment of NPAs depends according to countries. No uniform rule seems to apply.

NRB Directives related to Assets quality

According to the NRB unified directives for Banks and Non-Banks FIs issue number E.Pra.N1.No. 02/061/62 (Ashar 2062 BS), finance company has to classify loan into the following four categories.

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

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

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

Loss: All loans and advances which are past due for more than 1 year and have least possibility of recovery or considered unrecoverable shall included in this category. Besides this, any loan whether past due or not, in situations of inadequate security, borrower declared insolvent, misuse of borrowed fund is to be classified as loan category.

Loans and advances falling in the above category of Sub-Standard, doubtful and loss class are defined as non-Performing loan.

The loan loss Provisioning, on the basis of the outstanding loans and advances and bills purchased classified as above should be provided as follows:

S.N	Classification of Loan	Loan Loss Provision
1.	Pass	1%
2.	Substandard	25%
3.	Doubtful	50%
4.	Loss	100%

Loan loss Provision set aside for performing loans is defined as general loan loss provision and loan loss provision set aside for non-performing loan is defined as specific loan loss provision.

With the objectives of lowering the concentration risk of company loans to a few big borrowers and to increase the access of small and middle size borrowers to the company loans, NRB through directive number E.Pra.Ni.No 03/061/62 limits finance companies to extend credit to a single borrower or group of related borrowers up to 25% of its core capital

for fund based credit facilities fund based credit facilities like letters of credit, guarantees, acceptances, commitments.

2.1.8.3 Management Quality (M)

The management Component (M) reflects the amount of existing credit risk of directors and senior management systems and procedures to identify, measure, monitor and control risk (Koch and Macdonal; 2004)

Good management can make and poor management can break an organization. The performance of the other four CAMEL components will depend on the vision, capability, agility, professionalism, integrity and competence of the financial institutions management. As a sound management is crucial for the success of any institution, management quality is generally accorded greater weighting in the assessment of the overall CAMEL framework. Generally, directors do not actively involved in day to day operations; however, they provide clear guidance regarding acceptable risk exposures levels and ensure that appropriate policies, procedures and practices have been established. Senior management is responsible for developing and implementing policies, procedures and practices that translate the bood's goals, objectives and risk limit prudent operating standards.

The quality of management is the most important element in CAMELS framework of financial performance analysis. The competence of the management is the key in evaluating the performance of the financial institution. The management is responsible to mobilize the resources of the firm and to create a sound control environment and risk management practices. Thus, it focuses on appraising the competence, involvement and integrity of the management in the day to day administration of the firm, involvement in formulating policies and procedures and the implementation of systems and controls ; and in ensuring the firm's compliance with applicable laws and regulations. The board of director

plays a key role in formulation of polices, supervisions and control. On the other hand managing director is liable to the successful operation of the bank. The success of any bank is largely determined by the efficiency of its management. Poor loan policies and the poor assets / liability management lead any firm to failure. The problematic variable for researcher in the development of CAMELS models has largely been the choice of a representative measure for management quality NRB also has evaded this component of CAMELS in the performance evolution of commercial banks in Nepal.

2.1.8.4 Earning Quality

The earning quality reflects not only the quantity and trend in earnings, but also the factors that may affect the sustainability or quality or earnings (Koch and Macdonald, 2004). The quality and trend of earnings of an institution depend largely on how well management manages the assets and liabilities of the institution. This parameter lays importance on how an institution earns its profit. This also explains the sustainability and growth in earnings in the future. Future earnings adversely affected by an inability to forecast or control funding and operating expenses, improperly execute or ill-advised business strategies, or poorly managed or uncontrolled exposure to the risks.

The purpose of the earnings measure in CAMEL is to provide a ratio representative of management's level of effectiveness in utilization of assets to earn profits. Earning capacity or profitability keeps up the sound health of a financial institution. Profit is important for survival and economic welfare of the business. It is used as yardstick to measure the economic efficiency of the firm.

Good earning performance inspires the confidence of depositors, investors, creditors, and the public at large. However, the earnings of the firm should be able to absorb normal and expected losses in a given period and provide a source of financial support by contributing to the institution's internal generation of capital and its ability to access capital externally.

The earnings are, thus, assessed to evaluate the current and future earning capability and the efficiency of the firm based on the existing asset and liability structure, as well as pricing and costs (Madura, 2001). Under the UFIRs, in evaluating the adequacy of FI's earnings performance, consideration should be given to:

- The level of earnings, including trends and stability,
- The ability to provide for adequate capital through retained earnings,
- The quality and sources of earnings,
- The level of expenses in relation to operations,
- The adequacy of the budgeting systems, forecasting processes and management information system in general,
- The adequacy of provisions to maintain the ALLL and other valuation allowance accounts.
- The earnings exposure to market risk such as interest rate, foreign exchange, price risks.

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

Evaluation of Earning Performance

An analysis of earnings comprise of examiner reviewing each component of the Earnings Analysis Trial and Ratio Analysis. Generally, the analysis of earnings begins with the examiner reviewing each component of the earnings analysis trial. The earnings analysis trial provides means of isolating each major component of the income statement

for individual analysis. The earnings analysis trial consists of the following income statement components: net interest income, non-interest income, non-interest expense, provision for loan and lease losses, and income taxes. Each component of the earnings analysis trial is initially reviewed in isolation. Typically, ratios are examined to determine a broad level view of the component's performance. The level of progression along the analysis trial will depend on a variety of factors including the level and trend of the ratio, charges since the previous examination, and the institution's risk profile.

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

- Net income to Average Assets Ratio [Return on Assets (ROA)ratio]
- Net Interest Income to Average Assets Ratio.
- Non-interest Income to Average Assets Ratio.
- Non-Interest Expenses to Average Assets Ratio.
- Provision for loan and Lease losses (PLLL) to Average Assets Ratio.
- Realized Gains/Losses on securities to Average Assets Ratio

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

Rating the Earning Factor

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

2.1.8.5 Liquidity

Liquidity is the ability of a company which has funds available to meet cash demand for loans and deposit withdrawal. The liquidity component (L) reflects the adequacy of institution's current and prospective sources of liquidity and fund management practices (Koch and Macdonald, 2004).

A firm should always keep adequate fund to meet depositors' and creditors' demand. Lack of adequate liquidity is often one of the first signs that a company is in serious trouble. Much more liquidity surplus hurts the profitability of the finance companies by reducing the return on assets. So both the deficit and excess liquidity indicate the problem in the financial health of a company. Despite, liquidity management need to design to ensure that the firm has ability to generate or obtain sufficient funds in a timely manner and on a cost effective basis in order to meet its commitments to its customers and counter parties as they fall due.

While evaluating the adequacy of a financial institution's liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs, as well as to the adequacy of funds management practices relative to the institution's size, complexity, and risk profile. Moreover, there needs to be an effective asset and liability management system to minimize maturity mismatches between assets and liabilities and to optimize returns. Liquidity is rated based upon, but not limited to, an assessment of the following evaluation factors:

1. The adequacy of liquidity sources compared to present and future needs and the ability of the institutions to meet liquidity needs without adversely affecting its operations or conditions.
2. The availability of assets readily convertible to cash without undue loss.
3. Access to money markets and other sources of funding.

4. The level of diversification of funding sources, both on-and off-balance sheet.
5. The degree of reliance on short-term, volatile sources of funds, including borrowing and brokered deposits, to fund longer- term assets.
6. The trend and stability of deposits.
7. The ability to securities and self certain pools of assets.
8. The capability of management to properly identify, measure, monitor and control the institution's liquidity position, management information systems and contingency funding plans.

Rating the Liquidity Factor

1. A rating of 1 indicates strong liquidity levels and well-developed funds management practices. The institutions has reliable access to sufficient sources of funds on favorable terms to meet present and anticipated liquidity needs.
2. A rating of 2 indicates satisfactory liquidity levels and funds management practices. The institution has access to sufficient sources of funds on acceptable terms to meet present and anticipated liquidity needs modest weaknesses may be evidence in funds management practices.
3. A rating of 3 indicates liquidity levels or funds management practices in need of improvement. Institutions rated 3 may lack ready access to funds on reasonable terms or may evidence significant weaknesses in funds management practices.
4. A rating of 4 indicates deficient liquidity levels or inadequate funds management practices. Institutions rated 4 may not have or be able to obtain a sufficient volume of funds on reasonable terms of meet liquidity needs.

5. A rating of 5 indicates level or funds management practices so critically deficient that the continued viability of the institutions is threatened. Institutions rated 5 require immediate external financial assistance to meet maturing obligations or other liquidity needs.

Theories of Liquidity Management

There are apparent conflicts between objectives of liquidity, safety and profitability relating to commercial bank. Economist has tried to resolve these conflicts by laying down certain theories from time to time. These principles or theories, in fact, govern the distribution of assets keeping in view these objectives. They have also come to be known as the theories of liquidity management which are as follows:

The Real Bills Doctrine: The real bills doctrine states that a commercial bank should advance only short-term self-liquidating productive loans to business firms. Self liquidating loans are those which are meant to finance the production, storage, transportation and distribution. Such short-term self-liquidating productive loans pass three advantages. First, they posses liquidity that is why, they liquidate themselves automatically. Second, since they mature in the short run and are for productive purposes there is no risk of their running into bad debts. Third being productive, such loans earn income for the banks.

The Shift ability Theory: H.G. Moulton who assessed that if the commercial banks maintain a substantial amount of assets that can be shifted on to the other banks for cash without material loss in case of necessity, then there is no need to rely on maturities propounded the shift ability theory of bank liquidity. According to this view, an asset to be perfectly shiftability must be immediately transferable without capital loss when the need for liquidity asses. But in a general crisis requires that all

banks should posses such assets which can be shifted on to the central bank which is the lender of the last resort.

The Anticipated Income Theory: In 1994, this theory developed by H.V. which is based on the practice of extending term loans by the U.S.A commercial banks. According to this theory, regardless of the nature and character of a borrowers' business, the bank plans the liquidation of the long-term loan from the anticipated income of the borrower. A term loan is for a period exceeding one year and extending to less than five years. It is granted against the hypothecation of machinery stock and even immovable property. The bank puts restrictions on the financial activities of the borrower while granting this loan. At the time of granting a loan, the bank takes into consideration not only the security but also the anticipated earnings of the borrower. In fact, the anticipated income is the main consideration. This theory is superior to the bills doctrine and the shift ability theory because it fulfills the three objectives of liquidity, safety and profitability.

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

Liquidity Gap Analysis

Liquidity gap analysis is the most widely known ALM (Asset and Liabilities Management) technique, and is used for managing both liquidity risk and interest rate risk. Liquidity risk is generated in the balance sheet by the mismatch between the sizes and maturities of assets and liabilities.

The risk relates to the possibility of holding in adequate resources to balance the assets. The liquidity gap is typically defined as the difference between net liquid assets and volatile liabilities. If the firm's assets exceed liabilities, the gap should be funded in the market. In the reverse case, the excess resources must be invested. The maintenance of adequate liquidity remains one of the most important features of financial institutions. They can either store liquidity in their assets or purchase it in money and deposit markets. Because liquid assets have lower returns, stored liquidity has an opportunity cost that result in a trade-off between liquidity and profitability. The aim of ALM is to increase the earning capacity of the firm while at the same time ensuring an adequate liquidity cushion. Although there are many definitions of the term 'liquidity' in general it refers both to the ability of a firm to meet commitments when they fall due (deposit withdrawls) and to provide funds to undertake new transactions when desirable (loan demand). Unexpected changes in the flows of loans and volatile liabilities create liquidity problems for financial institutions (Mishkin and Eakins,2006).

Techniques of Liquidity Management

Techniques for liquidity assessment have evolved over the years with the significant changes in the monitory policy operating procedures. Despite the uncertainly in predicting liquidity conditions. Econometric models could be used to provide first indicative forecast given the estimated structure of interrelationship based on past information. Various methods were identified to determine the long term liquidity need including seasonal and cyclical trend, contingency forecasts, gap analysis and liquidity at risk. To provide for the short-term and long term liquidity needs, the liquidity position must be managed actively. This will ensure that the right sources of funds are used for the liquidity need, thereby reducing the cost of funding. The treasury or fund manager of any banks

and financial institutions should adopt following techniques for effective liquidity management.

Liquidity Planning: The liquidity planning entails the accurate estimation of liquidity needs and the structuring of the portfolio to meet the expected liquidity needs. It is essential to minimize unanticipated large deposit outflows. The liquidity Planning takes place on two levels, namely Planning to manage the required reserve Position and estimating liquidity needs that arise from seasonal and cyclical changes and growth prospect. To ensure that funds are available to meet the liquidity needs at the lower cost, the treasury manager of the banks and financial institutions must manage is money position of comply with the reserve requirement well as managing its liquid sources.

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

Managing the Liquidity Position: Once the liquidity needs of the banks and financial institutions have been estimated, the treasury manager must decide how these needs are to be funded. The banks and F1s must choose between two general liquidity management strategies namely, asset management and liquidity management. In the asset management, assets are sold to meet liquidity needs. In the liability management, money is borrowed to meet liquidity needs. A combination of these strategies is normally employed and the factors dealing with matching liquidity sources and needs are applicable when choosing the liquidity management strategy.

The following guideline must be kept in mind the treasury manager when managing the liquidity position of the banks and financial institutions.

- The treasury manager must coordinate and keeps track of the activities and strategies of the funds-raising and funds-using departments within the banks and financial institutions.
- The treasury managers should know the timing of large withdrawals from big credit clients or depositors in order to plan.
- The priorities and objectives of liquidity management should be clear and properly communicated.
- The needs and decisions must be evaluated on a continuous basis to invest access liquidity and avoid liquidity shortages.

Controlling Liquidity Risk: To assess how well the banks and financial institutions are managing its liquidity position, it only has to look at the market place. The management should be cautious on the following signals from the market place that indicate a pending liquidity problem:

- Public confidence in terms of withdrawl of deposits from the banks and financial institutions.
- Share Price behaviour, falling share prices indicate perceived liquidity problems.
- Risk premiums on money market borrowings.
- Losses because of the hasty sale of assets for liquidity purposes.
- Inability to meet the demands of new credit customers.
- More frequent and larger borrowings from the central bank.

The treasury manager must also consider the purposes of the liquidity need the length of time for which funds are needed, the access to liability markets, the costs and characteristics of various liquidity sources and interest rate forecast. It is revealed that the large banks have better access to liability liquidity sources due to the better quality assets and a broader capital base. The small banks have to rely more on assets for

liquidity. Thus, an effective liquidity management is essential to reduces costs.

Directives relating to maintenance of Liquidity by NRB

NRB has set certain liquidity requirement to all banks and non-bank financial institutions sufficient liquidity is important not only for deposits withdrawals or the provision of loans but also for regulatory purposes.

The NRB (2023 B.S.) had given the instruction to the commercial banks into deposit the amount, ratio of 8% from their liability of deposit. In the beginning of 2047 B.S. the increase in the quantity of internal credit was very high and began to show negative effect on economy. The deflation grew up to 21 percent. So, high liquidity appeared in economy, hence, control of the negative effect that mayfall on economy to improve the growth of price rate and improvement of the position of loss of running account and the NRB second time pescribed liquidity ratio. It has made compulsory to invest 24 percent the amount of the total deposit of the commercial bank in the bond of Nepal Government, in treasury bills, or in the bond of the Nepal Rastra Bank. With some signs of improvement of economy appeared and the investment ratio has been revised accordingly, since poush 2049 B.S. In this way, provision has been made for the commercial banks to 4 percent in their own treasury 8% in the Nepal Rastra Bank's account. Since the beginning of 2050 B.S. the sign of improvement began to appear in economy and the rate of deflation fall down to 8.8 percent. And, Nepal Government removed the provision of investing in the bond of Nepal Government in treasury bills or in the bond of NRB.

With effective firm 2054, chaitra 31st, it has been provided for commercial banks are to keep the balance with in NRB was 8 percent from the liquidity of current and saving deposit and 6 percent from deposit. They have to maintain cash stock, which is to keep in their own treasury, 3 percent from the total deposit. However, this type of provision also has

been changed by NRB. To ensure adequate liquidity in the commercial banks to meet the depositor's demand for cash at any time to inject the confidence in depositor's regarding the safety of their deposit funds, following arrangements have been put into force by NRB effective from 22 July 2002 (2059/04/06).

