ANALYSIS OF NON PERFORMING ASSETS OF COMMERCIAL BANKS OF NEPAL

(With reference to Nepal Bank Ltd., Nepal Credit and Commerce Bank Ltd. and Rastriya Banijya Bank)

By

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RECOMMENDATION

This is to certify that the Thesis

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Entitled:

CREDIT CARD BUSINESS IN NEPAL WITH SPECIAL REFERENCE TO HIMALAYAN BANK LTD.

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VIVA-VOCE SHEET

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DECLARATION

I hereby declare that the work reported in this thesis entitled **"ANALYSIS OF NON PERFORMING ASSETS OF COMMERCIAL BANKS OF NEPAL (With reference to Nepal Bank Ltd., Nepal Credit and Commerce Bank Ltd. and Rastriya Banijya Bank)"** submitted to Office of the Dean, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirement for the Master's Degree in Business Study (M.B.S.) under the supervision of **Shree Bhadra Neupane** and **Dhurba Subedi** of Shanker Dev Campus.

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CHAPTER - I

INTRODUCTION

1.1 Background of the Study

Financial intermediaries are vital in the economic prosperity of the nation. There are different types of financial intermediaries of financial institutions such as Commercial Banks, Development Banks, Finance Companies, Cooperatives, etc. Among all those institutions, commercial banks are the key players which deal in the process of channelizing the available resources in the needed sectors in the economy of the country. It is the intermediary between the deficit and surplus of the financial resources. Economic liberalization policy of Government has encouraged the establishment and growth of financial institutions in Nepal.

Banking sector are the backbone of a country's economy. Commercial banks are the financial department stores that provide a number of services to the people. There are numerous services provided by commercial banks like accepting deposit, providing financial securities, granting loan, money exchanges, financial consultancy, fund transfer, etc. among many tasks performed by commercial banks, commercial banks work as intermediaries between the two sectors of the economy. The surplus sector and the deficit sector:

The **surplus sector** includes the people who are middle and lower class people who save money that is not enough to invest or start a new business. Generally, they are employees and labours. They generally do not want to take risk.

The **deficit sector** comprises the business people who always seek money to invest in the business. They are investor rather than saver. They are risk taker.

The commercial banks collect money in small amount from the surplus sector and gives to the deficit sector. While collecting money from surplus sector bank gives the guarantee of repayment of money as well as a certain amount as interest. In the other hand while giving money to the deficit sector as a loan, it will charge certain percent as interest which is greater than that paid to saver.

The mushrooming growth of the banks has led them towards cutthroat competition. On the other hand economic condition of the country is not growing. The less opportunity for getting avenues for loan floatation has compelled the banks to finance without being choosy. Quality of the loans and advances could not be maintained to the desirable level if there is no choice whether to finance or not once the loan is given it is supposed that the repayment of interest or principal shall have to be served without any hindrance. The resources could not be regular and if there is cumulative overdue outstanding. There may be various reasons behind the loans that turn irregular from regular one. The main reason may be economic situation of the country which has global and far reaching impact. The smooth operation of the commercial banks is possible only when the economy of the country functions well. Satisfactory level of return on investment is the prerequisite for the financial sector to be groomed. The other contributing factors that turn the good loan into bad are the attitude of the borrower, types and quality of security taken and legal hurdles created by the borrower when the recovery action is started. Once the distributed loan is not returned timely by clients and becomes overdue than it is known as non performing assets (NPA) for the banks. Reduction of NPA has always been a significant problem for every commercial banks and proper attention for the management of the NPA now under top priority. Due to various hurdles on way of management of NPA, commercial banks are now losing their profitability and struggling for their existence.
An NPA is defined as any credit facility in respect of which interest and/or instalment has remained unpaid for the period of two quarter or more from the date it has been past due is to be regarded as 'Non Performing'. It is the part of lending programmed of joint venture banks. In simple terms NPA are defined as the bad debts for the banks and financial institutions.

Loans and advances form a major component of assets for a bank which account for half to almost three quarters of total value of all bank assets. NRB allows the banks to build up a reserve for future loan losses called the Allowance for Possible Loan Losses (ALL) from their flow of income based on their recent loan loss experiences. The ALL, which is a contra asset account, represents an accumulated reserve against which loans declared to be uncollectible could be charged off. The ALL is built up gradually over time by annual reduction from current income. These deductions appear on bank's income statement | (Profit and loss account) as a non cash expense item called the provision for loan loss (PLL). Banks are to follow NRB directives on making provision for the loan losses.

1.2 Brief History of Banking Sector in Nepal

The Nepalese financial system development has a very recent history, starting just from the early twentieth century. The full period, from initiation to the present, can be broken down into three distinct phases. The shifts in these phases are determined by different milestones: the first milestone is the establishment of the Nepal Rastra Bank (NRB), the Central Bank of Nepal, in 1956 - this determines the shift from the first to the second phase; similarly the second milestone is the promulgation of the current NRB Act 2002 - this determines the shift from the second phase to the ongoing third phase.

The first phase: This phase corresponds with the initiation of formal domestic banking system in Nepal till the establishment of NRB in 1956. Nepal's formal financial system had a late start and began less than one and a half centuries ago. The establishment of *Tejarath Adda* in 1880 can be conceived as the beginning of the process of credit mobilization in Nepal. However, this institution, although formally established, was not allowed to take public deposit and provide credit to public – the fund had been provided by the government for credit to their staff and landlords only. Therefore, it was not a bank per se. Even the urban people in need of the financial support had to rely on *Shahus* (merchants) and landlords because of the limited activities of *Tejarath Adda* (Pant, 1964). It was only with the establishment of Nepal Bank Limited (NBL) in 1937 that the financial services were made available to the general public. In this regard, the establishment of NBL was the epoch-making since it signified commencement of formal banking system in Nepal.

The second phase: This phase commences with the establishment of NRB in 1956 under the NRB Act 1955, and completes with the promulgation of the current NRB Act 2002. With the establishment of NRB in 1956, the process was made easier for establishment of banks and financial institutions in the country. However, this phase can be further subdivided into two sub-periods: The first sub-period (or second phase A), was a period of restriction where the Nepalese payment system was characterized as "predominantly a cash-economy" (NRB, 1965); but, this period took a different turn with the establishment of Nepal Arab Bank Limited as the first joint-venture bank in 1984, under the Government's liberalized policy. The first sub-period saw more directed role of NRB in terms of credit control (including directed credit programs) and control of different categories of interest rates. In this sub-period, three institutions of diverse nature were established under the full ownership of the Government of Nepal (GON). They were (i) Nepal Industrial Development Corporation (NIDC in 1959)3; (ii) Rastriya Banijya Bank (RBB in 1966)4; and (iii) Agriculture Development Bank, Nepal (in 1968)5. The second sub-period (or second phase B) witnessed greater financial liberalization that practically started from 1984 until the enactment of new NRB Act in 2002. This sub period corresponds with the overall economic liberalization policy of GON after the nation underwent sustained balance of payment crisis in the early 1980s. This later sub- period saw major shifts in the policy measures such as: from a controlled to a deregulated framework of interest rate; from direct to indirect methods of monetary control, emphasizing open market operations as the main policy tool; and permitting market determined exchange rate of the Nepalese currency against convertible currencies and full convertibility of the Nepalese currency in the current account (NRB, 1996). During this sub-period, Nepal Indosuez Bank (later named as Nepal Investment Bank) and Nepal Grindlays Bank (now Standard Chartered Bank Nepal) were established in 1986 and 1987 respectively as the second and third joint-venture banks. However, no fully owned domestic-funded banks were established during this period. The entry of other development banks, finance companies, micro-credit development banks, savings and credit cooperatives and Non-government organizations (NGOs) for limited banking transactions started after 1992 under three major acts namely Finance Company Act 1985, Company Act 1964 and Development Bank Act 1996.

The third phase: The current NRB Act of 2002 marks the initiation of the currently undergoing third phase. This act replaced the NRB Act 1955 and allowed NRB to be more autonomous in exercising decisions relating to formulation of monetary and foreign exchange policy as well as monitoring and regulating banks and financial institutions across the nation. However, it was felt that the existing situation of multiple numbers of acts under banking and financial institution sector made the process of regulation and monitoring system very cumbersome. As a result and as a process of financial sector reform program, all those diversified acts were grouped together under the 'Bank and Financial Institution Act (BAFIA), 2006'. This Act, also known as *Umbrella Act*, categorized all the banks and financial institutions under four heads on the basis responsibility differences: Group A as commercial bank; Group B as development bank; Group C as finance company; and Group D as microcredit development banks. The other two forms of institutions, namely saving and credit cooperatives and Non-Government Organizations (NGOs), both allowed by NRB for limited banking transactions, are however not put in any of those groups and are being operated under specific directives and rules.

Current Status: At present the number of banks and financial institutions (BFI) licensed by NRB are: 26 commercial banks under Group A; 60 development banks under Group B; 78 finance companies under Group C; and 13 microcredit development banks under Group D. Similarly, there are 16 savings and credit cooperatives and 45 non-government organizations (NGOs), both being allowed by NRB for undertaking limited banking transactions.

Table No. 1.1

1.1.1 Licensed Commercial Banks and their year of Establishment:

S.N	Names	Operation Date	Head Office
1	Nepal Bank Limited	1937/11/15	Kathmandu
2	Rastriya Banijya Bank	1966/01/23	Kathmandu
3	Agriculture Development Bank Ltd.	1968/01/02	Kathmandu
4	NABIL Bank Ltd.	1984/07/16	Kathmandu
5	Nepal Investment Bank Ltd.	1986/02/27	Kathmandu
6	Standard Chartered Bank Nepal Ltd.	1987/01/30	Kathmandu
7	Himalayan Bank Ltd	1993/01/18	Kathmandu
8	Nepal SBI Bank Ltd.	1993/07/07	Kathmandu
9	Nepal Bangladesh Bank Ltd.	1993/06/05	Kathmandu
10	Everest Bank Ltd.	1994/10/18	Kathmandu
11	Bank of Kathmandu Ltd.	1995/03/12	Kathmandu
12	Nepal Credit and Commerce Bank Ltd.	1996/10/14	Siddharthanagar
13	Lumbini Bank Ltd.	1998/07/17	Narrayangadh
14	Nepal Industrial & Commercial Bank Ltd.	1998/07/21	Biratnagar
15	Machhapuchhre Bank Ltd.	2000/10/03	Pokhara
16	Kumari Bank Ltd.	2001/04/03	Kathmandu
17	Laxmi Bank Ltd.	2002/04/03	Birgunj
18	Siddhartha Bank Ltd.	2002/12/24	Kathmandu
19	Global Bank Ltd.	2007/01/02	Birgunj
20	Citizens Bank International Ltd.	2007/06/21	Kathmandu
21	Prime Commercial Bank Ltd.	2007/09/24	Kathmandu
22	Sunrise Bank Ltd.	2007/10/12	Kathmandu
23	Bank of Asia Nepal Ltd.	2007/10/12	Kathmandu
24	Development Credit Bank Ltd. *1	2001/01/23	Kathmandu
25	NMB Bank Ltd. *2	1996/11/26	Kathmandu
26	KIST Bank Ltd.*3	2003/02/21	Kathmandu

*Upgraded to Commercial bank on:*1: 25th May 2008,*2: 1st June 2008,*3: 7th May 2009*

1.3 Profile of Selected Banks

In this study, three commercial banks are selected. Brief profile is presented below:

1.3.1 Nepal Bank Ltd.

The oldest bank of Nepal, Nepal Bank Limited (NBL) was established on 1994 B.S. Kartik 30, Monday (November 15, 1937). NBL's authorized capital was Rs.10 million and issued capital was Rs. 2.5 million of which paid up capital was Rs. 482 thousand with 10 shareholders. It is the first bank of Nepal to establish under the principle of joint venture (joint venture between government and general public).

Vision Statement

To remain the leading financial institution of the country.

Mission Statement

Nepal Bank Limited seeks to provide an environment within which the bank can bring unique financial value and services to all customers. It will be a sound institution where depositors continue to have faith in the security of their funds are receive reasonable returns; borrowers are assured of appropriate credit facilities at reasonable prices; other service-seekers receive prompt and attentive service at reasonable cost; employees are paid adequate compensation with professional career growth opportunities and stockholders receive satisfactory returns for their investment.

Values Statement

At Nepal Bank Limited, we believe that our banking should be based on: Respect, service and safety for the customers we serve. Respect, reward and opportunity for the people with whom we work. Respect, cooperation and support for the economic community of Nepal.

Objectives

Nepal Bank Limited has the following objectives:

- Continue to maintain leading share of banking sector with a significant presence in all major geographical areas in the country.
- Provide competitive and customer oriented banking services to all customers through competent and professional staff.

) Reclaim leadership within the national financial community.

Shareholding Composition

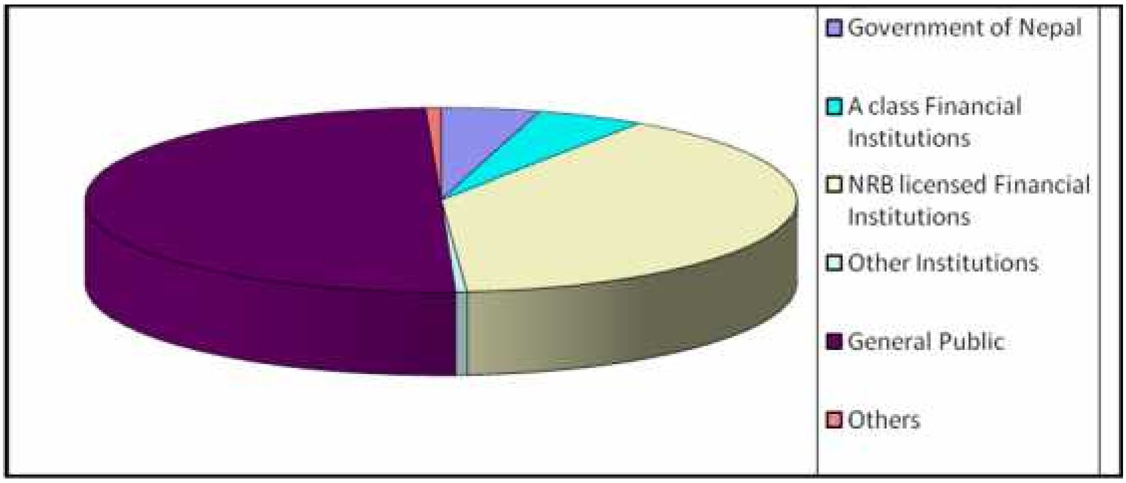
Table No. 1.2

Shareholding Composition

1	Government of Nepal	40.49 %
2	A class financial institutions	4.92 %
3	NRB licensed financial institutions	3.42 %
4	Other Institutions	0.52 %
5	General Public	49.94 %
6	Others	0.71 %

Figure No. 1.1

Shareholding Composition



1.3.2 Nepal Credit and Commerce Bank Ltd.

Formally registered as Nepal Bank of Ceylon Ltd. (NBOC), commence its operation on 14th October, 1996 as a joint venture with Bank of Ceylon, Sri Lanka. It was the first private sector bank with the largest authorized capital of Rs. 1000 million. The head office of the bank is located at Siddhartha Nagar, Rupandhehi, the birth place of Lord Buddha, while its corporate office is placed at Bagbazar, Kathmandu.

The name of the bank was changed to NCC Bank on 10th September 2002, due to transfer of share and management of the bank for Bank of Ceylon, an undertaking of government of Sri Lanka to Nepalese promoters.

At present, NCC Bank provides banking facilities and services to rural and urban areas of the kingdom through its 17 branches. The bank has developed corresponding agency relationship with more than 150 international banks having world wide network.

Mission of the Bank

NCC Bank, goal is to provide a wide range of banking services and products in the emerging socio-economic environment within and outside the country maintaining high standards of integrity and efficiency with excellence.

Capital Structure

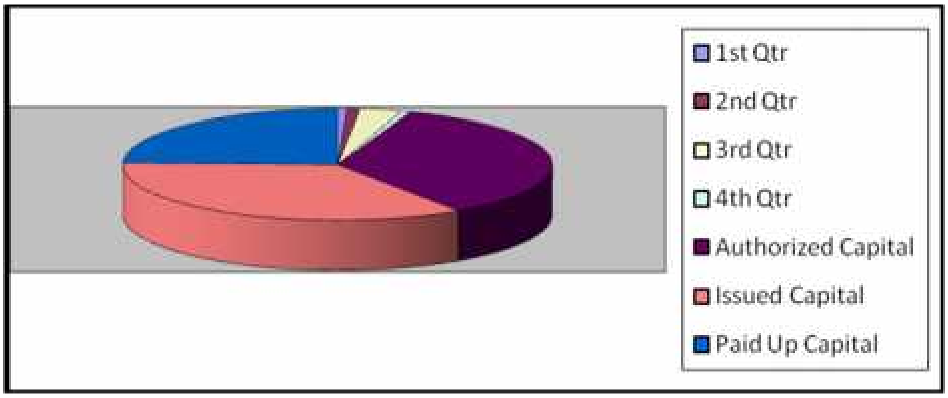
Table No. 1.3

Capital Structure

Authorized Capital	Rs. 1000 million
Issued Capital	Rs. 1000 million
Paid up Capital	Rs. 700 million

Figure No. 1.2

Capital Structure



1.3.3 Rastriya Banijya Bank

Rastriya Banijya bank is fully government owned, and is the largest commercial bank in Nepal which was established in January 23, 1966 (Magh 10, 2022 B.S.) by act of parliament and currently under a restructuring process. The bank was established to support economic growth and development in Nepal, since then, the bank has developed and diversified its role to provide various banking services to the community. It has been closely associated with the government programs targeting the priority and deprived sector, while undertaking innovative methodologies to finance self help groups. RBB is committed towards the satisfaction of its customers by providing modern banking facilities. At the same time the bank is equally committed to the economic growth and development of the country, the bank aim to reach every rural and urban corner of Nepal and develop banking habits among people.

RBB provides various banking services to a wide range of customers including banks, insurance companies, industrial, trading houses, hotels and many other sectors with main objectives to provide banking services through out Nepal and contribute in the economic development of the country, the bank's major activities include deposits, investment in government securities, lending to productive sector, foreign currency, remittances, merchant banking, correspondent banking etc. rural people are encourage to use peer pressure as collateral, to provide initial small loan, and to set their own interest rates on loan, members are encouraged to save first before accessing credit.

RBB's authorized capital of Rs. 1.56 billion and paid-up capital of Rs. 1.17 billion. RBB has Nepal's most extensive banking network with 123 branches with one special class branch and 3200 staffs and international connection. It has 12 correspondent and agency banks. RBB has covered 63 districts. It has branches with Government transactions 63, number of regional offices 4, number of central departments 14, number of foreign exchange counters 12, number of evening counters 23, number of 365 days banking branches 9, number of extension counters 5, number of lockers service branches 8, computerized branches 110, ABBS 40, SMS banking 60, no. of ATM 12, Direct foreign remittance payment services 123. In this regard, RBB works with western union and international money express, two leading person to person funds transfer networks. The bank also provides financial services to the low-income population in rural areas, within the framework of government programs and seeks to promote economic development and the improvement of living standards. Rastriya Banijya bank plays multiple roles as a commercial banks, micro finance owned Grameen Bikas Bank, loans with RBDC. However, as a government owned body its key priority is to act as a commercial bank.

Although RBB is one of the largest, fully government owned commercial bank of the country, the financial health of the bank is very poor. As per the audit report of KPMG Barent, an international agency, the bank has declared “technically bankrupt”. It is because of government interfere, political appointment to higher level of corruption as well. To rescue from the collapse of the bank under financial sector reforms programs of NRB, government has handed over the management of RBB to foreign expert under the leadership of American national M. Bruce. Henderson. In magh 2, 2059 to restructure of the bank for two years contract. Having positive management restructuring the bank and efficient service by adopting computerized system the government has renewed the contract.

