A CASE STUDY ON
SUPERVISORY ROLE OF CENTRAL BANK
(With Reference to Laxmi Bank, Nepal Investment Bank & Nepal Credit and Commerce Bank)

A THESIS

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RECOMMENDATION

This is to certify that the thesis:

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DECLARATION

I hereby declare that the work reported in this dissertation entitled "**SUPERVISORY ROLE OF NEPAL RASTRA BANK: A CASE STUDY OF LAXMI BANK, NEPAL INVESTMENT BANK AND NEPAL CREDIT & COMMERCE BANK"** submitted to Nepal Commerce Campus, Faculty of Management, Tribhuvan University, is my original work done in the form of partial fulfillment of the requirement of the degree of Master of Business Studies under the guidance and supervision of Mr. Bihari Binod Pokharel, Professor, Nepal Commerce Campus, Tribhuvan University.

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I believe, this dissertation paper may help for taking appropriate policy measures and it may help to the all of interested readers, managers, college students and researchers who want to know the role of central bank in banking system of Nepal.

Kamala Subedi

Researcher

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LIST OF ABBREVIATIONS

&	=	And
A.D.	=	Anne Domino
ADB	=	Asian Development Bank
ADB/N	=	Agricultural Development Bank Nepal
B	=	Billion
BIS	=	Bank of International Settlement
BOP	=	Balance of Payment
BS	=	Balance Sheet
B.S.	=	Bikram Sambat
BTC	=	Bankers Training Center
CAR	=	Capital Adequacy Ratio
CB(s)	=	Commercial bank (s)
CBS	=	Central Bureau of Statistics
CD Ratio	=	Credit Deposit Ratio
CEO	=	Chief Executive Officer
CGB	=	Credit Guarantee Corporation
CIB	=	Credit Information Bureau
Co.	=	Company
CRR	=	Cash Reserve Requirement
CSI	=	Cottage and Small Scale Industry
DTT	=	Deloitte Touche Tohmatsu
Ed.	=	Edition
EOI	=	Expression of Interest
FINGOs	=	Financial Non-Governmental Organizations
Forex	=	Foreign Exchange
Foreign ABC	=	Agent Bill Collection of Foreign Exchange
FY	=	Fiscal Year
GBB	=	Grameen Bikas Bank
HMG/N	=	His Majesty Government of Nepal
Ibid	=	in the same place, from the same book
IBRD	=	International Bank for Reconstruction & Development
ICCMT	=	International Business Technical Consultants, Capital Incorporation Management Team
Id	=	the same
IMF	=	International Monetary Funds
IS	=	Interest Spread
Ktm.	=	Kathmandu
Ltd.	=	Limited
M	=	Million
n.d.	=	No date of Publication
NABIL	=	Nepal Arab Bank Limited
NBL	=	Nepal Bank Limited

NGO(s) = Non-government Organization(s)
NIC = National Insurance Company
NIC = Nepal Industrial & Commercial Bank
NIDC = Nepal Industrial Development Corporation
No., nos = Number(s)
NPA = Non Performing Assets
NPL = Non-Performing Loan
NRB = Nepal Rastra Bank
Op. cit = in the work cited
P & L A/C = Profit & Loss Account
P., PP. = Page(s)
P.Er = Probable Error of r
PFC = Provident Fund Corporation
Pvt. = Private
r = Coefficient of correlation
RBB = Rastriya Banijya Bank
Reqt. = Requirement
RFP = Request for Proposal
RS = Rupees
SBI = State Bank of India
SDC = Shanker Dev Campus
TRWA = Total Risk Weighted Assets.
TSA = Technical Service Agreement
TU = Tribhuvan University
TUCL = Tribhuvan University Central Library
Viz. = Namely
Vol. = Volume
WADR = Waited Average Deposit Rate
WALR = Waited Average Lending Rate
WB = World Bank
Wrt = With Respect to
X = Mean
Yr(s) = Year(s)

CHAPTER ONE

1. INTRODUCTION

1.1 About the Research

This research work is done with the main purpose of looking minutely at the supervisory role of the Central Bank and its impact on the commercial banks. The research takes into its study the three commercial banks and tries to study and analyze the data of the considered bank in regard to the compliance to the three important directives laid out by the Central Bank. The research also tries to identify the financial position to meet the obligations of the depositors of these banks and classifies the banks as strong, average and weak in terms of their compliance to these three directives issued by Nepal Rastra Bank. In addition to this, the research tries to observe minutely the monitoring aspect of the Central Bank.

1.2 Background

The overall financial picture of a country comprises of a regulatory body – Central Bank – and other financial institutions such as Commercial Banks, Development Banks, Finance Companies and other Micro Finance Companies. The country can foster economically when these main players of financial world of any country actually play their role effectively. Central Bank with its guidance should be ever vigilant and be able to keep things in control. Similarly, financial institutions should be able to create an environment conducive to overall socio-economic development of the country by abiding to the laws, directives and guidance of the monitoring authority.

Since Nepal is a developing country, its central bank needs to play a development role along with other regular monitory, supervisory and policy making role. The data shows that the number of commercial banks is on the rise since last few years but the quality of banking service and financial performance is not increasing proportionately.

1.3 Bank

According to Singh[1] a bank is a financial intermediary accepting deposits and granting loans. It offers the widest menu of services of any financial institutions. In fact a modern bank performs such a variety of functions that it is not possible to give a precise and general definition of a bank.

Similarly, Prof. Kinley defines bank as an establishment which makes to individuals such advance of money as may be required and safely made, and to which individuals entrust money when not required by them for use.

There are several types of banks: central banks, commercial banks, corporate banks, credit unions, savings banks, trust companies, finance companies, life insurers, investment banks, etc. Banks have drastically evolved throughout time, increasing their services but also becoming institutions that cater to greater numbers of people.

1.4 Commercial Bank

According to Commercial Bank Act, 1974, p1, "A commercial bank is one which exchanges money, deposits money, accepts deposits, grants loans and performs commercial banking functions and which is not a bank meant for co-operative, agriculture industries or for such specific purpose".

Regmi (2001)[2] in his comparative study of the financial position between two different banks stresses that commercial banks play a significant role in the development of a country as they become one very important means via which the major industries of the country get financial assistance. The development of commercial banks is instrumental for the country as they act as intermediary between those who have surplus of fund and those who are in need of it. Therefore, they assist in the optimum mobilization of resources of the country which is a key to economic development.

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[1] Singh H.B. (2062) *Banking and Insurance,* Aisa Publication

[2] Regmi G. (2001) *A Comparative study of the financial performance of Himalayan Bank Limited and Nepal Bangladesh Bank Limited*

1.5 Central Bank

According to Wikipedia Encyclopedia[3], a central bank, reserve bank or monetary authority, is one of the country's most powerful economic institutions. It is an entity responsible for the monetary policy of its country or of its group of member states, such as in the European Union. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system).

It may also have supervisory powers to ensure that banks and other financial institutions do not behave recklessly or fraudulently. A central bank is usually headed by a Governor.

According to R.S. Sayers “The central bank is the organ of the government that undertakes the major financial operations of the government and by its conduct of these operations and by other means, influences the behavior of financial institutions so as to support the economic policy of the government.”

In most countries the central bank is state-owned and has a minimal degree of autonomy, which allows for the possibility of government intervening in monetary policy. An "independent central bank" is one which operates under rules designed to prevent political interference.

1.6 Need for Bank Supervision

Commercial Banks and their activities are generally subject to much closer official supervision than other kinds of businesses. The following important aspects of the economic and financial life of the country justify the need of proper and efficient supervision of the commercial banks.

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[3] Encyclopedia *Wikipedia*

(a) They occupy a central place in the payments mechanism for households, government and business.

(b) They accept deposits, which are widely regarded as "money"; which are expected to be repaid in full, either on demand or at their due term; and which constitute part of society's financial assets.

(c) Banks in market economies play a major role in the allocation of financial resources, intermediating between depositors of surplus funds and would-be borrowers, on the basis of active judgments as to the latter's ability to repay.

This is in marked contrast to practice under conditions of central planning, where banks would typically act merely as passive conduits for the distribution of funds, without the necessity to make credit decisions.

The primary justification for banking supervision is to limit the risk of loss to depositors, and by so doing to maintain public confidence in banks. And while supervision naturally focuses on the individual bank, supervisors must also be alert to the possibility that problems in one institution may have wider, systemic repercussions on others as well.

1.6.1 Objectives of Supervision

Pradhan[4] in his article published in the Golden Jubilee Ceremony of NRB says that "Good macroeconomic policy and a stable and growing real economy are the preconditions for a sound banking system". A sound banking system is a precondition for a healthy macro economy and efficient macroeconomic policy formulation. Central Banks need to supervise banking institutions because banks play a critical role in the working of a market economy.

The balance sheets of banks are virtually a mirror of the economic and commercial life of a country. The key consideration for the involvement of a central bank in supervision is to maintain the confidence in the banking system. While maintaining this basic

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[4] Pradhan S.M (2062) *NRB Golden Jubilee Publication*

condition, it is also to the interest of the country to see that credit and other banking services are readily available at competitive prices. Another aspect of central bank supervision in Nepal's context, although not universally practiced, had been to intervene in credit distribution to meet certain social and other objectives.

The basic objective of NRB supervision is to conduct a direct assessment of the overall condition of the banking institutions based on off-site and on-site evaluation of the institution's capital, assets, management, earnings, liquidity and a review of their records, systems and internal control and to determine whether the institution has complied with relevant mandatory and regulatory requirements. It also helps to facilitate the detection of frauds, malpractices, abuses of power by management and staff and undesirable trends and imprudent practices, such as deterioration in the quality of loan portfolio and the concentrations of risks.

Since the last two decades, the world of finance has undergone profound changes as evidenced by the rapid technological development for processing and transmitting data, the growing internationalization of financial system, the increasing phenomena of financial innovations coupled with competition and deregulation. This new financial environment has necessitated the development of new and the adaptation of existing supervisory policies, practices and procedures.

Banks are supervised in order to achieve both long-term financial stability and sectoral efficiency. A weak regulatory framework and poor supervision provide backgrounds for inefficient and unsafe banking practices, which increase the risk of bank failure.

Preventing systemic risk, protecting small depositors, and containing financial crimes are concrete steps in attaining these objectives. They require the supervisors enforce fundamental discipline in the banking system with the well-crafted laws and regulations and the presence of strong in-house supervisory expertise. Last but not the least, the autonomy in the mandatory provisions rather than in practice may not pay good returns. Hence, despite all the steps for strengthening supervision as mentioned above, the

courage to implement the autonomy in practice is also a necessary component in making supervision effective. The commitment to implement all the supervisory regulations and supervisory instructions without any prejudice towards any particular side in practice on the part of Nepal Rastra Bank, the only Monitory Authority of the country, is of paramount importance on the one hand and on the other, the full-hearted support from government as well as the judiciary system of the country are also very necessary so as to strengthen NRB's supervisory effectiveness and enhance financial discipline and good corporate governance in the financial system of the country.

Although, as noted above, the focus of supervision is the individual bank, with the aim of limiting the risk to depositors, the safety and soundness of the banking system as a whole is so critical to the proper functioning of the economy, that supervisors must also be concerned about the possible wider, “systemic” implications of problems or failures in individual banks.

Systemic consequences may, most obviously, result from a particular bank itself playing a major or dominant role in national economic life, including in the payments system. But it is also possible for the difficulties of a small bank to generate systemic problems - if, for instance, depositors begin to worry about the safety of other banks, thereby precipitating large scale withdrawals from sound institutions. And the growing internationalization of banking means that such effects may spread across national boundaries.

Supervisors must be alert to all such possibilities. Sometimes the concerns may be judged sufficient to prompt some kind of official support to the banking system. Although such a decision would be for the central bank and government rather than supervisors alone, the detailed institutional knowledge of the supervisors would be an invaluable input.

1.7 Current Scenario of Banking Sector in Nepal

Financial system of Nepal is still in its primary stage of development. Small and fast growing financial sector comprises of commercial banks and other financial institutions

like development banks, finance companies, cooperatives etc. So far, development of financial services in the country is uneven. In some regions of the country, fast and advanced banking services are available while other regions are fully deprived of banking services.