Prevailing directives with respect to maintenance of Cash Reserve Requirement (CRR)

a.	Balance held with Nepal Rastra Bank	1. 7% of current and saving deposit lines. 2. 4.5% fixed deposits liabilities.
b.	Cases in Vault	2% of total deposit liabilities

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

a. The CRR maintained by the banks will be examined boxed on average weekly balance of deposit liabilityimmediately preceding 4th week. A week shall comprise from each Sunday through Saturday.
b. CRR will not be calculated for the week, which is fully off i.e full holidays for the entire week.
c. Weekly statement of deposit balances to be submitted to NRB inspection and supervision department within 15 days from the date of end of the week for examining the balance held with NRB against the average weekly balance of deposit liabilities of preceding 4th week.
d. Weekly average of Monday to Friday of total deposit, cash in vault and NRB balance is calculated by dividing by 5.
e. Incase of any holiday befalling in the week the balance of preceding day shall be considered as the balance of the day.

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

a. In the case of shortfall in maintenance of NRB balance but cash at vault is exactly 2%.

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

c. In case of shortfall in cash in vault as well as shortfall in NRB balance then on total shortfall amount.

The applicable rate of penalty on shortfall amount is as follows:

First time Shortfall = Equivalent to bank rate/ highest refinance rate

Second time shortfall = Equivalent to 2 times of bank rate

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

For the purpose of application of bank rate, the highest refinance rate as prescribed by NRB shall be considered as the bank rate and penalty on shortfall amount shall be calculated at such highest refinance rate.

Penalty at existing rate on shortfall amount shall be on weekly basis. Such shortfall shall be multiplied by the percentage of bank rate and divided by 52. NRB Bank Act 2058 came into effect from January 30, 2002 and section 47 of the Act has provided for imposition of penalty as specified by NRB.

As per the macro economic indicators of Nepal January 2007, NRB research department statistics division, CRR over the years has been presented as below:

Percent Per Annum	Mid-July			
	2003	2004	2005	2006
Cash Reserve Ratio(CRR) with NRB	6.0	6.0	5.0	5.0
Cash in vault	2.0	-	-	-
CRR is applied in commercial banks' total domestic deposit				

Maintenance of CRR as per NRB directives is to maintain the liquidity of the commercial banks. In evaluating the adequacy of a FIS

liquidity position, consideration should be given to the current level and prospective sources of liquidity compared to funding needs as well as to the adequacy of funds management practices relative to the institutions size, complexity and risk profile. In general, funds management practices should ensure that an institution is able to maintain a level of liquidity sufficient to meet its financial obligations in a timely manner and to fulfill the legitimate banking needs of its community. Practices should reflect the ability of the institution to manage unplanned changes in funding sources, as well as react to changes in market conditions that affect the ability to quickly liquidate assets with minimum loss. In addition, funds managements practices should ensure that liquidity is not maintained at a high cost, or through undue reliance on funding sources that may not be available in times of financial stress or adverse changes in market condition.

2.1.8.6 Sensitivity to Market Risk

Sensitivity is assessed to determined the firm's ability to monitor and manage its exposure to market risk. In addition, consideration should be given to management's ability to identify, measure, monitor and control market risk; the institutions size; the nature and complexity of its activities and the adequacy of its capital and earning in relation to its level of market risk exposure to evaluate this component. Sensitivity to market risk refers to the risk that changes in market conditions could adversely impact earning and capital. This reflect the degree to which changes in interest rate, foreign exchange rates, commodity prices, an equity prices can adversely affect a financial institutions earnings or economic capital (Koch and Macdonal, 2004).

2.2 Research Review

This section deals with the review of Journals, International and Nepalese along with masters' dissertations. International Journals have

been accessed through the website www.blackwell-synergy.com and www.springerlink.com. Similarly, Nepalese Journals and Masters' dissertations have been accessed from Western Regional Library of Prithvi Narayan Campus and Central Library T.U.

2.2.1 Review of Research and Work Papers.

This section provides a picture about what international and Nepalese scholars have done in similar subject. Those studies and issues which the researcher has found relevant to this study are resented below:-

Banker and Holdsworth (1993) found a evidence that CAMEL rating is significant predictors of bank failure, even after controlling for a wide range of publicly available information about the condition and performance of banks.

Deyoung (1998) found a strong positive correlation between efficiency and management quality, as Proxies by bank CAMEL ratings. Examining the relationship between cost efficiency and problem loans, he found that cast efficiency to Granger cause reductions in problem loans. He notes that a decline in cost inefficiency generally tends to be followed by a rise in nonperforming loans, "evidence that bad management practices are manifested out only in excess expenditures, but also in sub par underwriting and monitoring practices that eventually lead to non performing loans."

Cole and Gunther (1995, 1998) found that the information contained in CAMEL ratings decays quickly with respect to predicting bank failure from 1986 to 1992. In particular, they found that a model using publicly available financial data is a better indicator of the likelihood of bank failure than the previous CAMEL rating that are more than two quarters old. These two studies address the issue of information decay directly; however, the primary purpose of CAMEL ratings is not to identify future bank failures; but to provide an assessment of bank's overall conditions at the time of the examinations.

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

Berger, Davies, and Flannery (2000) carried out a research study on "Comparing Market and Supervisory Assessments of Bank Performance: who knows what when?" In this paper, researchers have compared the timeline less and accuracy of (confidential) government assessments of bank condition against market evaluations of large U.S. bank holding companies. They found that supervisors and bond rating agencies both acquire some information that would help the other group forecast changes in bank condition. In contrast, supervisory assessments and equity market indicators are not strongly interrelated. Furthermore, supervisory assessments are generally less accurate than either stock on bond market indicators in predicting future changes in performance, except when those assessments derive from a recent on-site inspection visit. To some extent, these findings are consistent with the various parties' differing incentives.

Barth and others (2002) carried out a study on "Bank Safety & Soundness and the structure of Bank Supervision: A cross country Analysis". They have raised two central questions about the structure of bank supervision are whether central banks should supervise banks and whether to have multiple supervisors. They have used data for 70 countries access developed, emerging and transition economies to estimate statistical

connections between banking performance, the structure of bank supervision, permissible banking activities, legal environments, banking market structure and macroeconomic conditions. They found that where central banks supervise banks, banks tend to have more non-performing loans. Countries with multiple supervisors have lower capital ratios and higher liquidity risk. They also found that conclusions from non-transition economies may not necessarily apply to transition economies.

Derviz and Podpiera (2004) investigated that the determinants of the movements in the long term standard a pours and CAMELS bank ratings in the Czech Republic during the period of 1998 to 2001. The same list of explanatory variables corresponding to the CAMELS rating inputs employed by the Czech National Bank's banking sector regulators was examined for both ratings in order to select significant predictors among them. They have employed an ordered response logit model to analyze the monthly long run S&P rating and a panel data framework for the analysis of the quarterly CAMELS rating. The predictors for which they found significant explanatory power are: Capital Adequacy, credit spread, the ratio of Total Loans to Total Assets, and the Total Asset value at Risk. Models based on these predictors exhibited a predictive accuracy of 70 percent. Additionally, they found that the verified variables satisfactorily predict the S&P rating one month ahead.

Baral (2005), carried out a research study on " Health check-up of Commercial Banks in the Framework of CAMEL: A case study of Joint ventures Banks in Nepal." It has covered four fiscal years period from 2001 to 2004. The study was based on historical data disclosed by annual reports of Joint Venture banks, and NRB in its supervision annual reports. The Study concluded that the financial health of joint venture banks is better than that of the other commercial banks. The study further indicates that the CAMEL component indicators of the joint venture banks are not so strong to manage the possible shocks.

2.2.2 Review of Dissertations

Prior this, large volume of thesis works have been carried out by various scholars covering the various aspects of finance companies such as financial performance analysis, investment portfolio, and growth of finance companies, resources mobilization and capital structure. Some of them, as supported to relevant for the study are presented below:

Shrestha (1990) conducted a research work on Portfolio behaviours for commercial banks in Nepal. She has analyzed the debt to equity ratios of commercial banks in aggregated and Agriculture Development Bank from 1971 to 1990. She has found that the capital adequacy ratio explains the strength of the capital base of commercial banks. Higher the capital adequacy ratio, higher is its internal sources. Lower the value of capital adequacy ratio with regard to the standard value shows that the bank's ability to attract deposit from the surplus units and inter bank funds also be limited.

Bohara (1992) has done a study on financial performance of Nepal Arab bank Ltd. (NABIL) and Nepal Indosuez Bank Ltd (NIBL). The basic objectives of this study were to highlight on the functions and policies of joint ventures banks and to evaluate the comparative financial performance of NABIL and NIBL. The study has covered the five FY 1986/87 through 1990/91. In this study, financial tools along with statistical tools have been used. Different ratios-liquidity, activity, coverage, advantage, profitability and other indicators like earning per share, dividend per share, market value to book value ratio, have been used to evaluate the performance of NABIL and NIBL. In statistical tools, the least square method has been employed. The researcher has based on different financial indicators concluded that performance of NABIL is better than that of NIBL. The researcher further concluded that bank performance could not be Judged solely in term of profit as it may have earned profit by maintaining adequate liquidity and safety position. The researcher has recommended to

NIBL to extend their banking facilities even in the rural areas by opening up branches besides the improvement in maintaining the adequate capital structure by increasing equity base.

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

Gurung (1995) conducted a research on, "A financial Study on joint venture banks in Nepal". The objective of this study was to examine the financial strength and weaknesses of Nepal Grindlays Bank Ltd (NGBL) and Nepal Indosuez Bank Ltd (NIBL). The study has covered the period of seven fiscal years from 1986/87 through 1992/93. In this study, he has used financial ratios activity, profitability, capital structure and statistical tool V.Z. karl person's coefficient of correlation. The researcher has based on different financial indicators, found that performance of NGBL is better than that of NIBL.

Rana Bhat (1997) carried out a study on financial performance of finance companies in context of Nepal. The objective of the study was to analyze the financial performance of finance companies. The study has covered the six years of period 1991 through 1996. He has used different analytical tools like percentage change, index and comparative study. He had found that the performance of finance companies in regard to hire purchase, housing loans was not satisfactory. Further more, the researcher

concluded that the finance companies had not managed in true professional approach.

Sapkota (1999) carried out the research study entitled, "Investment Portfolio of Annapurna Finance Company Limited" with the objectives to analyze the investment Portfolio and to find out the liquidity and profitability position of the company. The study has covered only the five fiscal years 2050/51 through 2054/55. He has employed various financial indicators like current ratio, return on capital, return on net worth, return on total assets and earning per share to measure the financial position of the company. The scholar concluded that the investment of AFCL has been managed efficiently to maximize the return there from. But the company has not sufficiently diversified its investment to reduce its portfolio risk. However, the company has maintained a balance ratio among the deposit and investment. Moreover, allocation of loan and advances by the company does not seem as meaningful as the productive sector has not got its due share in the loan portfolio. As compared to housing loan, term loan and fixed deposit loan have got quite negligible share percentage in the loan disbursement of the company. But, hire purchase loan has got the maximum share percentage in loan disbursement of the company.

Sharma (2005) carried out the research study entitled, "Finance companies in Nepal" with the main objective of presenting the up to date study on the growth of finance companies in Nepal and analyzing the assets and liabilities structure of finance companies in Nepal. The study was based on data from mid-July 1997 to mid-Jan 2004. The study as per its nature was largely based on secondary data. He has employed simple statistical tools and financial ratios to analyze the data and presenting the position of finance companies. The study concluded that the growth of finance companies is very speedy. Total liabilities of finance companies was Rs.5117.4 million in mid-July 1997 which reached to Rs. 24681.1 million in mid-Jan 2004. The deposits constituted as the major source and

the capital fund remained in second. It is seemed that public deposit remained the major source of fund of finance companies. The liquidity position of finance companies remained higher than the legal limit of 7 percent.

Bhandari (2006) performed a study on Financial Performance Analysis of Himalayan Bank Limited in the Framework of CAMEL. The basic objective of the study was to analyze the financial performance of Himalayan Bank Limited through CAMEL framework. He has used secondary data for the period of six years from 1999 to 2004. The study revealed that adequate capital of the bank. The non-performing loan though in decreasing trend is still a matter of concern. The bank is still with better return on equity (ROE) however it is in decreasing trend. The decreasing trend of net interest margin shows management slack monitoring over the bank's earning assets. The liquid funds to total deposit ratio is above the industrial average ratio. NRB balance and cash in vault-to total deposit ratios are below the industrial average ratio during the study period.

Chand (2006) conducted a study on "Financial Performance Analysis of NABIL Bank Limited in the framework of CAMELS". The main objective of the study was to analyze the financial condition of NABIL. This study has covered only five fiscal years 2000/1 through 2004/5. The research was based on secondary information data. Some financial and statistical tools and descriptive techniques are applied to evaluate the financial performance of NABIL. He found that the capital adequacy of the bank were generally above the NRB standards in all the years. The non performing loan to loan ratios were all below the industrial average and the international standard. The loan loss provision of the bank is decreasing constantly in each year. The management proxy ratios, total expenses to total income ratio and earning per employees were favorable to the bank. The earning quality ratios were generally above the benchmark pescribed by world Bank. The overall liquidity position of the bank was in

good condition. The cumulative gap of risk sensitive assets and risk sensitive liabilities, repriced over the over maturity bucket was in continuous decreasing trend. The interest rate sensitivity ratio to the total earning assets over the short term horizon was in decreasing trend.

Similarly, Sharma (2007) carried out the research study entitled "Financial Performance Analysis of Nepal SBI Bank Ltd. in the Framework of CAMEL" with the basic objective of analyzing the financial performance of Nepal SBI Bank Ltd. (NSBL) in the CAMEL Framework. The study was based on secondary data covering the period of six years from 2001 to 2006 A.D. He has used only the financial tools. The researcher concluded that NSBL was well capitalized and complying with the directives of NRB. The bank has maintained satisfactory level of Post due Loan on total loan except in 2001. Earning per employees of the bank was found quite high. NIM of the bank was found satisfactory. Furthermore, the liquidity position of the bank was found sound.

Gurung (2007) performed the research study entitled "Financial Performance analysis of Annapurna Finance Company Limited in the Framework of CAMEL". The study was based on secondary data covering the period of five years from F.Y. 058/59 to F.Y. 062/63. She has used various financial and statistical tools. The basic objective of the study was to analyze the financial performance of Annapurana Finance Company Limited through CAMEL Framework. She has following a descriptive and analytical research design. The study concluded that the company is financially sound and strong. The Company is running with adequate capital and strictly followed the NRB directives. The capital fund of the company is sound and sufficient to meet the financial operation as per the NRB standard. The Company has placed efficient credit management and recovery efforts. The amount of non-performing loans and possibility of default in future is increasing. The company is running with the inadequate liquidity to meet its short term obligation.

Koirala (2007) carried out the research study on "Diagnosis of Financial Health of Nepal Investment Bank Limited in the Framework of CAMELS", based on secondary data covering the period of six years from F.Y. 2001 to F.Y. 2006. She has used descriptive and analytical research design. The basic objective of the study was to analyze the financial health of Nepal Investment Bank Limited in the framework of CAMELS. The study concluded that the bank is financially sound and strong. The supplementary capital of the bank is sufficient or adequate. The bank is running with the adequate capital and the capital fund of the bank is sound and sufficient. The bank is gradually moving towards cost minimizations and cost efficiency. The bank management is aware about stock holder's wealth maximization. The bank has adequate liquidity to meet its short term obligation in later years.

Although various studies have been carried out regarding financial performance analysis of banks and other financial institutions in Nepalese context, those studies mainly focused on liquidity, leverage and profitability of the banks. The financial performance analysis done in the past lack the analysis in the framework of CAMEL, a new technique of assessing financial performance of the banks and financial institutions. However very few studies have been done applying this technique, they also lack through study using appropriate models. This study attempts to analyze the financial performance of OFL in the framework of CAMEL using appropriate models of five components.

2.2.3 Research Gap

It would be wrong to claim that my research subject matter is totally undone, just a few researches have been done in this topic. However, by focusing the CAMEL tools to analyze, Om Finance (FY 2059/060 – FY 2064/065), the dissertation will contribute more and add new dimension in the field of research.

CHAPTER THREE

RESEARCH METHODOLOGY

This chapter provides the overall framework or plan for the collection, analysis and presentation of data required to fulfill the objectives of the study. It also specifies the methods and procedures for acquiring the information needed to solve the research problems. The main objective of the study is to analyze and evaluate financial performance of finance company namely Om Finance Ltd. (OFL). To meet the objectives, the methodology applied in the study is described as below.

3.1 Research Design

The study is designed within the framework of descriptive and analytical research design to achieve the desired objectives. Descriptive research seeks to find out the fact by the help of sufficient data and information. In order to evaluate the financial performance of OFL, some financial and statistical tools are applied.