Capital Structure of RBB

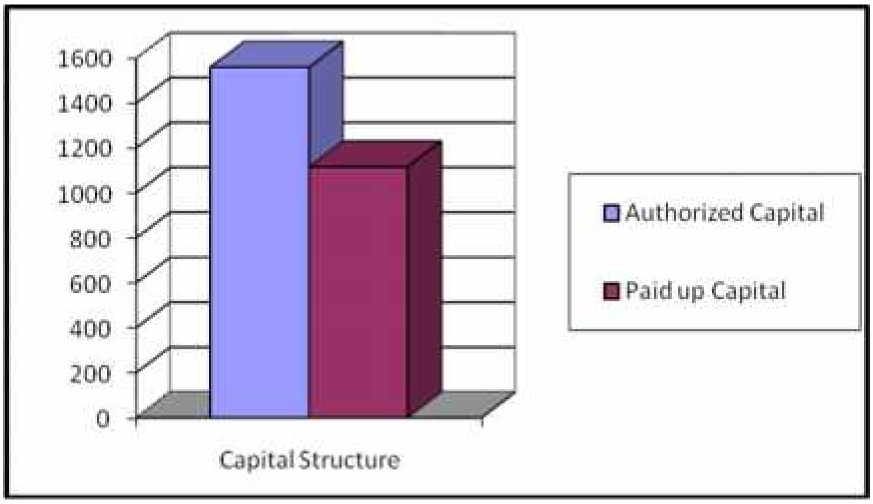
Table No. 1.4

Capital Structure of RBB

Authorized Capital	Rs. 1560 million
Paid up Capital	Rs. 1117 million

Figure No. 1.3

Capital Structure of RBB



Mission/Vision

RBB is committed towards the satisfaction of its customers by providing modern banking facilities. At the same time, the Bank is equally committed to the economic growth and development of the country. The bank aims to reach every rural and urban corner of Nepal to accommodate the requirement of the people. The Bank's extensive branch network and international connections are designed to transact banking activity between any part of the country and any part of the world.

Board of Directors of RBB Bank

Table No. 1.5

Board of Directors of RBB Bank

Name	Position	Representation
Mr. Krishna Hari Baskota	Chairman	Secretary, Ministry of Finance/Revenue
Mr. Bimal Prasad Wagle	Director	Joint Secretary, Ministry of Finance
Mrs. Manu Humagain	Director	Professionals
Mr. Naryan Prasad Baskota,	Director	“
Mr. Bhesh Raj Sharma	Director	“
Mr. Janardan Acharya	Director	“

1.4 Focus of the Study

An asset which ceases to generate income of the bank is called **Non Performing Asset**. The past due amount remaining uncovered for the two quarter consequently the amount would be classified as NPA for the whole year. It includes borrower’s defaults or delays in interest or principal repayment.

NPA may be defined broadly as the Bad Debt. However, NPA in terms of banking sector consists of those loans and advances which are not performing well and likely to be turn as bad loan. NPA as per current directives of Nepal Rastra Bank (NRB) has been categorized as classified loans and advances. NPA has severe impacts on the financial institution. On the other hand the investment becomes worthless as expected return cannot be realizable and on the other, due to the provisioning required for the risk mitigation the profitability is directly affected. The existence of the bank can be questioned on this situation. Thus interest along with principal has to be recovered timely and without obstacles. For the probable loss on lending that can not be recovered even after liquidation of security held with banks, NRB has directed to maintain loan loss provisioning according to aging basis for risk mitigation. The loan loss provision is to be maintained by debiting profit and loss account. Thus as the quality of loan degrades the ratio of loan loss provision is increased affecting the profitability of the banks. This study will have effort to analyse NPA with other relevant variables of the commercial banks.

Loans and advances are the most profitable of all the assets of the banks universally seek after the assets. These assets constitutes primary source of income to banks. As the business institution, a banks aim at making a huge profits and is willing lend loans and advances for the certain predetermined fixed period or maturity period. While lending loans advances s/he has to be careful about the safety of such loans. The borrowers must repay the loans by the maturity periods or expiry date but there is no certainty that all the loans are recovered by the maturity date. Loans that can not be recovered even after its maturity remain as non performing assets of the bank. In Nepal, increasing non performing assets (NPA) is major problem faced by the Nepalese banks.

Credit information bureau (CIB) was established to function as an intermediary between bank and financial institution for credit information where by customer availing credit facility of Rs. 2 million and above and not repaying the loans by the stipulated time and / or violating other terms and condition of the credit would be listed in the black list. On 16 July 2003, altogether 2074 borrowers are black listed by CIB. From this list it is clearly known those banks are facing the problem in recovering the granted loans that had turned to NPA. Even two nationalized commercial bank namely Nepal bank limited and Rastriya Banijya bank had non performing assets to the extend of 49.64 % and 50.70 % in the 2005respectively but by 2008 Mid- July, 2008, it has reached to 8.95% and 21.65% respectively.. Over all, total NPA of Nepalese banking system adversely affecting the depositors and other parties of the society.

Management of NPA has led the banks towards the rigorous recovery action which ultimately may cause auctioning of the security held with bank’s custody. Due to adverse economic situation of the country and perception build up among people that the properties under auction are always over evaluated there is less participation of the bidder during auction. Such situation compels the banks to accept the security on its own name.

For the analyzing of the cause and consequences, the level of three commercial banks shall be taken into consideration.

1.5 Statement of the Problem

The commercial banks give loans to the deprived sectors and the loan receiver is entitled to pay the interest and the principal amount on time. But in practice all loans are not recovered as per the sanction or within the expiry of repayment period. The management of NPA has led the banks towards the rigorous recovery action, which ultimately cause the auctioning of the security held with banks. Due to adverse economic situation of the country and perception of the people that the properties under auction are always over evaluated, there is little or no participation of the bidders during auction. This situation compels the banks to accept the security in its own name. This has piled up the volume of non banking assets with banks. As a major part of these a non banking assets is fixed in nature, the funds supposed to be rolled over are being tied up on fixed assets, which are hitting the liquidity of the banks. NPA's can have severe impact on the financial health of the bank. Lending carries risk, which arises from the failure of borrower to fulfill its contractual obligation droving the course of transaction. NRB directives No.2 related to loan classification and provisioning all commercial banks are supposed to categorized the loans disbursed to the customer into different groups on the basis of the past due period , these category of the loan amount requires certain percentage of it to be provisioned for the probable loss. This provisioning amount is taken deducted form the profit of the bank this is done mainly to safe guard the money of the depositors and to protect the banks from becoming bankrupt.

The study has identified the following research questions.

a. Is there any significant difference between the NPAs of commercial banks of Nepal?
b. What are the causes of NPA?
c. What is the trend of NPA of commercial bank?
d. What is the overall impact of NPA on the profitability of the Bank?
e. What are the methods to control NPA?

1.6 Objectives of the Study

The general objective of this research is to analyze the NPA and the loan and advances of the commercial banks of Nepal. The specific objectives of research are as follows:

- To highlight the trend and level of Non Performing Assets of the Commercial banks of Nepal.
- To study the relationship between the ratios of Income and the Non Performing Assets to the Loan and Advances.
- To analyze and compare the impacts of Non Performing Assets to the bank
- To make recommendations and suggestions to overcome the Non Performing Assets.

1.7 Significance of the Study

Loan is the main area of the commercial banking. It plays the significant impact on the commercial bank's profitability and goodwill. But most worry for in banking industry is the total management of loan. Due to mismanagement and economic condition the commercial banks are facing high level of NPA. This has wide spread suspicion on the performance on the commercial banks.

Government of Nepal has enacted the debt recovery act approved the long waited regulation on debt recovery to speed up the financial reforms in the financial sector.
The proposed study will make comparison between the NPA of commercial banks of Nepal. It will also check the NPA level between the commercial banks. It will wipe out some misconception that general people having about NPA of commercial banks.

The strength of any economy shows that the foundation upon which the banking business of banks lending (credit) in various quantity and quality etc. it is expected that this study will provide some of the present issues , latest information and data regarding non – performing loan and loss provisioning and other theoretical as well as conceptual framework of different aspects of non performing assets which may help the bankers , professional and readers interested there in. A non performing asset is one of major problem Nepalese financial institutions are facing today.

Hence it is important that a study be taken to study the impact of non performing assets. Rastriya Banijya bank, Nepal bank ltd, and Nepal credit and commerce bank have been selected for the study.

1.8 Limitations of the Study

Errors are inevitable but we have to give full effort to minimize them. We have to do many staying within many types of limitations and boundaries.
The study has been subject to the following limitations:

- Only the selected banks will be considered for the study.
- This study is based on the data and information provided by the commercial banks and published in the report of NRB.
- Only the data of five years are considered for research study.
- The study is not a final study on the subject.

1.9 Organization of the Study

CHAPTER -I: INTRODUCTION

This chapter generally covers the general background regarding the impact of non performing assets of commercial bank. And it includes focus of study, statement of problem, objectives of study, significance of the study and limitation of the study.

CHAPTER – II: REVIEW OF LITERATURE

It discovers what other research in the area of non performing assets has covered and left over in this regard. It avoids needless duplication of research effort. While reviewing literature, various experts, and NRB directives, rules and regulation are being considered.

CHAPTER – III: RESEARCH METHODOLOGY

Descriptive as well as analytical research methodology is being used to carry out this study. Since the study of impact of non-performing asset is a vague subject, appropriate methodology are adopted to analysis the achievement made so far in the three banks out of 26 commercial banks.

CHAPTER – IV: DATA PRESENTATION AND ANALYSIS

This chapter analyzed the impact of non-performing assets in quantitative approaches. Various financial tools like ratio analysis and statistical tools like standard deviation mean and co-relation analysis have been used. Beside these, qualitative improvements, which cannot the quantified, are also the part of analysis.

CHAPTER –V: SUMMARY, CONCLUSION AND RECOMMENDATIONS

Based on above analysis, achievement in terms of quality will be traced after the analysis. The needful recommendation will be cited to get rid of any shortcomings and borrowings.

CHAPTER - II
REVIEW OF LITERATURE

The review of literature is a very important aspect of the research. It is reviewing of research studies of other relevant proposition in related area of the study so that all the past studies, their conclusion and deficiencies may be known and further research can be conducted. For this several books, dissertation, reports, and articles published in journals are reviewed. This chapter is divided into two parts: Theoretical and Review of related studies.

2.1 Theoretical Review

2.1.1 Concept of Commercial Bank

"The commercial bank is the oldest form of bank. There is considerable change in the original form of commercial bank. In general, bank means the commercial bank. The banks that collect deposits and advance loans are called commercial banks. They are the banks "for profit" organizations. Their objective is to make a profit. The profits either can be paid out to bank stockholders or to the holding company in the form of dividends, or the profits can be retained to build capital (net worth). Commercial banks traditionally have the broadest variety of assets and liabilities. Their historical specialties have been commercial lending to businesses on the asset side and checking accounts for businesses and individuals on the liability side. However, in present days commercial banks also make consumer loans for automobiles and other consumer goods as well as real estate (mortgage) loans for both consumers and businesses."(*Joshi*; 2000: 209)

As per the Commercial Bank Act of Nepal, 2031 B.S. "a commercial bank is a bank which deals in exchanging currency, accepting deposits, giving loans and doing commercial transactions". As per Banking and Financial Institution Act (BAFIA), commercial bank is defined as any financial institution that is operating under section 47(1) of BAFIA 2063.

The government introduced Commercial Bank Act in Nepal in 2033 B.S. to cover the vast field of financial sector. This act has helped to emerge number of commercial bank with a view to maintain the economic interest in comfort of the public in general facilitated to provide loan for agriculture, industry, and trade and make a available banking services to the country and people.

"We can say that bank is an institution which accepts deposits from the public and in turn, advance loan to business and personal customers. It is the financial institution which provides wide range of banking services such as saving, credit payment, remittance etc. Hence, a bank may be called the financial supermarket providing all kinds of monetary services necessary for the industrialization an economic development of a country." (*Singh*; 2009: 20)

2.1.2 Functions of Commercial Banks

The commercial banks play an important role in the modern economy. The accepting of deposits from individuals and institutions and providing loans to the needy persons and businesses are its two important functions. Besides, it performs many other functions. On the one hand it helps in capital formation by mobilizing savings and on the other hand it promotes trade and industries by providing loans.

Commercial banks functions can be explained under following three major categories: deposits, loans, and cash management services. (*Microsoft's Encarta Reference Library;* 2005: 17)

A. Deposits:

There are four major types of deposits: demand deposits, savings deposits, hybrid checking/savings deposits, and time deposits. What distinguish one type from another are the conditions under which the deposited funds may be withdrawn.

A demand deposit is a deposit that can be withdrawn on demand at any time and in any amount up to the full amount of the deposit. The most common example of a demand deposit is a checking account. Money orders and traveller's checks are also technically demand deposits. Checking accounts are also considered transaction accounts in that payments can be made to third parties—that is, to someone other than the depositor or the bank itself—via check, telephone, or other authorized transfer instruction. Checking accounts are popular because as demand deposits they provide perfect liquidity (immediate access to cash) and as transaction accounts they can be transferred to a third party as payment for goods or services. As such, they function like money.

Savings accounts pay interest to the depositor, but have no specific maturity date on which the funds need to be withdrawn or reinvested. Any amount can be withdrawn from a savings account up to the amount deposited. Under normal circumstances, customers can withdraw their money from a savings account simply by presenting their "passbook" or by using their automated teller machine (ATM) card. Savings accounts are highly liquid. They are different from demand deposits, however, because depositors cannot write checks against regular savings accounts. Savings accounts cannot be used directly as money to purchase goods or services.

The hybrid savings and checking account allows customers to earn interest on the account and write checks against the account. These are called either negotiable order of withdrawal (NOW) accounts, or money market deposit accounts, which are savings accounts that allow a maximum of three third-party transfers each month.

Time deposits are deposits on which the depositor and the bank have agreed that the money will not be withdrawn without substantial penalty to the depositor before a specific date. These are frequently called certificates of deposits (CDs). Because of a substantial early withdrawal penalty, time deposits are not as liquid as demand or savings deposits nor can depositors write checks against them. Time deposits also typically require a minimum deposit amount.

B. Loans

Banks and thrifts make three types of loans: commercial and industrial loans, consumer loans, and mortgage loans. Commercial and industrial loans are loans to businesses or industrial firms. These are primarily short-term working capital loans (loans to finance the purchase of material or labour) or transaction or longer-term loans (loans to purchase machines and equipment). Most commercial banks offer a variable rate on these loans, which means that the interest rate can change over the course of the loan. Whether a bank will make a loan or not depends on the credit and loan history of the borrower, the borrower's ability to make scheduled loan payments, the amount of capital the borrower has invested in the business, the condition of the economy, and the value of the collateral the borrower pledges to give the bank if the loan payments are not made.

Consumer loans are loans for consumers to purchase goods or services. There are two types of consumer loans: closed-end credit and open-end credit.

Closed-end credit loans are loans for a fixed amount of money, for a fixed period of time (usually not more than five years), and for a fixed purpose (for example, to buy a car). Most closed-end loans are called instalment loans because they must be repaid in equal monthly instalments. The item purchased by the consumer serves as collateral for the loan. For example, if the consumer fails to make payments on an automobile, the bank can recoup the cost of its loan by taking ownership of the car.

Open-end credit loans are loans for variable amounts of money up to a set limit. Unlike closed-end loans, open-end credit does not require a borrower to specify the purpose of the loan and the lender cannot foreclose on the loan. Credit cards are an example of open-end credit. Most open-end loans carry fixed interest rates–that is, the rate does not vary over the term of the loan. Open-end loans require no collateral, but interest rates or other penalties or fees may be charged—for example, if credit card charges are not paid in full, interest is charged, or if payment is late, a fee is charged to the borrower. Open-end credit interest rates usually exceed closed-end rates because open-end loans are not backed by collateral.

Mortgage loans or real estate loans are loans used to purchase land or buildings such as houses or factories. These are typically long-term loans and the interest rate charged can be either a variable or a fixed rate for the term of the loan, which often ranges from 15 to 30 years. The land and buildings purchased serve as the collateral for the loan. See Mortgage.

C. Cash Management and Other Services

Although deposits and loans are the basic banking services provided by banks and thrifts, these institutions provide a wide variety of other services to customers. For consumers, these include check cashing, foreign currency exchange, safety deposit boxes in which consumers can store valuables, electronic wire transfer through which consumers can transfer money and securities from one financial institution to another, and credit life insurance which automatically pays off loans in the event of the borrower's death or disability.

In recent years, banks have made their services increasingly convenient through electronic banking. Electronic banking uses computers to carry out transfers of money. For example, automated teller machines (ATMs) enable bank customers to withdraw money from their checking or savings accounts by inserting an ATM card and a private electronic code into an ATM. The ATMs enable bank customers to access their money 24 hours a day and seven days a week wherever ATMs are located, including in foreign countries. Banks also offer debit cards that directly withdraw funds from a customer's account for the amount of a purchase, much like writing a check. Banks also use electronic transfers to deposit payroll checks directly into a customer's account and to automatically pay a customer's bills when they are due. Many banks also use the Internet to enable customers to pay bills, move money between accounts, and perform other banking functions.

For businesses, commercial banks also provide specialized cash management and credit enhancement services. Cash management services are designed to allow businesses to make efficient use of their cash. For example, under normal circumstances a business would sell its product to a customer and send the customer a bill. The customer would then send a check to the business, and the business would then deposit the check in the bank. The time between the date the business receives the check and deposits the check in the bank could be several days or a week. To eliminate this delay and allow the business to earn interest on its money sooner, commercial banks offer services to businesses whereby customers send checks directly to the bank, not the business. This practice is referred to as "lock box" services because the payments are mailed to a secure post office box where they are picked up by bank couriers for immediate deposit.

Another important business service performed by banks is a credit enhancement. Commercial banks back up the performance of businesses by promising to pay the debts of the business if the business itself cannot pay. This service substitutes the credit of the bank for the credit of the business. This is valuable, for example, in international trade where the exporting firm is unfamiliar with the importing firm in another country and is, therefore, reluctant to ship goods without knowing for certain that the importer will pay for them. By substituting the credit of a foreign bank known to the exporter's bank, the exporter knows payment will be made and will ship the goods. Credit enhancements are frequently called standby letters of credit or commercial letters of credit. (*Microsoft's Encarta Reference Library;* 2005: 22-25)

2.1.3 Loans and Advances, Cash Credits and Overdrafts

"The main function of the commercial bank is to generate the resources or funds and make loan and advances. Major portions of the funds available with the commercial banks are invested as loan and advances. Banks enjoy the interest on the loans and advances made by it. Which is normally is greater then the interests to be paid by it to the depositors and thereby make profit. However, loans and advances are not made to all those seeking for it. Banks analyze various factors before they advance loans and advances. At the time of lending loan, the bank carefully study the lending sector and make a sound policy for rendering loan. The policy should contain the Credit Deposit Ratio (CDR), the bank wishes to maintain. CD ratio is much influenced by the behaviours of banks liabilities. The higher the volatile deposit and volatile borrowings lower the volume of loan and vice versa." (*Dahal, Bhuvan & Sarita;* 2002: 8)

2.1.4 Performing Loan

"Performing loans are those loans that repay the principal and interest timely to the bank from the cash flow it generates. In other word, performing loan are the productive assets that generates the some profits. Loans have the certain time period to return its principle with its interest. If any one repays loan with its interest on time, is known as the performing loan. It is the most profitable assets of banks it helps to rapid growth of banking sector in this fast pace competitive age. Better performing loan are the symbol of success of bank, But many banks are suffering from the non repayment of loan amount." (*Shrestha; 2004:13*).