At present there are altogether 17 commercial banks in Nepal. Rastriya Banijya Bank is fully owned by HMG of Nepal while in case of Nepal Bank Ltd, HMG of Nepal is major shareholder. There are six joint venture banks in collaboration with the foreign investment partners and remaining seven banks are fully owned by Nepalese investors. As can be seen from the data given below most of commercial banks were established during late eighties and early nineties due to liberalization of financial sector. Number of financial institutions is also growing. Non-banking financial system comprises of 55 finance companies, 21 development banks (including rural development banks), 34 licensed cooperative institutions and 15 non-government organizations. Keeping in view, such fast growth of financial institutions separate department for supervision of financial institutions was established in 1998. At present there are separate departments for supervision of commercial banks and financial institutions namely bank supervision department and financial institution supervision department.
List of Commercial Banks and their established date is as follows:

S.No.	Name of the Banks	Operation (A.D.)	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 Limited	1984/07/16	Kathmandu
5	Nepal Investment Bank Limited	1986/02/27	Kathmandu
6	Standard Chartered Bank Nepal Limited.	1987/01/30	Kathmandu
7	Himalayan Bank Limited	1993/01/18	Kathmandu
8	Nepal SBI Bank Limited	1993/07/07	Kathmandu
9	Nepal Bangladesh Bank Limited	5/6/1994	Kathmandu
10	Everest Bank Limited	1994/10/18	Kathmandu

11	Bank of Kathmandu Limited	1995/03/12	Kathmandu
12	Nepal Credit and Commerce Bank Limited	1996/10/14	Siddharthanagar
13	Lumbini Bank Limited	1998/07/17	Narayangadh
14	Nepal Industrial & Commercial Bank Limited	1998/07/21	Bi
15	Machhapuchhre Bank Limited	2000/10/03	Pokhara
16	Kumari Bank Limited	2001/04/03	Kathmandu
17	Laxmi Bank Limited	2002/04/03	Birgunj, Parsa
18	Siddhartha Bank Limited	2002/12/24	Kathmandu
19	Global Bank Ltd.	2007/01/02	Birgunj, Parsa
20	Citizens Bank International Ltd.	2007/6/21	Kathmandu
21	Prime Commercial Bank Ltd	2007/9/24	Kathmandu
22	Sunrise Bank Ltd.	2007/10/12	Kathmandu
23	Bank of Asia Nepal Ltd.	2007/10/12	Kathmandu
24	Development Credit Bank Ltd.	2001/01/23	Kamaladi
25	NMB Bank Ltd.	1996/11/26	Babarmahal

This research study takes into its consideration the three banks viz. Laxmi Bank, Nepal Investment Bank, NCC Bank. Their brief overview is as follows:

Nepal Investment Bank Ltd. (NIBL), previously Nepal Indosuez Bank Ltd., was established in 1986 as a joint venture between Nepalese and French partners. The French partner (holding 50% of the capital of NIBL) was Credit Agricole Indosuez, a subsidiary of one the largest banking group in the world.

With the decision of Credit Agricole Indosuez to divest, a group of companies comprising of bankers, professionals, industrialists and businessmen, has acquired on April 2002 the 50% shareholding of Credit Agricole Indosuez in Nepal Indosuez Bank Ltd.

The name of the bank has been changed to Nepal Investment Bank Ltd. upon approval of bank's Annual General Meeting, Nepal Rastra Bank and Company Registrar's office with the following shareholding structure.

A group of companies holding 50% of the capital are as follows:

- Rastriya Banijya Bank holding 15% of the Capital.
- Rastriya Beema Sansthan holding the same percentage
- The remaining 20% being held by the General Public (which means that NIBL is a Company listed on the Nepal Stock Exchange).

Nepal Credit & Commerce Bank Ltd. (NCC Bank) formally registered as Nepal - Bank of Ceylon Ltd. (NBOC), commenced 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 NRS. 1,000 million. The Head Office of the Bank is located at Siddhartha Nagar, Rupandehi, while its Corporate Office is placed at Bagbazar, Kathmandu.

The name of the Bank was changed to Nepal Credit & Commerce Bank Ltd., (NCC Bank) on 10th September, 2002, due to transfer of shares and management of the Bank from 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 worldwide network.
Laxmi Bank was incorporated in April 2002 as a commercial bank. The current shareholding constitutes of promoters holding 55.42 percent, Citizen Investment Trust holding 9.02 percent and the general public holding 35.56 percent. Promoters represent Nepal's leading business families with diversified business interests. The Bank's shares are listed and actively traded in the Nepalese Stock Exchange

Laxmi Bank has grown with branches in Birgunj, Banepa, Pokhara and more recently Biratnagar. Following the merger with Hisef Finance Ltd., a decade old first generation finance company, its office in Hattisar, Kathmandu was converted to that of Laxmi Bank. This office was converted to a full branch and our corporate office in October 2005.

With a view to providing safe, seamless, quick and advance banking services, the bank has been heavily investing in contemporary banking technologies. The Bank uses Flex cube as its main banking platform. Flex cube incidentally has been ranked the number one selling core banking solution globally, and has been embraced by over 500 financial institutions across over 90 countries. The Bank provides its services through a host of delivery channels including cell phone, Internet, ATM, PoS etc., in addition to a network of physical branches. Our Internet banking facility comes with capabilities of online shopping in addition to regular Internet banking features. Similarly, through the bank's alliance with Smart Choice Technologies (SCT), the ATM/Debit cardholder of Laxmi Bank has access to a network of ATMs, and PoS terminals located in all major urban centers of the country. The bank is the first in South Asia to have implemented SWIFT Net, the advanced version of the SWIFT technology, which is used for speedy and secure payment and messaging services.

From the perspective of resource mobilization, total deposits collected by the commercial banks during the review period from the year 2058 to year 2062 were as follows:

Table No. 1

Deposit and Borrowings of Commercial Banks from the year 2060 to 2064.

	2060	**2061**	**2062**	**2063**	**2064**
Deposit	165517768	165498736	181292438	206678378	226034287
Borrowings	81561952	75676176	82863450	98950840	119661067

(Source: Annual Supervision Report NRB, Supervision Department NRB)

On capital market front, shares of commercial banks are regarded blue chip stocks. Most of commercial banks are able to make profit and distribute dividends. Stock exchange bulletin also points out that active participation of banking industry stocks in capital markets have made them most influential factor in stock markets.

To strengthen financial sector of the country, Nepal Rastra Bank has started the financial reform process. Nepal Bank Limited and Rastriya Banijya Bank, the two senior banks of country were under heavy accumulated losses resulting complete erosion of its capital. Management of these banks is already given to foreign management team. New prudential regulations has been issued regarding capital adequacy, loan loss classification and provisioning, single obligor limit, corporate governance etc.,

1.8 Statement of the Problem

Nepal has relatively small banking area compared to the developed nations. The banks number of banks and financial institutions are slowly coming up. The banks and financial institutions are gradually practicing modern banking practices recently. Banking culture is slowly coming to the scene. Central Bank is coming with new and unified directives. In this context, some of the failures of this sector are quite prevalent. These failures are caused by number of reasons and can be tackled by efficient, strict and up-to-date guidelines by the Central Bank.

The weak financial position of most of the government-owned financial institution, negative net worth and huge accumulated losses of the government-owned CBs, higher proportions of non-performing assets (NPA) and large interest rate spread between lending and borrowing rates in the formal financial sector. Besides, there is predominance of the informal financial system with high interest rate differentials between the formal and informal sectors of the economy.

The Central Bank of Nepal, Nepal Rastra Bank (NRB) issues directives. The directives are revised considering the need of time as well as considering other factors which will

affect the economy of the country. The directives cover various aspects of the banking sector and aims at keeping the financial scenario of the country in balance.

Financial institutions are required to oblige with the directives issued by the Central Bank. The directives, if not properly addressed, can cause major unrest in the financial system of the country. The directives need to be properly monitored as they are the major tool to supervise and monitor the financial institutions.

Any rule should be strictly obeyed. These directives which have the potential to change the financial scenario of the country are even more important in that they should be strictly monitored.

This study is based on the primary and secondary data of three banks regarding the selected directives. Since the three directives more or less give a good picture of the financial health of commercial bank, this study did not consider other relevant directives. So, the actual outcome of the research may be biased to some degree. Also, the data provided in the questionnaire solely depends on the sincerity of the data provider, the result cannot be deemed as 100% correct.

A good sample size of the questionnaire could have added more weight to the analysis drawn from the questionnaire but due to the time constraint only the limited numbers of respondents were considered.

Similarly, because of the time constraint only the three banks were selected for the study.

1.9 Focus of the Study

The main objective of the study is to clearly define the supervisory guidelines or the directives issued by Nepal Rastra Bank and analyze the impact of the directives on the selected Commercial Banks.

Nepal Rastra Bank issues following categories of directives to commercial banks.

- Directives relating to banking regulations and prudential norms
- Directive(s) relating to foreign exchange
- Directive(s) relating to Credit Information Bureau
- Directive(s) relating to the list and format of different forms

Among many directives issued by the Central Bank, the study focuses on the first three important directives under the category of directives relating to banking regulations and prudential norms mainly because the three directives are directly responsible with the bank being able to meet the obligations of the depositors and also these three directives actually give the financial performance of the bank.

The study aims to spread the impact of monitoring guidelines of the Central Bank and its impact on the selected Commercial Banks.
The study mainly focuses on the off-site monitoring aspect of the central bank.

1.10 Objective of the Study

NRB has undertaken various activities for the banking & financial development of the country. There are many aspects for the development of banking in Nepal. Out of these aspects, the researcher has selected these are main factors.

1. To examine the role of NRB in the supervisory role of the Central Bank.
2. To enumerate the norms and standards laid by Nepal Rastra Bank relating to different aspects of banking such as
   - Capital Adequacy
   - Loan Classification and Provisions
   - Single Borrower Limit
3. To find out whether the selected banks actually implement the directives issued by NRB.
4. To analyze how NRB monitors the issued directives.
5. To provide the concerned parties with necessary suggestions and recommendations on the basis of the findings.

1.11 Limitations of the Study

This study is a partial requirement of MBS Program. It will mainly be limited by following factors.

1. Although NRB has varieties of policies such as economic development, monetary, foreign exchange etc. this study can't cover whole financial system. It covers only on the supervisory policy of NRB that need to be complied by different financial institutions. All other aspects of banking sector are not included due to the constraint of time.
2. Among the various directives issued by the Central Bank, the study covers the major three directives that need to be obeyed by the Commercial Banks.
3. Only three commercial banks are covered by the research.
4. The study covers only a five-year period of the selected Commercial Banks.
5. The study is also based on secondary data and Degree of truth depends on the secondary information provided by the concerned institutions.

1.12 Research Methodology

As aforementioned the main objective of this thesis is to study the supervisory role of Central Bank and its impact in the performance of financial institutions of Nepal. The study will be primarily based on the secondary data gathered from chiefly the Central Bank and other financial institutions of the country. Therefore, "descriptive" research design is more or less adopted.

Various financial and statistical tools have been used to achieve the objectives of the study**.** Because of the available resources, simple analytical tools will be taken for the analysis. The different graphs and charts will also be presented for the analysis process. The data will be taken from different thesis; books and other bulletins from different banks. Interpretation will be done where as necessary.

1.13 Significance of the Study

This research study is mainly based on the supervisory guidelines or directives of Nepal Rastra Bank. Even though several research have been conducted on the directives of

Nepal Rastra Bank, this study is different from them in that this research deals with the insights of three of the prominent directives of Nepal Rastra Bank and their overall impact on the commercial banks. The directives of the Central Bank holds the key to the good financial health of the nation and therefore its actual insight as well as overall impact needs to be clear to all the stakeholders.

This study shall mainly assist commercial banks to reassess their strategies and policies to comply with the changes made and to be made in the directives. This study shall also help other Commercial banks and other financial institutions because of the similarity in the directives issued by the Central Bank. Similarly policy makers of the Central bank and further researcher in similar topics may benefit from the study. Various recommendations and suggestions will also be posted at the end of the study.