3.2 Population and Sample

For the purpose of this study, finance companies are taken as population. Till mid January 2008, there are altogether 79 finance companies established in Nepal (NRB, 2008). But being a case study of a single unit, Om Finance Limited (OFL) is selected as sample for this study after knowing that no one has done any research study of Om Finance in the framework of CAMEL.

3.3 Nature and sources of Data

As per nature of the study, the study is based on secondary data. For the study purpose, annual reports of OFL are used as the major sources of data. In addition to this, necessary information are available from the NRB reports, bulletins and its website, various articles published in journals, and books written by the various authors. Formal and informal discussions with the senior staff of the company were held which was helpful in understanding and obtaining the additional information.

3.4 Data Collection Procedure

Field visit to OFL was made to collect the annual reports covering different fiscal years of OFL as secondary data. Similarly, NRB directives, banking and financial statistics and other publication are collected from the website of NRB. Other supplementary information, literature reviews are collected from the western Regional Library Pokhara, Public Library Pokhara and Central Library T.U.

3.5 Data Processing

Firstly data were extracted from the annual reports of the Om Finance and put them in a sheet. Then data were entered into the spreadsheet to work out the financial ratios and prepare necessary figures, according to the need and requirement of this study. For this purpose, gathered data have been processed using computer programs like Microsoft Excel and Word.

3.6 Data Analysis Tools

Financial ratios are the major tools used for the descriptive analysis of the study to get the meaningful result of the collected data and to meet the research objectives. In addition to the financial tools, simple statistical

(descriptive) tools were also used. The major tools applied in this study are described in the following sections.

3.6.1 Financial Tools

Financial tools are used to determine the performance of the finance company in the framework of CAMEL components. These ratios are categorized in accordance of the CAMEL components. Following category of key ratios are used to analysis the relevant components in terms of CAMEL.

Capital Adequacy Ratio: Capital adequacy ratio is the numerical relationship between total capital fund and total risk adjusted assets. It measures the adequacy of capital and financial soundness of a firm. Capital adequacy ratio is used to measure of Capital in the Company. It is worked out by using the following model.

$$\text{CAR} = \frac{\text{Total Capital Fund}}{\text{Total RiskAdjusted Assets}} \times 100 \quad \ldots\ldots. (1)$$

Where,

CAR = Capital Adequacy Ratio

Total Capital Fund = Core Capital + Supplementary Capital

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

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

$$\text{CCAR} = \frac{\text{Core Capital}}{\text{Total Risk Adjusted Assets}} \times 100 \ldots(2)$$

Where,

CCAR = Core Capital Adequacy Ratio

Core Capital = Paid up capital + Share Premium + non-redeemable preference share + general reserve + cumulative profit – goodwill if any.

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

$$SCAR = \frac{\text{Suplementary Capital}}{\text{Total Risk Adjusted Assets}} \times 100 \ldots (3)$$

Where,

SCAR= Supplementary Capital Adequacy Ratio.

Supplementary Capital = Loan Loss Provision for Pass loan + Assets Revaluation Reserve + Hybrid Capital instrument + Unsecured subordinate Term Debt + Exchange equalization reserve+ Interest rate fluctuation fund + other free reserves.

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

$$\text{Non-performing loan Ratio} = \frac{\text{Non ZPerforming Loan}}{\text{Total Loan and Advances}} \times 100 \ldots (4)$$

Where,

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

Loan Loss Ratio: The loan loss ratio is the expression of numerical relationship between loan loss provision and total loan and advances. The loan loss provision is a reserve account established by the company in anticipation of loan losses in future. This ratio shows the possibility of loan default of the company. This ratio is used to appraise quality of assets of the company. Higher ratio implies higher portion of non performing loan portfolio and vice-versa. For the purpose of the study following model is used to determine the loan loss ratio.

$$\text{Loan Loss Ratio} = \frac{\text{Loan Loss Provision}}{\text{Total Loan and Advance}} \times 100 \ldots(5)$$

Total Expense to Total Income Ratios: The total expenses to total income ratio is the expression of numerical relationship between total expenses and total incomes of the company. It measures the proportion of total expenses in total revenues. A low or decreasing ratio of expenses to total revenues indicates that a firm is operating efficiently. The increasing ratio of expenses to total revenues will negatively affect profitability of the firm.

Following is the expression of total expenses to total income ratio.

Total Expenses to Total Income Ratio

$$= \frac{Total\ Expenses}{Total\ Income} \times 100 \ldots(6)$$

Where,

Total Expenses = Operating expenses + Non operating expenses + provision per staff Bonus + provision for taxation

Total Income = Operating Incomes + Non Operating Income + Write Back of Provision for possible loss.

Earning per Employee: Earning per employee is the numerical relationship between net profit after taxes to total number of employee.

Low or decreasing earning per employee can reflect inefficiencies as a result of overstaffing, with similar repercussions in term of profitability. It is calculated by using the following model.

$$\text{Earning per employee} = \frac{Net\ \text{Pr}ofit\ After\ taxes}{Total\ Number\ of\ Employees} \ldots (7)$$

Return on Equity (ROE): The return on equity indicates the relationship between net profit after taxes to total equity capital. It is a measure of the rate of return flowing to the firm's share holders. Higher the ratio, higher the investment which the shareholders will undertake. For the purpose of the study following model is used to determine the return on equity ratio.

$$\text{Return on Equity} = \frac{\text{Net Profit after Taxes}}{\text{Total Equity Capital}} \times 100 \ldots (8)$$

Where,

Total Equity Capital = Paid up Capital + Reserve funds and surplus

Return on Assets (ROA): Return on Assets expresses the relationship between net income and total assets. It is primarily an indicator of managerial efficiency; it indicates how capably the management of the firm has been converting the institution's assets into net earning (Rose, 2002). It is calculated by using the following model.

$$\text{Return on Assets} = \frac{\text{Net Income After Tax}}{\text{Total Assets}} \times 100 \ldots (9)$$

Net Interest Margin: Net interest margin in the extension of numerical relationship between net interest income and total earning assets of a firm. Earning assets are these generating interest or fee income, principally the loans and investment on securities, the company has made. The ratio measures how large a spread between interest revenues and interest costs management has been able to achieve by close control over the firm's earning assets and the pursuit of the cheapest sources of funding (Rose,

2002). For the purpose of the study following model is used to determine net interest margin:

$$\text{Net Interest Margin} = \frac{\text{Net Interest Income}}{\text{Earning Assets}} \times 100 \ldots(10)$$

Where,

Net Interest Income = Interest income – Income Interest Expenses.

Earning Assets = Loan and Advances + Investment on Securities

Earning Per Share (EPS): Earning per share provides a direct measure of the returns flowing to the firm's owners- its stockholders measured relative to the numbers of shares to the public (Rose, 2002). It gives the strength of the share in the market. Flowing is the expression of earning per share:

$$\text{EPS} = \frac{\text{Net Income/ Profit after Tax}}{\text{No. of shares of Common Stock}} \ldots(11)$$

Where,

$$\text{No. of shares of Common Stock} = \frac{\text{Paid up Capital}}{\text{Rs.100}}$$

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

Total Liquid Funds to Total Deposits Ratio

$$= \frac{\text{Total Liquid Funds}}{\text{Total Deposits}} \times 100 \ldots(12)$$

Where,

Total Liquid Funds = Cash in hand + Balance with NRB + Balance with Domestic FIs + Money at call and short notice + Investment in Government Securities

NRB Balance to Total Deposits Ratio: NRB balance to total deposits ratio is the expression of numerical relationship between NRB balance and total deposits of a firm. It measures the proportion of NRB balance in total deposits. It shows whether a company is holding the balance as required by Nepal Rastra Bank or not for the purpose of this study the NRB balance to total deposits ratio:

$$\text{NRB Balance to total Deposits Ratio} = \frac{\text{NRB Balance}}{\text{Total Deposits}} \times 100 \ldots(13)$$

Where,

NRB Balance = Balance with NRB

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

$$\text{Vault to Total Deposit Ratio} = \frac{\text{Cash in Vault}}{\text{Total Deposits}} \times 100 \ldots(14)$$

Where,

Cash in Vault = Cash in Hand

3.6.2 Statistical Tools

In the study, different some statistical tools have been used to analyze the data and reach the meaningful results, which are as below:

Average: A simple arithmetic average is used to summarize the data as a representation of mass data. A simple arithmetic average is a value

obtained by dividing the sum of the values by their numbers (Kothari, 2004). Thus, the average is expressed as:

$$\overline{X} \; X\frac{X}{N} \ldots (15)$$

Where,

$\overline{X}$ = Simple Arithmetic Mean

= Symbol for Summation

N = Total number of observation

During the analysis of data, mean is calculated by using the statistical formula 'AVERAGE' of excels data sheet on computer.

Standard Deviation: Standard deviation is often powerful and helpful measure of dispersion in order to measure the size of deviation from the average (Kothari, 2004). It is said that higher the value of standard deviation the higher the variability and vice versa. Karl Pearson introduced the concept of Standard Deviation in 1983. Standard Deviation is determined in the following way:

$$\text{S.D.} = \sqrt{\frac{f_x Z \bar{x} \AA}{n}} \ldots (16)$$

Where,

X = Individual Value

$\overline{X}$ = Simple Arithmetic Mean

n = Total Number of Observation

During the analysis of data, standard deviation is calculated by using the statistical formula 'STDEV' on excels data sheet on computer.

Co-efficient of Variation: It is a relative measure of dispersion based on standard deviation and is usually denoted by its short form, C.V. It is the product of standard deviation divided by their respective mean multiply by 100. In order to compare the validity between two sets of data; coefficient of variation is used as a useful method. A distribution having more

coefficient of variation is considered more variable or less consistent and vice versa. (Sharma, 2064). Symbolically, the coefficient of variation is defined as:

$$CV = \frac{\pm}{x} \mid 100 \ldots (17)$$

Where,

± = Standard Deviation

$\overline{X}$ = Simple Arithmetic Mean

CV = Coefficient of Variance

Least Square Trend Analysis: Least Square trend analysis is used to find out the trend of ratios. The General equation used for trend is given below:

$$\hat{Y} \quad X a \Gamma bx \ldots (18)$$

Where,

$\hat{Y}$ = Dependent Variables

X = Coded Time in year (independent variable)

a = Y- intercept

b = Slope of the Trend Line

In the above model,

$$b = \frac{XY \; Z n \; \overline{XY}}{X^2 \; Z n \; \overline{X}^2}$$

$$a = \overline{Y} \; Z b \overline{X}$$

3.7 Limitation of the Methodology

The study is carried out within the framework of case study research design. So, it is difficulty to eliminate the limitations of the case study research design, in which the study as well as the methodology is bounded. Only a single is takes for the study, therefore, the study may not be able to represent the whole scenario.

The study is focused on the financial analysis of OFL in the framework of the five components of CAMELS system and are based on the audited financial annual reports of condition of OFL during the period 2059/60 to 2064/65 B.S. Different models and tools which are used for data collection in the research work are not completely free from the criticism. So, it is also imposes to draw the line of limitation. Finally, the different tools are used to analyze the collected data, which are based on certain assumptions so, reliability of the analysis depends upon the circumstances on which the models are based.

CHAPTER FOUR

PRESENTATION AND ANALYSIS OF DATA

This chapter deals with the presentation and analysis of data collected from the different sources . As stated in the theoretical presentation, the financial performance analysis of OFL is concentrated in the five components, CAMEL: Capital Adequacy, Asset's Quality, Management Quality, Earning Quality and Liquidity. The data collected from annual reports of OFL have been analyzed with the application of CAMEL.

4.1 Data Presentation and Analysis

In this section, the data collected from different sources has been refined and documented in excel tables and graph, which are further processed to analyze and arrive at the findings on the financial conditions of OFL in term of CAMEL framework.

4.1.1 Capital Adequacy

Capital adequacy is a measure of financial institutions financial strength, in particular its ability to cushion operational and abnormal losses. In addition, it provides a cushion against the risk of failure. Adequate capital reduces firm's risk. A firm should have adequate capital to support its risks assets in accordance with the risk-weighted capital ratio frame work. So, the adequacy of firm capital is the most important aspect of a firm. Such company becomes successful to gain the trust of all sectors (Mishkin and Eakins, 2006).

Adequacy and inadequacy of firm capital directly affects the transaction. The adequacy of firm capital is the most important aspect of the firm. If there is inadequacy of capital, the firm should take step for the adequacy of capital as per legal requirement because its financial health can't be regarded capable and healthy without having adequate capital.

Nepal Rastra Bank (NRB) determines the Capital adequacy ratio of all banks and non-bank financial institutions in Nepal. NRB concerned with this because some financial institutions do not hold enough capital and have increased capital requirements. If the firms hold more capital, they can more easily absorb potential losses and are more likely to survive more over, it reduces the likelihood of failure. The company with higher capital ratios is therefore assigned a higher capital adequacy rating. However, a firm with a relatively high level of capital could fail if the other components of its balance sheet have not been properly managed (Madura, 2001).

4.1.1.1 Core Capital Adequacy Ratio

Core Capital is also known as primary capital. It is also called tier 1 Capital Tier 1 Capital includes the paid-up capital, share premium, non-redeemable preference share, general reserves, retained earnings, proposed bonus share and goodwill deductible if any.

Core Capital adequacy ratio (CCAR) measures the adequacy of internal sources of shareholder's fund to support the financial activities. It reflects the financial strength and soundness of a company. Thus, core capital is the amount of shareholders' fund. Nepal Rastra Bank has provided the minimum standard of CCAR in order to stabilize the Capital and assets of finance companies. They are required to maintain the CCAR of 5.0 percent, 5.5 percent, 5.5 percent, 6 percent and 5 percent in the FY 059/60 to FY 064/65 respectively. A higher value of the ratio above the

NRB standard shows the adequacy of internal sources and higher security to creditors and depositors and vice-versa.

Table 4.1 Presents the observed value of Core capital Adequacy ratio in OFL during the study period and minimum core capital standard set by NRB.

Table 4.1

Core Capital Adequacy Ratio

(Rs in thousand)

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Core Capital (Rs.)	24939.00	30507.00	38009.00	79841	98123.00	116212
Total risk weighted assets (Rs.)	162697.00	268494.00	378433.00	490899.00	712699.00	987703
Core Capital Adequacy Ratio (%))	15.32	11.36	10.05	16.10	13.77	11.77
Nepal Rastra Banks Standard (%)	5.00	5.50	5.50	6.00	6.00	5
Core Capital Ratio (Excess/ short) (%)	10.32	5.86	4.55	10.10	7.77	6.77

Source: OFL, Annual Reports.

The data shown in the Table 4.1, the core (Tier 1) capital adequacy ratio of OFL is maximum of 16.10 percent in FY 062/63 and minimum of 10.05 percent in FY 061/62 with the average ratio of 13.06 percent. The ratio are 15.32 percent, 11.36 percent, 10.05 percent, 16.10 percent and 13.77 percent and 11.77 in FY 059/60 to FY 064/65 respectively. It reveals that the ratios are fluctuating over the study period. Therefore, it is clear that the core capital adequacy ratio of the company is in decreasing tendency in beginning FYs and then it is in the increasing trend up to final FYs. The observed value of Core Capital adequacy ratio (CCAR) of the OFL is shown with NRB standard in Figure 4.1 below.

Figure 4.1

Comparing Core Capital Adequacy Ratio with NRB Standard

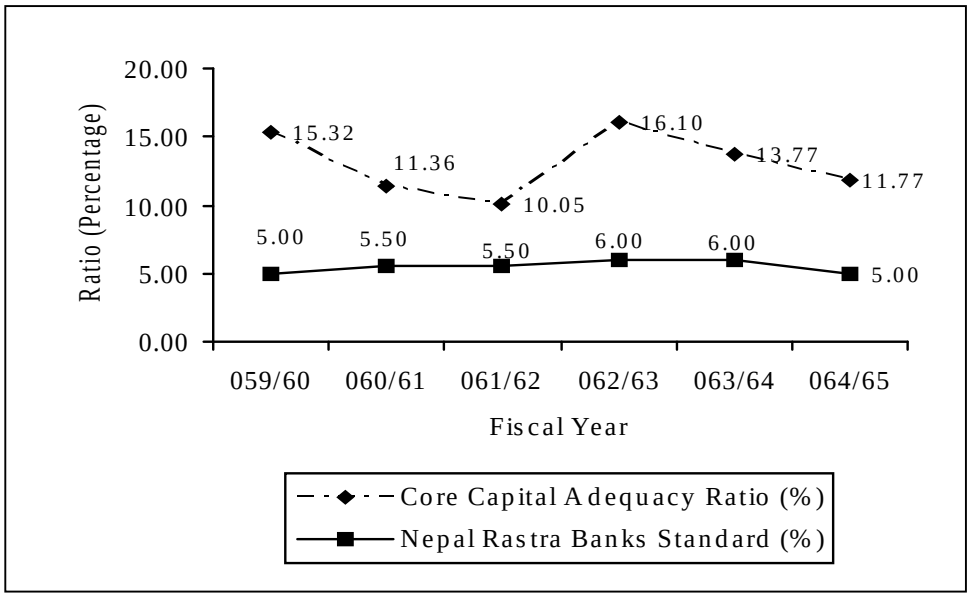


Figure 4.1 shows the core capital adequacy ratios compare with NRB standard. As compared to NRB standard, the core capital adequacy ratios of OFL are excess throughout the study period. The graph further shows that the company has met NRB standard in all the company has met NRB standard in all fiscal years. It indicates that the company is applying adequate amount of internal sources of shareholder's funds with significant core capital adequacy ratio throughout the study period.