2.1.5 Non- Performing Assets/ Loan (NPA/NPL)

"An asset is classified as non performing assets if the borrower does not pay dues in the form of principal and interest. To define NPA first of all meaning of assets should be understood. Asset means the property of a person or a company. This indicates that assets are the property of company accumulated with the help of sources. Non performing loan means an outstanding loan that is not repaid. i.e. neither payment on interest or principle are made. In case of the bank, the loans and advances are the assets as the banks flow loans from the funds generated through shareholders equity, money deposited by the people and fund having through the borrowing. Hence the term of NPA means the loan and advances that are not performing well. Thus all the irregular loans and advances can be turned as NPA.

But NPAs have different meaning that varies from country to country. In some countries, it means that the loan is impaired. In some countries, it means that the payment are due but there are significant different among countries how many days a payment should be in arrears before past due status is triggered According to current banking act, the banks have to make provision for bad and doubtful debts, after deducting the bad and doubtful debts from the nonperforming assets; net non performing assets can be achieved.” (*Shrestha; 2004:14*)

Therefore,

NPA = (NPL+NBA+RNPL+SI+UA)

Where,

NPA = Non- performing assets

NPL = Non performing Loan

NBA = Non- banking assets

RNPL = Remaining Non – performing loan

SI = Suspend Interest

UA = Unutilized Assets

“Non performing loan (NPL) can be defined as the non – performing assets of the banks, In other words, it is the loan or a bad and doubtful debt that does not repay timely, generally the loan, which does not repay within three months, is known as non- performing loan. The loan amount that dies but covered by the collateral after selling is known as non – banking assets (NBA).Non –performing assets also includes suspend interest. It is the interest, which becomes receivable. Unutilized assets and those investments which do not generate any cash or incomes to the bank are also non performing assets (NPAs). The proper management of those assets to generate income is known as management of non- performing assets."(*Regmi; 2062:75*)

Increasing NPAs is the emerging problem of the banks. We know that the some banks are close down due to the uncontrollable NPAs. In USA, 1016 commercial banks were declared as unsuccessful (bankruptcy) from 1985 to 1990 and banks from 1995 to 2001. However, Nepalese commercial banks face this type of problem till now but they have to take step towards it. For this, appropriate amount of bad and doubtful debts is made provision from their incomes / profits.

2.1.6 Loan Loss Provision

Loan loss provision is the accumulated fund that is provided as a safeguard to cover possible losses up on classification of risk inherited by individual loans.

There is risk inherent in every loan. Hence provisioning is made as cushion against possible losses and to reflect the true picture of the bank's assets. Hence there is practice of showing net loan (Total Loans- Loan Loss Provision) in financial statements. The amount required for provisioning depends upon the level of NPAs and their quality. High amount of provision is an indication of that bank's credit portfolio needs serious attention. One percent provision of total credit is and ideal position as it is the minimum requirement for all good loans. In Nepal, 1%, 25%, 50% & 100% provisioning should be made for pass, substandard, Doubtful and Loss loans respectively.

2.1.7 Factors Responsible for NPA

Since NPA is a serious problem for today's banking industry, it seems necessary to identify the factors that are responsible for NPA. The factors can be broadly classified into two-those that are internal to the organization and those that are external to the organizations which are as follows: (*Singh*; 2009: 45)

Internal Factors

a. Management Inefficiency/Weakness

The following leads to management inefficiency and weakness:

- The major factor responsible for arising NPA is due to inexperienced by over ambitious people.

- The second factor is faulty planning i.e. cost and time overruns.
- The factor is location error.
- Due to lack of capital/equity also may NPA.
- The Credit analyst the inadequate costing arise the NPA.
- Due to faulty Marketing survey of clients.
- Obsolete Technology. The dishonest management of bank has arisen the NPA.
- Due to dissension among Promoters.
- Because of poor Industrial Relations.
- The bank’s attitude of dependence on few buyers
- The bank’s policy like poor distribution network
- Due to high competition on Market.
- Long delivers at fixed prices

b. Financial Reasons

The other factors for arising NPA is financial reasons. The financial reasons may arise due to following points.

- Faulty pricing
- Inadequate fund
- Unplanned expansion
- Diversion of funds
- Poor realization of book debts/receivable
- Delayed credit borrowings
- Inability to identify loss/profit contributing product/areas/centres

c. Marketing Weakness

Other internal factors of arising NPA are due to marketing weakness of banks. There are certain factors of marketing weakness which are stated below:

- Due to glut (excess supply/ availability)
- Due to excessive competition
- Due to demand recession-domestic and global
- Due to change in fashion and taste
- Due to weak marketing plan and strategy
- Because of the habit of Reactive-not proactive

External Factors

a. Government Policies and Actions

The first reason for arising NPA on external factors is government policies and actions. The barriers arise by government policies are stated below:

- Due to credit squeeze of government policies
- The government has implement the delayed decisions
- Due to regulated interest rates
- Because of priority/non-priority sector lending
- Withdrawal of subsidy
- Withdrawal of support price
- Government inaction-dumping of overseas product
- Foreign exchange control regulation
- Inconsistency in policies regarding capital investment/divestment.

b. Tax, Tariff, Custom Duties- Both Domestic and Foreign

The second point of arising external factor is tax, tariff, and custom duties both domestic and foreign. There are certain factors of tax, tariff and custom duties which are stated below:

- Adverse change in tax, tariff, vat, custom duties
- Regional trade blocks

- Special duties e.g.; SAD(special additional duty)
- Quantity restriction etc by India

c. Production Difficulties, Product Obsolescence

The third reason of external factor is product obsolescence difficulties, product obsolescence, which are stated below:

- Irregular supply of raw material, power, fuel, water
- Natural calamities
- Technological advancement
- Environmental regulations
- Product obsolescence

d. Overall Non – Conductive Industrial Environment/ Insecurity

The fourth reason of arising external factor is non- conductive industrial environment (insecurity) which is stated below:

- Industrial unrest
- General insecurity
- War etc.

e. Unexpected Economic Downturn

The fourth reason is unexpected economic downturn like recession; drastically decrease in income of people etc.

2.1.8 Principles to Lending Loan and Advances

While granting advances, the precautions should be taken by a banker and the principles to be taken of. By the way of introduction an attempt is being made in the following paragraph to discuss the general principle to be born in mind by a banker while granting advances (*Shekher and Shekher;* 1999: 551) :

1. Liquidity

Liquidity implies the ability to produce cash on demand. A bank mainly utilizes its deposit for the purpose of granting advances. These deposits are repayable on demand or on the expiry of a specific period. In either case, the banker must be ready to meet these liabilities whenever necessary. The advances granted by the banker are as liquid as possible.

2. Profitability

Banks are essentially commercial venture. It is true that excessive and unjustifiable profits can only be at the cost of the customer, on so far as higher lending rates push up production costs and in the ultimate analysis, adversely affects society in general. at the same time , the facts remains that while strong profits allow for full prudential provisioning high net profits allow for allocation to capital and reserves , which is essential for any bank to maintain its competitive viability and expand its lending operation . Also, the shareholders of a bank are entitled to reasonable dividend. All this indicates that it is their lending operations are sufficiently profitable.

3. Safety and Security

The banker should ensure that the borrower has the ability and will to repay the advances as per agreement. The banker should carefully consider the margin of safety. If it is as unsecured advance, its repayment depends on the creditworthiness of the borrower, and that of guarantor. The banker should consider the charter, capacity and capital (popularly known as 3 Cs) or Reliability, Responsibility, and Resources (popularly known as 3 Cs) of the borrower and the guarantor.

4. Purposes

The banker has to carefully examine the purpose for which advance has been applied. Of course the exact purpose for which is actually utilized. There is always the possibility that the advance, once granted, may be diverted for purposes other than that indicated by the borrower at the time of application. Thus, there should be proper analysis of purpose.

5. Social Responsibilities

While admitting that banker are essentially commercial venture, a bank should not forget the fact that it is not enough only people of means are given bank finance , the identification of priority sectors for the purpose of extending bank credit should be considered as a positive development in the banking system, aimed at effectively discharging its responsibility towards society. At the same time, this social responsibility should not deter the banks from paying adequate attention to the qualitative aspect of lending. Social responsibility is no doubt highly exacting.

2.2 Review of Related Studies

For the purpose of this study, relevant journals and articles, NRB Directives, thesis works regarding several aspects of banking sectors conducted by different intellectuals and students are discussed below:

2.2.1 Review of Journals and Articles

2.2.1.1 International Context:

Subhashis Kundu, (2003) has published an article, "*Non Performance of Non-Performing Assets*" where he has mentioned the problem of having non performing assets, the reasons for mounting of non-performing assets and the practices present in other countries for dealing with non performing assets.

He has indicated difficulties with the Non- Performing Assets as follows:

1. Owners do not receive a market return on their capital. In the worst case, if the bank fails, owners lose their assets. In modern times, this may affect a broad pool of shareholders.
2. Depositors do not receive a market return on savings. In the worst case if the bank fails, depositors lose their assets or uninsured balance. Banks also redistribute losses to other borrowers by charging higher interest rates. Lower deposit rates and higher lending rates repress savings and financial markets, which hampers economic growth.
3. Non performing loans epitomize bad investment. They misallocate credit from good projects, which do not receive funding, to failed projects. Bad investment ends up in misallocation of capital and, by extension, labour and natural resources. The economy performs below its production potential.
4. Non performing loans may spill over the banking system and contract the money stock, which may lead to economic contraction. This spill over effect can channelize through illiquidity or bank insolvency; (a) when many borrowers fail to pay interest, banks may experience liquidity shortages. These

shortages can jam payments across the country, (b) illiquidity constraints bank in paying depositors e.g. cashing their pay checks. Banking panic follows. A run on banks by depositors as part of the national money stock become inoperative. The money stock contracts and economic contraction follows (c) undercapitalized banks exceeds the banks capital base.

Lending by banks has been highly politicized. It is common knowledge that loans are given to various industrial houses not on commercial considerations and viability of project but on political considerations; some politician would ask the bank to extend the loan to a particular corporate and the bank would oblige. In normal circumstances banks, before extending any loan, would make a thorough study of the actual need of the party concerned, the prospects of the business in which it is engaged, its track record, the quality of management and so on. Since this is not looked into, many of the loans become NPAs.

The loans for the weaker sections of the society and the waiving of the loans to farmers are another dimension of the politicization of bank lending. Most of the depositor's money has been frittered away by the banks at the instance of politicians, while the same depositors are being made to pay through taxes to cover the losses of the bank.

He made a comparative study with other countries as follows:

I. China:

(a) Causes: (i) The State Owned Enterprises (SOE's) believe that there the government will bail them out in case of trouble and so they continue to take high risks and have not really strived to achieve profitability and to improve operational efficiency. (ii) Political and social implications of restructuring big SOE's force the government to keep them afloat,(iii) Banks are reluctant to lend to the private enterprises because while an NPA of an SOE is financially undesirable, an NPA of a private enterprise is both financially and politically undesirable,(iv) Courts are not reliable enforcement vehicles.

(b) Measures: (i) Reducing risk by strengthening banks, raising disclosure standards and spearheading reforms of the SOE's by reducing their level of debt, (ii) Laws were passed allowing the creation of asset management companies, foreign equity participation in securitization and asset backed securitization, (iii) The government which bore the financial loss of debt 'discounting'. Debt/equity swaps were allowed in case a growth opportunity existed, (iv) Incentives like tax breaks, exemption from administration fees and clear cut asset evaluation norms were implemented. The AMCs have been using leases, transfers, restructuring, debt- for-equity swaps and asset securitization, among other methods, to dispose of non-performing loans.

II. Korea:

(a) Causes: (i) Protracted periods of interest rate control and selective credit allocations gave rise to an inefficient distribution of funds, (ii) Lack of monitoring..... Banks relied on collaterals and guarantees in the allocation of credit, and little attention was paid to earnings performance and cash flows,

(b) Measurers: (i) The speedy containment of systemic risk and the domestic credit crunch problem with the injection of large public funds for bank recapitalization, (ii) Corporate Restructuring Vehicles (CRVs) and Debt/Equity Swaps were used to facilitate the resolution of bad loans, (iii) Creation of the Korea Asset Management Corporation (KAMCO) and a NPA fund to fund to finance the purchase of NPAs, (iv) Strengthening of Provision norms and loan classification standards based on forward-looking criteria (like future cash flows) were implemented; (v) The objective of the central bank was solely defined as maintaining price stability. The Financial Supervisory Commission (FSC) was created (1998) to ensure an effective supervisory system in line with universal banking practices.

III. Japan:

(a) Causes: (i) Investments was made real estate at high prices during the boom. The recession caused prices to crash and turned a lot of these loans bad, (ii) Legal mechanisms to dispose bad loans were time consuming and expensive and NPAs remained on the balance sheet, (iii) Expansionary fiscal policy measures administered to stimulate the economy supported industrial sectors like construction and real estate, which may further exacerbated the problem, (iv) Weak corporate governance coupled with a no-bankruptcy doctrine, (v) Inadequate accounting systems.

(b) Measures: (i) Amendment of foreign exchange control law (l997) and the threat of suspension of banking business in case of failure to satisfy the capital adequacy ratio prescribed, (ii) Accounting standards – Major business groups established a private standard-setting vehicle for Japanese accounting standards (2001) in line with international standards, (iii) Government Support - The government's committed public funds to deal with banking sector weakness.

IV. Pakistan:

(a) Causes: (i) Culture of "zero equity" projects where there was minimal due diligence was done by banks in giving loans coupled with collusive lending and poor corporate governance, (ii) Poor entrepreneurship, (iii) Chronic over-capacity/lack of competitive advantage,(iv) Directed lending where the senior management of the public sector banks gave loans to political heavy weights/ military commanders.

(b) Measures: (i) The top management of the banks was changed and appointment of independent directors in the board of directors, (ii) aggressive settlements were done by banks with their defaulting borrowers at values well below the actual debt outstanding and/or the amount awarded through the court process..... i.e., large haircuts/ write offs, (iii) setting up of Corporate and Industrial Restructuring Corporation (CIRC) to take over the non-performing loan portfolios of nationalized banks on certain agreed terms and conditions and issue government guaranteed bonds earning market rates of return,(iv) The Banking Companies (Recovery of Loans, Advances, Credits and Finances) Act, 1997 was introduced in February 1997. Special banking courts have been established under this Act to facilitate the recovery of non-performing loans and advances from defaulted."

In conclusion has suggested threes ways of solving this problem of NPAs. They are as follows:

(i) Recapitalization of banks with Government aid,
(ii) Disposal and write off of NPAs, and
(iii) Increased regulation.

2.2.1.2 National Context:

Shiva Raj Shrestha (1999), in his article '*Modus Operandi of Risk Appraisal in Bank Lending'* has tried to highlight different aspects of credit risk management. As per his view, as the effective risk management is central to good banking, the trade off between risk and return is one of the prime concern of any investment decision whether long – term or short term. He concludes, “Effective credit risk management allows a bank to reduce risks and potential NPAs. It also offers other benefits. Once a bank understands their risks and their costs, they will be determining their most profitable business, thus price products according the risk. Therefore, the bank must have an explicit credit risk strategy and support by organizational changes, risk management technique and fresh credit process and systems. There are five crucial areas that management should focus on.

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

Apart from these, the bank management should regularly review all assets quality issues including portfolio composition, big borrower exposures and development in credit management policy and process.” Improving risk management will not be easy or quick. However, Nepalese banker loves little choice. Hope fully, the bank adopt good risk management practices and will be able to reap both Strategic and optional benefit.

Sagar Basyal (2000) discussing the financial performance of government owned banks in his article "*Placing RBB and NBL under Management Contracts: Rational and Opposition*" agreed that the disappointing performance of these two banks has become serious concern to all the stockholders. Further he mentions that they are having with huge level of NPA which could be termed as the darkest sides of their operational inefficiency and undisciplined financial behaviour.

Suresh Pradhan (2001) in his article *"NPA: Some Suggestions to Tackle Them"* found saying that unless the growth in NPA is kept in control, it has the potential to cause systematic crisis. He has mentioned that a dream of globalization led to huge investment which unfortunately could not be utilized properly due to hesitant liberalization policies. Large corporate misused the credits and delayed payments and contributed indirectly for enhancing NPA ratio. He further argues the lack of vision in appraisal of proposal while loan sanctioning, reviewing or enhancing credit limits, absence of risk management policy of financing, concentration of credit in few group of parties and sector, lack of coordination among a various financiers, lack of initiatives to take timely action against wilful defaulters, indecision on existing out of bad loans for fear of investigating agencies like special police, CIAA, Public Accounts Committee of the parliament have also contributed in whatsoever measures to the worsening situation of NPA front. He further pointed out that most crucial reason for the increase in the NPA is the shabby and defaulter friendly legal system. Suggesting the remedy of NPA he adds that Administrative system should be strengthened, Legal reforms should be made and Assets Reconstruction Company should be formed. Henderson (2003), CEO of RBB turnaround is restructuring and collection of NPA.

Though these studies are found to be quite useful in their own side but the question of NPA and its cause as well as effect on various aspects in commercial bank is yet to be reviewed. In view of these, this study has been based on the various contributing factors that increase NPA level in commercial banks in Nepalese perspective and its effect on profitability position of the banks.

Krishna D. Bhattarai, (2003) has presented an article about the *"Non- Performing Assets (NPA) Management"*. According to him, a loan is a very easy term for a borrower when he has already taken and for a lender not availed. It is equally difficult for a borrower to avail and for lender to recover. From a banker's view, it is just like a stone to roll down from the top of the hill while sanctioning, but too difficult to roll back the same stone to the top of the hill while recovering. A loan not recovered within the given timeframe either in the form of interest servicing or principal repayment is called non-performing loan. There are other parameters as well to quantify a NPL. Security not to the extent of loan amount with specified safety margin, value of security not realizable, possession not as per the requirement of bank, conflict of charges are some of the reasons which causes difficulties while recovering the loan.

According to him, NPL of a bank is like a cancer in a human body, which will collapse the entire bank if not taken care in time. This is an important discipline in banking to prevent the entire NPL or avoid situation for a loan to turn into NPL.

Loan for banks is very essential to generate revenue for operational expenses as well as to provide return to the shareholders.

When a loan advanced from good money turns into a bad loan, the chances of shareholders return as well as the survival of the bank is at stake. Ailing banks cannot portray a better image in public. When a public looses the confidence on a bank and does not deposit, the bank will be in the verge of extinction. Therefore, deposits are the essence for a bank. A loan disbursed as good loan does not turn into bad overnight. It has certain course to turn into bad. An efficient bank management can recover the loan before turning it into bad and can save itself from the unwanted catastrophe. A general survey reveals following reasons why a good loan turns into a bad one:

Situational Problems

- Poor analysis of project and its capital requirement leading to a situation of over/under capitalized.
- Problem in managing the unit.
- Faulty evaluation of loan and security.
- Mismatch in demand and supply leading over inventory or under inventory.
- Actual modus operandi is very different from the projection and unit unable to cope with the situation.
- Sudden change in internal and external environment and project not being able to run according to its plan.
- Collection of receivables unnecessarily delayed resulting delay in re-order and chances of business penetration by other competitors.

Intentional Problems

- Intention to flee without settling the loan.
- Intention to cheat the bank.
- Intention to auction the property.
- To relieve from other debts.
- Malicious acts of both the bank staffs and the borrower.
- To show other creditors of his bankruptcy, this is not manageable.
- To waive interest/ penal interest or avail discount on loan if paid in later stage when bank offers such facilities.

Gopal Tiwari (2004), in his article "*Financial Sector hobbled with Chaos, Fragility*", states that Nepal's financial sector is moving like a 'sinking boat'. According to him, financial institutions have failed in delivering beneficial services to needy people by developing credit giving centres in rural areas with out which sustained economic growth is impossible. On the other hand, banks and financial institutions have enough liquidity but they are finding it difficult to find suitable places for investment.