1.14 Organization of the Study

This study is categorically divided into five different chapters viz. Introduction; Literature Review; Research Methodology; Data presentation and Analysis; and Summary, Conclusions and Recommendations.

The first chapter briefly explains among many issues the background of the study, introduction of bank, central bank and commercial banks, banking supervision and its objective, present scenario of the banking sector of Nepal, statement of the problem, focus, objective, limitation and significance of the research under study.

Literature review explains the theoretical part of the study under consideration. The chapter briefly looks into the conceptual review with description about the origin of banks, the Central bank and commercial banks, basic principles of supervision and the directives of Nepal Rastra Bank. The chapter also reviews the related studies and different articles which have been published earlier and relevant to the study. The chapter finally reviews few website with pertinent information.

Research methodology explains various terminologies related to research. The chapter explains about the research design, sources of data collected, data collection process, population and sample of data and methods of data analysis.

Next chapter mainly presents the collected data in the desired format. The presented data is analyzed and interpreted in order to come to some conclusion. This section is the actual output of the whole research and some conclusion can be drawn from the analysis and interpretation of the collected data.

The last chapter mainly comprises of the summary of the research. It describes the major findings of the research work and gives some conclusion of the study. The section also tries to provide some logical recommendations to the stakeholders of the study undertaken.

CHAPTER TWO

2. LITERATURE REVIEW

The review of literature is a very important aspect of the research. A critical literature review within a specific field or interest of research is one of the most essential, but also complex activities in the process of research. This chapter highlights upon the existing literature. For this, several books, dissertations, reports, handouts and articles published in journals and newspapers are reviewed. This chapter also seeks to scan the literature efficiently, using manual or systematic methods, to identify a set of useful articles and books and perform critical appraisal to apply principles of analysis to identify unbiased and valid studies. The chapter is divided into three parts: Conceptual Review, Review of Articles and Review of Websites.

2.1 Conceptual Review

2.1.1 Origin of Banks

It is pointed in Vaidya (1997)[5] that very little is known about banking before the Middle Ages. The first bank known to be formally established is the Bank of England in 1694. The development of modern commercial banking institutions came to scene after the Banking Act of 1833 which provided freedom for the establishment of joint stock banks. While banking arose far early and more rapidly in some countries, it was only in the 19th century that the modern joint stock commercial banking system developed in the leading countries of the world. When early colonies were established in North and South America, old banking services were transferred to the New World.

2.1.2 Meaning of a Bank

Banks are among the most important financial institutions in the economy and essential business in thousands of local towns and cities. In this context, there is much confusion about exactly what a bank is. Indeed many financial institutions – including security dealers, brokerage firms and insurance companies are trying to be as similar as possible

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[5] Vaidya S. (1997) *Money and Banking* Kathmandu: Pratibha Joshi

to banks in the services they offer. On the contrary, bankers are challenging these non-bank competitors by lobbying for expanded authority. Hence the meaning of a bank is necessary to be precise and clear. Therefore, a bank is an institution which accepts deposits from the public and in turn advances loans by creating credit. Therefore, it should be differentiated from other institutions as they cannot create credit though they accept deposits.

"Bank is also a financial intermediary institution for receiving, lending, and safeguarding money as well as conduction other financial transactions. There are several types of banks: central banks, commercial banks, corporate banks, credit unions, savings banks, trust companies, finance companies, life insurers, investment banks, etc. Banks have drastically evolved throughout time, increasing their services but also becoming institutions that cater to greater numbers of people."[6]

2.1.3 Central Bank

"A central bank, reserve bank or monetary authority, — is one of the country's most powerful economic institutions. It is an entity responsible for the monetary policy of its country or of its group of member states, such as in the European Union. Its primary responsibility is to maintain the stability of the national currency and money supply, but more active duties include controlling subsidized loan interest rates, and acting as a "bailout" lender of last resort to the banking sector during times of financial crisis (private banks often being integral to the national financial system)."[7]

Sayers points out that "Central bank is the organ of government that undertakes the major financial operation of the government and by its conduct of these operations and by other means influences the behaviors of financial institutions so as to support the economic policy of the government."

It may also have supervisory powers to ensure that banks and other financial institutions do not behave recklessly or fraudulently. A central bank is usually headed by a

[6] www.banknet.org
[7] http://en.wikipedia.org/wiki/Central_Bank

Governor. In most countries the central bank is state-owned and has a minimal degree of autonomy, which allows for the possibility of government intervening in monetary policy. An "independent central bank" is one which operates under rules designed to prevent political interference.

According to investopedia[8], the central bank is government owned but separate from the country's ministry of finance. Although the central bank is frequently termed the "government's bank" because it handles the buying and selling of government bonds and other instruments. Political decisions should not influence central bank operations. Of course, the nature of the relationship between the central bank and the ruling regime varies from country to country and continues to evolve with time. To ensure the stability of a country's currency, the central bank should be the regulator and authority in the banking and monetary systems.

2.1.3.1 Growth of Central Bank

Historically, the role of the central bank has been growing, some may argue, since the establishment of the Bank of England in 1694. It is, however, generally agreed upon that the concept of the modern central bank did not appear until the 20th century as problems developed in the commercial banking system. Thus, the central bank's modern function emerged in response to an already present commercial banking structure.

Singh[9] points out that Central Banking is a recent phenomenon mainly related to 19th and 20th centuries. In the old days, certain central banking functions were performed by certain institution. However, they were not like the central bank of modern days, Its functions, responsibilities and area coverage were limited.

The growth of central bank has been very slow. The Rikis Bank of Sweden is the earliest central bank established in 1656A.D. The Bank of England was founded in 1694A.D. It started functioning as the central bank with the passing of the Bank Charter

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[8] (http://www.investopedia.com/articles)

[9] Singh H.B. (2062) *Banking and Insurance*, Kathmandu: Aisa Publications

Act 1882. Other major countries, which established central banks in 19th century, are France (1882), Netherlands (1814) Russia (1860), Japan (1882) etc.

The movement of central banking started in the 20th century, particularly after the International Financial Conference Meeting at Brussels in 1920. The meeting suggested the opening of central banks in all countries. It gained momentum after the establishment of IMF in 1947. As the central bank of U.S.A. the Federal Reserve System (FRS) was established in 1913. In India, Reserve Bank of India (RBI) was established in 1935. Similarly, Nepal Rastra Bank was established in 1956 as the central bank of Nepal.

Today, there is hardly any country, which does not have a central bank. Initially central banks were privately owned and privately managed joint stock banks. However, now, particularly after World War II, most of the central banks have been nationalized. In the countries, where such banks are not functioning, governments have established central banks as state-owned institutions. Nepal Rastra Bank is one of the central banks set up in this condition.

2.1.3.2 How Central Bank Influences an Economy

Investopedia[10], a financial website claims that a central bank can be said to have two main kinds of functions: (1) macroeconomic when regulating inflation and price stability and (2) microeconomic when functioning as a lender of last resort.

a) Macroeconomic Influences

As it is responsible for price stability, the central bank must regulate the level of inflation by controlling money supplies by means of monetary policy. The central bank performs open market transactions that either inject the market with liquidity or absorb extra funds, directly affecting the level of inflation. To increase the amount of money in circulation and decrease the interest rate (cost) for borrowing, the central bank can buy government bonds, bills, or other government-issued notes. This buying can, however,

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[10] http://www.investopedia.com/articles

also lead to higher inflation. When it needs to absorb money to reduce inflation, the central bank will sell government bonds on the open market, which increases the interest rate and discourages borrowing. Open market operations are the key means by which a central bank controls inflation, money supply, and price stability.

b) Microeconomic Influences

The establishment of central banks as lender of last resort has pushed the need for their freedom from commercial banking. A commercial bank offers funds to clients on a first come, first serve basis. If the commercial bank does not have enough liquidity to meet its clients' demands (commercial banks typically do not hold reserves equal to the needs of the entire market), the commercial bank can turn to the central bank to borrow additional funds. This provides the system with stability in an objective way; central banks cannot favor any particular commercial bank. As such, many central banks will hold commercial-bank reserves that are based on a ratio of each commercial bank's deposits. Thus, a central bank may require all commercial banks to keep, for example, a 1:10 reserve/deposit ratio. Enforcing a policy of commercial bank reserves functions as another means to control money supply in the market.

The rate at which commercial banks and other lending facilities can borrow short-term funds from the central bank is called the discount rate (which is set by the central bank and provides a base rate for interest rates). It has been argued that, for open market transactions to become more efficient, the discount rate should keep the banks from perpetual borrowing, which would disrupt the market's money supply and the central bank's monetary policy. By borrowing too much, the commercial bank will be circulating more money in the system. Use of the discount rate can be restricted by making it unattractive when used repeatedly.

2.1.3.3 Central Bank - Its Functions

According to Wikipedia Encyclopedia[11], functions of the Central Bank are as follows:

- Monopoly on the issue of banknotes

[11] http://en.wikipedia.org/wiki/Central_Bank

- The Government's banker and the bankers' bank ("Lender of Last Resort")
- Manages the country's foreign exchange and gold reserves
- Manages Government's stock register;
- Regulation and supervision of the banking industry;
- Setting the official interest rate - used to manage both inflation and the country's exchange rate.

The central bank's main responsibility is the management of monetary policy to ensure a stable economy, including a stable currency. It aims to manage inflation (rising average prices) as well as deflation (falling prices). It is the lender of last resort, and will (at a price) assist banks in cases of financial distress (see also bank runs).

Furthermore, it will hold foreign exchange reserves (usually in the form of government bonds) and official gold reserves, and will often have some influence over exchange rates. Some exchange rates are managed, some are market based (free float) and many are somewhere in between ("managed float" or "dirty float").

Typically a central bank controls certain types of short-term interest rates. These influence the stock- and bond markets as well as mortgage and other interest rates. The European Central Bank for example announces its interest rate at the meeting of its Governing Council (in the case of the Federal Reserve, the Board of Governors).

The Central Bank is also responsible to devise rules, guidelines and directives that need to be obeyed by all the financial institutions so that the financial health of the country is in check.

2.1.3.4 Central Bank - Its Importance

Jim Clark (1997)[12] says that Central Bank and monetary policy is important because:

- Monetary policy can dominate fiscal policy in certain circumstances.
- Inflation is determined by monetary policy.
- The Central Bank influences interest rates.

[12] Saxton J. (March 1997) Chairman, Joint Economic Committee, USA, www.house.gov/jec/welcome.htm

- The Central Bank stabilizes the financial system.

These functions are important, for example, because they imply that the Central Bank controls and hence is responsible for the management of total spending or aggregate demand as well as inflation. In carrying out its monetary policy management (via manipulating reserves), the Central Bank influences interest rates—especially short-term rates—as well as foreign exchange rates and other financial market prices. And in times of financial crisis, the Central Bank's lender-of-last-resort function stabilizes the entire financial system.

The supervision aspect of the Central Bank mainly assist it in keeping the financial health of the country in good condition there by helping to stabilize the financial system.

2.1.3.5 Nepal Rastra Bank

Nepal Rastra Bank (NRB)[13], the Central Bank of the Kingdom of Nepal, was established in 1956 to discharge the central banking responsibilities including guiding the development of the embryonic domestic financial sector. Since then, there has been a huge growth in both the number and the activities of the domestic financial institutions.

To reflect this dynamic environment, the functions and objectives of the Bank have been recast by the new NRB Act of 2002. Joshi[14] points out that the objectives of NRB as a central bank are as follows:

- Formulate and implement monetary and foreign exchange policy to maintain price and balance payment stability for the sustainable development of the economy.
- Promote stability of banking and financial sector and necessary liquidity
- Develop safe, sound and efficient payment system.

[13] http://www.nrb.org.np
[14] Dr. Joshi S. (2062) *Banking & Insurance Management* Kathmandu: Taleju Prakashan

- Make regulation, inspection, supervision and monitoring for the sound development of banking and financial system.
- Promote overall banking and financial system of the kingdom of Nepal and enhance confidence of general public toward them.