4.1.1.2 Supplementary Capital Adequacy Ratio

Supplementary Capital is also known as Tire II Capital Tire II Capital includes loan loss provision for pass loan, asset revaluation reserves, hybrid capital instrument, unsecured subordinate term debt, exchange equalization reserve, interest rate fluctuation fund and other free reserves.

Supplementary capital adequacy ratio indicates the contribution of supplementary capital in capital adequacy ratio of a firm. A high value of supplementary capital ratio means the higher proportion of supplementary capital in total risk adjusted assets and large portion of supplementary

capital in capital adequacy ration and vice versa. As per the NRB unified directives for Banks and Non Banks FIs issue number E. Pra. Ni.No o1/061/62 (Ashar 2062 B.S.), the maximum limit of supplementary capital ratio that can be included in capital adequacy ratio of the company in each year.

Table 4.2 presents the supplementary capital adequacy ratio of OFL during the study period last six years.

Table 4.2

Supplementary Capital Adequacy Ratio

(Rs. in thousand)

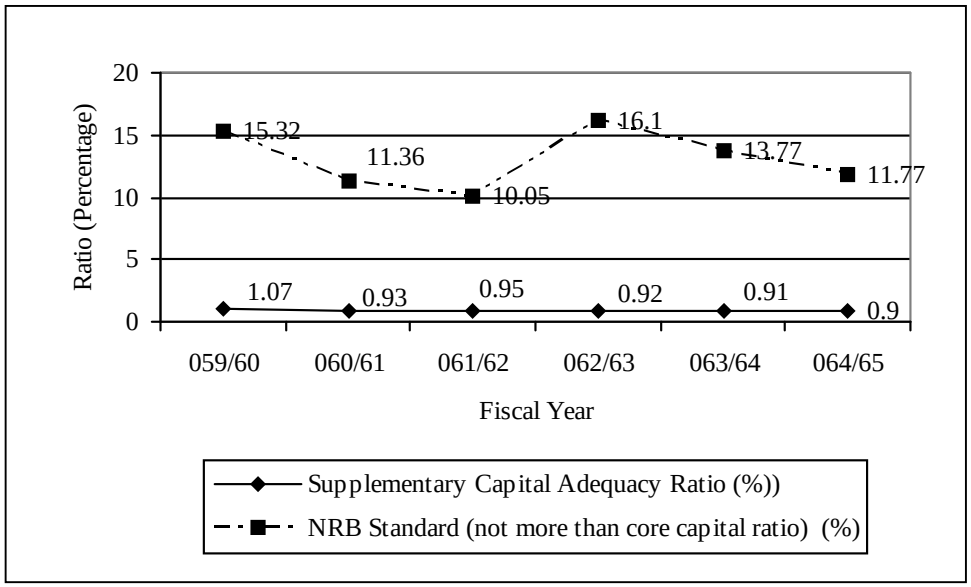
Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Supplementary Capital (Rs.)	1745	2494	3590	4512	6451	8925
Total Risk Weighted Assets (Rs.)	162697	268494	378433	490899	712699	987703
Supplementary Capital Adequacy Ratio (%))	1.07	0.93	0.95	0.92	0.91	0.90
NRB Standard (not more than core capital ratio) (%)	15.32	11.36	10.05	16.10	13.77	11.77
Excess/ Short (%)	-14.25	-10.43	-9.1	-15.18	-12.86	-10.86

Source: OFL, Annual Reports.

As shown in table 4.2, the supplementary capital adequacy ratio (SCAR) of OFL is 1.07 percent, 0.93 percent, 0.95 percent, 0.92 percent, 0.91 percent and 0.90 percent in FY 059/60 to FY 064/65 respectively. The ratio is maximum in FY 059/60 with 1.07 percent and minimum in FY 064/65 with 0.90 percent. The ratio of the company is decreasing continuously up to FY 064/65 from FY 059/60. The observed value of supplementary capital adequacy ratio of OFL is shown with NRB standard in Figure 4.2.

Figure 4.2

Comparing Supplementary Capital Adequacy Ratio with NRB Standard



From the above Figure 4.2, it is clear that the OFL is significantly above the standard set by NRB throughout the study period. Risk based supplementary Capital Ratio in excess of NRB standard is 14.25 percentage in FY 059/60. It then has grown maintaining more than 9 percent excess in the consecutive years of the study period. It indicates that OFL has maintained adequate supplementary capital in the study period.

4.1.1.3 Total Capital Adequacy Ratio

Total capital fund is the summation of core capital and supplementary Capital. This means the total amount invested by shareholder, creditors and the amount collected from the various free reserves maintain in the company.

Capital adequacy ratio (CAR) measures the adequacy of capital and financial soundness of a company for smooth operation. CAR above the NRB standard reveals the sound and strong financial position and higher security to depositors. On the contrary, the low value of capital adequacy ratio with regard to the minimum requirement of NRB shows that the

lower is its internal sources, comparatively weak financial position and lower security to depositors.

NRB has set the standard of capital adequacy ratio as 10 percent, 11 percent, 11 percent, 12 percent and 12 percent and 11 percent in the FY 059/60 to FY 064/65 respectively.

Table 4.3 presents the observed values of capital adequacy ratio in OFL during the study period and minimum capital adequacy ratio set by NRB.

Table 4.3

Capital Adequacy Ratio

(Rs in thousand)

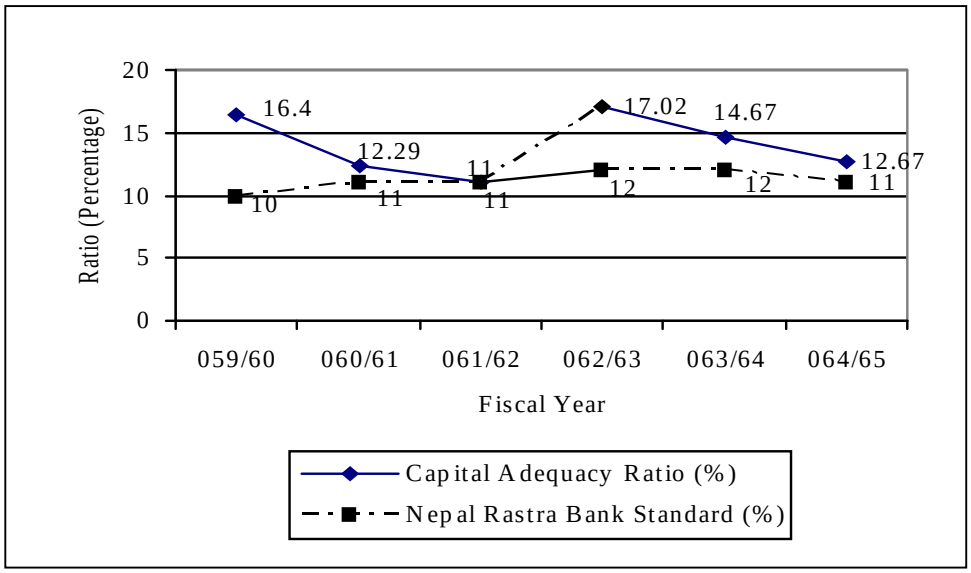
Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Total Capital Fund	26685	33001	41599	84354	104574	125137
Total Risk Weighted Assets (Rs.)	162697	268494	378433	490899	712699	987703
Capital Adequacy Ratio (%)	16.40	12.29	11.00	17.02	14.67	12.67
Nepal Rastra Bank Standard (%)	10.00	11.00	11.00	12.00	12.00	11
Capital Adequacy Ratio (Excess/ Shorts) (%)	6.40	1.29	-	5.02	2.67	1.67

Source: OFL, Annual Reports.

The data given in the Table 4.3 shows that capital adequacy ratio of OFL is 16.40 percent, 12.29 percent, 11 percent, 17.02 percent, 14.67 percent and 12.67 percent in FY 059/60 to FY 064/65 respectively. The ratio are fluctuating over the study period. The ratio of OFL is minimum 11 percent in FY 061/62 and maximum 17.02 percent in FY 062/63. The ratio is decreasing in the beginning FYs up to FY 061/62 and then moving upward up to final FYs. The ratio is excess in all the year but in FY 061/62, the ratio is equal to NRB standard. Figure 4.3 exhibits the observed capital adequacy ratio of the OFL is shown with NRB Standard within the study period.

Figure 4.3

Comparing Capital Adequacy Ratio with NRB Standard



As shown in Figure 4.3 the observed capital adequacy ratio OFL is above the NRB standard during the study period. The graph further shows that the company has met NRB standard in all years. It implies that the company has maintained and adequate capital adequacy ratio in each year of the study period. Hence, OFL has strictly followed the NRB directives and its capital adequacy requirements.

4.1.2 Assets Quality

Assets Quality is one of the most important factors which measures how effective an institution is at lending money to people who are willing and able to pay it back. So, the health of finance companies largely depends on the quality of assets held by them and quality of the assets relies on the financial health of their borrowers. Thus, assets quality has direct impact on the financial performance of a financial institution (Mishkin and Eakins, 2006).

Assets quality is one of the most critical assets in determining the overall condition of a company. The primary factor effecting overall asset quality is the quality of the loan portfolio and the credit administration

program. The extent of the credit risk depends on quality of assets held by an individual FI. The quality of assets held by and FI depends an exposure to specific risk, trends in non-performing loans and the health and profitability of bank borrowers especially the corporate sectors.

There are different indicators of measuring the quality of assets held by a company such as portfolio in arrear, assets compositions, loan loss ratio, non-performing loan ratio and reserve ratio.

NRB has laid down minimum criteria for the classification of loans based on the overdue period of the advances. Loans with inherent credit weaknesses are classified as non-performing loans (NPL), which are further, classified into three categories, namely substandard, doubtful and loss loan requiring provisioning of 25 percent, 50 percent and 100 percent respectively.

In this study, non-performing loan ratio and loan loss ratio are used to measure and prove the quality of assets held by OFL. The increasing trend of these ratio shows the deteriorating quality of OFL assets.

4.1.2.1 Non-performing loan to Total Loan and Advances Ratio

Loan and advances usually represent the single largest assets category for most finance companies. Loan is a risky assets. Each firm makes its decisions as to how deposited funds should be allocated, and these decisions determine its level of credit (default) risk. Risk of non-repayment of loan is known as credit risk. If the borrowers fail to pay the interest or principal with in the time frame, the performing loan turns into non performing loan.

As per the NRB unified directives, 2062 all loans and advances must classify on the basis of aging of principle amount. The total loan and advances consists of pass, sub-standard, doubtful and loss loan. The ratio of NPL to total loan and advances shows the percentage of NPL in total

loan. Lower ratio shows the better proportion of performing loans and risk of default and vice-versa.

Table 4.4

Non- performing Loan Ratio

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Non-performing Loan	41865.62	1348034.81	1411704.34	5337040.22	5312457.32	3950947.86
Total Loan and Advances	148326607.73	252597286.42	363949579.23	456565363.32	650451939.83	895834435.05
NPL Ratio (%)	0.03	0.53	0.39	1.17	0.82	0.44

Source: OFL, Annual Reports.

The data given in the Table 4.4 exhibit that the non-performing loan to total loan and advances ratio of OFL is maximum in FY 062/63 with1.17 percent and minimum in FY 059/60 with 0.03 percent and an average of 0.56 percent. The lower ratio is considered favourable for the company and vice-versa. The ratios of the company are fluctuating over the study period. The C.V. between them is 69.83 percent. On the basis of C.V., it can be concluded that the ratios are variable and less conistent. The observed value of NPL ratio of OFL is shown with trend line in figure 4.4

Figure 4.4

Trend of Non-performing Loan Ratio

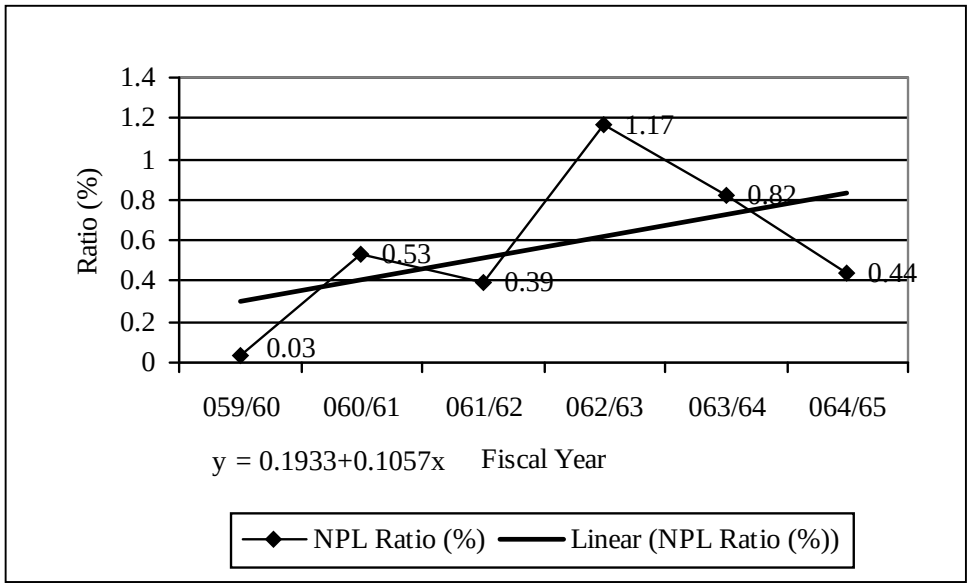


Figure 4.4 shows the NPL ratio of OFL compared with trend line. The graph shows that NPL ratio of the Company is in fluctuating trend.

The reason of this fluctuating of the NPL ratio of OFL is due to decline in loan quality, increase in loan volume and changes in NRB directives in NPL classification. However, the NPL ratios are below the international standard i.e. 5 percent. It shows the efficient credit management. It indicates that the company has low credit risk. It reflects the good performance of the company in mobilizing loan and advances.

4.1.2.2 Loan Loss Ratio

The loan loss ratio shows how efficiently the company manages its loan and advances and makes effort for the loan recovery. More delay the company gets to collect the loan, more provision has to make and the ratio will be higher. This will lead to low earning and high losses in the company. The loans loss provisioning ratio indicates adequacy of allowance for loan and trend in the collection of loan and the performance in loan portfolio. It's obtained by the ratio of loan loss provision to the total loan (Garden and miller, 1988).

The provision for loan loss reflects the increasing probability on NPL in the volume of total loans and advance. Loan loss provision on the other hand signifies the cushion against future contingency created by the default of the borrowers. The high ratio signifies the relatively more risky assets in the volume of loans and advances. The high provision for loan loss shows the recovery of loan to be difficult and irregular and the age of the loan is increasing. So higher the ratio more will be risky assets in the volume of loans and advances.

Table 4.5 presents the observed loan loss ratio of OFL during the study period of six years.