He stated that "problem such as insecurity lack of market research from banks, low investment opportunities, weak operational policies for carrying out financial transaction, among others have contributed to the problem of this sector .Despite central banks directives regulating banks and financial institution, private and government banks functioning haphazardly. Nepal bank limited (NBL) and Rastriya Banijya Bank (RBB), the two largest banks, occupies about 50 percent of the country's banking assets. An effective reform of these two is the key to improved performance of the whole sector. The process currently underway to reform these two, despite paying huge amounts to foreign experts, has not given expected results.

Beside NBL and RBB, the non- performing assets (NPA) of some private banks are also very high. If the government and central bank allow the financial sector reforms to focus only on RBB and NBL, it might become a futile effort. The current management of RBB and NBL has not been able to reduce their NPL even after two years, which have crossed over 60%. Earlier KPMG had calculated NPL at 30- 35 percent. The central bank itself says, despite efforts NBL has high NPLs and negative capital of RS 9.75 billion”.

At last he suggests that the forthcoming budget should not remain a document merely but should address financial sector ills with a wide vision. He further recommended that in order to create a well regulated, prudent, market oriented, competitive and strong financial system in Nepal, the government should look to build up on its indigenous strength and improve upon its regional lies to improve its efficiencies.

In conclusion, a borrowing may reflect one or all the above signals that may cause harm to the bank. There are few ways to protect bank from intentional defaulter but for those default caused by situations we can reschedule or restructure their facilities and help them to meet their debt obligation as per the cash flow they are having. Even an authentic loan that has been sanctioned with a good intention may turn into bad due to lack of proper management and carelessness. The bank will have to face heavy consequences in such a case. When a good loan, with all effort to protect it, turns into bad and the borrower’s ability is not sufficient to repay it, he then tries to hide it from the bank and wants to be relieved temporarily. Such situations give some signals to the bank and these signals are called danger signals.
A bank must be one-step further than its customers must. It must collect all the relevant information that are required by the borrower for the establishment of a business and be rigid to give loan than to give his own money without any security. When a borrowing unit is not able to serve the debt from the source explored, the documentations are merely a decree to enforce legal action against him. Nevertheless, what gets realized when everything is lost. A jail and punishment does not satisfy the interest of bank. Therefore, he is of the view that the bank should always keep in mind the formula Know Your Customers (KYC) before giving loans.

The security given by a borrower may be ample for the exposure. However, the borrower from other source of business may not be able to generate substantial earning to service the debt. Bank has the right to auction the property and liquidate the loan but in doing so realization from the auction of the property is always less than the value of the assets. This will serve neither the purpose of bank nor the borrower instead cause loss to both.

2.2.2 An Assessment to NRB Directives:

NRB has issued **"Unified Directives 2062 B.S"** relating to Loan Classification and Loan Loss Provisioning under **Directive No.2**.This directive is issued as per the right provided by NRB Act, 2058 B.S., Section 79 for running the financial activities by the licensed financial institutions in relation to loan classification and loan loss provisioning, effective from F.Y 2061/62 B.S. (2004/05). NRB has issued new circulars as amendments related to the provisions of the directives. The licensed financial institutions should classify loans and maintain loan loss provisioning on the basis of the provisions given below:

1. Classification of Loans and Advances

a. Pass Loan

Loans and advances whose principal amount are not past due and past due for a period up to 3 months shall be included in this category. These are classified and defined as Performing Loans**.**

b. Sub-standard Loan

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

c. Doubtful Loan

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

d. Loss

All loans and advances which are past due for a period of more that 1 year as well as advances which have least possibility of recovery or considered unrecoverable and those having thin possibility of even partial recovery in future shall be included in this category.

Clarification:

1. Active loans and advances are defined as Performing Assets.
2. Loans and Advances falling in the category of Sub-standard, Doubtful, and Loss are classified and defined as Non-Performing Loan.

Note:

1. If it is appropriate in the views of the bank management, there is no restriction in classifying the loan and advances from low risk category to high risk category. For instance, loans falling under substandard may be classified into doubtful or loss and loans falling under doubtful may be classified into loss category.
2. The 'term' loan and advances also includes Bill purchased and Discounted.

2. Additional Arrangement in respect of Pass Loan

Loans and advances fully secured by gold, silver, fixed deposit receipts and Government's securities shall be included under 'Pass' category. However, where collateral of fixed deposit receipt or Government's securities or NRB Bonds is placed as security against loans for other purposes, such loan has to be classified on the basis of ageing.

3. Additional Arrangement in respect of 'Loss' Loan

Even if the loan is not past due, loans having any or all of the following discrepancies shall be classified as 'Loss':

a) Insufficient security/collateral.
b) The borrower has been declared bankrupt.
c) The borrower is absconding or cannot be found.
d) Purchased or discounted bills are not realized within 90 days from the due date.
e) Misuse of loan, i.e. credit not been used for the purpose originally intended.
f) Owing to non-recovery, initiation as to auctioning of the collateral has passed six months and if the recovery process is under litigation.
g) Loans provided to the borrowers included in the blacklist and where the Credit Information Bureau blacklists the borrower.
h) If project/ business are in non-operative condition or closed.
i) Credit card loan not write off within 90 days from its expiry date.

4. Additional Arrangement in respect of Term Loan

In respect of term loan, the classification shall be made against the entire outstanding loan on the basis of the past due period of overdue instalment.

5. Principle and interest should not be recovered by overdrawing in excess of the overdraft limit.

6. Letter of Credit and Guarantee

If non-funded facilities such as letter of credit, guarantees and other liabilities turn into funded liabilities and becomes the responsibility of the financial institution, those kind of credits have to categorized under 'pass' loan up to 90 days and if overdue for more than 90 days then to be categorized as 'loss' loan.

7. Rescheduling and Restructuring of Loan

1. In respect of loans and advances falling under the category of substandard, doubtful or loss, banks may reschedule or restructure such loans only upon receipt of a written plan of action from the borrower citing the following reason:

a. Evidence for adequate collateral and documentation regarding loans.

b. Financial institutions have confidence that loans can be recovered after rescheduling.

Note:

i. Rescheduling means to extend the duration of loan payment period.

ii. Restructuring means to change the loan type and terms and condition including change in loan payment period.

2. As per clause '**1**', to reschedule or restructure the loan, it is mandatory that at least 25% of past due interest up to rescheduled or restructuring date should be paid by the borrower. If all interests have been recovered before renewal of loans, it can be categorized into 'pass' loan.

3. If sick industries (under the recommendation of Sick Industries Preliminary Investigation and Recommendation Committee) require rescheduling and restructuring, at least 12% of interest must be cleared along with other procedures completed; then after at least 25% loan loss must be provisioned. But, in case less than 12% of interest is cleared, on the basis of normal expiry period loan loss provision should be maintained for rescheduling and restructuring. Here, sick industries are those sick industries under the control of Government of Nepal, Industry, commerce and Supplies Ministries.

4. As per the clauses ‘1’ and ‘3’ categorized loans and advances should be listed separately.

8. Minimum Loan Loss Provisioning

1. The loan loss provisioning, on the basis of the outstanding loans and advances and bills purchases classified as per this directives, shall be provided as follows:

Table No. 2.1
Classification of Loan Loss Provision

Loans & Advances	Minimum Loan Loss Provisioning
Pass	1 Percent
Sub standard	25 Percent
Doubtful	50 Percent
Loss	100 Percent

2. Loan loss provisioning to rescheduled or restructured loans should be as follows:

a. For rescheduled/ restructured loan, loan loss provision should be at least 12 percent.

b. If priority sector or deprived sector loan which is insured or guaranteed priority sector credit has been rescheduled or restructured, provision should be only 25 percent of above point (i) for such loans.(i.e. 25% of 12.50%)

c. If interest and principle of rescheduled/restructured loans have been served regularly since last two years, such loans can be converted into 'pass' loan.

3. Priority sector or deprived sector loans which are not insured should be provisioned as per clause no 'a'.

4. Where the loan is extended only against personal guarantee, a statement of the assets, equivalent to the personal guarantee amount not claimable by any other shall be obtained. Such loan shall be classified as per above and where the loans fall under the category of pass, substandard and doubtful, in addition to the normal loan loss provision applicable for the category, an additional provision by 20 percentage shall be provided. Classification of such loans and advances shall be prepared separately. Hence the loan loss provision required

against the personal guarantee loan will be 21%, 41%, and 70% for pass, substandard and doubtful category respectively.

Note: Loan loss provision set aside for performing loan is defined as ' General Loan Loss Provision' and loan loss provision set aside for non-performing loan is defined as 'Specific Loan Loss Provision.' Where the banks provide for loan loss provisioning in excess of the proportion as required under the directives of NRB, the whole amount of such additional provisioning may be included in General Loan Loss Provision under the supplementary capital.

Table No. 2.2
New Loan Classification and Provision System Compared with Loan Loss Provisioning as per Old System
As the per Directive no. 2

Effective from 2058/4/1 i.e. July 16, 2001					Effective March 22, 1991 to July 15, 2001 (10 years)
Classification	**For F.Y. 2059/60 (03/04)**	**For F.Y. 2060/61 (04/05)**	**For F.Y. 2061/62 (05/06**	**Loan Loss**	**Provision Loan Loss Provision**
Pass	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	Loans not past due and past due up to 3 months	1%	0%
Sub-Standard	Loans and advances past due for a period of over 3 months to 1 year	Loans and advances past due for a period of over 3 months to 9 months	Loans and advances past due for a period of over 3 months to 6 months	25%	5%
Doubtful	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 3 months to 9 months	Loans and advances past due for a period of over 6months to 1 year	50%	25%
Loss	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 2 years	Loans and advances past due for a period of over 1 year	100%	50% (For 100% provision the overdue to exceed 5 years)
The last column of the table shows what the Loan Loss Provisioning Percentage would be if the old directive followed is for provisioning figures but the new directive is followed for loan classification					

2.2.3 Review of Thesis

Lila Prasad Ojha (2002), has carried out research on "*Lending practices: A Study in NABIL Bank , Standard Chartered Bank, and Himalayan Bank Limited*" his main objectives of the study are to analyze the various aspects of bank's lending in various sectors of economy, the individual banks performance regarding the lending quantity, quality, efficiency and its contribution in total income. The problem conclusion and recommendation figured out by him in this thesis are discussed as below.

As stated by him, over-liquidity causes due to lack of good lending opportunities, risk arising to mismanagement of lending portfolio, increasing non- performing assets etc are some of the problem that is facing by Nepalese banking sector. His main objective is to analyze the various aspects of banks lending in various sector of economy, the individual banks performance regarding the lending quantity and quality.

From his analysis the major findings are that "the highest growth rate, proportionately high volume of loans and advances, the best contribution in priority and agricultural sector and the high level of deposits mobilization of HBL has put this bank in the top position in the lending function. However the better activity ratio of SCBNL has proved this bank the best in managing the lending portfolio according to the demand of profit oriented business. The high volume of lending activities and high volume of productive sector loan of NABIL has put the bank in the top position in absolute terms. – The increasing provision on loan loss and high volume of non performing assets in NABIL & HBL certainly attracts the high attention of any person interested with these banks. The high volume of NPA of HBL may have caused due to the failure of industrial and agricultural sector. NABIL increase in NPA may have caused due to the accumulated bad debts that is kept behind the curtain to show the high efficiency of management."

He suggested that following, normal guidelines of NRB and acting up on this also reduce many of the credit risk arising from borrowers. He recommended banks to be more cautious and realistic while granting loans and advances. As suggested by him, the major solution of reducing the risk ifs to avoid lending in more risky area until the bank does not fully satisfy itself regarding the future viability of the project. He further suggested that the establishment of asset management company (AMC), which helps commercial banks in collecting their debts and improving their credit rating efficiency, should be initiated. As per his opinion, lack of proper credit appraisal, default by black listed borrower and professional defaulter, the over confidence in commercial banks regarding credit appraisal efficiency and negligence in taking information from credit information bureau has caused many of he bad debts in these banks.

Santosh Pandey (2002), in his thesis *"Nepal Rastra Bank- Directives their Implementation and Impact on the Commercial Bank"*: a Case Study of Himalayan bank limited with the objectives to find out the impact of changes in NRB directives on the performance of the commercial bank and to find out whether the directives were implemented or not.

"The directives if not properly addressed have potential to wreck the financial system of the country as they are the only tools of the NRB to supervise and monitor the financial institutions. The directives in themselves are not that important unless properly implemented. The implementation part depends upon the commercial banks. In case commercial banks are making such huge profit with full compliance of NRB directives , then the commercial banks would deserve votes of praise because they would then be instrumental in the economic development of the country .--- all the changes in NRB directives made impact on the banks and the result are the followings:

- Increase in operational procedures of the bank which increases the cost of the bank.
- A short term decrease if profitability which result to lesser dividends to shareholders and lesser bonus to the employees.
- Reduction in the loan exposure of the bank., which decreases the interest income but increases the protection of the depositor's money
- Increase protection to the money of the depositors through increased capital adequacy ratios and more stringent loan related documents.

- Increase demand for shareholder’s contribution in the banks by foregoing dividends for loan loss provisions and various other reserves to increase the core capital.

All the aforesaid result lead to one direction; the bank will be financially healthy and stronger in the future .HBL will be able to withstand tougher economic situation in the future with adequate capital and provision for losses. The tough time through which the bank is under going at present will prevail only for a couple of years but in the ling run , it will be strong enough to attract more deposits and expose itself to more risk with capital cushion behind it. The quality of the assets of the banks will become better as banks will be careful creating credit. Ultimately, the changes in the directives will bring prosperity not only to the share holders but also to the depositors, the employees and the economy on the country as a whole”.

At last he recommended that the bank has go make it’s monitoring and follow up department stronger needs to give priority in human resource development through training to its staffs and make them efficient enough to monitor and collect already disbursed loans.

Dinesh Kumar Khadka (2003) in his thesis*: “Non- Performing Assets of Commercial Banks”* with reference to NABIL Bank Ltd, Nepal SBI Bank, Nepal Investment Bank, Nepal Bangladesh Bank and Bank of Kathmandu. His main objective are to examine the level of non- performing loan / assets in total assets, total deposit and total lending of Nepalese Commercial banks, effects of nonperforming loans to return on assets (ROA) and return on equity (ROE) and following of NRB circulars by commercial banks.

He has pointed out the problems of commercial banks as, “Escalating level of NPAs has been becoming great problem in banking business in the works. In this context Nepal can not be run off from such situation. The level of NPA in Nepalese banking business is very alarming. It is well known fact that the bank and financial institution in Nepal have been facing the problem of swelling nonperforming assets and the issue is becoming more and more unmanageable day by day. He added from different financial reports, news paper and news, it is understood that total NPA in Nepalese banking system is about 35 billion, while it is very worse in case of two largest commercial banks i.e. Rastriya Banijya Bank (RBB) and Nepal Bank Limited (NBL).

At last he has concluded that the high degree of negative correlation of different commercial banks between NPA & ROA and NPA&ROE indicates towards the inverse relation between them. It means the level of NPA effects the return on assets and return on shareholders equity. High level of non- performing assets not only decreases the profitability of banks but also affects the entire financial as well as operational health of the organization.

He recommended that that the proper financial analysis of the borrower should be made before sanctioning the loan. Different department have to be set off for disbursement and control of the loan, all commercial banks should follow the NRB directives regarding the loan loss provision, efficient management system should be better to decrease NPA, banks should take enough collateral so that bank at least can able to recover its principal and interest amount in case of default situation of the borrower.

Niva Shrestha (2004), in her thesis on *“A Study on Non –Performing Loan and Loan Loss Provisioning of Commercial Banks: with reference to Nepal Bank Limited, NABIL Bank Limited and Standard Chartered Bank Limited”*, has the main objective to find the proportions of non-performing loan, relationship between loan loss provision and loan and loss provision and profitability factors that affects to accumulate the nonperforming loans in selected banks.

In her thesis she has pointed out the problem on commercial banks as “Commercial banks/ financial institution in Nepal have been facing several problems like back of smooth functioning of economy , different policies and guidelines of NRB , political instability , security problem , poor information system , over liquidity caused by lack of good lending opportunities, increasing non performing assets etc, In the Present context where have Nepalese Banks are facing the problem is increasing NPAs , more amount have to be allocated for loan loss provision.”

She has concluded that "ineffective credit policy, political pressure to lend to uncreditworthy borrowers, overvaluation of collateral are the major causes of mounting non performing assets in government owned banks NBL. Other factors leading to accumulation of NPAs are weak loan sanctioning process, ineffective credit control review and classification of loans enables banks to monitor quality of their loan portfolios and to take remedial action counter deterioration in credit quality. In addition to these, establishing recovery cell, hiring asset Management Company are also measures to resolve the problem on NPL. She has found that NBL has very high portion of non –performing loam resulting higher provision on comparison to NABIL and SCBNL. Even the NBL has highest investment in the most income generating assets i.e. Loans higher non- performing loans and provision which is higher than acceptable during the study period.

Govinda Ghimere (2005**)** has conducted his research on, *"Non Performing Assets of Commercial Banks: Caused and Effect"*. His main research objectives are to evaluate the impact of NPA on the profitability of the bank, to assess the relationship of NPA and NBA and aso to analyse the internal and external factors that influence the NPA.

During his research he found that the operating profit of the sample banks are increasing but the growth on net profit is negative because of loan loss provision. During the analysis he also found the positive relation between credit expansion and the incremental on Non Performing Assets (NPA). The NBA is created due to having NPA but it cannot be said that whether there is NPA that always created NBA.

He concluded that the profitability of commercial banks has been affected due to increasing level of non performing assets. Bad intension, weak monitoring and mismanagement were found the major responsible factors for NPA growth. He further suggested the bank to analyze the loan proposal properly before extending any loan and conduct all feasibility study of the project. The banks should also act immediately to collect the bad loans.

Sushmita Lama (2009) has carried out research on, *"Impact of Non Performing Assets on the Performance of Commercial Banks"*. Her main objectives of the study are to analyse the overall impact of the Loss Provision on the profitability of the commercial banks, to find out whether the NPA guidelines are followed in making provision relating to NPAs or not and to study the internal and external factors that have significant contribution on NPA increment.

In her thesis she pointed out the instable political condition, insecurity, ineffective credit policy, and political pressure to lend non viable project, overvaluation of collateral and even without collateral disbursement etc., the major factors causing of mounting nonperforming assets in banks mainly in government owned banks. Commercial banks investment has been found lower productivity due to the lack of supervision regarding whether there is proper utilization of their investment or not. Lack of farsightedness in policy formulation and absence of strong commitment towards its proper implementation has also caused many problems to commercial banks. Proper classification and close review of loans enable banks to monitor loan portfolio and take remedial step to safe guard deterioration of its credit quality.

Further more, she emphasised on the establishment of proper rules and laws essential to solve the problem on NPL. The guidelines in themselves are not important unless properly implemented. The rules and regulation are only the tools of NRB to supervise and monitor the financial institution. So, NRB need to monitor the concerned authorities in order to ensure that they are being followed.

She has concluded that “the banking sector is facing various problems. One of them is, the banking has been becoming huge victim of huge non performing assets (NPAs). NPAs are one of the serious problems faced by commercial banks. Although NBL and RBB has almost more than 50% of market share deposit and resources, these two banks are facing vicious circle of NPL resulting high provision. These banks have higher percentage on market share in lending too which are the most income generating assets but operating in loss since long time.

Therefore these two banks are handed over to the foreign group to manage NPA. Similarly NCC bank is also suffering from NPA so, this bank also effectively manage loan to generate profit.”

Research Gap

The NPA is one of the challenging problem of commercial banks in Nepal, which is followed by increasing loan loss provisioning. This gives more emphasis on the relationship between NPA and other relevant variables like volume of total assets, level of deposits, loan loss provision, non performing loans, net profit. In this connection, this study contributes something new towards the loans and advances of the commercial banks. Some research had been done in the related topic but, probably first of its kind no research was found in detail regarding analysis on the impact of non –performing assets.