2.1.4 Commercial Bank

According to Commercial Bank Act, 1974, p1, "A commercial bank is one which exchanges money, deposits money, accepts deposits, grants loans and performs commercial banking functions and which is not a bank meant for co-operative, agriculture industries or for such specific purpose". Regmi (2001)[15] stresses that commercial banks play a significant role in the development of a country as they become one very important means via which the major industries of the country get financial assistance. The development of commercial banks is instrumental for the country as they act as intermediary between those who have surplus of fund and those who are in need of it. Therefore, they assist in the optimum mobilization of resources of the country which is a key to economic development.

2.1.4.1 Function of Commercial Banks

Sudharsanam (1976) [16] says that "The business of commercial banks is primarily to hold deposits and make loans and investments with the object of securing profits for its shareholders. Its primary motive is profit, other considerations are secondary".
According to Vaidya (1999)[17] the functions of commercial bank are as follows:

a) Accepting Deposits

This is one of the major functions of a commercial bank. Commercial banks accept deposits from the general public and institutions. They not only protect the money but also provide the depositors a convenient method for transferring funds by the use of cheque leaves. It accepts deposits from people of every walk of life. It undertakes to

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[15] Regmi G. (2001) *Thesis: A Comparative study of the financial performance of Himalayan Bank Limited and Nepal Bangladesh Bank Limited*
[16] Sudharsanam D.P (1976) *Principles of Bank & Banking.*- Delhi: Setu Publication House
[17] Vaidya S. (1999) *Banking Management.* Kathmandu: Monitor Nepal

repay the money, either in part or in full as per the requirement of the depositor or the agreement. There are different types of deposits, saving deposits and fixed deposits.

b) Advancing Loans

Another very important function of commercial banks is to provide loans and advances to the needy, from the money, which it receives in the form of deposits. Direct loans and advances are given to all, both individual and institutions against their personal guarantee or against the security of movable and immovable properties, popularly known as collateral. Loans are granted by banks in various forms such as overdrafts, cash credits, direct loans and discounting bills of exchange.

c) Credit Creation

Credit creation is one of the most important functions of the commercial banks. Commercial banks accept deposits and advances loans. They normally do not disburse the entire amount of deposits as loan, instead they keep a small potion as reserve for the day-to-day transactions. When a bank advances a loan, it opens an account to draw money by cheque according to his needs. By granting a loan, the bank creates credit or deposit.

d) Facilities for the Financing of Foreign Trade

The other primary function of commercial banks is making arrangement for the amount of foreign exchange needed by business organization to pay in the foreign country. Bank provides more satisfactory guarantee to an individual or firms that bought issuance of a commercial letter of credit, drafts telegraphic transfer (T.T.) and a accepting travelers letter of credit or travelers cheque.

e) Making Venture Capitals Loans

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

f) Financial Advising

Banks can be a financial advisor to its customers, particularly when it comes to the use of credit and the saving or investing of funds. Many banks offer a wide range of financial advisory services, from helping financial planning to consulting to business managers and checking on the credit standing of firms.

g) Offers Investment Banking and Merchant Banking Services

Banks today are following in the footsteps of leading financial institutions all over the globe in offering investment banking and merchant banking services to corporations. These services include identifying possible merger targets, financing acquisitions of other companies, dealing in security underwriting, providing strategic marketing advice, and offering hedging services to protect their customers against risk from fluctuating world currency prices and changing interest rates.

Banks further support the overall economic development of the country by various modes of financing.

2.1.4.2 Assets and Liabilities of a Commercial Bank

Vaidya (1997)[18] points out that the details of the Assets and Liabilities of commercial banks are mentioned in the balance sheet of the respective commercial bank. In Nepal, commercial banks are required to publish their audited balance sheet at the end of each Fiscal Year (FY). Each Fiscal Year runs from mid July (Shrawan 1 to Ashad 32). As per the directives of Nepal Rastra Bank, the commercial banks are required to publish their financial statements, including the balance sheet within the month of the end of the previous Fiscal Year. Also, it should be noted that, Banks are required to publish their unaudited balance sheets at the end of each quarter of the Fisal Year, i.e., at the end of Asoj, Poush, Chaitra, and Ashad.

The assets and liabilities of commercial bank reflect their financial position. The essence of banking, accepting deposits and disbursing credit, the outcome of both of

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[18] Vaidya S. (1997) *Money & Banking*. Kathmandu: Pratibha Joshi)

these phenomenon affect the balance sheet because the bulk of the liability side is comprised of deposits and that of the asset side is occupied by disbursed loans. The C/D ratio, the ratio of credit to the deposit determines the level of profit for the commercial banks. Higher C/D ratio means effective mobilization of funds and this in turn means more profitability.

Therefore, the balance sheet shows how well the bank has been able to mobilize the funds. Besides, there are some other factors that can be observed through a balance sheet such as the capital, the reserves, the amount invested on fixed assets. Hence, it is utmost important to know about the items of the balance sheet of a commercial bank before analyzing the impact of the directives on such items. The very important items of a balance sheet of a commercial bank are as follows:

a) Assets

i) Cash: Cash is the liquid form of an asset of the commercial bank. There can be three reservoirs of cash, the bank vault, the reserve maintained with the central bank and the deposits in other commercial banks. One of the major functions of a commercial bank is to accept deposits and provide loans to its customers. In between comes another very important function, entertaining the cheques presented to the bank for withdrawals of the deposits. Therefore, banks need to maintain a certain level of cash with it so that it can make payments of the cheques presented in its counters. For the same, the banks keep a certain percentage of the total amount of the deposits as cash in vault.

Sometimes, due to various reasons, there are huge withdrawals, in order to meet the withdrawals; it maintains a certain amount with the central bank so that it can fulfill the customers' need. Also, in some cases, when banks have excessive deposits with them, they maintain deposits with other commercial banks account at certain interest rates.

However, the banks always try to minimize the amount of cash and rather invest the amount exceeding the minimum requirement, so that they can earn and make money.

ii) Bills discounted and purchased: These are normally available in three forms viz. the promissory notes, the bills of exchange and the treasury bills. All of these are negotiable and can be easily bought and sold. These financial instruments of the banks generate income. They are safe in the sense that most of them can be further presented to the central bank for rediscounting. Therefore, commercial banks prefer to have these as part of their assets as they are supported to be the ideal assets with safety, liquidity and profitability.

iii) Investments: Investment is considered by many including Mr. Vaidya, as the banks' third line of defense when it comes to liquidity. They generate more income than cash and bills but are less profitable compared to the loans and advances. Banks mainly invest on government securities and some gilt edged securities so that they can easily be converted to cash as and when required. The amount of investments of banks on such securities increases at times of slack economy when the credit disbursements are on a decline and they sell the securities when the demand for loans and advances increases. In Nepal, it can be observed that major portion of the banks' investment is comprised of government treasury bills and bonds.

iv) Loans and Advances, Cash Credits and Overdrafts: Loans and advances are the main sources of revenues for the commercial banks. Major portion of the funds available with the commercial banks are invested as loans and advances. Banks enjoy the interests on the loans and advances made by it, which normally is greater than the interests to be paid by it to the depositors and thereby make profit. However, loans and advances are not made to all these seeking for it. Banks analyze various factors before they advance loans and advances. The main characteristics that a bank expects to be in its borrowers are character, capital and capacity. The bank rarely disburses loans without proper collateral. Collateral is a security kept by the borrower against the loan disbursed by the bank. Collateral may be of different types ranging from property to the various types of securities. These are various forms of credit such as fixed term loan, overdrafts, working capital loan, hire purchase loan and trust receipt. Since considerable

percentage of asset is comprised of loans and advances, it requires great care and focus for bank's progress.

v) Fixed Assets: Furniture and office premises owned by the bank comprise fixed assets of a bank. They cannot be converted to cash easily. They are normally owned by the bank so as to avoid rental costs. Depreciation is charged against each of these assets every year at different rates depending on the type of assets.

vi) Other Assets: Other assets of banks include valuable metal such as gold and silver, prepaid expenses, development expenses and accrued interest on investments.

b) Liabilities

Liabilities of a bank are the main sources of fund of the bank and mainly include the following:

i) Capital: The authorized capital is the maximum amount that a bank may issue during the course of its operation and is mentioned in the Memorandum of Association of the bank. The issued capital is that portion of the capital which is issued by the bank to the public for subscription. The subscribed capital is the amount of capital subscribed by the general public. It can be whole or just a part of the issued capital. Called Up capital is the amount of capital that the shareholders need to pay. The Paid Up capital is the capital already paid by the shareholders. This is the only cash that have been realized by the bank. The difference between the Called Up capital and the Paid Up capital is the Uncalled Capital.

ii) Reserve Fund: The banks always keep aside part of the profits they make as reserves. These reserves are mainly kept by the banks to meet some uncertain contingent liabilities of the future. They provide security, not only to the shareholders but also to the depositors. There are various types of reserves, for instance, the exchange equalization fund, which is the reserve made out of the profit made from the reevaluation of the foreign exchange during the previous years, and kept in order to

meet the contingent losses, if any, to be confronted in future due to subsequent reevaluation.

iii) Deposits: The deposits of the bank constitute major portion of the bank's liability. They are the main sources of funds for the banks. The success of bank highly depends on its ability to attract depositors at low interest rates and mobilize it to earn the maximum. There are mainly three types of deposits, the fixed deposit, the saving deposit and the current deposit.

iv)Bills for Collection: The banks receive bills from customers against which payment have to be made. However, the banks charge certain amount of commission on the bills collected on behalf of its customers.

v) Borrowings: Banks borrow funds from the central bank and other banks from time to time. All such funds are included in the liability side of the balance sheet under the heading of borrowings. They constitute small portion of the total liability of the bank.

vi) Other liabilities: Other liabilities include pension funds, staff bonus, unpaid dividends and insurance funds.

2.1.5 Principal Reasons for Banking Supervision

Rose[19] points out that following are the main reasons why banks are subjected to supervision.

- To protect the safety of the public savings.
- To control the supply of money and credit in order to achieve a nation's broad economic goals such as high employment and low inflation.
- To ensure equal opportunity and fairness in the public's access to credit and other vital financial services.

[19] Rose P.S. Commercial Bank Management

- To promote public confidence in the financial system, so that savings flow smoothly into productive investment, and payments for goods and services are made speedily and efficiently.
- To avoid concentrations of financial power in the hands of a few individuals and institutions.
- To provide the government with credit; tax revenues, and other services.
- To help sectors of the economy that have special credit needs (such as housing, small business and agriculture).

However, regulations must be balanced and limited so that:

- Banks can develop new services that the public demands.
- Competition in financial services remain strong enough to ensure reasonable3 prices and an adequate quantity and quality of service to the public, and
- Private sector decisions are not distorted in ways that misallocate and waste scarce resources.

2.1.6 Basic Principles of Banking Supervision

Ware (1996)[20] in his report on banking supervision has outlined the following necessary issues in regard to the Banking Supervision.

2.1.6.1 General Principles of Supervision

Underlying the diversity of supervisory regimes and practices which exist in different countries are some common objectives and judgments.

As objectives, supervisors seek to ensure that banks are

(a) Financially sound

(b) Well managed, and

(c) Not posing a threat to the interests of their depositors

In pursuing these objectives supervisors are trying to form three judgments

(a) How much risk is each bank undertaking?

(b) What resources are available to manage that risk?

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[20] Ware D. (1996) *Basic Principles of Banking Supervision*

The resources may be tangible (e.g. capital, liquidity) or intangible (e.g. quality of management and control systems).

(c) Whether the identified level of resources is sufficient to balance the risk.

Although supervisors need to have some understanding of the markets and the business environment in which banks operate, they cannot be expected to know as much as the bankers themselves about the commercial realities of banking. Anyway, it is *not* the supervisor's role to make the commercial decisions that are the prerogative of bank management. Rather, the supervisor monitors and evaluates the overall strategies, policies and performance of the bank - where appropriate with reference to specific legal or prudential criteria - and reaches a view as to the soundness of the bank and the competence of those running it.