Table 4.5

Loan Loss Ratio

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Loan Loss Provision	2024413.28	4446291.92	6114028.56	9849323.45	11763852.14	12875532.73
Total Loan and Advances	148326607.73	252597286.42	363949579.23	456565363.32	650451939.83	895834435.05
Loan Loss Ratio (%)	1.37	1.77	1.68	2.16	1.81	144

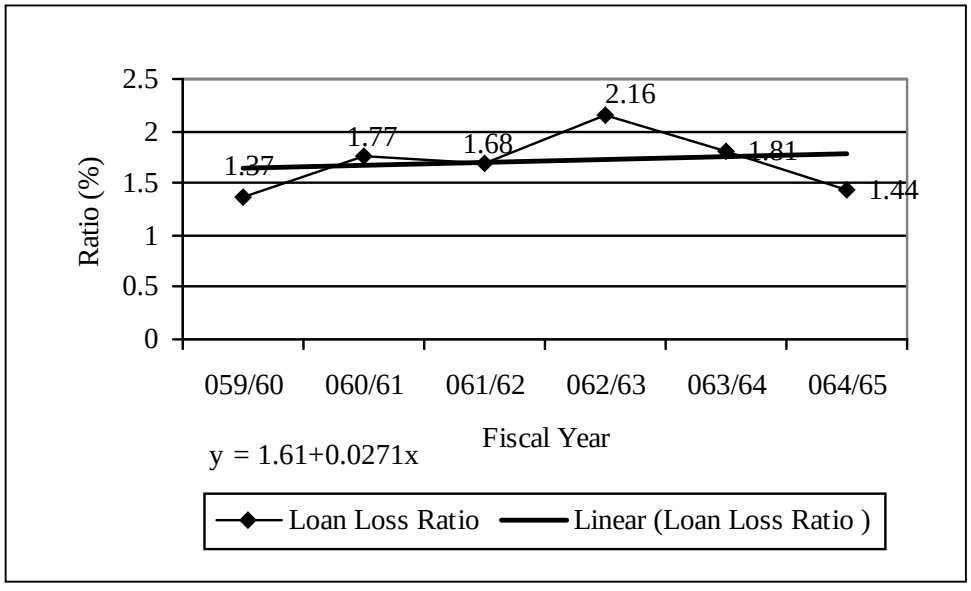
Source: OFL, Annual Reports.

The data given in the Table 4.5 exhibits that the loan loss ratio of OFL is 1.37 percent, 1.77 percent, 1.68 percent, 2.16 percent, 1.81 percent and 1.44 percent in FY 059/60 to 064/65 respectively. It reveals that the ratio are fluctuating over the study period. The ratio ranges from 1.37 percent to 2.16 percent with a mean average of 1.71 percent. The C.V. between them is 15.20 percent. On the basis of C.V., it can be concluded that the ratio are variable and less consistent with the increasing trend.

The observed value of loan loss ratios of the OFL is shown with trend line in figure 4.5 below

Figure 4.5

Trend of Loan Loss Ratio



As shown in Figure 4.5, the observed value of loan loss ratio along with lest square trend line. The slope of the trend line determined by the least square method is positive and sharp which indicates the trend of the

loan loss ratio is increasing over the study period. The loan loss ratio of the company has fluctuating trend with increasing over the years. The reason of this fluctuating of the loan loss ratio is due to changes in NRB directives in classification of non-performing loan and increase in loan loss provision. But from the FY 062/63, the slope is decreasing trend which indicates that loan loss of the company is also decreasing slowly.

4.1.3 Management

Good management can make and poor management can break an organization. Sound management is the key of financial institutions performance. It is primarily a qualitative factor applicable to individual institutions. However, for the successful operation of a company, the quality of management is the most important factor. As the other four CAMEL components can be quantitied easily from financial statements of a company (Koch, 2004).

There are several indicators which can be used as a proxy of management quality. But, here only the ratio of total expenses to total income and earning per employee are used to indicate the quality of management. Total expenses to total income ratio is used as a proxy of management quality in this study as the profitability of a company is determined by the gap of total income and total expenses which one in direct control and monitoring of the management.

4.1.3.1 Total Expenses to Total Income Ratio

The ratio of total expenses to total income is used as a proxy measure of the management quality. A high level of expenditure in unproductive activities may reflect an inefficient management. A high or increasing ratio of expenses to total income indicates inefficient operation of the company which may negatively affect profitability of the company (Koch, 2004).

Finance companies mainly earned incomes from interest on loans and advances, commissions, fees and discounts and other miscellaneous income. The main components of expenses of finance companies are interest on deposits, staff salary, provision for staff bonus, allowances, provident fund and other operating expenses like rent, water and electricity, fuel expenses, audit fee expenses, management expenses depreciation miscellaneous expenses and all other expenses directly related to the operation of company. Expenses such as loan on sale of assets, provision for possible losses, loss on sale of investment and provision for income tax are non-operating expenses.

Table 4.6 present the observed total expenses to total income ratio of OFL during the study period of six years.

Table 4.6

Total Expenses to Total Income Ratio

(Rs. in thousand)

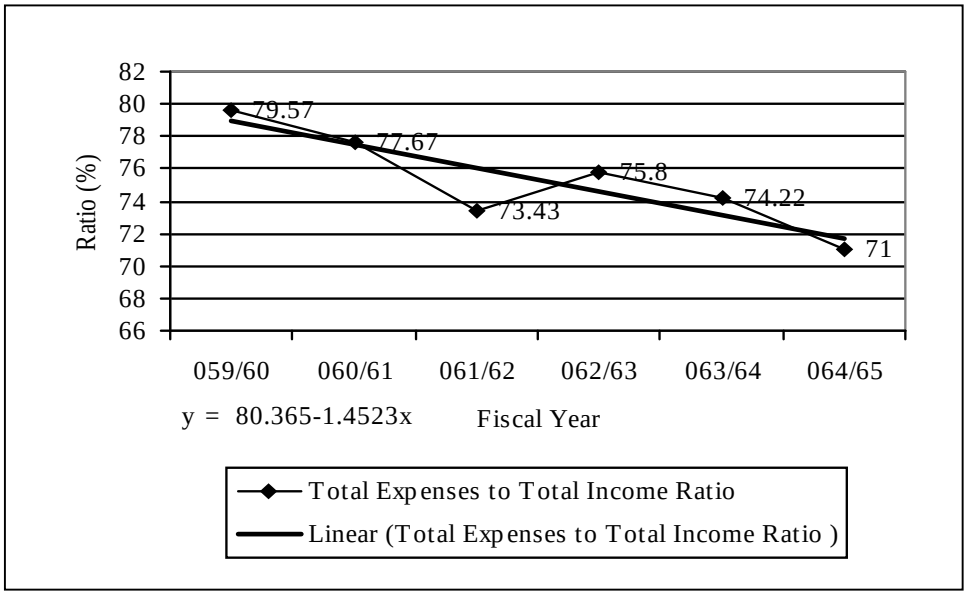
Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Total Expense	16435	28666	36631	48376	57530	73535
Total Income (Rs.)	20655	36906	49885	63815	77517	103539
Total Expenses to Total Income Ratio (%)	79.57	77.67	73.43	75.80	74.22	71.00

Source: OFL, Annual Reports.

As shown in Table 4.6, the total expenses to total income of OFL is decreasing up to FY 061/62 and in FY 062/63 it is increased and then decreasing till last final FYs. This ratio is distributed from a minimum of 71 percent in FY 064/65 and maximum 79.57 percent in FY 059/60 with average of 75.28 percent. It can be concluded that the ratios are in decreasing trend with in the study period.

Figure 4.6

Trend of Total Expenses to Total Income Ratio



As shown in figure 4.6, the total expenses to total income ratio is decreasing slowly. The slope of the trend line determine by the least square method is negative i.e. -1.4523. Decreasing trend of ratio is favourable and measure management quality. Thus, negative slope of trend line of the ratios indicates the decreasing expenses with respect to income. This is good sign for the company in measuring the quality of management. It can be concluded the company is careful to reduce the expenditures in unproductive activities in later FYs.

4.1.3.2 Earning Per Employee

The ratio of earning per employee is used as a proxy of management quality. It indicates the productivity and profitability of a company's workforce (Koch, 2004). It is calculated dividing net profit after taxes by number of employees. Low or decreasing earning per employee can reflect in efficiencies as a result of overstaffing with similar repercussion in terms of profitability (IMF, 2001).

Table 4.7

Earning Per Employee

(Rs. in thousand)

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Net Profit After Tax (Rs.)	2935	5991	9079	10884	13691	18684
No. of Employees	9	9	9	11	11	14
Earning Per Employee (Rs.)	326	666	1009	989	1245	1335

Source: OFL, Annual Reports.

The data given in the Table 4.7 exhibits that the earning per employee in rupees during the study period. The net profit after tax of the company has increased in all the fiscal years. On the other hand, total number of employees is in increasing trend in the review period. The mean at the ratios for the study period is Rs. 928333.33.

Figure 4.7

Trend of Earning Per Employee

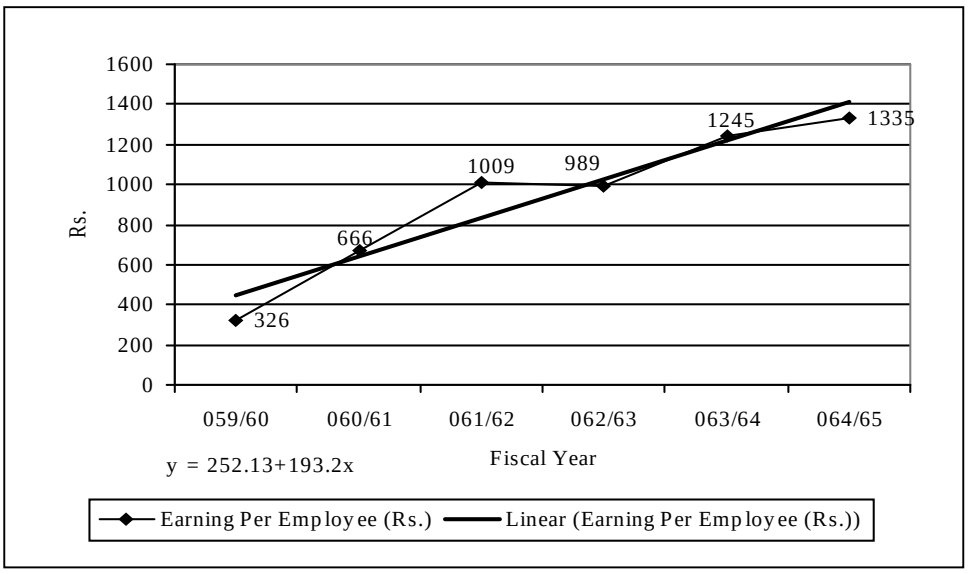


Figure 4.7 shows the observed value of earning per employee along with least square trend line. The slope of the trend line is positive. Which indicates the earning per employee is increasing over the study period. Increasing earning per employee can reflect efficiencies as a result of well staffing. However, In FY 062/63 is has reduced due to increased number of staff with similar repercussion in terms of profitability.

4.1.4 Earning Quality

Earning is a yardstick indicating the management, shareholders and depositors to evaluate the performance of the company, sustainability of earning and to forecast growth of the company. The success of the firm heavily relies upon the efficiency of its management to drive the bank to earn good profits. Net profit is the major yardstick to measure such profits. A required level of profit is necessary for the firm's growth and survival in the competitive environment. Profitability is vitally more important for assuring that a firm stays in business or activity.

The quality and trend of earning of an institution depend largely on how well the management manages the assets and liabilities of the institutions. In addition, earning capacity largely counts on the efficiency of management. Chronically, loss making finance companies reduce their capital base, risk the solvency and eventually bring down the wealth of their shareholders conversely, constantly profit making company add equity to the capital fund, reduces the risk of insolvency, and finally increases the wealth of their shareholder (Saunders and Cornett, 2004).

Earning quality is one of the indicators of the sound health of a finance company. Sound health of a company requires earning profit. The survival of a company is determined by the generation of profit. The ratio which measure the profitability of business operation are mainly, return on equity (ROE), return on assets (ROA), net interest margin (NIM) and earning per share (EPS) are used to evaluate the profitability of OFL.

4.1.4.1 Return on Equity (ROE)

ROE measures how well the owners are doing on their investment. It indicates how profitability the owners' funds have been utilized by the firm. So, it is one of the important ratios to judge whether the company has earned a satisfactory return for its equity shareholder or not. Higher ratio of ROE ensures to owners that their investment is safe and they can get

regular return (Mishkin and Eakins, 2006). Therefore the higher ratio represents sound management and efficient mobilization of the owners equity and vice versa. The return on equity ratio should be 15 percent and higher as prescribed by the world bank (MC Nally, 1996).

Table 4.8

Return on Equity

(Rs. in thousand)

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Net Profit After Tax (Rs.)	2935	5991	9079	10884	13691	18684
Shareholder Equity	24939	30507	38009	79841	98123	116212
Return Equity (%)	11.77	19.37	23.89	13.63	13.89	16.08

Source: OFL, Annual Reports.

The data given in the Table 4.8 show that the ratio is in fluctuating trend with the highest ratio 23.89 percent in FY 061/62 and the lowest 11.77 percent in FY 059/60. The mean ratio of OFL is 16.44 percent and the C.V. between them is 27.20 percent, which is adjustable and consistent. The mean ratio of the company is above the 15 percent bench mark, so the ratio of the company is good and not so bad. At last, the ratio is in increasing slowly.

Figure 4.8

Trend of Return on Equity Ratio

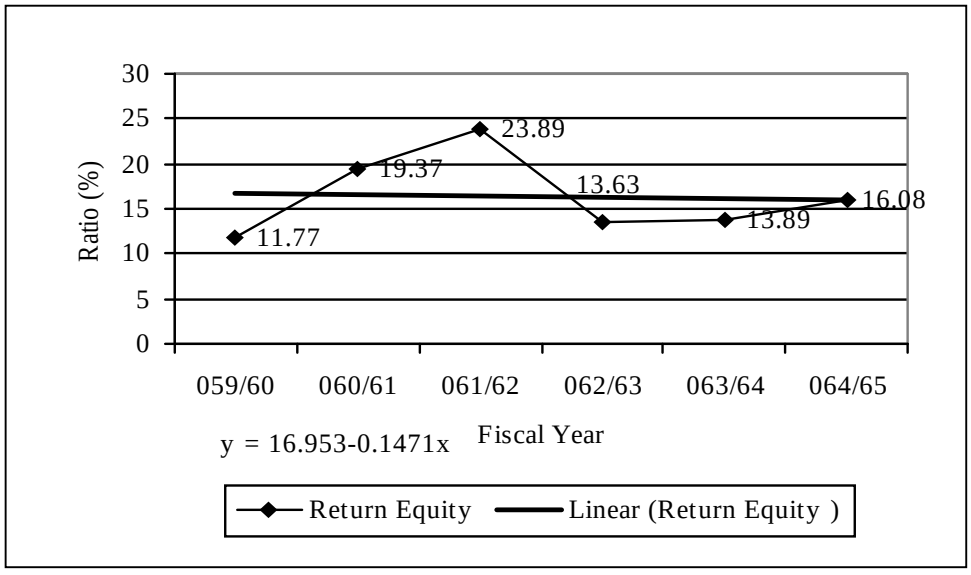


Figure 4.8 shows, the observed value of ROE along with lest square trend line. The slope of the trend line determined by the least square method is negative. Despite, the average ratio is above the World Bank Benchmark. The ROE ratio of the company is fluctuating due to increase in shareholders' equity but the profit of the company has not increased in same ratio as the equity has increased.

4.1.4.2 Return on Assets (ROA)

A basis measure of company profitability that corrects for the size of the firm is the return on assets (ROA), which divides the net income of the company by the amount of its assets. ROA is a useful measure of how well a manager is doing the job because it indicates how well an institutions assets are being used to generate profits. It measures the overall effectiveness of management in generating profit with its available assets. The higher the company's return on assets the better it is doing in operating and vice versa. A company has to earn satisfactory return on assets for its survival (Mishkin and Eakins, 2006). ROA is a popular tool measure how well its assets are utilized in generating profit. It measures the profit earning capacity by utilizing available resources i.e. total assets, return will be higher if the banks resources are well managed and efficiently utilized. Generally, the return on assets ratio should be 1.5% and higher as presibed by the world Bank (MC Nally, 1996).

Table 4.9

Return on Assets

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Net Profit After Tax (Rs.)	2935292.86	5991376.56	9079381.09	10884537.28	13690979.13	18684571.76
Total Assets (Rs.)	182311340.27	311691943.28	432345136.92	586707147.16	761783742.24	1152130949.94
Return Assets (%)	1.61	1.92	2.1	1.86	1.8	1.62

Source: OFL, Annual Reports.

The data given in the Table 4.9 shows that the net profit after tax of the company is in increasing trend. On the other hand, the return on assets

ratio of company is minimum of 1.61 percent in FY 059/60 and maximum of 2.1 percent in FY 061/62. The ratio is increasing from FY 059/60 to FY 061/62 but then from FY 062/63 is slightly decreasing. The mean ratio of OFL is 1.82 percent and the C.V. of them is 9.37 percent, which is variable and less existent. The mean ratio of the company is above the benchmark 1.5 percent and higher. This shows that the company's ratio is better. The observed value of ROA ratios of the OFL is shown with trend line in Figure 4.9 below.