Hence this research has attempted to fill the gap by taking reference of Nepal Bank Limited, Rastriya Banijya Bank, and Nepal Credit and Commerce Bank Limited. This study will try to show the present issues, latest information on the bank’s NPA’s and other ratios, data and real picture of loans and advances of Nepalese commercial banks from the year 2004 to 2008 (mid July).

After reviewing the relevant literatures, the next chapter concentrates in the research methodology applied in the study.

CHAPTER - III

RESEARCH METHODOLOGY

Research as the name implies means to search or study about a phenomenon. It is a repeated action to find or investigate something in a scientific manner. It seeks to find out facts and relationships by defining and redefining problems, formulating hypothesis, collecting, organizing and evaluating data, making deductions and conclusions to determine whether they fit the formulated hypothesis. Thus, research refers to a critical, careful and exhaustive investigation, inquiry and experimentation with the aim of the revision of accepted conclusions in the light of newly discovered facts.

In the words of John W. Best, “Research may be defined as the systematic and objective analysis and recording of controlled observations that may lead to the development of generalizations of principles or theories, resulting in prediction and possibly ultimate control of events”.

Similarly, the Advanced Learner’s Dictionary of current English defines research as, “A careful investigation or inquiry especially through search for new facts in any branch of knowledge”.

Research Methodology refers to the various sequential steps to be adopted by a researcher in studying a problem with certain objectives in view.”(*Kothari*, 1989). In other words, research methodology describes the methods and processes applied in the entire aspect of the study. It is a way to solve the research problem systematically and scientifically. In fact research methodology is much vague than research methods i.e. research method is just a part of research methodology. It considers the logic behind the use of the methods in the context of research study and explains why a particular method or technique is used. Thus, research methodology is concerned not only about the different types of methods but also about various other facts like what data have been collected, what are the purpose and problem of research, why hypothesis has been formulated etc.

So, to sum up the research methodology that has been adopted for the study is mentioned in this chapter, which deals with research design, sources of data, data collection, population and sample, processing and tabulating procedures.

3.1 Research Design

Research design is a planned structure and strategy of investigation conceived to obtain answer to research objectives through analysis of data. The first step of the study is to collect necessary information and data concerning to study. Therefore research design means, the definite procedure and technique, which guides the study and propound ways of doing research. In this way a descriptive and analytical survey will be done. The justification for the choice of these methods is preferred because it concludes reliable data and information covering a long time and avoids numerous complex variables.

The main objective of research design is to make analysis in non performing assets of commercial banks in Nepal and provide valuable recommendation. This will follow analytical and descriptive research design .and it also analyzes the composition of trend of non performing assets. Loan recovery and profitability conducted of commercial banks. The design for this research is made by collection of information from different sources by using various financial statistical tools.

3.2 Population and Sample

Population or universe refers to the industries of the same nature and its services and product in general. It is the collection or the aggregate of objects or the set of results of an operation. The object of population may be finite or infinite in number and hypothetical or existence in character. Sample, on the other hand is the representative part of population selected from it with the objective of investigating its properties. If some elements are selected with the intention of finding out something about the population from which they are taken then that group of element is called a sample. Thus, a sample is just a portion of the selected with a view to draw conclusions about the universe under study.

Hence, it is a representative selection of a population that is examined to gain statistical information about the whole. At present, the total number of object in the general topic deals with the commercial banks. There are all together 26 commercial banks in Nepal, out of these total commercial banks some selected banks are selected as the sample. For this study Nepal bank Limited, Rastriya Banijya Bank, and Nepal credit and commerce bank are taken as sample.

3.3 Sources of Data

Making study more reliable and justifiable, secondary data has been used in this study. The annual reports of the subjected banks are the major sources of the data for the study. However, beside the annual reports of the respective banks, the following sources of data are also considered.

1. NRB reports
2. Annual reports of the selected commercial banks
3. Various publications dealing in the subject matter of study
4. Various Articles published in the newspaper
5. Different websites

Another source like interviews, desertion, remarks by the specialist of the subject, those are capable in providing valuable data and conclusion, should be considered in the study.

3.4 Data Procedures and Analysis

After collection of research data, an analysis of data and interpretation result are necessary. Applying different financial and statistical tool made data analysis.
Further to represent the data in simple form bar diagram and graphs have also been used.

3.4.1 Financial Tools

While adopting financial tools, a ratio is used as a bench mark for evaluating the financial position and performance of any firm.” Financial analysis is the process of identifying the financial strength and weakness of the firm by properly establishing relationship between the items of the balance sheet and profit and loss account” (*Pandey*; *2000: 108).”* financial analysis is the use of financial statement analyze a company’s financial position and performance and to assess future financial performance” *(Wild, Subramanyam and Halsey; 2003:13).*

3.4.1.1 Ratio Analysis

Ratio analysis is the widely used tool of financial analysis. A ratio is simply one number expressed in terms of another and as such it express the numerical or quantitative relationship between two variables . Ratio analysis reflects the relative strengths and weakness of any organization also indicates the operating and financial growth of the organization. It summaries the financial figures and make quantitative judgment about the financial performances and positions. The relationship between two accounting figures expressed, mathematically is known as financial ratio (*Pandey*, 2000:108)

To make analysis, we can use various ratios, but only those ratios have been calculated which are related to the subject matter.

1. Loan and Advances to Total Assets Ratio

The loan and advances to total assets ratio measures the amount of loan and advances in the total assets. It means that it shows the proportion of loan and to total assets. High degree of loan and advances indicates the good position of the organization that of good mobilization of deposits of fund. In inverse, low degree of loan and indicated that use of fund properly. Loan is the risky assets. Thus higher loan and advances to total assets ratio shows high risk and inversely low loan and advances to total assets ratio shows low risk. Risk consist the uncertainty and future is uncertain. Thus, the loan and advances may or may not be recovered with its interest. This ratio can be calculated as follows:

$$\text{Loan and Advances to Total Ratio} \quad X \quad \frac{\text{Loans and Advances}}{\text{Total assets}}$$

2. Loan and Advances to Total Deposit Ratio (CD Ratio)

The main objective of commercial banks is to make deposit and lend it in the secure field. The loan and advance to deposit shows the relationship between the loan and advance and total deposit. It shows how much fund of deposit is provided as loan and advance. This ratio is used to find out how successfully the bank are utilizing their deposit fund in credit or loan for profit generating purpose as loan and advances yield high rate of return. Higher CD ratio implies the better utilization of total deposits and better earning. Hence 70% to 80% CD ratio is considered as more appropriate. This ratio can be calculated as follows:

$$\text{Loan and Advances to Total Deposit Ratio} \quad X \quad \frac{\text{Loans and Advances}}{\text{Total Deposit}}$$

3. Non- performing Assets to Total Loans and Advances Ratio

This ratio determines the non- performing assets in the total loan advances portfolio. Greater ratio implies the bad quality of loan of the bank. Hence lowernon- performing assets to loans and advances ratio are preferable. As per international standard only 5% NPA is allowed but in the context of Nepal 10%

NPA is acceptable. It is calculated as under:

$$\text{NPA to Total Loans and Advances Ratio} \quad X \quad \frac{\text{Non - performing Assets}}{\text{Total Loans and Advances}}$$

4. Provision Held to Non- performing Assets Ratio

This ratio describes the proportion of provision held to non- performing assets of the bank. This ratio measures up to what extent of risk inherent in NPA is covered by the total loan provision. Higher ratio signifies that the banks are safeguard against future contingencies that may create due to non – performing assets. So, higher the ratio better is the financial strength of the bank. This ratio is calculated as follows:

$$\text{Provision Held NPA} \quad X \quad \frac{\text{Total Loan Loss Provision}}{\text{Non - Performing Assets}}$$

5. Non – performing Assets to Total Assets

This ratio indicates the ratio between the non – performing assets and total assets. Higher NPA to total assets implies ratio implies the bad effect in banks performance and it decreases the profitability of the banks and lower ratio implies the better performance of the bank and it increases the profitability of banks. This ratio can be calculated as follows:

$$\text{NPA to Total Assets} \quad X \quad \frac{\text{Non - Performing Assets}}{\text{Total Assets}}$$

6. Return on Loan and Advances

This ratio indicates the proportion of the over total loans and advances. It describes how efficiently the bank has employed its resources in the form of loan and advances of the bank , higher the ratio better is the performance of the bank and vice versa . it is calculated as follows:

$$\text{Return on Loans and Advances} \; X \quad \frac{\text{Net Profit}}{\text{Total Loans \& Advances}}$$

3.4.2 Statistical Tools

The statistical tool is essential to measure the relationship of two or more variable. It is the mathematical technique used to facilitate the analysis and interpretation of the performances of the organizations. It helps to compare the performance, strengthen, weakness of the organizations. It also helps to present the data, show the relation and deviation or differences of variables of organizations, in this study, the following statistical tools are used. Arithmetic mean or simply a 'Mean' of a set of observation is the sum of all the observation divided by the number of observation (*Bajaracharya*; 1996:177). It is the best value, which represent to the whole group. Mean is the arithmetic average of a variable. Arithmetic mean of a series is given by:

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

Where,

X = sum of the variable 'X'

N= No of observation

Standard Deviation

The standard deviation is the absolute measures of dispersion in which the drawbacks present in other measures of dispersion are removed. It is said to be the best measure of dispersion as it satisfies most of the requisites of a good measure of dispersion (*Bajracharya; 1996:177).* Standard deviation is defined as the positive square root of the mean of square of the deviation takes from the arithmetic mean. It indicates the ranges and size of deviation n from the middle or mean. It measures the absolute dispersion. Higher the standard deviation higher will be the variability and vice versa. Dispersion measures the variation of the data from the central value. In other word, it helps to analyze the quality of data regarding its variability. It can be:

$$\text{Standard Deviation } (\sigma) = \sqrt{\frac{(X \; \text{Z} \bar{X})^2}{N}}$$

Coefficient of Variation

Standard deviation is the absolute measure of dispersion. The relative measure of dispersion based on the standard deviation is known as the coefficient of standard deviation

(*Bajracharya;* 1996:177). It is independent of unit. So, two distributions can bitterly be compared with the help of C.V for their variability. Less the C.V, more will be the uniformity, consistency etc. and more the C.V less will be the uniformity, consistency etc. it is calculated as under:

Coefficient of variation (CV) = $\frac{\pm}{\overline{X}} | 100$

Correlation Coefficient (r)

Correlation coefficient is defined as the association between the dependent variable and independent variable. It is a method of determining the relationship between these two variables. If the two variables are so related change in the value of independent variable cause the change in the value of dependent variable then it is said to have correlation coefficient (*Sunity and Silwal:325).*

Correlation Coefficient (r) = $\frac{XY}{\sqrt{X^{2} \quad Y^{2}}}$

The Karl Pearson Coefficient of Correlation always falls between -1 to +1. The value of correlation on coefficient in -1 signifies the negative correlation and +1 signifies the positive correlation coefficient. The following general rules are mentioned for interpreting the value of r.

When r = 1, there is positive perfect correlation between the two variables
When r = -1, there is a negatively perfect correlation between the two variables.
When r = 0, the variables are uncorrelated.

Near the value of r to +1, closer will be the relationship between two variables and nearer the value of r to 0, lesser will be the relationship.

Probable Error

Probable error of the correlation coefficient denoted by P.E. is the measure of testing the reliability of the calculated value of r. if r be the calculated value of r from a sample of n pair of observations, then P.E. is defined by

$$P.E. X 0.6745 \left| \frac{1-r^2}{N} \right.$$

Where, r = correlation coefficient

N= no of observation

It is used in interpretation whether calculated value of r is significant or not.

i. If r< P.E., it is insignificant. So, perhaps there is no evidence of correlation.

ii. If r>6 P.E., it is significant.

In other cases, nothing can be concluded.

The probable error of correlation coefficient may be used to determine the limits with in which the population correlation coefficient lies. Limits for population coefficient are r+ P.E.

Trend Analysis

One of the most popular and mathematical method of determining the trend of time series is the least square method. By using this method, we can estimate the future trend values of different variables. Hence, for the estimation of linear trend line following formula is used.

Y= a + b X

Where,

Y= Trend value

a= Y intercept

b= slope of trend line of the amount of change in Y Variable that is an associate with change in 1 unit in X variable

X= Time variable

Diagram and Graphical Representation

Diagram and graphs are visual aids that give a bird eye view of a given set of numerical data .They represent the data in simple and reality comprehensive form.

Hence, the various bars, charts and graphs are used to present the data and data analysis in this study.

CHAPTER - IV

DATA PRESENTATION AND ANALYSIS

In this chapter, raw forms of data which are collected from various sources are processed and changed into an understandable presentation using financial as well as statistical tools supported by diagram and graphs as mentioned in the previous chapter. Similarly, the process of transforming of data is called analysis for the examination and interpretation of the data to draw conclusion. Therefore, this chapter is the heart of the study, as all the findings, conclusions and recommendation are going to be derived from the calculations and analysis done in this section

4.1 Ratio Analysis

4.1.1 Loans and Advances to Total Assets Ratio

Loans and advances of any commercial banks represent the major portion in the volume of Total Assets, the ratio of loans and advances to total assets ratio measures the volume of loans and advances in the structure of total assets.

The higher degree if this ratio indicates the good performance of banks in mobilizing its funds by way of lending function. However in its reverse side, the high degree of this ratio is representative of low liquidity ratio either.

Granting the loans and advances always carries a certain degree or risk. Thus this asset of banking business is regarded as risky asset, the low ratio shows low productivity and high degree if safety in liquidity and vice versa. The interaction between risk and return determine this ratio. *(Appendix 1)*

Table No. 4.1

Loans and Advances to Total Assets Ratio

(Rs. In Million)

Year (Mid July)	NBL			RBB			NCC		
	Loan & Advances	Total Assets	Ratio (%)	Loan & Advances	Total Assets	Ratio (%)	Loan & Advances	Total Assets	Ratio (%)
2004	17938	44162	40.62	25106	45056	55.72	4717	6661	70.81
2005	16867	47045	35.85	27001	35189	76.73	6012	7485	80.31
2006	12442	35919	34.63	23101	39913	57.88	5899	6428	91.77
2007	13757	39259	31.69	24871	46368	53.00	5122	6037	84.84
2008	15771	42053	37.50	27495	60164	45.70	5281	10014	52.74
Mean			36.06			57.81			76.09
S.D			2.97			10.32			14.36
C.V			8.24			17.85			18.87
Combined Mean = (36.06 + 57.81 + 76.09) / 3 = 56.65									

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table shows the loans and advances to total assets of three banks for five consecutive years. Here, ratio of NBL and RBB is in decreasing trend except in the year 2008 where NBL has 37.50% and 53.00% but in case of NCC bank ratio is in fluctuating trend. The mean ratio of NBL, RBB and NCC is 36.06%, 57.81 % and 76.09 % respectively. The overall combined mean of these three banks are 56.65%. Among the three banks NCC bank has highest proportion of loans and advances in total assets structure followed by RBB and NBL .This refers that NBL has the lowest degree of investment in risky assets. The low ratio shows low productivity and high degree of safety in liquidity and vice versa.

In case of the standard deviation NBL has 2.97%, RBB has 10.32% and NCC has 14.36% and CVs are 8.24%, 17.85% 18.87% respectively. Through this it can be interpreted that NCC has higher deviation and higher variation.

4.1.2 Loans and Advances to Total Deposit Ratio

Loans and Advances to total deposit ratio is often called credit deposit ratio (CD ratio). The core banking function is to mobilize the funds obtained the depositors to borrowers and earns profit and CD ratio is the fundamental parameter to ascertain fund deployment efficiency of commercial bank. In other words this ratio is calculated to find it how successfully the banks are utilizing their total deposits on credit or loans and advances for profit generating purpose as loans and advances yield high rate of return. Greater CD ratio implies the better utilization total deposits and better earning, however, liquidity requirement also needs due consideration. Hence 70%-80% CD ratio is considered as appropriate. This ratio is calculated by dividing total credit or loans and advances by total deposit of bank.

Table No. 4.2

Loans and Advances to Total Deposits Ratio

(Rs. In Million)

Year (Mid July)	NBL			RBB			NCC		
	Loan & Advances	Total Deposits	Ratio (%)	Loan & Advances	Total Deposits	Ratio (%)	Loan & Advances	Total Deposits	Ratio (%)
2004	17938	36289	49.43	25106	40314	62.23	4717	5960	79.14
2005	16867	34744	48.55	27001	43489	62.09	6012	6630	90.68
2006	12442	35445	35.10	23101	45701	50.55	5899	6620	89.11
2007	13757	38715	35.53	24871	50193	49.55	5122	6500	78.80
2008	15771	41452	38.05	27495	57991	47.41	5281	7320	72.15
Mean			41.29			54.37			81.98
S.D			6.34			6.44			6.947
C.V			15.35			11.85			8.47
Combined Mean = (41.29 + 54.37 + 81.98) / 3 = 59.21									

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table exhibits the loans and advances to total deposit of the banks for five consecutive years'. This ratio shows decreasing trend in RBB, but in case of NBL and NCC there is fluctuating trends. Where as in NCC bank its ratio increased to 90.68% in 2005 but in 2006 onwards its ratio is in decreasing trend. The mean ratio of NBL, RBB, and NCC bank is 41.29%, 54.37%and 81.98% respectively. The over all combined mean of these three banks are 59.21%. If we compare NCC, it has highest ratio, the increasing trend of loans and advances shows more possibility of income of the bank.

Whereas RBB and NBL has less mean ratio, which is not good sign for economy. This may be due to world down business and Nepal's current situation

The standard deviation of NBL, RBB and NCC bank are 6.34%, 6.44% and 6.947% and C.V's is 15.35%, 11.85% and 8.47% respectively. Here NCC has higher deviation, whereas higher variation is of NBL.

4.1.3 Loan Loss Provision to Total Loans and Advances Ratio

The ratio of loan loss provision to total loans and advances describes the quality of assets that a bank is holding. Nepal Rastra Bank has given directives to commercial banks to classify its loans and advances into the category of pass, substandard, doubtful and loss on the basis of maturity of principal, to make the provision of 1, 25, 50 and 100 percentages respectively.

Loan loss provision signifies the cushion against future contingency create by the default of the borrower in payment of loans and ensures the continued solvency of the banks. Since high provision has to be made for non- performing loan, higher provision for loan loss reflects increasing non- performing loan in volume of total loans and advances. The low ratio signifies the good quality of assets in the volume of loans and advances. It indicates how efficiently it manages loan and advances and makes efforts to cope with probable loan loss. Higher ratio implies, higher portion of NPL in the total loan portfolio.

Table No. 4.3

Loan Loss Provision to Total Loan and Advances

Year (Mid July)	NBL			RBB			NCC		
	LLP	Loan & Advances	Ratio (%)	LLP	Loan & Advances	Ratio (%)	LLP	Loan & Advances	Ratio (%)
2004	9056	17938	50.48	14275	25106	56.87	445	4717	9.43
2005	8647	16867	51.23	13570	27001	50.26	592	6012	9.85
2006	2685	12442	21.58	8441	23101	36.54	1256	5899	21.29
2007	2698	13757	19.61	6804	24871	27.36	1414	5122	27.61
2008	2506	15771	15.89	6640	27495	24.15	861.41	5281	16.31
Mean			31.76			39.04			16.90
S.D			15.70			12.71			6.93
C.V			49.43			32.56			41
Combined Mean = (31.76 + 39.04 + 16.90) / 3 = 29.23									

(Rs. In Million)

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table exhibits the ratio of loan loss provision to loans and advances of the banks i.e NBL, RBB, and NCC bank for the five consecutive years. The table shows that ratio of NBL and RBB is in decreasing trend where as in NCC bank ratio is in increasing trend which is 27.61 % in 2007. However it decreased to 16.31% in 2008. Higher LLP is indicative of poor and ineffective credit policy, higher proportion on non-performing assets and poor performance of the economy. Hence the greater ratio of NBL and RBB which is 31.76%, and 39.04%, suggest that there are higher proportion of NPL in the total loans and advances. But, decreasing trend of loan loss provision ratio of NBL and RBB explains that they successfully reducing its non performing loan to decrease LLP. The over all combined mean of these three banks are 29.23%.