2.1.6.2 Banking Risks

The risks to which banks are exposed can be categorized as

(a) Credit risk - the risk that the bank's counterparty might not pay on the due date. Though most often associated with lending, credit risk arises whenever another party enters into an obligation to make payment or deliver value to the bank, e.g. in foreign exchange or securities transactions.

(b) Liquidity risk - the risk that the bank might itself fail to meet its obligations when they fall due.

(c) Yield risk - the risk that the bank's assets may generate less income than the expense generated by its liabilities.

(d) Market risk - the risk of loss resulting from movements in the market price of financial instruments in which the bank has a position. Such instruments include bonds, equities, foreign exchange and associated derivative products.

(e) Operational risk - the risk of a failure in the bank's procedures or controls, whether from external causes or as a result of error or fraud within the institution.

(f) Ownership/management risk - the risk that shareholders, directors or senior management might be unfit for their respective roles, or actually dishonest.

Any banking risk is heightened if it appears in concentrated form - for example through large exposures to single or related counterparties, industrial sectors, countries or currencies.

2.1.6.3 Key Prudential Issues

a) Capital adequacy

A bank's capital is required as a cushion to absorb losses, which should be borne by shareholders rather than depositors, and to finance the infrastructure of the business. The importance of capital adequacy is indicated by the development of an internationally accepted measure by the Basle Committee on Banking Supervision1 in 1988, based on what is know as the "risk asset" approach.

This approach defines the elements of capital for supervisory purposes, allocates weights to different broad categories of asset (e.g. government securities, loans to banks, customer advances) and expresses capital as a percentage of total risk-weighted assets.

The Committee consists of senior representatives of bank supervisory authorities and central banks from Belgium, Canada, France, Germany, Italy, Japan, Luxembourg, Netherlands, Sweden, Switzerland, United Kingdom and the United States.
A minimum result of 8 percent is widely accepted, though national authorities are free to impose higher standards on their banks - and often do so. As originally designed, this approach was only concerned with credit risk, but at the beginning of 1996 the Basle Committee published proposals to bring market risks into the calculation of capital requirements. Countries represented on the Committee are committed to implementing those proposals by end-1997.

b) Liquidity

The ability to meet its obligations on time, especially in relation to repayment of inter-bank borrowings and customer deposits, is crucial to a bank's reputation and even its continued existence. Banks need to manage liquidity to that end, not least because their

prime economic function of intermediation necessarily entails maturity transformation – for in general borrowers seek funds of longer term than banks' deposit liabilities.
Banks have three principal ways of arranging their liquidity, usually employing them in combination.

(i) Holding a stock of readily marketable liquid assets capable of being turned into cash quickly in response to unforeseen needs. Supervisors may prescribe which assets may be regarded as liquid, and require holdings equivalent to some percentage of total deposits or of those of short maturity.

(ii) Using information on the residual maturity of assets and liabilities to analyze future cash flows, and setting limits on mismatches or net positions in particular time bands. Supervisors, too, may set such limits and allow defined liquid assets to be included in the calculation at a maturity earlier than their final repayment date to reflect their marketability.

(iii) Borrowing in the market to smooth out cash flows by reducing mismatches in particular time bands. Supervisors may be prepared to allow the inclusion in liquidity calculations of the undrawn portion of irrevocable and committed standby borrowing facilities from other banks, but are cautious about the extent to which it is prudent to rely on such facilities.

c) Asset quality

The central issue in relation to the quality of a bank's assets is the ability of its borrowers to service and repay loans. Problems with asset quality are very often a key element in the failure of banks, with losses too large to be absorbed by capital. In the USA and other countries which practice detailed on-site examination of banks, the review of individual loans is a major focus of the process. Supervisors will expect banks to establish, and adhere to, documented lending policies. These should specify such items as the standards which loan applications must meet, credit assessment and loan authorization procedures, the regular monitoring of the performance of each loan, and its periodic review by staff independent of the original lending officers.

The early identification of problem loans is important if remedial action is to succeed, and banks may to this end employ grading systems for loans. Such systems use information on each loan to classify it in the range from trouble-free to problematic or worse. The numbers of categories and precise criteria used in the classification process may vary widely. Some countries, including the USA, assign ratings to individual loans as part of the examination process in order to evaluate the quality of banks' assets on a consistent basis;

d) Risk concentration

Safeguarding against excessive concentration of risk on individual counterparties, sectors or countries is a most important component of prudential supervision - for the greater is the concentration; the larger will be the potential for loss.

The conventional supervisory response is to limit exposures to single counterparties, or groups of counterparties, to the equivalent of some proportion of the bank's capital base; the European Union, for example, imposes a limit of 25 percent. In addition, the total of all the bank's large exposures (in the EU case, any exceeding 10 percent of capital) is constrained to a multiple of capital base.

Two aspects of the control of large exposures merit particular mention.
First, the banks may face practical difficulties in identifying those exposures which should be aggregated and treated as one for this purpose, because linkages between borrowers may not always be obvious. Larger banks may face an additional problem in collating data on exposures throughout their entire networks.

Secondly, there is the question of exposures to parties related to the bank itself. Such parties will include shareholders, directors and their associates as well as subsidiary and affiliated companies of the bank. There will be concerns that such exposures may be entered into on terms more favorable than other customers receive, not least when industrial or commercial undertakings own the bank. For this reason, it is common

practice to subject the totality of exposures to related parties to the same limit as a single exposure to an unrelated one.

Risk concentration may figure as a concern in other aspects of a bank's business than its assets. For example:
(i) Funding, if individual deposits are large and volatile, or if funds come from a narrow range of sources.
(ii) Profits, if income derives from a small number of transactions or activities, as opposed to showing diversification.
(iii) Product range, if over-specialization occurs.
(iv) Type of collateral, if a high proportion of loans are made against a particular kind of collateral, a reduction in the value of which could impact on many otherwise unrelated borrowers.

e) Management

A bank's success or failure in large part depends on the experience, capability, judgment and integrity of its board of directors and senior executives. Indeed, when banks fail, deficiencies at these levels are invariably discovered. At the same time, evaluation of management is as much art as science and involves the making of difficult judgments.

The board of directors should be strong, independent and actively involved in the bank's affairs, particularly in establishing and reviewing strategy, and monitoring risk and performance. Directors and executives are responsible for setting, and ensuring adherence to, policies and procedures covering all aspects of the bank's activities. Important in this is creating an organizational structure in which individual responsibilities and reporting lines are clear, and effective communication is facilitated.

f) Systems and controls

The policies and procedures laid down by directors and senior executives of a bank are intended to control risks, safeguard assets, control liabilities, and provide accounting and other systems which record all transactions and commitments in a timely manner

while providing management with reports enabling it to identify and assess the risks of the business. In order to be effective, internal controls need to be comprehensive, clearly documented, periodically reviewed, understood by those involved in the relevant activities or processes, and enforced. Three fundamental concepts are of wide application - authorization, reconciliation and segregation.

(i) Authorization refers to the need for senior management to determine, and policy and procedures manuals clearly to set out, the extent to which individuals - or sometimes committees – at various levels of seniority are empowered to commit the bank to transactions or obligations.

(ii) Reconciliation is the comparison of two independently prepared sets of information which cover the same ground, and should in principle be identical; examples include reconciliation of nostro account statements with the bank's own records, and of dealers' profit and position figures with those generated in the back office.

(iii) Segregation of duties (perhaps the oldest and most fundamental control in banking) limits the scope for staff fraud by making successive steps in a process the responsibility of different individuals or departments; a key example is the complete separation of dealing activities from the supporting confirmation and settlement tasks performed in the back office. The role of an internal audit department is clearly an important aspect of systems and controls. Supervisors will expect it to have clear and appropriate terms of reference, independence from line management, a direct reporting line to the board and to be adequately resourced.

2.1.6.4 Basis for an Effective Supervisory System

An effective supervisory system rests on: legislation relating to banking and its supervision; the supervisory regime itself; and an appropriate legal and accounting environment. It should be noted that various parts of the financial sector, other than banks, may also be subject to supervisory regulation of one form or another. Attention may therefore need to be given to possible overlaps or gaps in regulation; to questions

of consistency and fairness across the financial sector; and to the justification for any gradations of treatment as between different classes of institution. This thesis is, however, concerned only with the supervision of banks, so does not address those other issues, important though they are.

a) Banking legislation

Legislation must first define which institutions are to be regarded as "banks". One approach is to define a bank in terms of taking deposits from the public; another is to do so in terms of taking deposits *and* making loans. In either event, unauthorized deposit-taking should be prohibited and penalties for doing so be laid down. It is for national consideration whether the law should distinguish between different types of banks, for example large and small, full service or specialized, and domestic or foreign.

b) The supervisory regime

It is for national consideration whether licensing and supervision should be entrusted to the central bank or to some other agency. In either event, it is most important that the supervisory authority be independent of political or other outside pressure, so that its decisions can be made on objective supervisory grounds. It is equally important that there should be a mechanism by which the supervisory authority is accountable to government or parliament for the discharge of its duties. Precise questions concerning the statutory position of the supervisor and the balance between independence and accountability are, however, beyond the scope of this thesis.

Historically, some countries have favored on-site examination as the core of their supervisory approach, while others have preferred to employ off-site surveillance. A growing consensus holds that a combination of these is desirable.

c) Legal and accounting environment

An appropriate legal and accounting framework is essential not only for effective supervision in a market economy, but also for banks themselves to serve their economic

purposes; this proposition rests on the underlying presumption that in a market-orientated system private enterprises can, and do, fail.

2.1.6.5 Off- And On-Site Approaches

As noted earlier, supervisors in different countries have in the past concentrated either on off-site analysis and review of information submitted by banks, or on obtaining the information themselves through on-site inspection. These approaches have increasingly become seen as complements rather than alternatives, forming a powerful combination when deployed in a coordinated manner.

The principal characteristics of each are discussed below.

a) Off-site supervision

This involves the receipt, review and analysis of financial statements and statistical returns submitted to the supervisors. The analysis of this information facilitates the monitoring of each bank's performance and of its observance of supervisory requirements over time, so that emerging problems may be identified. The process can thus assist in making the most effective use of any on-site inspection resources. Comparison of a bank's data and performance with those of its peers can also be illuminating.

These off-site procedures depend on the timely provision by banks of accurate information, without which the whole process is flawed from the outset. An important element in on-site inspection is the verification of suitable data samples. By its nature, while off-site review and analysis can readily deal with matters (e.g. capital, liquidity, and large exposures) which can be quantified, it is less well suited to qualitative issues such as management strength and operational risks. But one aspect of off-site supervision, central to the UK approach to supervision, which nevertheless has much value in relation to these judgmental questions, is the periodic, wide-ranging interview with an institution's senior management; and of course one would hope that supervisors

and bank management would maintain close contact with each other outside the formal program.

b) On-site supervision

Inspection provides an independent check on a bank's operations and condition, as well as enabling off-site supervision data to be verified. Using a sampling approach, as distinct from one of full audit, inspectors focus on the bank's accounting and control systems, and its adherence to its own policies and procedures in all aspects of the business, and make informed judgments about management capabilities.

The limited availability of suitably skilled staff has led some countries to enlarge the role of external auditors to encompass monitoring and reporting on supervisory matters; at least one, by contrast, faced with an undeveloped accountancy profession, has chosen to build on an existing body of central bank inspectors by transforming their role into that of supervisors.

2.1.6.6 Some Reflections on the Supervisor's Task

The supervisor's objective of minimizing the risk of loss to depositors is sometimes interpreted to mean that he should ensure that no bank ever fails. Such is not the case, for a basic principle of a market orientated system is that, while some enterprises thrive, others must of necessity fail and make their exit. For supervisors to prevent that would raise the problem known as "moral hazard": knowledge that any mismanaged bank would receive official support would reduce or remove management's incentive to operate in a prudent manner, and that of depositors to exercise care in choosing where to place their funds. Nor is it a supervisor's job to take commercial decisions which properly belong to bank managements, but rather to evaluate the latter's performance and the policies and procedures they put in place.