Figure 4.9

Trend of Return on Assets Ratio

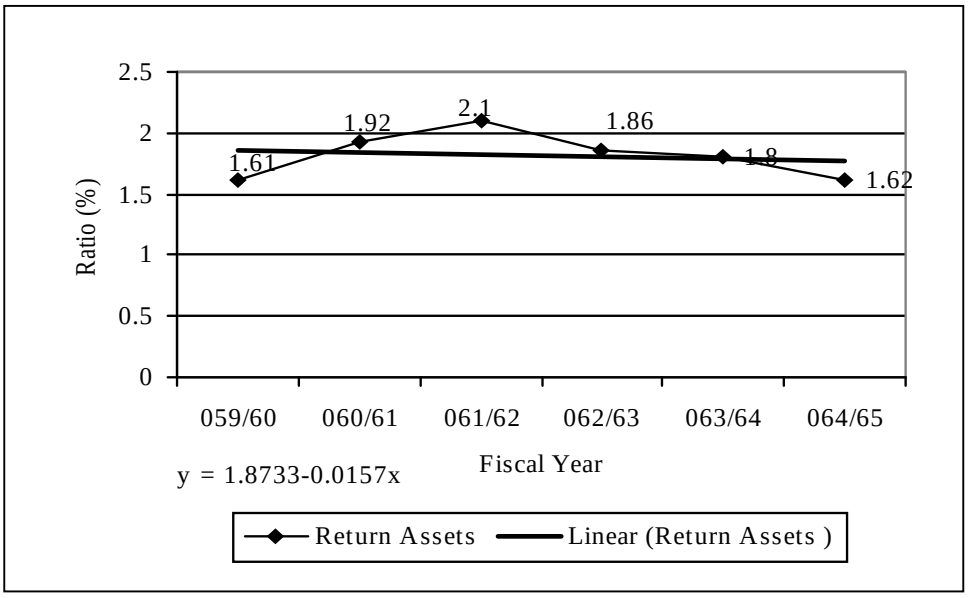


Figure 4.9 shows the observed ROA ratio with least square trend line. The slope of the trend line determined by the least square method is negative. The average ratio is above the World Bank benchmark. the ROA ratio of the company is fluctuating due to increase in total assets but the profit of the company has not increased in same ratio as the total have increased. At last, the negative slope indicates that the return on assets ratio decreasing slowly.

4.1.4.3 Net Interest Margin (NIM)

The difference between interest income and interest expenses as a percentage of net earning assets is the net interest margin. How well a company manages its assets and liabilities is affected by the spread between the interest earned on the company's assets and the interest earned on the company's assets and the interest costs on its liabilities. This spread is exactly what the net interest margin (NIM) measures (Mishkin and Eakins, 2006). The net interest margin measure how large a spread between interest revenues and interest costs management has been able to achieve by close control over the banks earning assets and the pursuit of the cheapest sources of finding (Peter, 1999). So, it is a measure of how effectively a company utilized its earning assets in relation to the interest cost of funding. Low interest expenses and high interest revenues (0n a relative basis) will increase the NIM and vice versa. The NIM ratio should be 3 to 4 percent and higher as prescribed by the World Bank (MC Nally, 1996).

Table 4.10

Net Interest Margin

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Net Interest Income (Rs.)	4959635.69	10056168.88	1459533.01	18619658.28	20851567.06	29251596.61
Earning Assets (Rs.)	150203194.4	252731994.5	363385550.6	474766039.8	669265087.6	908535902
Net Interest Margin (%)	3.3	3.98	4	3.92	3.1	3.22

Source: OFL, Annual Reports.

The data given in Table 4.10 shows the net interest margin of OFL is minimum in the FY 063/64 with 3.1 percent and maximum in the FY 061/62 with 4 percent. The NIM ratio is in increasing up to FY 061/62 and then decreasing trend. The mean ratio of OFL is 3.58 percent and the C.V. of them is 10.76 percent, which is variable and less consistent. The mean ratio of the company is between the benchmark 3 to 4 percent. This shown that the company's ratio is better.

Figure 4.10

Trend of Net Interest Margin

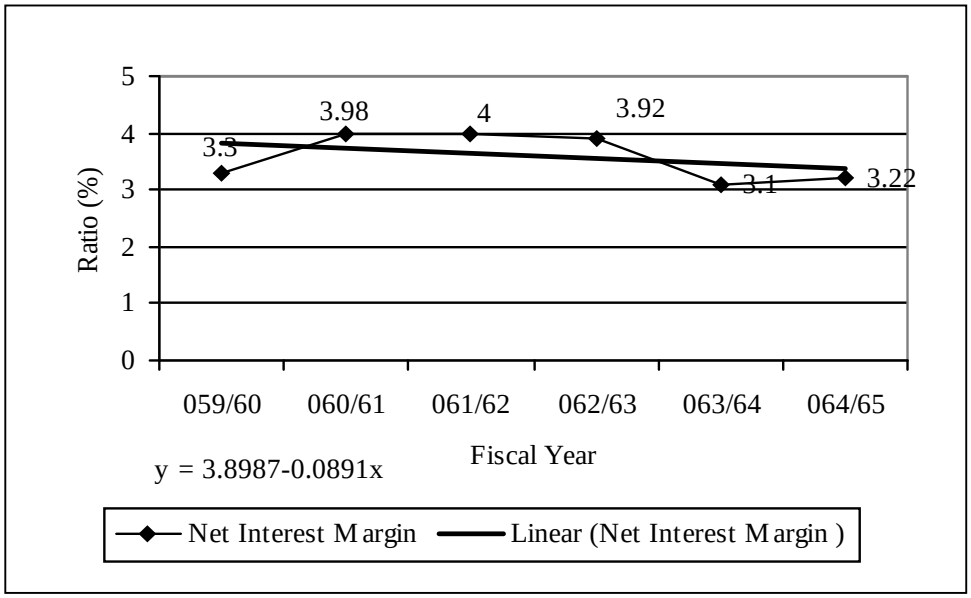


Figure 4.10 shows the observed net interest margin ratio along with least square trend line. It shows the down ward movement of observed net interest margin in FY 063/64. But from the FY 059/60 it is increasing. The trend of NIM indicates that the company manage has done a good job of asset and liability management during the study period.

4.1.4.4 Earning Per Share (EPS)

Earning per share provides a direct measure of the returns flowing to the banks owners, its stock holders measure relative to the number of share to the public (Peth, 1999).The earning per share of an organization give the strength of the number of shares in the market.

The earning per share of a company measures the profit available to the equity shareholders on per share basis. It reflects the earning power of a company. Higher EPS indicates greater net profits and lower EPS indicates less net profits (Pandey, 2005).

Table 4.11

Earning Per Share

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Net Profit After Tax (Rs.)	2935252.86	5991376.56	9079381.09	10884537.28	13690979.13	18684571
No. of Shares	200000	200000	200000	500000	700000	700000
EPS (Rs.)	14.67	29.95	45.40	21.77	19.56	26.70

Source: OFL, Annual Reports.

The data in Table 4.11 reveals that EPS of OFL has fluctuate and minimum EPS Rs.14.67 in FY 059/60 and maximum EPS Rs.45.40 in FY 061/62. The EPS is increasing from FY 059/60 with Rs.14.67 up to FY 061/62 with 45.40 and then decreasing. The mean average of EPS is Rs.26.34 and C.V. of the company is 40.97 percent. Which shows less consistent and more volatile during the study period. The observed value of EPS ratios of the OFL is shown with trend line in figure 4.11 below.

Figure 4.11

Trend of Earning Per Share

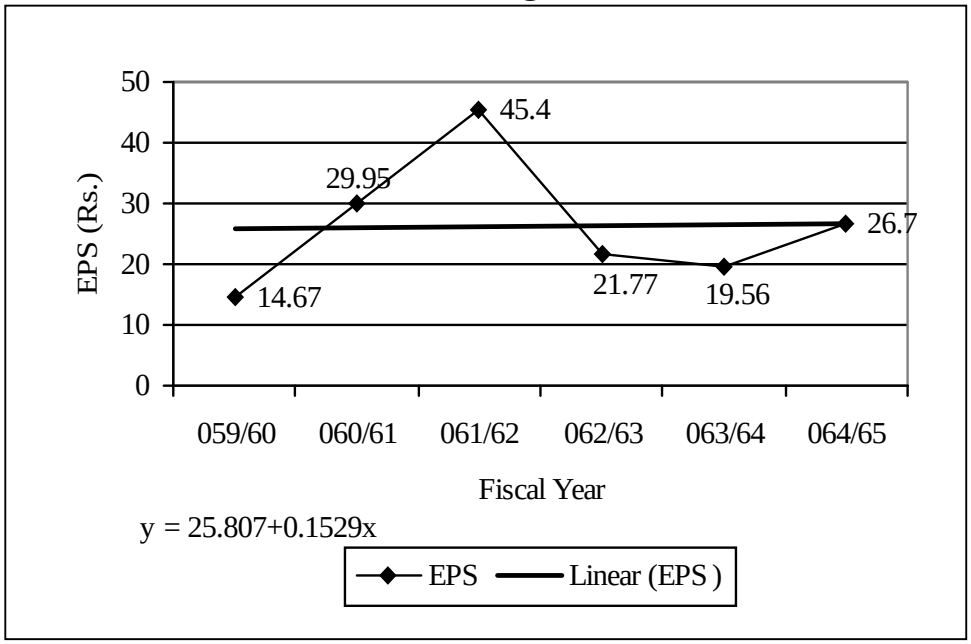


Figure 4.11 shows the observed values of earning per share along with the trend line. The slope of the trend line is positive which indicates that the trend of the earning per share increasing and then declining over the study period. The ratio of the company has declined due to increase in

paid up capital, issue of more number of right shares and stock dividend but profitability of the company has not increased proportionately. In FY 064/65, the EPS is increased which show that the profits of the company is also increased.

4.1.5 Liquidity

Every financial institution needs to maintain adequate level of liquidity to pay cash to its depositors. So it is a prime importance. In other words, a firm should always keep adequate fund to meet depositors' and creditors' demand. The failure of a company to meet its liquidity will result in poor credit worth ness, loss of creditors confidence or even in legal tangles resulting in the closure of the company. A very high degree of liquidity is also bad, idle assets earn nothing. The firm's funds will be unnecessary tied up in current assets. Therefore, it is necessary to strike a proper balance between high liquidity and lack of liquidity (Pandey, 2005). This will result in sound health of a company. A firm requires different amount of liquidity depending on its growth rate and variability in lending and deposit activities (Gup and Kolari, 2005).

4.1.5.1 Liquid Assets to Total Deposit Ratio

This ratio is computed by dividing liquid assets by total deposits. It measures the proportion of total liquid assets in total deposits of the company. Further more it shows the overall short term liquidity position. Cash in hand, balance with NRB, balance with domestic bank and financial institutions, money at call and investment in government securities are included in total liquid assets. The higher ratios implies the better liquidity position and lower ratio shows the inefficient liquidity position of the company. So a firm should always maintain sufficient and appropriate liquid funds to meet immediate obligation (Mishkin and Eakins, 2006). As per the NRB directives issued for non-bank financial institutions on 2059

B.S., directives no. 3, finance companies are required to maintain liquidity of at least 8 percent of the total deposits.

Table 4.12

Liquid Assets to Total Deposit Ratio

(Rs. in thousand)

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Liquid Assets (Rs.)	22582	54852	66006	121897	89861	153494
Total Deposits (Rs.)	151548	270554	376404	484137	627884	922274
Liquid Assets/ Total Deposit (%)	14.90	20.27	17.54	25.18	14.31	16.64
*Industrial Average (%)	16.2	23.05	17.48	22.14	17.6	35.56
Diff. from Industrial Average (%)	-1.3	-2.78	0.06	3.04	-3.29	-18.92

Source: OFL, Annual Reports and * Worked out from Appendix IV.

The data in Table 4.12 shows that the liquid assets to total deposit ratio of OFL are 14.90 percent, 20.27 percent, 17.54 percent, 25.18 percent, 14.31 percent and 16.64 percent in FY 059/60 to FY 064/65 respectively. The ratio is maximum in FY 062/63 with25.18 percent and minimum in FY 063/64 with 14.31 percent. It reveals that the ratios are fluctuating. In absolute term, total deposit is increasing during the study period. The observed valued of liquid assets to total deposit ratio of the OFL is shown with industrial average in Figure 4.12 below.

Figure 4.12

Comparing Liquid Assets to Total Deposit Ratio with Industrial Average

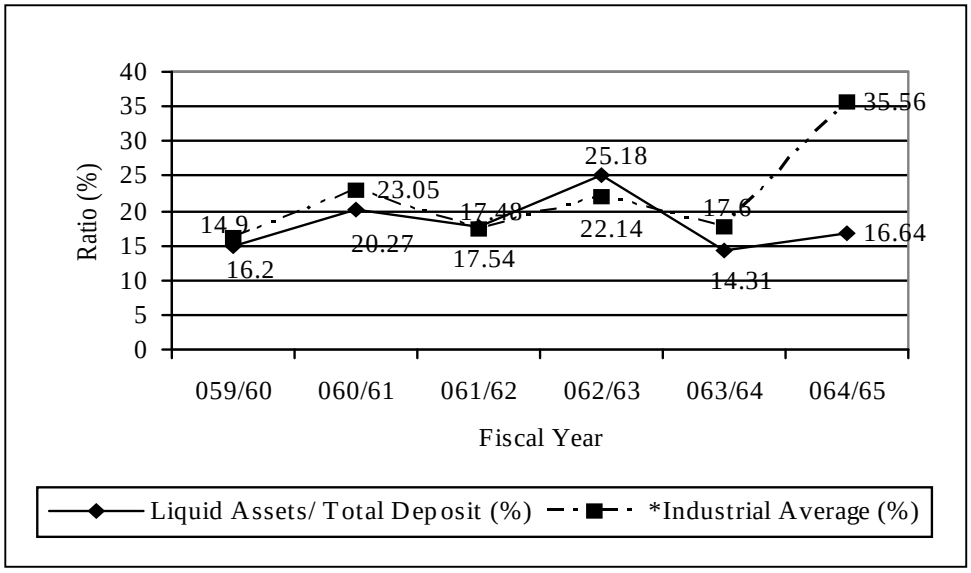


Figure 4.12 shows the observed liquid assets to total deposit ratio of OFL compared with industrial average. The ratios are less than the industrial average ratio from FY 059/60 to FY 060/61 but then the ratio is crossed over the industrial average ratio upto FY 062/63. Here, the difference is negative. It implies that the overall liquidity position of the company is poor than industrial average ratio. Despite, the company has maintained more than NRB standard of 8 percent throughout the study period. But more liquidity impact profitability negatively.

4.1.5.2 NRB Balance to Total Deposit Ratio

This ratio measures the proportion of NRB balance in total deposits. It shows whether the firm is holding the balance as required by NRB or not. To ensure adequate liquidity in the company to meet the depositors' demand for cash at any time, to inject the confidence in depositors regarding the safety of their deposited funds.

Table 4.13

NRB Balance to Total Deposit Ratio

(Rs. in thousand)

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
NRB Balance (Rs.)	1600	3079.50	4072.60	9793.24	14395	35190
Total Deposits (Rs.)	151548	270554	376404	484137	627884	922274
NRB Balance/ Total Deposit (%)	1.05	1.14	1.09	2.02	2.29	3.81
*Industrial Average (%)	1.08	2.22	1.97	3.08	2.24	3.01
Diff. from Industrial Average (%)	-0.03	-1.08	-0.88	-1.06	0.05	0.8

Source: OFL, Annual Reports and * Worked out from Appendix IV.

The data given in the Table 4.13 show that the NRB balance to total deposit ratio of OFL are 1.05 percent, 1.14 percent, 1.09 percent, 2.02 percent, 2.29 percent and 3.81 percent in the FY 059/60 to 064/65 respectively. The ratio is maximum in FY 064/65 with 3.81 and minimum in FY 059/60 with 1.05 percent. Balance with NRB has increased at lower

rate than deposit, which resulted in the decreasing trend in the ratio in FY 061/62 and then increasing.