The standard deviation of NBL is 15.70% 12.71& and 6.93% of RBB and NCC bank their CVs are 49.43%, 32.56% and 41% respectively. Here we can clearly see that NBL has higher deviation and variation during the study period.

4.1.4 Non – Performing Loans to Total Loans and Advances Ratio

It measures the proportion of non-performing loans on the total volume of loans and advances. Thus, it reflects the quantity of quality assets that the banks possess.

Higher ratio reflects the bad performance of the bank in mobilizing loans and advances and bad recovery rate and vice versa. Hence lower NPL to total ratio is preferred. As per international standard only 5% NPL is allowed but in the context of Nepal maximum 10% is acceptable.

Table No. 4.4

Year (Mid July)	NBL			RBB			NCC		
	NPL	Loan & Advances	Ratio (%)	NPL	Loan & Advances	Ratio (%)	NPL	Loan & Advances	Ratio (%)
2004	9640	17938	53.74	14471	25106	57.65	600	4717	12.72
2005	8372	16867	49.64	13689	27001	50.70	519	6012	8.63
2006	2262	12442	18.18	8046	23101	34.83	1290	5899	21.87
2007	1856	13757	13.49	6877	24871	27.65	1607	5122	31.37
2008	1411	15771	8.95	5952	27495	21.65	864	5281	16.36
Mean			28.8			38.5			18.19
S.D			18.96			13.64			7.90
C.V			65.83			35.43			43.43
Combined Mean = (28.80 + 38.50 + 18.19) / 3 = 28.50									

Non- Performing Loan to Loan and Advances

(Rs. In Million)

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table no 4.4 exhibits the ratio of Non -performing loan to loans and advances of NBL, RBB and NCC for five consecutive years. The figures represented in the above table show that NCC has increasing trend of NPL, which is 31.35% in 2007, but has gone down to 16.36% in 2008. NBL and RBB shows decreasing trend of NPL. It is the result of effective credit management of bank and its effort of recovering bad debts through establishment of recovery cell. The mean ratio of NBL, RBB and NCC are 28.8%, 38.5% and 18.19% respectively and the combined mean is 28.50%.

The ratio of NPL is significantly high of RBB in comparisons to NBL and NCC a private sector bank and shows the critical condition of the government and public banks. NBL, RBB and NCC have higher NPL than the acceptable standard of 10%, even NBL and RBB has reduced their ratio in these recent years. Over all these, three banks should manage their NPL level below the prescribed standard.

S.D of NBL, RBB and NCC is 18.96%, 13.64% and 7.90% and C.V is 65.83%, 35.43% and 43.43% respectively. Thus it signifies that NBL has highest deviation with higher degree of variation among three banks, RBB is moderate in term of variability during the study period. Since NPL is one of the causes of banking crisis, bank should give serious attention to this matter

4.1.5 Provision Held to Non – Performing Loan

This ratio determines the proportion of provision held to non performing loan of the bank. This ratio measures up to what extent of risk inherent in NPL is covered by the total loan loss provision. Higher ratio signifies that the banks are safeguarded against future contingencies that may create due to non performing loan or in other words banks are cushion of provision to cope the problem that may be cause due to NPL. Hence higher ratio shows the better financial position of the bank.

Table No. 4.5

Year (Mid July)	NBL			RBB			NCC		
	LLP	NLP	Ratio (%)	LLP	NLP	Ratio (%)	LLP	NLP	Ratio (%)
2004	9056	9640	93.94	14275	14471	98.65	445	600	74.17
2005	8647	8372	103.28	13570	13689	99.13	592	519	114.06
2006	2685	2262	118.70	8441	8046	104.88	1256	1290	97.36
2007	2698	1856	145.66	6804	6877	98.94	1414	1607	88.00

Provision Held to Non- Performing Loan

(Rs. In Million)

2008	2142	1411	151.81	6644	5952	111.63	861.41	864	99.70
Mean			122.68			102.65			94.66
S.D			22.78			5.55			37.40
C.V			18.57			5.41			39.51
Combined Mean = (122.68 + 102.65 + 94.66) = 106.67									

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table exhibits the ratio of provision held to Non- performing loan of three banks for five consecutive years. Here we can see that NBL has highest ratio which is 151.81 & in the year 2008. RBB shows moderate ratio with increasing trend in between the three years but in 2007 its ratio is decreased to 98.94%, but again increased to 111.63% in the year 2008. There is fluctuation in case of NCC. The mean ratios of three banks are 122.68%, 102.65% and 94.66% of NBL, RBB and NCC bank respectively and the combined mean is 106.67%. Higher mean ratio indicates that banks have adequate provision against non performing loan. Comparatively, among these three banks NBL has highest ratio, NCC bank has least provision and RBB has the moderate ratio.

The standard deviation of NBL RBB and NCC bank are 22.78%, 5.55% and 37.40% respectively. It signifies that NCC has high deviation and highest variation ratio. As for RBB bank both deviation and variation is the least during the study period.

4.1.6 Return on Loans and Advances

This ratio indicates how efficiently the bank has employed its resources in the form of loan and advances. It also measures the earning capacity of its loans and advances. The ratio is calculated by dividing net profit (loss) by loans and advances. Net profit refers to that profit which is obtained after all types of deduction like employee bonus, tax, provision etc. Hence this ratio measures bank’s profitability with respect loans and advances. Higher the ratio better is the performance of the bank.

Table No. 4.5

Net Profit to Loans and Advances

Year (Mid July)	NBL			RBB			NCC		
	Net Profit	Loan & Advances	Ratio (%)	Net Profit	Loan & Advances	Ratio (%)	Net Profit	Loan & Advances	Ratio (%)
2004	710	17938	3.96	1040	25106	4.14	3.4	4717	0.072
2005	1730	16867	10.26	1323	27001	4.90	(5)	6012	(0.083)
2006	1207	12442	9.70	1753	23101	7.59	(569)	5899	(9.65)
2007	226	13757	1.64	1697	24871	6.82	(115)	5122	(2.25)
2008	239	15771	1.52	1771	27495	6.44	496	5281	9.39
Mean			5.42			5.98			(0.504)
S.D			3.83			1.27			6.08
C.V			70.66			21.24			1206.35
Combined Mean = (5.42 + 5.98 – 0.505) = 3.63									

(Rs. In Million)

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table represents the ratio net profit to loan and advances of three banks i.e NBL, RBB and NCC bank for five consecutive years. Here we can clearly see that RBB has highest mean ratio. NCC bank has decreasing negative trend ratio which indicates this bank has not efficiently employed its resources in the form of loans and advances. However it has improved in the year 2008. RBB shows the increasing trend till 2006 and started decreasing then after. This indicates that NBL and RBB are in profit in between five years. The mean ratio of NBL, RBB and NCC banks are 5.42%, 5.98% and (0.504)% respectively. The combined mean of all three banks are 3.63% Here it can be concluded that NBL is able to perform better during this studying period. RBB and NCC bank should carefully monitor their assets and should concentrate on recovering of bad debts for better performance of bank. The standard deviation of NBL , RBB and NCC are 3.83% , 1.27% and 6.08% where as we can find that NCC banks higher deviation as for C.Vs of three banks are 70.66%, 21.24% and 1206.35 % respectively .

Below is the graphical presentation of 5 years Performing Loans, Non-Performing Loans and Loan Loss Provision of the three banks during the study.

Figure No. 4.1

Performing Loan, Non Performing Loan and Loan Loss Provision of NBL

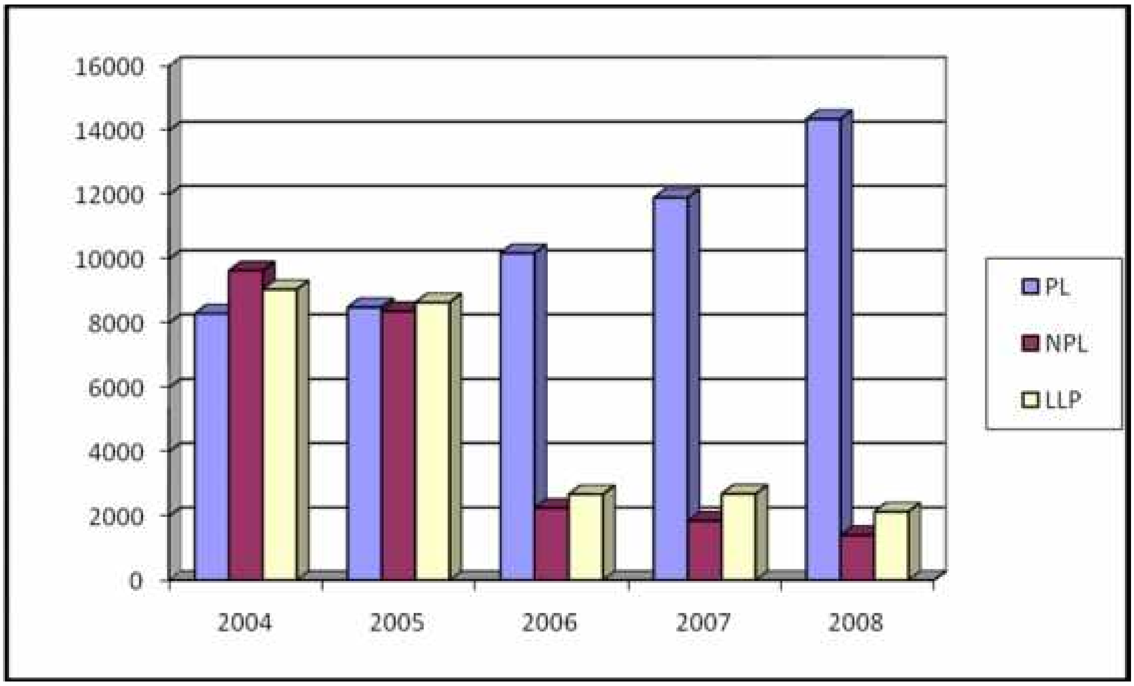


Figure No. 4.2

Performing Loan, Non Performing Loan and Loan Loss Provision of RBB

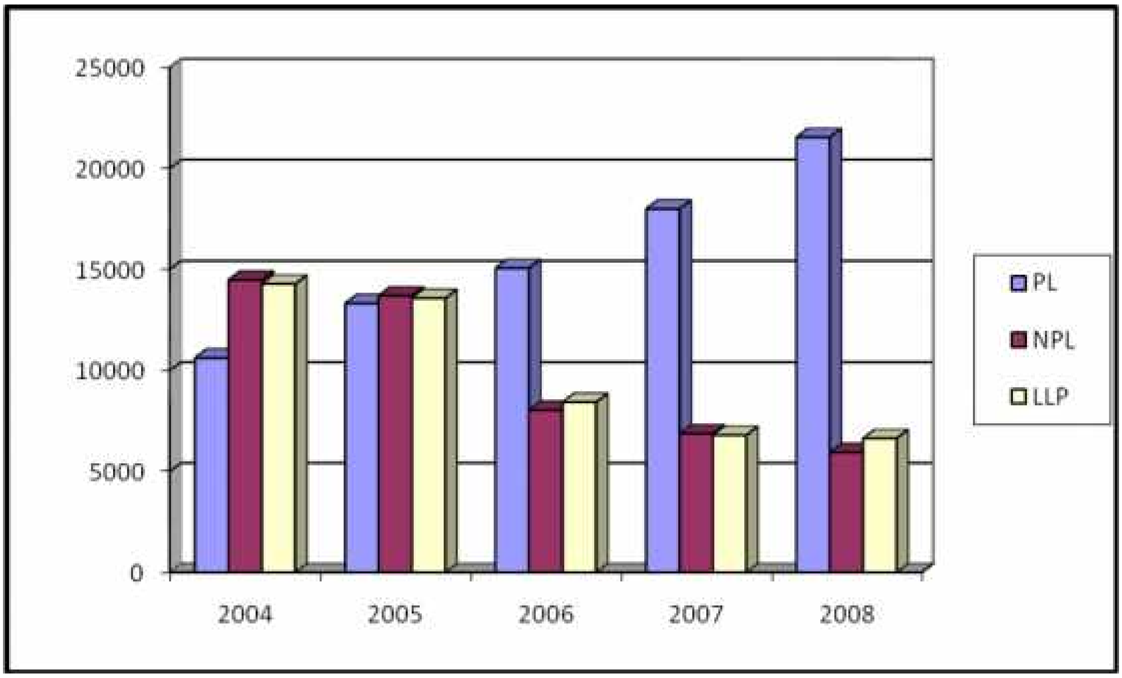
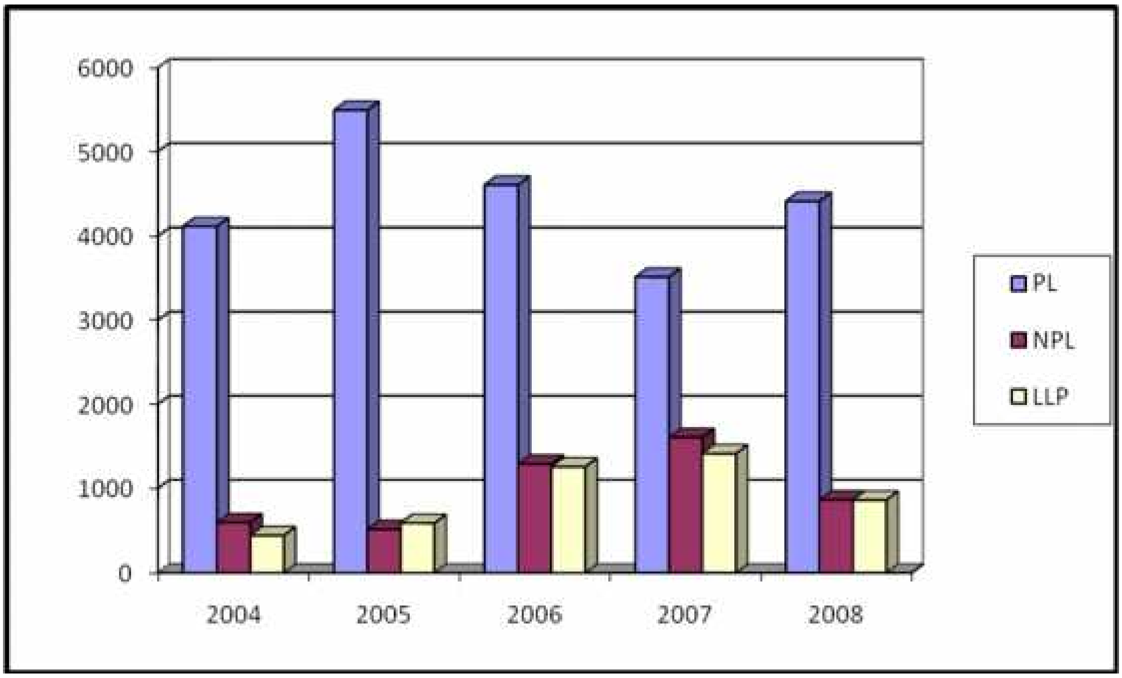


Figure No. 4.3

Performing Loan, Non-Performing Loan and Loan Loss Provision of NCC



4.2 Analyzing Correlation between Different Variables

4.2.1. Correlation between Deposit and Loan and Advances

The correlation between total deposit and an advance describes the degree of relationship between two items how a unit increase in deposit impact the volume of Loan and Advances is measured by this correlation. Here a deposit is the independent variable and Loan an Advance is depended variable. *(Appendix 2)*

Table No. 4.6

Correlation between Deposit and Loan and Advances

Banks	Correlation Coefficient(r)	Probable Error(P.E)	6 × P.E
NBL	-0.1618	0.2937	1.7625
RBB	0.4196	0.2485	1.49
NCC	0.3868	0.2565	1.539

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table 4.6 describes the relationship between total deposits and loans and advances. There is high degree of positive correlation between loan and advances and deposit in RBB and NCC bank but negative correlation in NBL. The respective value of NBL, RBB, and NCC are -0.1618, 0.4196, and 0.3868 respectively.

4.2.2. Correlation between Loan Loss Provision and Loan and Advances

The correlation between provision for Loan Loss and advances measures the degree of relations between there two variables. As independent variables the increase in Loan and Advances increase the volume of the dependent variable for Loan Loss.

Table No. 4.7

Correlation between LLP and Loan and Advances

Banks	Correlation Coefficient(r)	Probable Error(P.E)	6 × P.E
NBL	0.8112	0.1032	0.6189
RBB	0.1032	0.2984	1.7906
NCC	0.1781	0.2038	1.223

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

Above table 4.7 shows the relationship between loans and advances and LLP.

Here the correlation coefficient of NBL is 0.8112, which is greater than probable error (P.E) and 6×P.E. 0.6189. Since r>6×P.E, the correlation coefficient is significant. This means that the total LLP of NBL is correlated with loans and advances during the study period. Similarly the coefficient of RBB is 0.1032 and its 6× P.E is 1.7906, again here correlation coefficient is less than 6×PE, there is negative correlation between LLP and loans and advances of RBB. In case of NCC bank we can clearly see that its correlation coefficient is again less than PE and 6×P.E ratio. This indicates negative correlation.

4.2.3 Correlation between Loan Loss Provision (LLP) and Non- Performing Loan (NPL)

The correlation between LLP describes the relationship between LLP and NPL.

How a unit increase in NPL effect the LLP is exhibited by this correlation. Here non performing loan is independent variable and LLP is dependent variable. As earlier mentioned NPL are the loan falling on the category of substandard, Doubtful and loss and the respective provisioning requirement is 25%, 50%, and100%. Higher the NPL higher will be the provisioning amount.

Table No. 4.8

Correlation between LLP and Non Performing Loan

Banks	Correlation Coefficient(r)	Probable Error(P.E)	6 × P.E
NBL	0.9925	0.0045	0.027
RBB	0.9975	0.00151	0.00904
NCC	0.9745	0.0152	0.0913

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

Above table explains the relationship between LLP and NPL. Here we can see that correlation coefficient of all three banks are higher than P.E and 6×P.E value.

Correlation coefficient of NBL, RBB and NCC bank are 0.9925, 0.9975, and 0.9745 and 6×P.E are 0.027, 0.00904, and 0.0913 respectively. Since correlation coefficient (r) is greater than 6 times the value of P.E, the correlation coefficient is significant and reliable. In other words, the total LLP of all three banks is high correlated with the non performing loan during the study period.

4.3 Trend Analysis

Trend analysis is a statistical tool which helps forecast the future values of different variables on the basis of past tendencies of variable. Trend analysis informs about the expected future values of various variables. Amongst the various methods to determine trend the least square method is widely used in practices. Hence in this study also least square method has been adopted to measure the trend behaviours of these selected banks. However, trend analysis is based on the assumption that past tendencies continues in the future. Under this heading the trend values of following variables is forecasted for next five years bases on the tendencies of past five years

4.3.1 Trend analysis of Loans and Advances

Here, the calculated values of average loans and advances (a), rate of change of loans and advances (b) and expected loans and advances for 5 years from FY 2009 to 2013 are as follows. *(Appendix 3)*

Table No. 4.9

Expected Trend Values of Loan and Advances

(Rs. In Million)

Banks	a	b	2009	2010	2011	2012	2013
NBL	15355	(744.4)	13122	12122	11633	10889	10144
RBB	25514	265	26310	26575	26840	27105	27370
NCC	5406	23.8	5477	5501	5525	5549	5573

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

The above table shows the expected trend values of loans and advances of three banks for next five years based in the tendencies of past five years. Here NBL'S average loans and advances is Rs 15355 million, which is decreased every year at the rate of Rs (744.4) million. Hence the expected loan and advances of NBL is supposed to decrease from Rs 26045 million in 2008 to Rs 13122 million in 2009.