Some may be tempted to the view that the most effective way of averting loss to depositors is to prevent banks' taking any risks. Such a view misunderstands the essential nature of banking, which leads banks to run the risks outlined in Section 3

above if they are to provide the services of money transmission and financial intermediation which are their distinctive contribution to the market economy. The supervisor's concern is that bank managements should identify, understand, monitor and control such risks - for the biggest risk is the one that management has yet to identify or understand.

2.1.7 Supervisory Guidance on Dealing with Weak Banks

Bank for International Settlement[21] says that supervisors should be ready to deal with them.

A weak bank can be variously defined. In this report, it is "one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management". In such cases, and given the need to maintain confidence in the financial system, a supervisor should try to preserve the value of the bank's assets with minimal disruption to its operations, subject to minimizing resolution costs. It may well be that the bank as a legal entity ceases to exist.

A supervisor must distinguish clearly between symptoms and causes of bank problems. The report analyses these. A supervisor must also identify and tackle problems at an early stage before they become acute.

While supervisors have a range of corrective action tools at their disposal, primary responsibility for addressing weakness and problems rests with the Board and management of the bank. Supervisory measures have to be proportionate. Corrective action should fit the scale of the problem and be set within a clear time frame. A balance has to be struck between rigid prompt corrective action regimes and general, less binding frameworks. One effective combination would include "automatic" rules for pre-agreed acceptable supervisory actions plus room for flexibility in particular circumstances. A balance has also to be struck between informal methods, normally

[21] BIS Report (2002) *Task Force on Dealing with Weak Bank* England: Bank for International Settlements

where the bank's problems are less serious and bank management is co-operative and more formal actions that are binding on the bank, with penalties for non-compliance. Closure of the bank and revocation of the license remain the ultimate sanction.

2.1.7.1 Definition of a "Weak Bank"

A weak bank is one whose liquidity or solvency is or will be impaired unless there is a major improvement in its financial resources, risk profile, strategic business direction, risk management capabilities and/or quality of management.

The definition focuses on a bank where there are potential or immediate threats to liquidity and solvency, rather than one with observable weaknesses that are isolated or temporary and which can normally be corrected by appropriate remedial action. Of course, all weaknesses, whatever their magnitude and character, must be addressed by the bank.

The problems in a weak bank are more fundamental. They include, but are not limited to

- Poor management
- Inadequate financial resources
- Absence of a long-term sustainable business strategy
- Weak asset quality and
- Poor systems and controls

Weak banks do not occur overnight. Problems that seem to emerge rapidly are often the sign of financial or managerial weaknesses that have been allowed to persist for some time. These problems can rapidly become a major concern to a supervisor if minimum prudential requirements are not met and viability is threatened. The task of the supervisor is to identify these problems early, ensure preventive or corrective measures are adopted, and have a resolution strategy in place should preventive action fail.

2.1.7.2 Identification of Weak Banks

If undetected, weaknesses in banks tend to grow over time. The supervisor's challenge is to identify weaknesses before they become irreparable.

Successful identification of weak banks depends on the information collected by the supervisor from a wide variety of sources. A range of channels and methods is typically used. It is important that the information is timely, relevant and of good quality. Having good sources of information, though, will rarely be sufficient on its own; supervisory judgment will almost always be called for in interpreting information and assessing the financial health of a bank.

2.1.7.3 Methods Employing Mainly Quantitative Financial Information

a) Financial statements analyses

The supervisor can use a bank's financial information to produce a wide array of financial ratios to assess the performance and financial condition of the bank. The analysis involves:

- Comparison of the financial indicators of an individual bank to a peer group; and
- Examining the trend in an indicator.

The potential gaps and shortcomings in this monitoring tool are that:

- The relevance of the analysis is critically dependent on the quality of the information received from the bank. This is why many supervisors look for independent testing of the accuracy of a bank's returns;
- The ratios only portray the position at a particular point in time;
- Financial indicators tend to be lagging indicators of weakness; and
- It should not be used in isolation without considering qualitative aspects. The bank's corporate governance and risk management practices have a bearing on both the accuracy of the data and the likelihood that problems will in fact materialize.

b) Early warning systems

Based in large part upon the regulatory reports submitted by banks, some supervisors have developed or are developing statistically based early warning systems (EWS). These models attempt to estimate the likelihood of failure or financial distress over a fixed time horizon. Alternatively, some EWS aim at predicting future insolvency by estimating potential future losses.

EWS will normally not provide firm evidence of weaknesses but will give indications for further investigations by the bank and by the supervisor. Using EWS is particularly important for helping supervisors to direct limited supervisory resources towards banks or activities where weaknesses are most likely to be found.

2.1.7.4 Supervisory Assessments

a) Supervisory rating systems

Many supervisors use a rating system to draw together assessments of the various components of a bank's condition. Although supervisors may take into account different components and name their systems differently, there are many common factors in the rating process. They include capital, asset quality, management, earnings, liquidity, sensitivity to market risk and operational risk.

A major benefit of a supervisory rating system (SRS) is that it provides a structured and comprehensive framework. Quantitative and qualitative information are collected and analyzed on a consistent basis and supervision is focused on deviations from the "normal".

Applying the framework should lead to a closer co-operation between offsite and onsite supervision. Onsite examiners should be promptly informed of indications of weaknesses in specific banks; and onsite examiners should alert the offsite function to look for specific areas/banks/activities where they suspect that weaknesses may exist.

b) Risk-based supervision

An increasing number of supervisors are moving to risk-based supervision. This is a forward looking approach where the supervisor assesses the various business areas of the bank and the associated quality of management and internal controls to identify the areas of greatest risk and concern. The supervisory focus is directed to these areas to allow the supervisor to identify problems at an early stage. Many banks have seen the

advantages of a risk-based approach and adopted the methodology for their own internal audit work.

In practice this means identifying, often through the firm's own management accounts and internal audit function, the significant business units and those areas of inherently high business risk, such as a division of the bank that is consciously targeting riskier borrowers. The supervisor may concentrate his efforts on examining the robustness of the controls in these areas. Alternatively this approach may identify and focus on relatively weak controls, such as an understaffed internal audit function relative to the bank's peers. The supervisor's resources will be targeted at discovering more about, and probably implementing a remedial action plan for, the area of weakness.

c) Surveillance of the banking system

The surveillance of banks for supervisory purposes focuses mainly on the risks of failure of an *individual* bank. Surveillance of the banking system (and the financial system) as a whole can also provide early warning indicators of financial system problems which, in turn, may affect individual banks. Analysis of the state of the economy and credit conditions can help inform the supervisory approach to individual banks. For example, if economic surveillance suggests there is a significant risk of a decline in real estate values, the supervisor would be wise to monitor more closely those banks with particular exposure to the sector.

Many central banks and supervisory authorities publish surveillance analysis of the banking system in their annual reports while a few publish standalone financial stability reports on a more frequent basis.

2.1.7.5 Principles for Dealing with Weak Banks

As part of the background to the work, the Task Force considered why it is necessary and desirable to deal with weak banks. The answer is related to the fundamental objectives of banking supervision. These, of course, vary somewhat from country to country – and in some cases, are expressly stated in law. As a general proposition,

however, a central objective of supervision is to maintain stability and confidence in the financial system, thereby reducing the risk of loss to depositors and other creditors. Dealing effectively with weak banks fits neatly into this wider objective.

In dealing with weak banks, this objective translates into supervisory actions aimed at preserving the value of the bank's assets with minimal disruption to its operations (i.e. maintaining the *economic* entity), subject to minimizing any resolution costs. In certain cases, it may well be that the bank as a *legal* entity should cease to exist.

The guiding principles for a supervisor when dealing with weak banks include:

a) ***Speed.*** Supervisors should act promptly. Experience from many countries shows that regulatory and supervisory forbearance has exacerbated the problems of a weak bank. By not dealing with the problems promptly, they have grown rapidly making the eventual resolution efforts more difficult and more expensive, with the possibility of becoming more widespread and systemic.

b) ***Cost-efficiency.*** A least cost criterion should guide the supervisor when making choices between alternative actions consistent with achieving the supervisory objectives. It is important that the supervisor considers all costs, including exogenous costs such as instability of the financial system, in deciding on a course of action.

c) ***Flexibility.*** Legislation frequently adopts a rules-based approach. However, it is also helpful if the legislation permits the supervisor to exercise discretion in the deployment and timing of supervisory tools. It is outside the scope of this Task Force to prescribe the nature of any one country's legislative framework – suffice it to say that supervisors should be prepared to act flexibly by considering the full range of powers available when faced with a weak bank.

d) ***Consistency.*** Consistent and well-understood supervisory actions will not distort the competitive environment. Such an approach will also minimize confusion and uncertainty in times of crisis. Similar problems in different banks, large or small, private or state-owned,4 should receive similar treatment.

e) ***Avoiding moral hazard.*** Supervisory action should not create incentives for banks to act in a manner that incurs costs which they do not have to bear entirely. Shareholders should not be compensated for losses when a bank gets into difficulty;

otherwise it will encourage other banks to behave less prudently on the expectation that they will receive a similar bailout if problems occur. Equally, supervisory action should not protect the interest of the bank's corporate officers. As Bagehot wrote: "[A]ny aid to a present bad Bank is the surest mode of preventing the establishment of a future good Bank"[22].

f) ***Transparency and cooperation.*** Inadequate or incorrect information from the bank increases uncertainty for everyone involved. It can lead to misplaced supervisory action and add to the costs of solving the problems. The bank and the relevant authorities should aim for a high degree of information sharing and transparency about their intended actions. Decisions on disclosures – or not - to the wider financial community and the general public are more difficult and must depend on the specific situation. These will generally need to be carefully assessed in each particular case. The overriding consideration must be whether the disclosure contributes to the supervisor's objective in resolving the weak bank and maintaining broader systemic stability.

2.1.7.6 Dealing with Different Types of Weaknesses

This section discusses how to deal with different types of weaknesses, but in practice of course, the individual weaknesses do not appear in isolation. A bank and its supervisor will have to deal with a range of different problems simultaneously. As noted above, the key to turning around a weak bank is to identify and quantify the problems and implement a comprehensive and credible corrective action plan. Depending on the circumstances, disclosure of the fact that the bank has embarked on such a plan may help in maintaining or restoring confidence in the bank.

a) Capital adequacy

Declines in capital ratios have different explanations. The most common include:

- A rapid increase in risk-weighted assets;
- A reduction in the absolute amount of capital, e.g. Redemption of subordinated loans;

[22] Bagehot W. (1873), Lombard Street, Henry S. King & Co.

- Overall losses in the bank operations; and
- Adverse exchange rate movements, where there is a currency mismatch between risk-weighted assets and regulatory capital.

Improving the capital position addresses the symptom. The supervisor should also seek to understand in each instance why the capital ratio fell to determine if other measures are needed. In the first case of the instances listed above, the supervisor must assess whether the bank has the financial strength and the managerial and organizational capacity to handle the new risks. In the second case, the supervisor should determine if the reduction of capital is voluntary or involuntary, on the bank's part. In the third case, the underlying causes of the losses must be identified. A temporary loss, for example, emanating from unexpected market developments, calls for a different treatment from that of a bank that consistently makes a loss. In the fourth case, the supervisor should assess the bank's management of its foreign exchange exposure.

Where the bank's capital adequacy ratio has fallen below the supervisory and/or statutory minimum, the powers of the supervisor to take formal action against the bank to restore the ratio should be triggered.

The supervisor's main consideration is whether, and how soon, the bank can restore its capital to an acceptable level. The bank should therefore be required to provide the supervisor with a clear commitment of how it proposes to restore the ratio and the timescale, with relevant milestones, for doing so.

It would be prudent for the supervisor to ask for assurances from the major shareholders of the bank that they continue to support the bank and are prepared to contribute to restoring the capital position by means of capital injection if the position of the bank deteriorates further.

If the existing shareholders are unable to provide the necessary capital injection, various other options can be considered, such as:

- Selling or securitizing assets, thereby reducing the capital needed to support the business;
- Switching the portfolio from higher to lower risk weighted assets;
- Cutting operating costs and capital expenditure, including bonuses to managers and directors;
- Limiting or restricting the payment of dividends;
- Restricting redemption of subordinated debt or other instruments; and
- Bringing in a new shareholder who can contribute new capital.