Figure 4.13

Comparing NRB Balance to Total Deposits Ratios with industrial Average

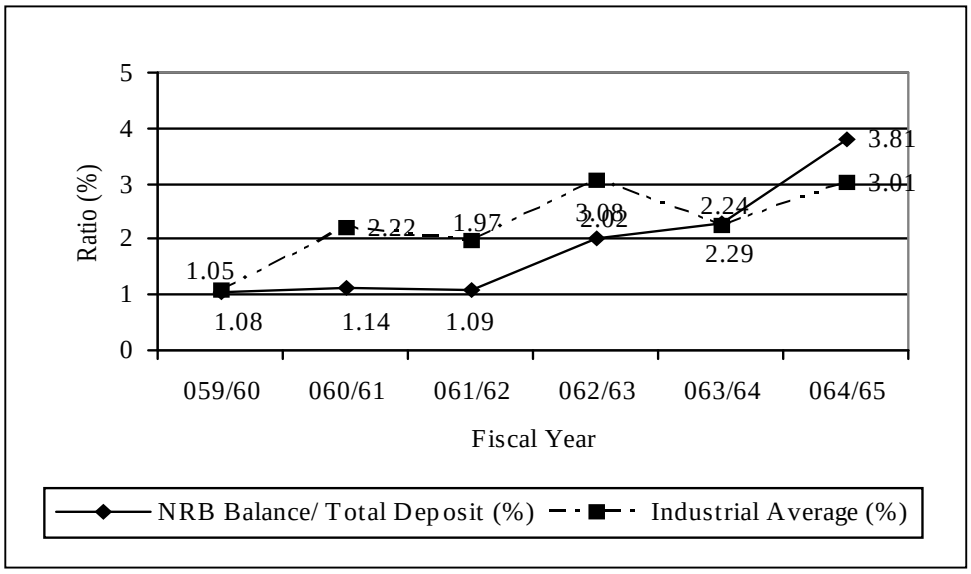


Figure 4.13 shows the NRB balance to total deposit ratio compare with industrial average ratio. As compare to industrial average, the ratio than industrial average i.e. difference is negative. Despite, company has held the balance as required by NRB in all fiscal years. In FY 064/65 the NRB Balance to total deposit ratios is above the industrial average. It means the company is followed strickly the NRB directives.

4.1.5.3 Cash in Vault to Total Deposit Ratio

This ratio shows the percentage of total deposit maintained in vault. The term cash in vault represent the cash in hand. The ratio measures the firm's ability to meet immediate obligation mainly cash withdraw by depositors. Lower ratio indicates that the company might face a liquidity crunch while paying its obligation; where as a very high ratio indicates that the company has been keeping idle funds and not deploying them properly.

So, a company should always maintain the sufficient and appropriate cash reserve (Gup and Kolari, 2005).

Table 4.14

Cash in Vault to Total Deposit Ratio

Fiscal Year	059/60	060/61	061/62	062/63	063/64	064/65
Cash in Vault	1576.7	1261.2	1103.9	1284.3	1243.1	2959.7
Total Deposits (Rs.)	151548	270554	376404	484137	627884	922274
Cash in Vault/ Total Deposit Ratio (%)	1.04	0.47	0.29	0.27	0.20	0.32
*Industrial Average (%)	0.66	0.68	0.56	0.81	0.60	0.69
Diff. from Industrial Average (%)	0.38	-0.21	-0.27	-0.54	-0.4	-0.37

Source: OFL, Annual Reports and * Worked out from Appendix IV.

The data given in Table 4.14 shows that the cash in vault to total deposit ratio of OFL during the FY 059/60 to FY 064/65. The ratios are in fluctuating trend. The highest ratio is 1.04 percent in FY 059/60 and the lowest ratio is 0.20 percent in the FY 063/64. The cash in vault has decreased at lower rate than deposit has. So, the ratio has came down in minimum slowly.

Figure 4.14

Comparing Cash in Vault to Total Deposit Ratio with Industrial Average

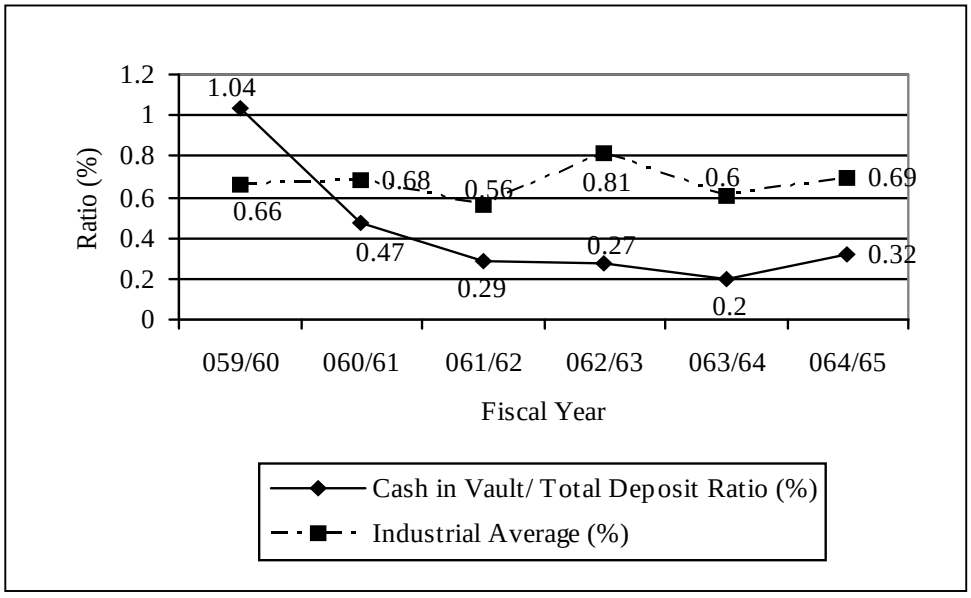


Figure 4.14 shows the observed cash in vault to total deposit ratio of OFL compared to the industrial average ratio. As compared to the industrial average, the ratios are first over and then below the industrial average throughout the study period i.e. difference is negative. But the company has maintained only the adequate level of cash in vault due to insurance limit and minimize the risk. Higher the cash in vault, higher will be the risk.

4.2 Major Findings

The major findings of the study on financial performance analysis of OFL in the framework of CAMEL are as follows:

4.2.1 over the six studies year period, OFL has maintained maximum core capital adequacy ratio of 16.10 percent in the FY 062/63 and the minimum ratio of 10.05 percent in the FY 061/62. The ratio of the company are fluctuating over study period. The ratio of OFL in the review period are 15.32 percent, 11.36 percent, 10.05 percent, 16.10 percent, 13.77 percent and 11.77 percent respectively. In all the six years of the review period, the core capital adequacy ratio is above the NRB standard. Thus, it is found that the core capital adequacy ratio of OFL is adequate and sufficient. It shows the protection and security to creditors and depositors and financial soundness of the company.

4.2.2 The supplementary capital adequacy ratio of OFL is maximum in FY 059/60 with 1.07 percent and minimum in FY 064/65 with 0.90 percent. The ratios of the company are fluctuating over the study period. The ratios of the company in the review period are 1.07 percent, 0.93 percent, 0.95 percent, 0.92 percent, 0.91 percent and 0.90 percent respectively. In all the six years of the review period, the core capital adequacy ratio is within the limit of NRB standard as prescribed by NRB. Which should not be more than core capital

ratio of company. Thus, it is clear that the company is running with adequate capital.

4.2.3 In the past six years, the total capital adequacy ratio of OFL are fluctuating. The ratios are 16.40 percent, 12.29 percent, 11 percent, 17.02 percent, 14.67 percent and 12.67 percent respectively in the review period. The ratio of the company is maximum in FY 062/63 with 17.02 percent and minimum in FY 061/62 with 11 percent. Throughout the study year period, the total capital adequacy ratio of OFL is above the NRB standard. It indicates that the financial position of the company is sound and strong.

4.2.4 The non-performing loan ratio of OFL is in fluctuating trend during the study period. The lowest ratio is 0.03 percent in FY 059/60 and the highest ratio is 1.17 percent in FY 062/63. The ratio are 0.03 percent, 0.53 percent, 0.39 percent, 1.17 percent 0.82 percent and 0.44 percent respectively in the review period. It is found that the NPL ratio of the company is below 5 percent. It shows the efficient credit management. It indicates that the company has low credit risk. It reflects the good performance of the company in mobilizing loan and advances.

4.2.5 The loan loss ratio of OFL has fluctuated over the six studies year period. The ratio has ranged from minimum to 1.37 percent in FY 059/60 and maximum to 2.16 percent in FY 062/63. The mean ratio is 1.71 percent and the coefficient of variation between them is 15.20 percent. On the basis of coefficient of variation, it is found that the ratios are variable and less consistent. Throughout the study period, the loan loss ratio of the company is in fluctuating trend due to changes in NRB directives in classification of non-performing loan and increased in loan loss provision.

4.2.6 The total expenses to total income ratio of OFL is maximum in FY 059/60 with 79.57 percent and minimum in FY 064/65 with 71

percent. The ratio the company are fluctuating over the study period. The ratios of OFL in the review period are 79.57 percent, 77.67 percent, 73.43 percent, 75.80 percent, 74.22 percent and 71 percent respectively. The mean ratio is 75.28 percent. The negative slope indicates that decreasing expenses with respect to income and is credited to good management quality.

4.2.7 The earning per employee ratio is increasing in all the fiscal years except in FY 062/63. The decline in the ratio in FY 062/63 is observed due to increase in number of staffs. The slope of the observed earning per employee trend along with least square trend line is positive which indicates the earning per employee is increasing over the study period. It reflects the efficiency of staffs as well as good management quality.

4.2.8 The return on equity ratio of OFL has fluctuated over the six studies year period. The ratio has ranged from minimum to 11.77 percent in FY 059/60 and maximum to 23.89 percent in FY 061/62. The mean ratio of OFL is 16.44 percent and the coefficient of variation between them is 27.20 percent. On the basis of coefficient of variation, it is found that the ratio are variable and less consistent. The slope of the trend line determined by the least square method is negative. Despite, the average ratio is above the World Bank benchmark i.e. 15 percent. Throughout the study period, the ROE ratio of the company is fluctuating due to increase in shareholders' equity but the profit of the company has not increased in same ratio as the equity has increased.

4.2.9 The return on assets ratio of OFL has fluctuated over the six studies year period. The ratio has ranged from minimum to 1.61 percent in FY 059/60 and maximum to 2.1 percent in FY 061/62. The mean ratio is 1.82 percent and the coefficient of variation, between them is 9.37%. On the basis of coefficient of variation. It is found that the

ratios are variable and less consistent. The slope of the trend line determined by the least square method is negative. The average ratio is above the World Bank benchmark i.e. 1.5 percent and higher. Throughout the study period, the ROA ratio of the company is fluctuating due to the company is fluctuating due to increased in total assets but the profit of the company has not increased in same ratio as the total assets have increased.

4.2.10 The net interest margin ratio of OFL is minimum in FY 063/64 with 3.1 percent and maximum in FY 061/62 with 4 percent. The mean ratio for the study period is found 3.58 percent and the coefficient of variation of them is found 10.76 percent. The slope of the trend line determined by the least square method is negative. Despite the average ratio of the company is between the benchmark 3 to 4 percent and it is not so bad. It indicates that the company manager had done a good job of assets and liabilities management during the study period.

4.2.11 Over the six studies year period, the EPS of OFL has fluctuated. The EPS of the company has ranged between Rs. 14.67 in FY 059/60 to Rs.45.40 in FY 061/62. The mean average of EPS is Rs.26.34 and the coefficient of variation of the company is 40.97 percent. The EPS is increasing from FY 059/60 to FY 061/62 and then decreasing slowly. The slope of the trend line is positive. The EPS ratio of the company is found slowly decreasing due to increase in paid up capital, issue of more number of right shares and stock dividends but profitability of the company has not increased proportionately. In FY 064/65, the EPS is increased which indicates that the company is growing properly.

4.2.12 The liquid assets to total deposit ratio of OFL is distributes as a maximum ratio of 25.18 percent in FY 062/63 and minimum ratio of 14.31 percent in FY 063/64. The ratios of OFL in the review period

are 14.90 percent, 20.27 percent, 17.54 percent, 25.18 percent, 14.31 percent and 11.64 percent respectively. The ratios are fluctuating over the study period. The ratio are found below the industrial average in three years. But it is above in FY 061/62 and 062/63. It implies that the overall short term liquidity position of the company is not so poor than industrial average ratio. Despite, the company has maintained more than NRB standard of 8 percent throughout the study period.

4.2.13 NRB balance to total deposit ratio of OFL are fluctuating over the study period. The ratios are 1.05 percent, 1.14 percent, 1.09 percent, 2.02 percent, 2.29 percent and 3.81 percent respectively. It is found that the company has maintained balance as per the standard set by NRB in all observed years. But while comparing the ratio with industrial average ratio, the ratio is found above in FY 063/64 and in FY 064/65.

4.2.14 The cash in vault to total deposit ratio of OFL is fluctuating during the review period. The highest ratio is 1.04 percent in 059/60 and the lowest ratio is 0.20 percent in FY 063/64. It is found that the company has maintained only the adequate level of cash in vault due to insurance limit and to minimize the risk. Higher the cash in vault, higher will be the risk. Despite comparing the ratios with industrial average, vault to total deposit ratio of OFL is found above than the industrial average in FY 059/60 and below in all observed years.

CHAPTER V

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

This chapter includes there aspects of the study summary, conclusion and recommendations. The first aspect summarizing the whole study. The second draws the conclusion, and the last one forwards the recommendations.

5.1 Summary

The study was conducted with the objective to analyze the financial performance in the framework of CAMEL of Om Finance Company Limited. Over the six years period from FY 059/60 to FY 064/65 following a descriptive and analytical research design. For the study purpose, OFL is drawn as a study unit with applying convenience sampling method out of 79 finance companies till mid-Jan. 2008. The study is based on secondary data. For the analysis of the study, annual reports and financial statements of OFL are used as the major sources of data. The analysis of financial statement is done to obtain a better insight into a firm's position and performed. Various financial and statistical tools have been used in this study to get the meaningful result and to meet the research objectives.

CAMEL is a common methods for analyzing the health of individual institution to qualify the performance and the financial condition of the firm. It was designed by regulatory authorities. The intrinsic strength of firm is usually evaluated based on a CAMEL framework, which consists of individual assessments of five core aspects of a company's financial condition and performance: Capital Adequacy Assets Quality,

Management Quality, Earnings Quality and Liquidity. In 1997, the rating became CAMELS with the addition of a market sensitivity rating. Under such framework, individual components are typically evaluated on a rating scale. The CAMELS rating ranges from 1 to 5, lower rating representing a better and well managed firm. The rating system serves as a report card to bank management and directors. It was originally used by the Federal Reserve Bank, the Federal Deposit Insurance corporation (FDIC) and the comptroller of the currency (OCC) and other financial supervisory agencies to provide a convenient summary of bank conditions at the time of exam.

The study has analyzed capital adequacy, non performing loan and loan loss provision, management quality earning quality and liquidity position of OFL during six years period from FY 059/60 to FY 064/65. Various materials were reviewed in order to build up the conceptual foundation and reach to the clear destination of research. During the research the areas that formed part of the conceptual review were: historical development of financial system and evolution of finance companies in ‘Nepal, concept of finance companies, types of financial produces and services, bank and financial institutions Act, 2063, approaches to supervision, financial performance approaches, concepts of CAMELS bank rating system, components of CAMEL, New Basel Capital Accord NRB norms, liquidity gap analysis. Besides these, review of journals articles and review of dissertations were carried out under research review.

The analysis has been made to compare the company's ratios with NRB standard, trend of ratios and industrial average. The core capital adequacy ratios above the NRB standard of the company above the NRB standard of the company shows the protection and security to creditors and depositors and financial soundness of the company. The supplementary capital adequacy ratios of OFL one as per NRB standard in all the years in

the review period which leads to conclude that the company is running with adequate capital. Moreover, observed capital adequacy ratios indicate that the capital of the company is sound and strong financial position of OFL in the review period. The non performing loan ratios are below the international standard i.e. 5 percent. It reflects the good performance of the company in mobilizing loan and advances. The loan loss ratio of the company are in fluctuating trend over the review period. The management quality proxy ratios, the total expenses to total income ratios are also in fluctuating and decreasing trend where as earning per employee ratios are in increasing trend which is a good sign on measure management quality. The earning quality ratios like return on equity and return on assets are in fluctuating trend but average ratios are above the world bank standard. Besides this, net interest margin is in fluctuating. First increasing and then slowly decreasing trend. But the average is between the benchmark 3 to 4 percent. It indicates that the company manager has done a good job of assets and liability management during the study period. The earning per share is also fluctuating trend increasing and slightly decreasing. The liquid assets to total deposit ratios and NRB balance to total deposit ratios of the company are as per NRB standard. Despite, OFL has maintained only the adequate level of cash in vault due to insurance limit and to minimize the risk. It shows that the liquidity position of the company in overall is sound.