Similarly the average loans and advances of RBB is Rs 25514 million which is increased at the rate of Rs 265 million every year. Loans and advances of RBB are expected to increase from Rs 26310 million in 2009 to Rs 27370 million in 2013.

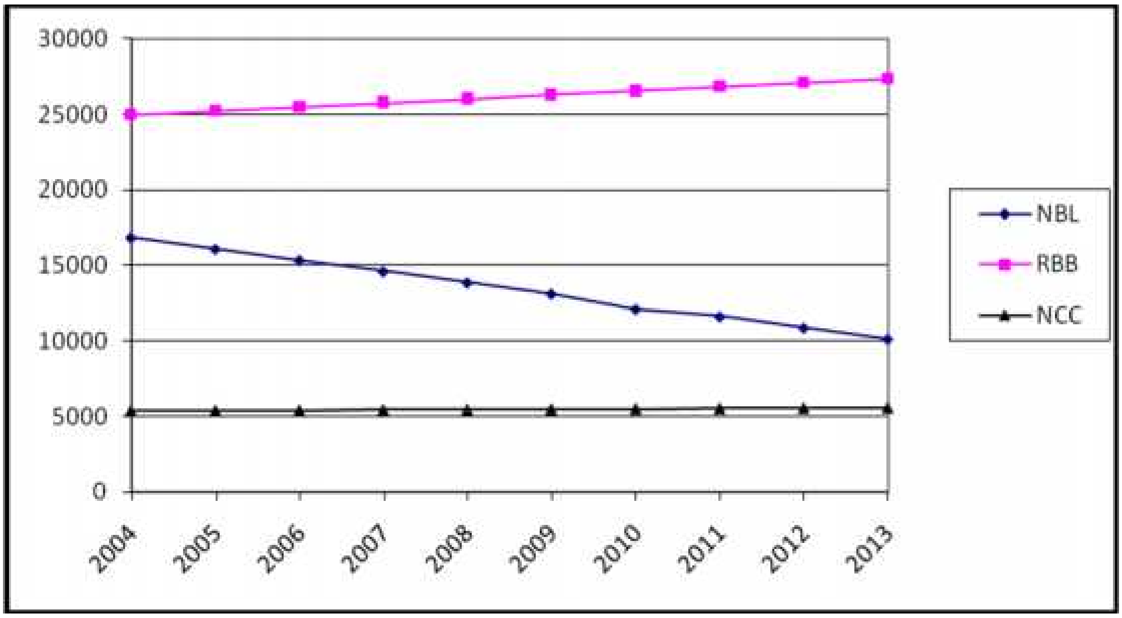
In case of NCC its loan and advances is Rs 5406 million and are increasing every year at the rate of Rs 23.8 million. Hence the expected loan and advances of NCC are supposed to increase from Rs 5477 million in 2009 to Rs 5573 million in 2013.

Here, as NBL is suffering from the problem of bad debts, it is concentrating more on recovering bad debts and there was no further investment in the form of loan and advances. Hence, the loans is decreasing trend where NBL shows negative trend. On the other side RBB and NCC have increasing trend on loan and advances.

The trend of loans and advances of three banks for ten consecutive years can also be presented in line graph.

Figure No. 4.4

Trend of Loans and Advances of NBL, RBB, NCC



4.3.2 Trend Analysis of Loan Loss Provision

The calculated values of average Loan Loss Provision (a), rate of change of LLP (b) and expected LLP for 5 years from FY 2009 to 2013 of the three banks are as follows:

Table No. 4.10

Expected Trend Value of Loan Loss Provision

(Rs. In Million)

Banks	a	b	2009	2010	2011	2012	2013
NBL	5118.4	(1905)	(596.3)	(2501)	(4406)	(6311)	(8216)
RBB	9946	(2203.6)	3335.2	(5479)	(16497)	(29719)	(45144)
NCC	913.68	165.48	1410	1576	1741	1907	2072

Source: Report of NBL, RBB &NCC (2004-08);

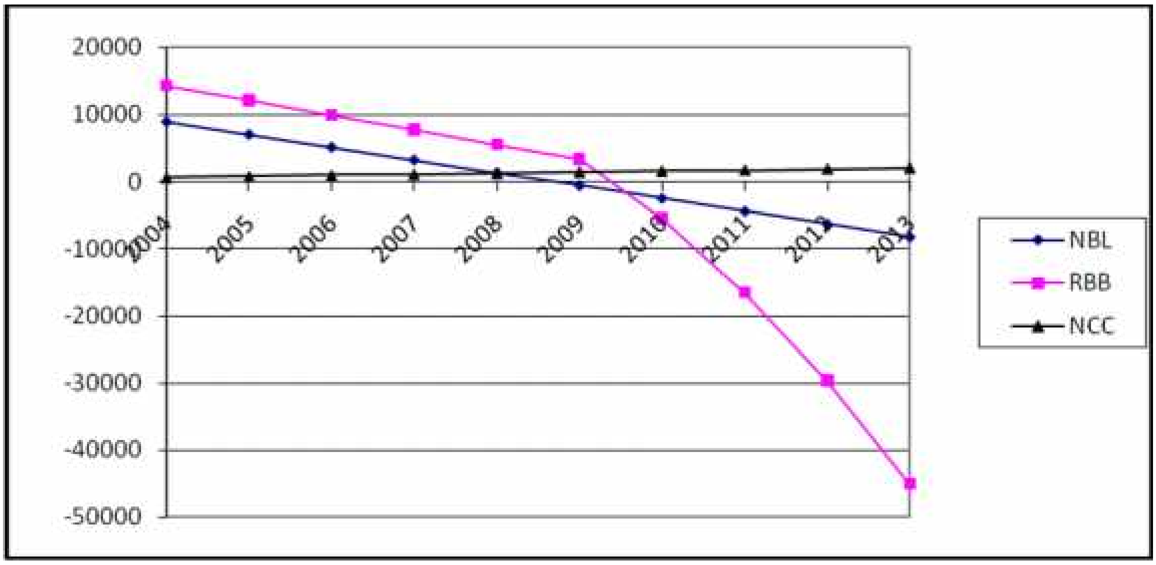
NRB: Banking & Financial Statistics Mid-July 2008

The above table shows NBL and RBB have decreasing trend of LLP but there is increasing trend in NCC bank. The average LLP of NBL is RS 5118.4 million which is decreasing at the rate of Rs (1905) million every year. LLP is expected to decrease from Rs (596.3) million in 2009 to Rs (8216) million in 2013. Similarly the LLP of RBB is Rs 9946 million which is also decreasing at the rate if Rs (2203.6) million every year. LLP of RBB is expected to be Rs 3335.2 million in 2009 to Rs. (45144) million in 2012. In case of NCC its average LLP is Rs 913.68 million which is increased every year at the rate on Rs 165.48 million. Hence the expected LLP of is supposed to increase from 1410 million in 2009 to Rs 2072 million in 2013.

NBL and RBB'S decreasing trend of LLP shows that these two banks are successfully reducing the non performing loans of the bank after undertaking these banks by foreign management. In case of NCC bank they have non performing loan hence its LLP is in increasing trend. Higher the non performing loan higher would be the LLP. The trend of loan loss provision of three banks for ten consecutive years is presented in line graph.

Figure No. 4.5

Trend of Loan Loss Provision of NBL, RBB and NCC



4.3.3 Trend Analysis of Non- Performing Loan

The calculated Values of average Non –Performing Loan (a) , rate of change of NPL (b) and expected NPL for 5 years from FY 2008 to 2012of the three banks are as follows:

Table No. 4.11

Expected Trend Value of Non-Performing Loan

(Rs. In Million)

Banks	a	b	2009	2010	2011	2012	2013
NBL	5708	(2297.4)	(2184.2)	(4482)	(6779)	(9076.4)	(11374)
RBB	9807	(2385)	2652	267	(2118)	(4503)	(6888)
NCC	976	161.6	1461	2107	2915	3885	5016

Source: Report of NBL, RBB &NCC (2004-08);

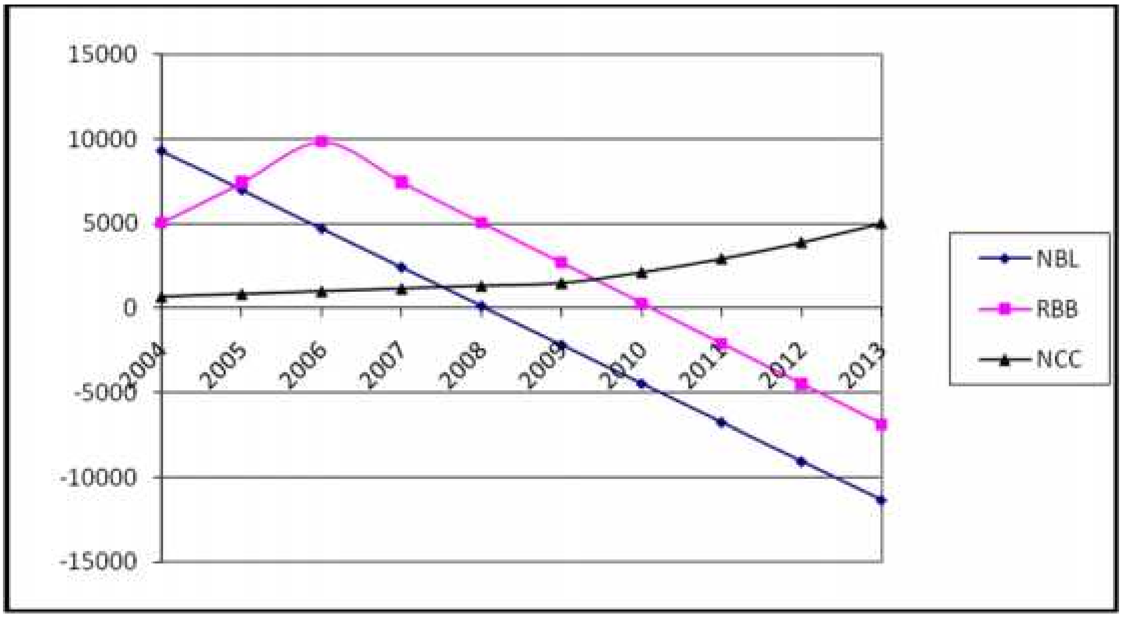
NRB: Banking & Financial Statistics Mid-July 2008

The above table shows that NRB and RBB have decreasing trend but NCC has increasing trend. The average NPL of NBL is Rs. 5708 million which is negatively increasing at the rate of Rs (2297.4) million every year. NPL is expected to decrease from Rs (2184.2) million in 2009 to Rs (11374) million in 2013. Similarly the average NPL of RBB is Rs 9807 million which is decreased every year at the rate of Rs 2385 million; accordingly NPL of RBB is expected to decrease from Rs 2652 million in 2008 to Rs (6888) million in 2013. NCC bank's average NPL is Rs 976 million which is increasing every year at the rate of Rs 161.6 million. Hence expected NPL of NCC is supposed to increase from Rs 1461 million in 2009 to Rs 5016 million in 2013.

As Nepal government has handed over the management of two banks NBL and RBB to foreign parties, NPL has started to decrease. But in case in NCC bank it shows the increasing trend of NPL. The trend of non performing loan of three banks for ten consecutive years can be presented in line graph also.

Figure No. 4.6

Trend of Non Performing Loans of NBL, RBB, NCC



4.3.4 Trend Analysis of Net Profit

The calculated values of average Net Profit (a), rate of change of Net Profit (b), and expected Net Profit for 5 years from FY 2009 to 2013 of the three banks are as follows:

Table No. 4.12

Expected Trend Values of Net Profit

(Rs. In Million)

Banks	**a**	**b**	**2009**	**2010**	**2011**	**2012**	**2013**
NBL	822.4	(244.6)	88.6	(156)	(400.6)	(645.2)	(889.8)
RBB	1516.8	183.6	2068	2251	2435	2618	2802
NCC	-37.92	87.5	224.6	312	400	487	575

Source: Report of NBL, RBB &NCC (2004-08);

NRB: Banking & Financial Statistics Mid-July 2008

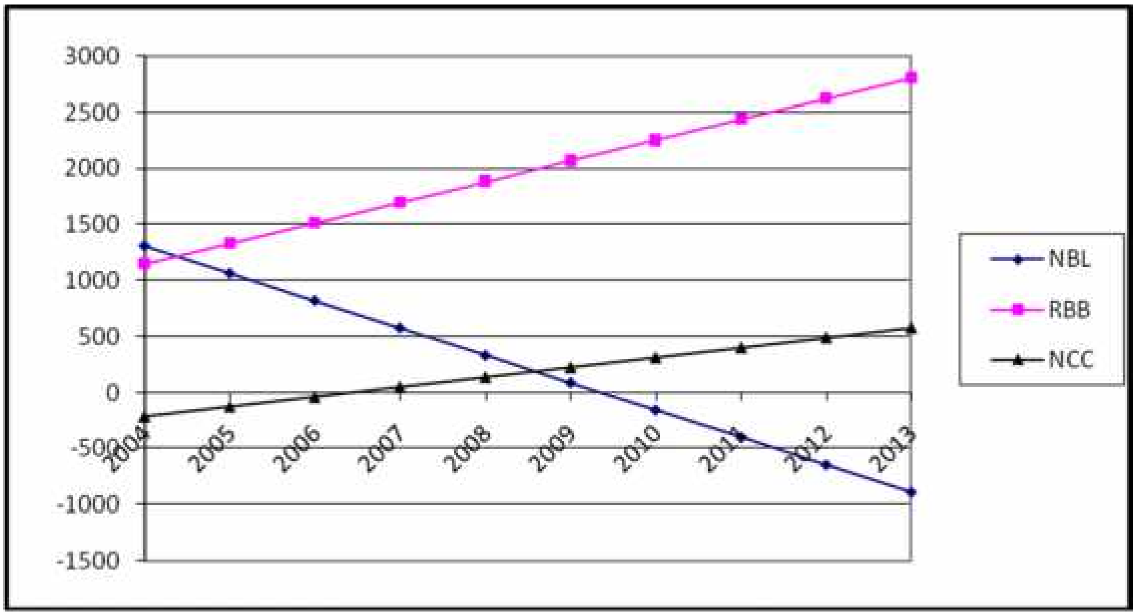
The above table shows that RBB and NCC has increasing trend of Net profit but net profit of NBL bank is in negative trend. RBB's trend shows increment of net profit at the rate of Rs 183.6 million each year. It's expected profit for the year 2009 is Rs. 2068 million and expected to increase to Rs. 2802 million by 2013. Similarly NCC has also increment of net profit at the rate of Rs. 85.5 million each year. The expected profit of NCC is Rs 224.6 million in 2009 to RS 575 million in 2013. NBL expected net profit in the year 2009 is Rs 88.6 milion, but then onwards it has negative trend. It is expected to surfer loss Rs 889.8 million in the year 2013.

From the above figure it can be concluded that RBB and NCC is ahead in generating net profit. RBB has higher rate if increment than of NCC. It is because of having high volume of assets and lending which are managing by foreigner. But there is negative increment in net profit or loss in NBL bank.

The trend of net profit of three banks for ten consecutive years is represented by the following line graph.

Figure No. 4.7

Trend of Net Profit / Loss of NBL, RBB and NCC



Comparative analysis of NPA in various Nepalese Bank

Table No. 4.14

Comparison of NPA Percentage

Name of Banks	NPA in percentage in 2008 (Mid - July)(%)
NABIL	0.79
NIBL	1.12
SCBNL	0.92
HBL	2.36
SBI	3.65
NCBL	31.11
EBL	0.64
BOKL	1.76

Source: NRB's Banking & Financial Statistics Mid-July 2008

Figure No. 4.8
NPA in Percentage

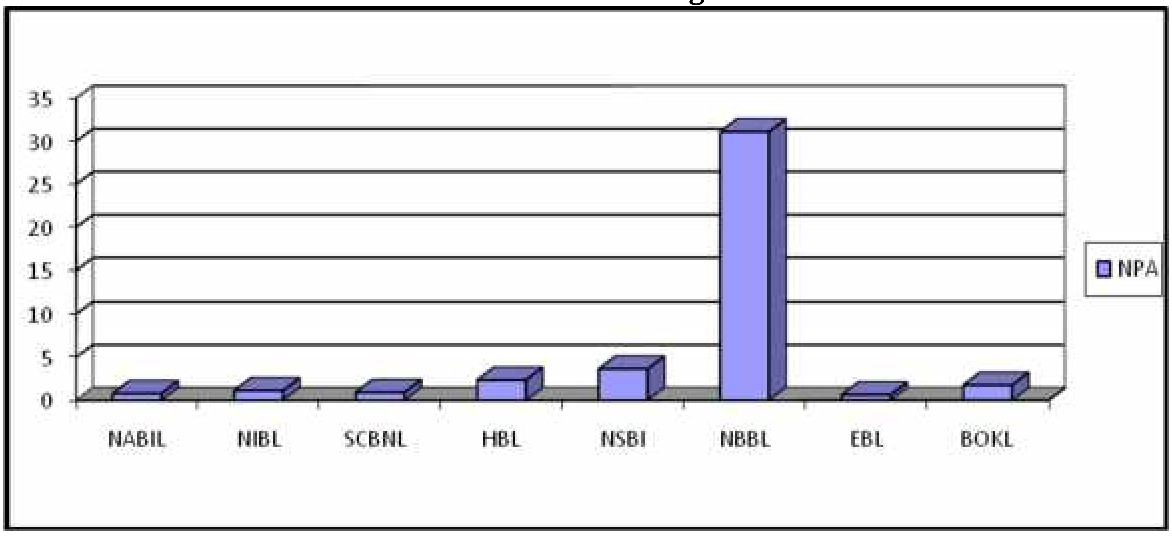


Table No. 4.15
Comparison of Total Loans and Advances

(Rs. In '0000')

Name of Banks	Total Loan and Advances in 2008
NABIL	2176977
NIBL	2752930
SCBNL	1396440
HBL	2017961
SBI	1274253
NCBL	561432
EBL	1883643
BOKL	1274772