A less obvious problem is where the bank's capital adequacy ratio falls significantly, for example, because the bank incurs a loss, to a level below what the market expects for the bank in question, but still remains above the supervisory and/or statutory minimum. This may affect confidence in the bank, particularly if there is an expectation that it may fall further in future.

In such circumstances a capital injection (perhaps restoring the capital adequacy ratio to the level before the loss was incurred) may also be appropriate, in order to reassure depositors and the market in general that the position of the bank will remain secure. In such cases, the supervisor will need to co-operate closely with bank management.

b) Asset quality

Asset quality problems can become "serious" in different ways. Provisions and write-offs can result in the bank incurring losses, leading to a reduction in its capital adequacy ratio. But even if the bank continues to make a profit, poor asset quality can still pose problems, for three main reasons:

- If the problem is not dealt with by proper problem loan management, the loan write-offs are likely to remain large or even escalate;
- Problem loans in excess of the industry norm may indicate not only poor credit underwriting standards but in all likelihood poor management which may be a warning of incipient problems elsewhere; and

- Public and market knowledge of the bank's relatively poor performance on asset quality may affect confidence in the bank, leading to deposit withdrawal or increased cost of funding.

For asset quality problems, onsite examinations are usually the most useful way of evaluating the extent of the problem. The examination should focus on whether problem loans are being identified promptly; whether the bank has a dedicated problem loan management/recovery unit, and whether this is operating effectively; whether problem loans are being classified correctly; and whether adequate provisions are being set aside. While the maintenance of adequate provisions is, in the first instance, primarily a matter for the bank and its auditors, the supervisor has a major role to play in determining whether the provisioning policy is prudent and is being applied effectively. If provisions are not adequate, the bank's capital adequacy ratio will be overstated.

The supervisor is likely to be able to make use of (1) peer group comparison (e.g. experience from other onsite examinations) and (2) stress-testing to gauge the scale of the problem and the particular areas of concern. Supervisors are increasingly requiring banks to do stress-testing as a routine management practice.

The bank with asset quality problems should be expected to devise an appropriate remedial action plan. This may include:

- Negotiating new agreements with its viable but weak debtors (through loan maturity extension, interest rate reductions, partial debt forgiveness, debt to equity swaps, etc.);
- Taking possession of loan collateral or other assets of the debtor;
- Writing off long-term problem loans; and
- Selling assets or transferring assets to a special purpose debt management vehicle (although the supervisor should determine that such transactions are not designed only as a form of regulatory arbitrage).

In practice, however, whatever approaches the bank takes; there are certain principles that apply. First, the bank needs to try to arrive at a realistic assessment of its current

asset quality, and not be tempted to hide the problem by entering into “cosmetic” restructurings with insolvent debtors. Second, it needs to put resources into strengthening its problem loan management unit so that it can boost recoveries. Third, it needs to be prepared to “bite the bullet” on provisioning. Asset quality problems that drag on cast a shadow over the bank for many years. To be effective, provisions must be determined on the basis of the short-term realizable value for collateral, or a conservative present value estimate of the borrower’s likely repayments, not on longer-term, potentially optimistic, projections of future value. If the bank has the resources or can secure additional resources, for example, by capital injection, it is preferable to try to “clean up the balance sheet” as expeditiously as possible. This may, however, result in the bank taking a big hit to profitability and capital.

The supervisor will almost certainly expect the bank to set targets in terms of reduction of problem loans to a certain level by a particular time and will want to monitor the progress the bank is making by means of onsite visits or reports by the bank’s external or internal auditors. It should ensure that all restructured debt is classified as non-performing and is provisioned until the bank demonstrates that the debtor has regained its capacity to repay its loan in full.

Beyond dealing with the immediate problem, the supervisor should also ensure that the bank fully reviews its credit assessment, credit approval and credit monitoring processes. Weaknesses in these will almost certainly have played a large part in the general asset quality problem.

c) Management

Poor management is likely to be a problem in most weak banks. While it is not the supervisor’s role to select senior management for banks, supervisors have the responsibility to evaluate proposed directors and senior management as to expertise and integrity (fit and proper test) and to prevent or discourage appointments deemed detrimental to the interests of depositors. Supervisors should also evaluate directors and senior managers as part of the regular supervision of the bank.

Unless there is evidence of fraud or massive incompetence – for example, if the supervisor feels that an individual is just not up to the job, as indicated by the bank's performance - it may be difficult to request formally the removal of unsuitable persons. In such situations it may be more effective for the supervisor to discuss the future of the management with the Board of Directors or the major shareholders of the bank and to seek their commitment, voluntarily, to strengthen the management. The emphasis should be on bringing in strong individuals with the skills the bank needs, for example CEO, Financial Controller, a Head of Credit or "consultants" to boost the existing team. As a last resort, if the law permits, a supervisor may appoint an individual to run the affairs of the bank temporarily for the purpose of seeking solutions to the difficulties encountered. The appointment should be conducted in such a manner that does not give the impression that responsibility for bank management has shifted to the supervisor.

d) Earnings

Declining bank earnings may have different causes. These include:

- Unprofitable investments in new activities or in branches, subsidiaries or overseas operations;
- Insufficient diversification and unsustainable income streams;
- Unreliability of non-core income items;
- Poor cost control; and
- Increased competition in core activities, leading to net interest margin compression.

Deteriorating earnings will lead directly to reduced liquidity and weaker solvency, so these problems must be addressed. Banks must be required to reduce or restructure unprofitable activities (e.g. close branches) and to reduce costs (e.g. cut bonuses and salaries and/or the number of employees). If the problems are severe, a significant reorganization of the bank may be necessary. In parallel, relevant measures such as changes to the bank's strategic business directions and operating plans to turn around its earnings must be taken.

e) Liquidity

Liquidity can be a problem when a bank's holdings of cash and marketable assets provide little margin for comfort above the level necessary for business, and thus little scope for maneuver in times of stress.

It is possible that liquidity may be a problem in and of itself in the scenario where the bank expands its loan book more quickly than it can secure adequate, reliable funding. However liquidity problems are more often than not a symptom of other problems. A lack of confidence in the bank is, for example, demonstrated by customers withdrawing deposits and other banks cutting inter-bank lines. Problem banks typically become insolvent far before they become illiquid.

Supervisors have different requirements on how minimum levels of liquidity are expressed. If a bank's liquidity falls below the required minimum, this will normally trigger a series of actions by the supervisor, such as requiring the bank to indicate how, and how soon, it plans to restore its liquidity to an acceptable level.

If the bank is unable to restore its liquidity position, or the position shows signs of weakening further, prompt action is critical. To facilitate this, the supervisor should require the bank to prepare detailed cash flow projections, for example, for the next five working days. The five-day period will allow the bank at least to continue to the end of the business week and the supervisor can then decide whether the bank should reopen in the following week. Stress tests should be carried out on the basis of these projections, so as to give a better idea of how long the bank's liquidity can last if the situation worsens (i.e. if there is no let-up, or an acceleration, in the loss of liquidity). The bank's cash flow projections should take into account, among other things, premature withdrawals and offsetting of the bank's placements against the liabilities owed by the bank on a global basis.

There are a number of actions that the bank can take to improve the position. First, as regards withdrawals, it can issue statements to reassure the public and may wish to

speak to large depositors directly. This of course depends on the bank's underlying position being healthy. Second, as regards its liquidity stock, it can try to secure lines from friendly banks, or to sell or repurchase assets so as to boost liquidity. It can also seek liquidity support from its major shareholders.

The question of central bank liquidity support is also likely to arise. The central bank may be able to assist a solvent bank in acquiring liquidity, within its normal loan facilities, such as the discount window, on market terms and against acceptable collateral. This may be quicker than the bank going to the market and more discreet.
On a case by case basis, the central bank may consider the discretionary provision of emergency liquidity assistance in addition to its normal standing facilities, to illiquid but presumed solvent banks. Private sector mechanisms should usually have been exhausted before emergency liquidity assistance is considered, partly to reduce moral hazard and partly to minimize the risk of possible losses of public monies. Where possible, collateral should be required to reduce the risk of losses. Depending on the circumstances, the central bank may wish to restore confidence by issuing a statement clarifying the position and perhaps confirming that it stands ready to provide liquidity support in the current case and to any other illiquid but solvent bank.

f) Risk management processes

Risk management processes may be inadequate for the size and nature of the activities of the bank and its risk profile. It is important these processes address adequately all the risks that the bank is facing. The following paragraphs deal with two examples.
As financial intermediaries, banks cannot avoid market risk. Bank management is primarily responsible for monitoring and controlling market risk. It has a duty to establish prudent risk limits in relation to its financial strength and risk management capabilities. These limits must be carefully and routinely monitored by management and if the risk becomes excessive and threatens the financial condition of the bank, prompt action must be taken to correct this condition. If however, management is unable to reduce excessive market risk, supervisory action may be required. This may be directed

not only at excessive exposures but the weak risk management and lax controls that permitted excessive risk taking to develop.

2.1.7.7 Bank Supervision in Nepal

Pradhan[23] points out that supervision of banks and financial institution is one of the prime responsibilities of the supervisory authority. Effective supervision of these institutions is an essential component of a strong economic environment. The task of supervision is to ensure that banks operate in a safe and sound manner and that they hold capital and reserves sufficient to support the risks that arise in their business. Strong and effective banking supervision contributes in enhancing effective macroeconomic policy along with financial stability in any country. While the cost of banking supervision is high, the cost of poor supervision has proved to be even much higher.

Banks are supervised in order to achieve both long term financial stability and sector efficiency. This is done through the promotion of safe and efficient banking practices and institutions-to support sound private business development and meet individual bank customer needs. A weak regulatory framework and poor supervision provide grounds for inefficient and unsafe banking practices, which increase the risk of bank failure.

Preventing systemic risk, protecting small depositors and containing financial crimes are concrete steps in attaining these objectives. They require that the supervisors enforce fundamental discipline in the banking system with the support of well-crafted laws and regulations and the presence of strong in-house supervisory expertise. Like most banking supervisory authorities the world over, at the backdrop of the inspirations of the above mentioned supervisory motives, Nepal Rastra Bank (NRB) has adopted a two-prong approaches to monitor and supervise the financial health of the financial institutions under its purview through off-site surveillance and on-site inspections.

[23] Pradhan S.M. (2062) *NRB Golden Jubilee Publication*

However, NRB's main approach to supervising banking institutions is to concentrate on corporate governance, market discipline and management oversight

Nepal Rastra Bank Act 2001 ensures whether commercial banks are operating prudentially and complying with regulatory requirements. The ultimate objective of the supervision lies in the protection of the depositors' interest. Nepal Rastra Bank is heading towards successful implementation of Basel II in our country. For this we have already formed an accord implementation group for proper analysis and formulation of necessary directives. This will again enhance our strength in the course of supervision.
NRB Supervision mainly adheres to following eight key operating principals to guide its processes:-

a) Risk-Based Supervision:

Risk-Based supervision is a process by which the risks facing each supervised bank is analyzed and an appropriate supervisory strategy is developed. The supervisory strategy is customized to each bank, thereby avoiding the rigid supervisory processes. Risk-focused supervision relies heavily on internal risk management processes. Those banks with a demonstrated ability to identify, measure, monitor and control the risk of financial loss will receive a reduced level of regulatory scrutiny during offsite financial analysis and compliance review. Reduced regulatory scrutiny may include infrequent examinations and minimal or no transaction testing and reduced application information and processing time requirements.

b) Integrated Overall Supervision:

Integrated supervision is the coordinated implementation of one or combination of supervisory activities among all supervisory functions in order to make the best possible decisions.

c) Coordinated Supervision within the Department:

Bank Supervision Department has onsite and offsite divisions. On site inspection report is reviewed during annual offsite review and the offsite review is taken as supplementary to the onsite supervision.

d) Service and Outreach:

Bank Supervision Department is committed to providing the best quality service possible. One means by which we will pursue this goal is by making resources available to the banking industry as many ways as possible: through participation in industry gatherings and presentations offered to industry representatives, and by making division staff available on a consulting basis. We recognize customer service as a key in our ultimate goal of excellence in supervision.

e) Open and Honest Communications:

Bank Supervision Department believes that open and honest communication is an important part of the supervisory process. As a part of these communication means' we are committed to providing banking industry with the best professional guidance and assistance possible. Informal contacts with commercial banks and industry associations are encouraged as a means by which to respond promptly to issues and development.

f) Reduced Regulatory Burden:

Bank Supervision Department believes that the public interest in a stable and efficient financial system is best served by minimizing the regulatory burden that is placed on the industry. The degree and regulatory burden is based on the financial soundness of each individual bank.

g) Use and Understanding of Technology:

Bank Supervision Department recognizes the value of technology as applied in the supervisory framework. Among other applications, management and staff are committed to employing technology to monitor the condition and operation of supervised commercial banks to the greatest possible extent.

h) Professional and Technical Competence:

Bank Supervision Department actively encourages the development of professionalism and technical competence among its staff. The combined effect of personal contact with banks between examination and the quarterly review and analysis of CAMELS results will undoubtedly improve our staff's ability to assess and supervise the condition of any

particular bank. It is also our goal for the quarterly financial analysis to foster a closer and more personal working relationship with each bank.