5.2 Conclusions

Based on the findings, following conclusions have been drawn as a concluding framework for the study on financial performance analysis of Om Finance Limited (OFL).

5.2.1 Core capital adequacy ratio of OFL is above the NRB standard in the review period. It reveals that the company has adequately maintained its internal sources or core capital in the past six year

period and has strictly followed the NRB standard. In this point of view OFL is financially sound and strong.

5.2.2 Supplementary capital ratio of OFL is within the NRB norms during the review period. It reveals that the company is running with adequate capital in the past six year period and has strictly followed the NRB directives. In this point of view OFL is sound.

5.2.3 The total capital adequacy ratio of OFL is also above the NRB standard over the study period. It can be concluded that the capital fund of OFL is sound and sufficient to meet the financial operation as per the NRB standard.

5.2.4 As the non-performing loan ratio of OFL is found fluctuating due to decline in loan quality, increase in loan volume and changes in NRB directives in NPL classifications. The NPL ratios are below the international standard i.e. 5 percent. It can therefore, concluded that OFL has placed efficient credit management and recovery efforts.

5.2.5 The loan loss ratios are also in fluctuating. The trend is increasing and then decreasing during the study period. It seems that the quality of loan in future is good going.

5.2.6 The total expenses to total income ratio are in fluctuating but decreasing trend. It means the expenses is decreasing with respect to income. Which shows that the management efficiencies is increasing.

5.2.7 The earning per employee ratio is in increasing trend. It indicates the efficient management in staffing and the profitability of the company is increasing.

5.2.8 The return on equity is in fluctuating trend. The return on equity percent is slowly increasing but the company has not earned satisfactory return for its equity shareholders.

5.2.9 The return on assets is in fluctuating trend. The return on assets ratio is also slowly declining. The depicts that the net income for each unit of assets of the company is depreciating. This shows that the ability of the management to utilize company's assets to generate profits is declining but average ratio is above the World Bank benchmark i.e. 1.5 percent.

5.2.10 The trend of net interest margin is slightly increasing which shows that the company has raised funds with liabilities that have low interest costs and acquired assets with high interest income. The mean ratio is also between the benchmark i.e. 3 to 4 percent. It can be concluded that the company manager has done a good job of assets and liability management during the study period.

5.2.11 The increasing trend of earning per share indicates that the company's earning power or earning capacity and earning performance on per share basis is also increasing. It means the return flowing to its stockholders is also increasing.

5.2.12 The liquid assets to total deposit ratio are above the NRB standard and also above the industrial average ratio in FY. 061/62 and FY 062/63. It can be concluded that the company has strictly followed the NRB directives.

5.2.13 The NRB balance to total deposits ratio is as per the NRB directives over the study period. The ratio is above the industrial average ratio in the FY 063/64. Overall it can be concludes that the company has maintained sufficient amount of balance with NRB in the review period.

5.2.14 Cash in vault to total deposit ratio is in fluctuating trend and the ratio is above the industrial average ratio only in FY 059/60. Then the ratio is decreasing and below the industrial average ratio. It indicates that the company is running with the inadequate liquidity to meet the short term obligation. Despite the company has

maintained only the adequate level of cash in vault to minimize the risk.

5.3 Recommendations

The following recommendations are made based on the conclusions as suggestions to overcome the weaknesses as regard to financial performance of Om Finance Limited.

5.3.1 The total capital adequacy ratios of the company as per the NRB standard over the review period but are in fluctuating trend. So, the recommendations is provided to maintain stable capital adequacy ratios in the company.

5.3.2 As the non-performing loan ratios of the company are in fluctuating trend during the study period it signals deterioration in the quality of loans. So, the company is recommended to improve the assets quality. For this the company should give serious attention towards the recovery, timely follow-up and disbursement of loan. More over, the company should strictly follow their own loan policies.

5.3.3 The loan loss ratio of the company are in fluctuating trend during the review period. The ratio are also slightly increasing. Therefore, it indicates that there is probability of loan default in future. So, the company is advised to reduce the proportion of loan loss provision by increasing the quality of assets by strengthening the credit appraisal and follow up measures.

5.3.4 Total expenses to total incomes ratios of the company are in fluctuating trend over the review period. So, it is recommended to the management of the company try to reduce the operating expenses. Decreasing in total expenses to total income ratio positively affect the company's profitability.

5.3.5 The earning quality ratios of the company like return on equity, return on assets and net interest margin are in fluctuating trend. The

ratios are increasing very slowly but it is not satisfactory. The most important performance measure for any firm is profitability. Without profit, no firm can grow and survive in long run in this competitive environment. So, the company is recommended to increase its yield as its net profit to gain the trust of the equity holders and other stakeholder.

5.3.6 The liquidity position of the company should meet its current and contingent obligations. The liquid assets to total deposit ratio, NRB balance to total deposits ratio and cash in vault to total deposit ratio are below the industrial average which need to be monitored and complied in accordance with the NRB requirements.

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APPENDIX I
List of Class "C" Licensed Institution (Finance Company)
Mid-Jan., 2008

S.N.	Names	Operation Date (A.D.)	Head Office
1	Nepal Housing Development Finance Co. Ltd.	8/3/1992	Naya Baneshwor, Kathmandu
2	Nepal Finance and Savings Co. Ltd.	1993/01/06	Kamaladi, Kathmandu
3	NIDC Capital Markets Ltd.	1993/03/11	Kamaladi, Kathmandu
4	National Finance Co. Ltd.	1993/05/07	Pako Newroad, Kathmandu
5	Annapurna Finance Co. Ltd.	1993/09/30	Chipledhunga, Pokhara
6	Nepal Share Markets Ltd.	1993/10/19	Ramshahapath, Katmandu
7	Peoples Finance Ltd.	1993/04/15	Tripureshwor, Kathmandu
8	Himalaya Finance & Savings Co. Ltd.	1993/11/11	Sundhara, Kathmandu
9	United Finance and Leasing Co.	1996/1/25	Kamaladi, Kathmandu
10	Union Finance Co. Ltd.	12/12/1995	Durbarmarg, Kathmandu
11	Mercentile Finance Co. Ltd.	1994/11/10	Adarshnagar,Birgunj
12	Kathmandu Finance Ltd.	1994/11/10	Putalisadak, Kathmandu
13	Inbeta Finance Ltd.	1995/07/17	Adarsanagar, Birgunj
14	Narayani Finance Ltd.	1995/03/08	Narayangadh, Chitwan
15	Gorkha Finance Ltd.	1995/03/12	Kantipath, Kathmandu
16	Nepal Housing & Merchant Finance Co. Ltd.	1995/04/09	Dillibazar, Kathmandu
17	Paschhimanchal Finance Co. Ltd.	1995/04/27	P.B. No. 11, Butwal
18	Universal Finance & Capital Markets.	1995/05/03	Kantipath, Kathmandu
19	Samjhana Finance Co. Ltd.	1995/05/16	Banepa, Kavre
20	Goodwill Finance & Investent Co. Ltd.	1995/10/31	Dillibazar, Kathmandu
21	Shree Investment & Finance Co. Ltd.	1995/11/26	Dillibazar, Kathmandu
22	Siddartha Finance Co. Ltd.	1995/12/12	Siddharthanagar, Bhairahawa
23	Lumbini Finance & Leasing Co. Ltd.	1996/01/02	Thamel, Kathmandu
24	Yeti Finance Co. Ltd.	1996/01/09	Bankroad, Hetauda
25	Standard Finance Ltd.	1996/02/02	Putalisadak, Kathmandu
26	ACE Finance Co. Ltd.	1996/02/04	Kantipath, Kathmandu
27	International Leasing & Finance Co. Ltd.	1996/07/16	Naya Baneshwor, Kathmandu
28	Mahalaxmi Finance Co. Ltd.	1996/11/26	Birgunj
29	Lalitpur Finance Co. Ltd.	1997/02/09	Lalitpur
30	Merchant Finance Co. Ltd.	1997/03/16	Kathmandu
31	BhajuratnaFinance & Saving Co. Ltd.	1997/03/07	Kantipath, Kathmandu
32	General Finance Ltd.	1996/02/02	Chabahil , Kathmandu
33	Nepal Shreelanka Merchant Bank Ltd.	1996/02/04	Kamaladi, Kathmandu
34	Alpic Everest Finance Ltd.	1996/07/16	Bag Bazzar Kathmandu
35	Nepal Merchant Banking & Finance Ltd.	1996/11/26	Darwarmarga, Kathmandu
36	Nava Durga Finance Co. Ltd.	1997/02/09	Itachhe, Bhaktapur
37	Pokhara Finance Ltd.	1997/03/16	Gairapatan, Pokhara
38	Janaki Finance Ltd.	1997/03/07	Janakpur Dham, Dhanusha
39	Centeral Finance Co. Ltd.	1997/04/14	Kupandole Lalitpur
40	Premier Finance Co. Ltd.	1997/05/08	Man Bhawan, Laltipur
41	Arun Finance Co. Ltd.	1997/08/17	Putali Bazar Dharan
42	Multipurpose Saving & Investment Finance Co. Ltd.	1998/3/25	Saptari Rajbiraj
43	Butwal Finance Co. Ltd.	1998/06/21	Butwal, Rupandehi
44	Nepal Bangladesh Finance & Leasing Co. Ltd.	1999/04/18	Mainroad, Biratnagar
45	Shrijana Finance Ltd.	1999/12/14	Siraha Lahan
46	Om Finance Co. Ltd.	9/17/2000	New Road, Pokhara-9
47	Cosmic Merchant Banking & Finance Ltd.	2000/11/20	Lal Durbarmarga, Kathmandu

48	World Merchant Banking & Finance Ltd.	2001/08/10	Mainroad, Hetauda
49	Capital Merchant Banking & Finance Ltd.	2002/02/01	Batish Putali, Kathmandu
50	Crystial Finance Ltd.	2002/02/13	Bagdurbar Kathmandu
51	RoyalMerchant Banking & Finance Ltd.	2002/02/14	Durbarmarga, Kathmandu
52	Guheshwori Merchant Banking & Finance Ltd.	2002/06/13	Jawalakhel, Lalitpur
53	Patan Finance Ltd.	6/23/2002	Man Bhawan, Lalitpur,
54	Kist Merchant Banking & Finance Ltd.	2003/02/21	Kamal Pokhari, Kathmandu
55	Fewa Finance Ltd.	2003/04/30	Pokhara, Chipledhunga
56	Everest Finance Co. Ltd.	2003/07/02	Siddartha Nagar Bhairahawa
57	Birgunj Finance Co. Ltd.	9/28/2003	Adarsha Nagar, Birgunj
58	Prudential Merchant Banking & Finance Ltd.	2003/06/06	Dilli Bazar Kathmandu
59	Investment Credit and Finance Co. Ltd.	2003/06/15	Bhatabhateni, Kathmandu
60	Sagarmatha Merchant Banking & Finance Co. Ltd.	2005/08/29	Lalit Maan Bhawan
61	Shikhar Bitiya Sanstha Ltd.	2005/09/15	Kathmandu Thapathali
62	Civil Merchant Bitiya Sanstha Ltd.	2005/09/18	Kathmandu Kuleshwor
63	Prabhut Bitiya Sanstha Ltd.	2006/02/16	Kathmandu, Kantipath
64	Imperial Bitiya Sanstha Ltd.	2006/03/08	Kathmandu, Putalisadak
65	Kuber Bitiya Sanstha Ltd.	2006/03/08	Kathmandu, Putalisadak
66	Nepal Expres Financial Insiutions Ltd.	2006/03/24	Rupendehi, Butwal
67	Valley Bitiya Sanstha Ltd.	2006/05/11	Kathmandu, Maharajganj
68	Seti Bitiya Sanstha Ltd.	2006/06/07	Kailali, Tikapur
69	Hama Bitiya Sanstha Ltd.	2006/06/16	Kathmandu Tripureshwor
70	Reliable Investment Bitiya Sanstha Ltd.	2006/09/06	Kathmandu, Bagdarbar, Sundhara
71	Loard Buddha Financial Institutions Ltd.	2006/11/19	Kathmandu, Newroad
72	Api Financial Institution	2007/4/25	Lekhnath, Kaski
73	Nameste Bitiya Sanstha Limited	2007/7/7	Ghorai Dang
74	Suryadarshan Financial Institution Ltd.	2007/7/30	Baneshwor, Kathmandu
75	Zenieth Merchant Financial Institution Ltd.	2007/10/08	Newroad, Kathmandu
76	Unique Financial Institution Ltd..	2007/10/12	Putali Sadak Kathmandu
77	Manjushree Financial Institution Ltd.	2007/10/15	New Baneshwor, Kathmandu
78	Swostik Merchant Finance Company Ltd.	2007/10/16	Kicha Pokhari, Kathmandu
79	Subhalaxmi Finance Ltd.	1007/11/11	Naksal, Kathmandu

Source: Banking & Financial Statistics. No. 50:73.

APPENDIX II

OM FINANCE LTD.

Comparative Financial Glimpses

(Rs. in thousand)

Statement		FY					
		059/60	060/61	061/062	062/63	063/64	064/65
1	Ejecting	151548	270554	376404	484137	627884	922274
2	Loan and Borrowing	146187	248151	357835	446716	638688	882959
3	Net Worth	24939	30930	38009	79841	98632	116212
4.	Total Liquid Assets	22852	54852	66006	121897	89861	153494
5.	Ratio of Income & Exp.	1.30:1	1.28:1	1.36:1	1.36:1	1.39:1	1.40
6.	Total Risk Weighted Assets	162697	268494	378433	490899	712688	987703
a)	Total Core Capital	24939	30507	38009	79841	98123	116212
b)	Total Supplementary Capital	1745	2494	3590	4512	6451	8925
	Total Capital Fund	26685	33001	41599	84354	104574	125137
7.	Capital Adequacy Ratio	16.40	12.29	11	17.02	14.67	12.67
8.	Core Capital Adequacy Ratio	15.32	11.36	10.05	16.10	13.77	11.77
9.	Total no. of shares	200	200	200	500	700	700
10.	Earning Per Share	14.67	29.95	45.40	21.77	19.56	26.70

Source: OFL, Annual Report.

APPENDIX III

OM FINANCE LTD.

Glimpses of Progress

Statement		FY					
		059/60	060/61	061/062	062/63	063/64	064/65
	Total Income	20655	36906	49885	63815	77517	103539
	Total Expenses	16435	28666	36631	48376	57530	73535
	Interest Expense	12262	21827	29523	37995	47754	62963
	Staff Expenses	908	1257	1525	1858	2121	3807
	Operating Expenses	1586	2402	2590	3243	3742	5654
	Risk Weighted Fund	1116	2307	1668	3735	1915	1112
	Other Expenses	563	873	1325	1544	1998	2728
	Profit before Tax	4219	8240	13254	15439	19987	27276
	Tax Provision	1284	2249	4175	4555	6296	8592
	Net profit after tax	2935	5991	9079	10884	13691	18684
	Due profit of Last year and addition of adjustment fund	1343	3545	8039	15302	2957	6910 7000
	Total Profit	4279	9536	17118	26186	16648	32595

Source OFL, Annual Report.

APPENDIX IV

Calculation of Liquidity Ratios of Aggregate Finance Companies (Industry Average Ratio)

(Rs. in Lakh)

End of Ashad (FY)	2059/060	2060/061	2061/062	2062/063	2063/064	2064/065
Mid-July	2002/03(57)	2003/04(58)	2004/05(59)	2005/06(70)	2006/07(72)	2007/08
Liquidity Assets to Total Deposit Ratio						
Liquidity Assets	26,740	44688	39049	53866.6	56075.70	145373.30
Total Deposit	165103	193917	223416	243325	318673	408846.70
Liquidity Assets/ Total Deposit (%)	16.20	23.05	17.48	22.14	17.60	35.56
NRB Balance to Total Deposit Ratio						
NRB Balance	1789	4301	4409	7499.30	7164.30	12330.2
Total Deposit	165103	193917	223416	243325	318673	408846.70
NRB Balance/ Total Deposit (%)	1.08	2.22	1.97	3.08	2.24	3.01
Cash in Vault to Total Deposit Ratio						
Cash in Vault	1090	1321	1259	1987.30	1930.1	2824.30
Total Deposit	165103	193917	223416	243325	318673	408846.70
Cash in Vault Total Deposit Ratio (%)	0.66	0.68	0.56	0.81	0.60	0.69

Source: Banking and Financial Statistics, No. 49, Mid July 2008: 52.

* Figures in Parenthesis show the number of Finance Companies.