Source: *NRB's Banking & Financial Statistics Mid-July 2008*

Figure No. 4.9

Comparison of Total Loans and Advances

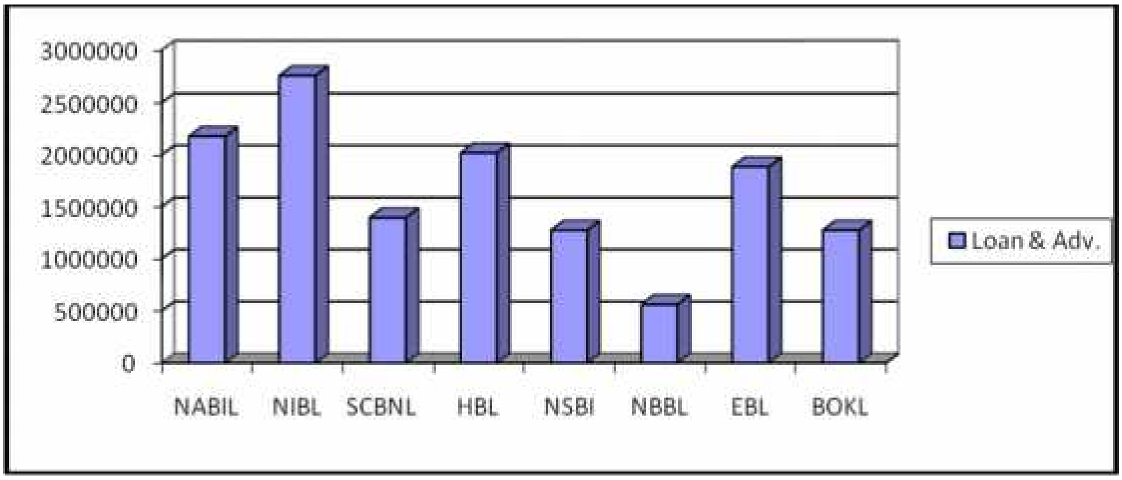


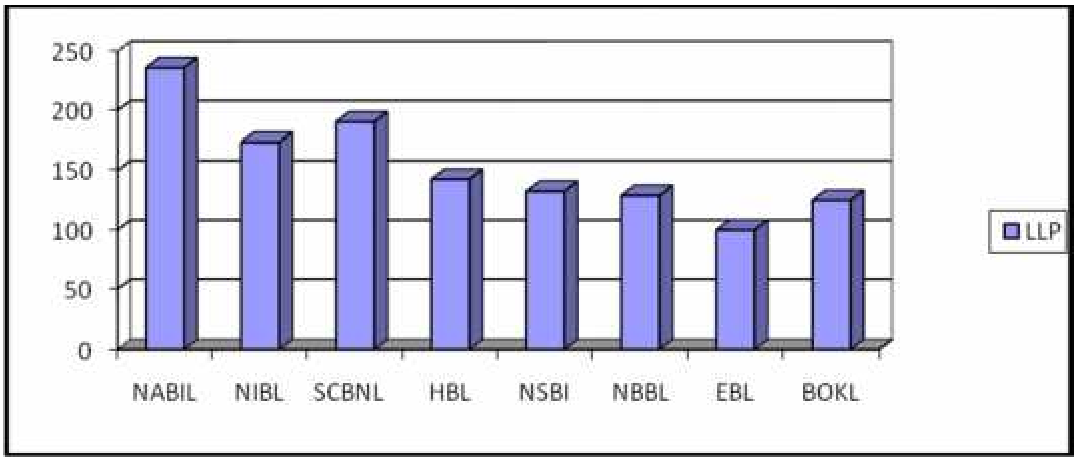
Table No. 4.16

Comparison of Total Loan Loss Provision to Total NPL

Name of Banks	LLP to Total NPL in 2008 (%)
NABIL	236.05
NIBL	173.61
SCBNL	190.62
HBL	142.62
SBI	132.55
NCBL	129.03
EBL	100.00
BOKL	125.05

Source: NRB's Banking & Financial Statistics Mid-July 2008

Figure No. 4.10
Loan Loss Provision in Percentage



4.4 Major Findings

As per the analysis of data, following major finding have been obtained. The average loans and advances to total asset ratio of NBL, RBB and NCC bank during the study period are 36.06%, 57.81% and 76.09% respectively and combined mean are 56.65%. The relatively low ratio of NBL is the indication of risk adverse attitude of the management or in other words we can say that they are investing low in the risky assets, i.e. in loans and advances. They have higher proportion of their investment on risk free of nominally asset like Treasury bill, National saving Bonds etc. Here NCC bank has highest ratio in term of loans and advances. In case of deviation and variation NCC bank has highest ratio. RBB is moderate in term of its deviation and variation.

Loans and Advances to total deposit ratio indicates the firm's fund mobilizing power in gross. The main sources of banks lending and investment is its deposits, thus this ratio measures how well the deposits have been mobilized. The average ratio of NBL, RBB, and NCC bank are 41.29%, 54.37% and 81.98% respectively. The overall combined mean are 59.21%. Here NCC bank has highest ratio in comparison to NBL and RBB. NBL has lowest ratio and RBB has moderate ratio. In case of deviation NCC bank has highest deviation, NBL has highest variation and RBB has moderate deviation and variation.

Loan Loss provision ratio indicates that RBB has significantly higher ratio which is 39.04% in average followed by NBL of 31.76% and NCC of 16.90% and combined mean of the three banks is 29.23%. Higher ratio is an indication of higher non performing loans in the total loans and advances. Here RBB has higher ratio which is the result of higher proportion of NPL in the total loan. NCC bank has least ratio in comparison to two banks. In case of deviation NBL has highest deviation and variation which are 15.70% and 19.43% respectively.

The analysis of non-performing loans to total loans reveals average NPL of NBL, RBB and NCC which are 28.8%, 38.5% and 18.19% respectively. Here, NBL and RBB have significantly higher proportion of the non-performing loan in the total loans portfolio, which exhibits critical conditions of the bank. But, its trend is in decreasing after taking management by the foreign management keeping views on the international standard. Not only the public sector bank, even private sector bank like NCC has higher proportion of NPL. So, all these banks should have effective credit management and should make effort in recovering bad debts through the establishment of recovery cell. During the study period, NBL has highest deviation and variation where as RBB is in moderate among other two banks. Over all combined mean of these three banks are 28.50%.

The average ratio of provision held to non-performing measures up to what extend of risk inherent in NPL is covered by the total loan loss provision, the ratio of NBL, RBB and NCC is 122.68%, 102.65% and 94.66% respectively. Here NBL has higher ratio in comparison to other two banks which shows that the bank has adequate provision against non-performing loan where as this ratio of NCC bank is comparatively lower. In case of deviation and variation NCC has higher ratio. RBB is least in deviation and variability accounting 5.55% and 5.41% respectively. Over all combined mean of the three banks is 106.67%.

The main objectives of commercial bank are to earn profit through the mobilization of funds. Higher ratio indicates that bank is generating profit. RBB has higher ratio which is 5.98% in comparison to NBL. NCC bank has negative ratio (0.504) which means this bank is failure to earn return on loans and advances. NCC has highest deviation and highest variance.

While analyzing correlation between loans and advance and deposit, it has been found that RBB and NCC has positive correlation where as NBL has negative correlation between the two variables. The respective correlation coefficient (r) of NBL, RBB and NCC is -0.1618, 0.4196 and 0.3868 respectively. As correlation coefficient of RBB and NCC bank is lesser than 6 times P.E it is not significant.

The correlation coefficient between LLP and loans and advances of NBL, RBB and NCC are 0.8112, 0.1032, and0.1781 respectively. Among these three banks, RBB and NCC have less values of 6 times P.E, it is insignificant and there is no evidence of correlation. This increase in provision of NCC and RBB is due to increment in its non performing loans. But, in case of NBL bank correlation coefficient is more than P.E. and 6×P.E.; this shows that correlation is significant and reliable.

The correlation coefficient (r) between LLP and NPL of NBL, RBB and NCC bank are 0.9925, 0.9975 and 0.9745 respectively; in which this ratio is greater than 6 times P.E; the correlation coefficient of all the three banks is significant and reliable. Higher provision needed for NPL, higher the NPL higher would be LLP.

Trend analysis has been done on the basis of data of past five years and forecast has made for next five years. In the analysis it is found that loans and advances of NBL is in decreasing trend, RBB and NCC are in increasing trends. NBL's loans and advances is expected to be Rs 10144 million, RBB is expected to increase up to Rs27370 million and NCC is expected to increase up to 5573 million in 2013.

In trend analysis of LLP, it is found that LLP is expected to increase in coming years in case on NCC and in case of NBL and RBB, trend value is negatively increasing at the rate of Rs (1905) million and Rs. (2203.6) million every year. RBB's expected trend will be Rs. 3335.2 million in 2009 but it will start becoming negative value in corresponding years; in 2013 its expected LLP is Rs (45144) million. The decreasing trend of LLP in RBB is due to recovery effort towards reducing NPL. In case of NBL, trend value is Rs. (596.3) million is 2009 and Rs. (8216) million in 2013 which also shows the decreasing trend of LLP in NBL is due to recovery effort towards reducing NPL, whereas NCC's trend value is increasing by Rs.165.48 million every year and expected trend value in 2013 is Rs. 2072.

From the trend analysis of NPL, it is found that NPL is expected to increase on coming year in NCC bank where as in NBL and RBB it is expected to decrease incoming years. The NPL of NBL and RBB is expected to decrease at the rate of Rs.(2297.4) million and Rs (2385) million each year respectively, but in case of NCC trend value is expected to increase at the rate of Rs 161.6 million every year. NBL's and RBB trend value in 2009 is expected to be Rs (2184.2) milion and Rs.(2652) million, and trend value in 2013 is expected to be Rs. (11374) million and Rs. (6888) million respectively. In case of NCC its trend value is Rs. 1461 million and Rs. 5016 million in 2009 and 2013 respectively. The decreasing trend shows that bank have put its effort towards recovering bad debts.

From the trend analysis of Net Profit, it is found that NP is expected to increase in next five years in RBB and NCC but, in case of NBL there is net loss. RBB shows the increment of net profit at the rate of Rs183.6 million, NCC shows increment at the rate of Rs 87.5 million every year. In case of NBL it is expected to bear net loss of Rs (244.6) million each year after 2009.

CHAPTER-V

SUMMARY, CONCLUSION AND RECOMMENDATIONS

In this chapter the whole study and findings are summarized with conclusion and suggestion and some recommendation based on the result of the analysis of data.

5.1 Summary

In today's globalized business world financial institutions are regarded as the backbone for the economic development of any country especially in the developing countries like Nepal. In other words, national development of any country depends upon the economic development of that country and economic development is supported by financial infrastructure of that country. Bank came to existence mainly with the objective of collecting the idle fund and mobilizing them to productive sector causing overall economic development. This research is mainly aimed to study the impact of non performing assets in commercial bank. Out of total population of 26 commercial banks, three major banks were taken as sample using judgmental sampling method. These banks are Nepal Bank Limited, Rastriya Banijya Bank and Nepal Credit and Commerce Bank. Secondary data have been used in the study. Other publications have been considered as the sources of secondary data. To come in the conclusion, descriptive and analytical research was adopted. For this, collected data are recorded systematically and presented in appropriate forms of tables, charts and graphs with appropriate mathematical, statistical, financial and graphical tools to analyze the data. Here the data of five consecutive years of three commercial banks have been analyzed. Although the study was limited to only NBL, RBB and NCC bank, however there was a significant impact on the performance of commercial bank.

The overall ratios on non performing assets on all three banks NBL, RBB and NCC are 28.8%, 38.5% and 18.19% respectively. Even NBL and RBB has decreasing trend, on average it is quite higher than the acceptable standard of 10%. Thus all three banks should make strategy to reduce the non performing assets.

RBB has highest portion of investment on loans and advances which shows that it has good lending procedures and good performance. Similarly, NBL has lower portion of investment in loans and advances in comparison to RBB. So, the return on loan and advance of RBB is a bit higher than NBL. On the other hand, NCC Bank has again low portion of investment than NBL and RBB, as a result there is negative return on loans and advances.

The correlation between LLP and loans and advances in NBL is significant and reliable which indicates that there is positive correlation between LLP and loans & advances. Size of provision depends upon the non performing loan. Higher the NPL higher will be the provision, hence even size of loans and advances do not increase, if NPL increase, LLP will automatically increase. On the other side, correlation coefficient of RBB and NCC banks are less than 6 P.E, it is insignificant. This indicates negative correlation.

After management handed by the foreign parties both NBL and RBB are concentrating on loan recovery management. The two banks have decreasing trend values of loan loss provision and non performing assets which is good for the bank. In contrast NCC has increasing trend of investment, loan loss provision and non performing assets resulting loss in the bank. So, NCC bank should properly manage loans with establishment of recovery cell.

Nepalese banking is highly affected by the vicious circle of NPA. The major factors leading to non performing assets are :- improper credit appraisal system , ineffective credit monitoring and supervision system , economic depression, borrower's misconduct, overvaluation of collateral , political pressure to lend creditworthy parties etc. setting up recovery cell , hiring assets management company , introducing effective laws to recover the bad loans etc are some measures to resolve the problem of NPA . Proper loan classification and loan loss provisioning also helps to confront the problems of NPA. The latest directives regarding loan classification and loan loss provisioning is very important for maintaining sound financial health of the banks.

5.2 Conclusion

The banking sector is facing various problems. One of them is the banking has been becoming huge victim of huge Non Performing Assets (NPAs). NPAs are one of the serious problems faced by commercial banks at present.

Although NBL and RBB has almost more than 50% of market share deposit and resources, these two banks are facing vicious circle of NPL resulting high provision. These banks have higher percentage on market share in lending too which are the most income generating assets but operating in loss since long time.

Therefore, these two banks were handed over to the foreign group to manage NPA.
Similarly, NCC Bank is also suffering from NPA so, this bank should also effectively manage loan to generate profit.

Due to instable political condition, insecurity, ineffective credit policy, and political pressure to lend non viable project, overvaluation of collateral and even without collateral disbursement are the major factors causing of mounting nonperforming assets in banks mainly in government owned banks. Commercial banks investment has been found lower productivity due to the lack of supervision regarding whether there is proper utilization of their investment or not. Lack of farsightedness in policy formulation and absence of strong commitment towards its proper implementation has also caused many problems to commercial banks.

Proper classification and close review of loans enable banks to monitor loan portfolio and take remedial step to safe guard deterioration of its credit quality.

Further more, establishment of proper rules and laws are also essential to solve the problem on NPL. The guidelines in themselves are not important unless properly implemented. The rules and regulation are only the tools of NRB to supervise and monitor the financial institution. So, NRB need to monitor the concerned authorities in order to ensure that they are being followed to improve the financial health of the banks and make them able to face any kind of future contingencies.

5.3 Recommendations

Higher level of NPA not only decreases the profitability of the bank but also affect the entire financial as well as operational health of the organization. If the NPL is not controlled immediately it will be proved as a curse for banks in future. Therefore based on the above findings and conclusion the following recommendations have been forwarded which will help to reduce the level of NPL of the banks.

It has been found that during the study period, NBL and RBB have high rate of non performing assets accompanied by higher loan provision. As foreign management was appointed for proper management of loan, they were able to bring both banks in profit but expected result could not be obtained. At present, both banks are managed by Nepalese professional under the supervision of NRB. The NPL should be decreased by taking remedial action such as implementation of proper laws, to recover the bad loans especially by big and wilful defaulter, hiring Assets Management Company to break the vicious circle of Non Performing Loan.

It has been observed that the size of loan and advances of all three banks are decreasing. This low investment affects the performance of banks in long run.

Therefore, these banks should focus on recovery of bad loans but, should also find out the new areas of investment to explore resources which may ultimately increase the performance of the bank and will support the national development as well.

NCC bank’s average non performing loan is also high during the study period. So, this bank should also follow the strict guidance of NRB and be more caution and analyze while granting loans and advances. The major solution for reducing risk is to avoid lending on more risky areas until bank doesn’t fully satisfy itself regarding the future liability of the project.

The bank has to offer training programs with related subject like NPA, the art of dealing with people, influencing them, winning them and finally retaining them.

The establishment of Asset Management Company (AMC) which helps the commercial banks in collecting their debts and improving their credit rating efficiency should be initiated. It is high time for the bank to undertake systematic and effective approach to mitigate the burden of NPA.

In Nepalese context, following points are recommended for reducing the volume of NPA.

- A Good credit policy is the key to the success of a loan function of a bank. The root cause for a loan to turn bad is a bad credit appraisal from the bank. Thus a sound credit appraisal has to be done especially by the credit department.

Internationally used models like COMPARI model, and four pillars model can be used.

The COMPARI Model:

This model identifies the major areas to be analyzed before disbursing loans to a borrower. The areas being:

C - Character: Integrity and credibility of the borrower.

A - Ability: Borrower's ability to manage business.

M - Margin: Is the return reasonable for risk?

P - Purpose: What is the money needed for?

A - Amount: How much is needed?

R - Repayment: How and when will we get the money back?

I - Insurance: Are we insured?

- Combining traditional wisdom with modern statistical tools like Value-at-risk analysis and Markov Chain Analysis should be employed to assess the borrowers. This is to be supplemented by information sharing among the bankers about the credit history of the borrower. In case of new borrowers, especially corporate borrowers, proper analysis of the cash flow statement of last five years is to be done carefully.

Markov Transition Matrix and Loan Tracking

Markov Transition theory deals with the probability of variable at a given state at any given time to move to another state at a time t+1. We can, therefore, define a transition matrix, P = [pij], as a matrix of probability showing the likelihood of credit quality staying unchanged or moving into R-1 category over a given time horizon, where R is a set of discrete categories into which all observations can be ordered.

Let me frame a matrix:

$$P = \begin{pmatrix} p_{11} & p_{12} \ldots\ldots p_{1R} \\ p_{21} & p_{22} \ldots\ldots p_{2R} \\ \vdots & \\ p_{R1} & p_{R2} \ldots\ldots p_{RR} \end{pmatrix}$$

where pij are the state at any given time.

The above matrix can be used by credit officers to monitor the loan assets and take preventive steps to control the slippage of loan assets to any lower category.

Based on the asset classification viz. Pass Assets (PASS), Sub-standard Assets (SUB), Doubtful Assets (DOUB) and Loss Assets (LOSS), a matrix can be formed with a given probability (Das & Bose, 2005):

$$
\begin{array}{c}
\text{Time } t+1 \\
\begin{array}{ccc}
 & & \begin{array}{cccc} \text{STD} & \text{SUB} & \text{DOUB} & \text{LOSS} \end{array} \\
\text{Time } t & \begin{array}{c} \text{STD} \\ \text{SUB} \\ \text{DOUB} \\ \text{LOSS} \end{array} & \begin{pmatrix} p_{11} & p_{12} & p_{13} & p_{14} \\ p_{21} & p_{22} & p_{23} & p_{24} \\ p_{31} & p_{32} & p_{33} & p_{34} \\ p_{41}(=0) & p_{42}(=0) & p_{43}(=0) & p_{44}(=1) \end{pmatrix}
\end{array}
\end{array}
$$

Since the probability of a loss asset being converted to any higher asset category is zero, p41 = p42 = p43 = 0 and thus p44 = 1.

This transition matrix can be used to assess the loan quality of a firm level borrower by evaluating the financial position. However, this matrix will be difficult to apply to assess individual borrowers because unlike a firm level borrower, financial data of an individual is not available. Therefore, this matrix can be better applied for a firm level or corporate level borrower.

- During the credit analysis, the major focus should be on the ‘character’ of the client and the purpose of him to request for the loan, rather than the collateral, he is supposed to pledge / mortgage. The loan officer must be convinced that customer has a well defined purpose for requesting bank credit and a serious intention repay. Once the purpose is known, the officer must determine of it is consistent with the bank’s current loan policy. Responsibility, truthfulness, serious purpose, and serious intention to repay all monies owed make up what a loan office calls character. The mind set of the bankers that start analyzing a client’s request by finding as many possibilities as possible of the client not paying back the loan should be changed.
- The trend of disbursing a loan merely on the recommendations from the higher management staff and political influences should be stopped.
- The constant counselling and training to the credit analysis and staff have to be done.
- Timely decision on genuine requirement of a genuine client should be done and the bank should be willing to help the client explore his business.

- Since banking is also a business, customer satisfaction should always be the first concern for the bank. So, depending on the situation, reliable and creditworthy clients can be given appropriate incentives that help them settle the loan. Assisting the borrowers in developing his entrepreneurial skills will not only establish a good relation between the borrowers but also help the bankers to keep a track of their funds.
- Commercial Banks should be allowed to come up with their own measures to address the problem of NPAs. This may include waiving and reducing the principal and interest on such loans, or extending the loans, or settling the loan accounts. They should be fully authorized and they should be able to apply all the preferential policies granted to the asset management companies.
- Almost care should be taken the financial analysis of the client. Cash flow rather than profit is what should be concerned the bank.
- It is recommended for all the banks to take preventive measures before the loan goes to default. All the banks are recommended to have an information system to gather all the possible information loan activities about its borrower's. So that necessary precaution can be taken in time.

Lastly, the ethical policy of "giving life is better than killing "should not be forgotten. In other words, recovering loan is better than auction should be kept in mind.

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