Banking supervision should foster an efficient and competitive banking system that is responsive to the public need for good quality financial services at the reasonable cost. It should be recognized that there is a trade-off between the level of protection that supervision provides and the cost of financial intermediation. But however, supervision cannot and should not provide an assurance that the banks will not fail. In a market economy, bank failures are a part of risk taking. Such matters cannot be the responsibility of the supervisors. But however, they should have in place adequate arrangements for resolving problem bank situation.

For strengthening effective supervision certain infrastructure elements are of paramount significance. Where such elements do not exist, supervisors should seek to persuade their government to put them in place. It is very essential that the licensing process establishes the same high standards as the process of on going supervision which is very much lacking in the context of NRB supervision.

Similarly, there is some lacking in the foundation necessary to achieve a sound supervisory system in our context. The existing supervisory systems have not been able to take into account the nature of and risks involved in the local banking market. The system do not consider the extent it needs to supplement international standard with additional requirements to address particular risks and general conditions prevailing in its own market. Furthermore, the dynamic functions of banking supervision in our context have not been able to match up with changes in the market place. Hence, it has been essential for strengthening NRB supervision that supervisors must be prepared to reassess periodically their supervisory policies and practices in the light of new trends or developments. There are certain preconditions necessary for effective banking supervision.

Those prerequisites include:

i) Sound and sustainable macro-economic policies.

ii) A well-established and developed public infrastructure.

iii) Effective market discipline.

iv) Procedures for effective and efficient resolution of banking problems.

v) Appropriate level of systemic protection.

Hence in order to strengthen the supervisory capability of the Bank and to ensure the financial stability and to ensure healthy financial sector development in Nepal, a stronger and more effective central bank is essential. Proper banking supervision is particularly important to ensure prudent banking practices to help develop healthy financial intermediation which can support the growth of the economy. For this purpose, it is very pertinent that we have a glimpse at the core principles of effective supervision. They are stated in 7 different groups hereunder.

2.1.8 Directives of Nepal Rastra Bank

Nepal Rastra Bank being the central bank of Nepal issues directives to various financial institutions including commercial banks. Recently, Nepal Rastra Bank has categorized all the financial institutions of the country as Class A,B,C or D depending upon the required capital and the kind of operations institutions perform. Commercial banks fall under Class 'A' financial institution.

With the changing nature of the financial scenario of the country as well as globally, Nepal Rastra Bank modifies the issued directives so that it is in accordance to the prevailing standard practice internationally. The donor agencies such as World Bank and International Monetary Fund also enforce certain modifications in the directives.
The stringent regulations set by Nepal Rastra Bank are regularly and strictly monitored by the Central Bank thereby maintaining a healthy financial picture of the country as well as safeguard the deposits of the general public.

Bajracharya (2001)[24] points out that Nepal Rastra Bank issues directives that broadly covers four important areas viz.
Foreign Exchange

[24] Bajracharya R. (2001) *NRB Directives Manual*

Directives relating to banking regulations and prudential norms

Credit Information Bureau

List of formats and tables

Out of these four broad categories the one that interests most is the directives relating to banking and regulations and prudential norms. Nepal Rastra Bank issues 10 directives under this category. This research focuses mainly in the first three directives of this category. The directives are as follows.

2.1.8.1 Directive No. 1: Capital Adequacy Norms

Maintenance of Minimum Capital Fund

Commercial banks or Class ‘A’ Financial Institutions need to maintain the prescribed proportion of minimum capital fund on the basis of the risk weighted assets. As per the directives issued by the Central Bank, the banks need to follow the time table:

Table No. 2

Capital Adequacy Ratio over the period of last 5 years.

Fiscal Year	Core Capital	Capital Fund
2060/061	4.5% of TRWA	9% of TRWA
2061/062	5% of TRWA	10% of TRWA
2062/063	5.5% of TRWA	11% of TRWA
2063/064	5.5% of TRWA	11% of TRWA
2064/065	6% of TRWA	12% of TRWA

TRWA: Total Risk Weighted Assets

Capital of Commercial Banks

For the purpose of Capital Fund, the capital of the bank is divided into two components; Core Capital and Supplementary Capital.

Core Capital of commercial banks includes:

- Paid Up Capital
- Share Premium
- Non-redeemable preference shares
- General Reserve Fund

- Accumulated Profit and Loss Account
- The amount of goodwill shall be deducted from the amount of core capital, if amount of goodwill exists at all.

Supplementary Capital:

Supplementary Capital of commercial banks includes:

- General Loan Loss Provision:

Previously, the total amount of loan loss provision made for all the six categories of loan used to be included in the supplementary capital but now with the new directives, the amount of general loan loss provision shall be included in the supplementary capital as per the following time table:

Table No. 3

Loan Provisions over the period of last 3 years.

Time Period (Fiscal Year)	Provision available for inclusion in the supplementary capital
2060/061	Pass, Sub-Standard, Doubtful
2061/062	Pass and Sub-Standard
2062/063	Pass*

(Source: Bajracharya 2001)

*Up-to 1.25 percent of Total Risk Weighted Assets

- Exchange Equalization Reserve
- Assets Reevaluation Reserve

The asset reevaluation reserve can be included in the supplementary capital but is limited only up to 2 percent of the total supplementary capital including this reserve amount.

- Hybrid Capital Instruments

  This includes the following instruments that have the characteristics of both debt and equity.

  1. Unsecured, fully paid up instruments issued by the bank which are subordinated to (priority of payment after) depositors and creditors, and available to absorb losses as well as convertible into ordinary capital.

2. Instruments which are non-redeemable at the option of the holder except with the approval of Nepal Rastra Bank.
3. Perpetual or long-term preference stock (shares) convertible into common stock if the profit and loss account becomes negative.

- Unsecured Subordinated Term Debt

Unsecured and subordinated debt instruments (priority of payment after the depositors) issued by bank with a minimum maturity term of over five years and limited life redeemable preference shares. To reflect the diminishing value of these instruments, a discount (amortization) factor of 20 percent during the last five years shall be applied.

The issue of these instruments by banks shall not exceed 50 percent of their core capital.

- Other Free Reserves not allocated for a specific purpose.

2.1.8.2 Directive No. 2: Loan Classification and Provisioning Norms

Clause 1:

Classification of outstanding loans and advances on the basis of aging:

The loans and advances of a commercial bank shall be classified on the basis of aging of the principal amount.

Clause 2:

Classification of Loans and Advances:

As per the directives issued by NRB, all loans and advances of the banks need to be classified into the following four categories:

- Pass Loan
- Sub-Standard Loan
- Doubtful Loan
- Bad Loan

The loan falling under the Pass category are said to be the performing loan and the loan falling under the other three categories is said to be a non-performing loan.

Loans and advances are required to be classified as per the following time-table in four phases.

Table No. 4

Loan Classification over the period of last 3 years.

Classification	2060/061	2061/062	2062/063	2063/064onwards
Pass	Loans not past due and past due upto 3 months	Loans not past due and past due upto 3 months	Loans not past due and past due upto 3 months	Loans not past due and past due upto 3 months
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 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
Doubtful	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 1 year to 3 years	Loans and advances past due for a period of over 9 months to 2 years	Loans and advances past due for a period of over 6 months to 1 year
Loss	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 3 years	Loans and advances past due for a period of over 2 years	Loans and advances past due for a period of over 1 year

Additional arrangement in respect of Pass Loan

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

Additional arrangement in respect of Loss Loan

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

- No security at all or security that is not in accordance with the borrower's agreement with the bank
- The borrower has been declared bankrupt
- The borrower is absconding or cannot be found
- Purchased or discounted bills are not realized within 90 days from the due date
- Owing to non-recovery, initiation as to auctioning or the collateral has passed six months and if the recovery process is under litigation
- Loans provided to the borrowers included in the blacklist and where the Credit Information Bureau blacklists the borrower

Additional arrangement in respect of Loss Loan

The classification shall be made against the entire outstanding loan on the basis of the past due period of overdue installment.

Relating to Collateral:

The collateral used by the bank to back up the loans and advances need to be adequate enough to cover up the principal and interest amount in the event of non-realization of the principal and the interest amount.

Loan Loss Provisioning:

The loan loss provisioning, on the basis of the outstanding loans and advances and bills purchases is classified as follows:

Table No. 5

Loan Classification & Provision

Classification of Loan	Loan Loss Provision	
Pass	1 Percent	General Loan Loss Provision
Sub Standard	25 Percent	Specific Loan Loss Provision
Doubtful	50 Percent	
Loss	100 Percent	

Provisioning against Personal Guarantee loan:

In case of Loans against Personal Guarantee, a statement of the assets, equivalent to the amount of the personal guarantee, not claimable by others has to be obtained. The provision for such loans has to be made as per the categorization shown above but in case of Pass, Sub-standard and Doubtful loans, in addition to the normal provision made on the basis of aging, another 20% extra provision should also be provided. Therefore, for loans against personal guarantee, the provision amount will be 21%, 45% and 70% for Pass, Sub-standard and Doubtful loans respectively.

Provisioning against Priority Sector Credit:

Priority Sector Credit/Deprived Sector Credit is normally insured with the Deposit Insurance and Credit Guarantee Corporation. In case certain loans under the priority sector credit/deprived sector credit are not insured, the loan amount will have to be provisioned at 25% of the provision percentage mentioned above for different categories.

The required provisioning for insured priority sector credit/deprived sector credit is as follows:

- Pass 0.25%
- Sub-standard 5%
- Doubtful 12.5%
- Loss 25%

2.1.7.3Directive No. 3: Single Obligor Limit

Single obligor limit is the single borrower/group of borrowers limit. In order to reduce the concentration risks of the banks, NRB has fixed the maximum percentage of loans and advances that can be provided by a bank to a single borrower or a single group of borrowers. For this purpose, NRB has classified loans into two types; the Fund-based loan (e.g. overdraft, term loan, trust receipt etc) and Non-Fund based loan (LC, guarantees, commitments). Both the loans are treated differently when it comes to the fixation of a Single Obligor Limit.

Table No. 6

Single Obligor Limit

Loans and Advances	Percentage (By 2059 end)	Percentage (By 2060 end)
Fund Based	40% of the total Core Capital	25% of the total Core Capital
Non Fund Based	75% of the total Core Capital	50% of the total Core Capital

Exemptions in limit of credit and facilities:

The credit limits mentioned above are not applicable in the following cases:

- Credits and facilities extended against FDRs, deposits placed with the bank, HMG securities, NRB Bonds as well as against unconditional guarantees issued by the World Bank, Asian Development Bank and International Finance Corporation including multilateral institutions and loans and advances and facilities extended against unconditional guarantees issued by internationally rated banks having rating of atleast A+ by reputed Rating Agency or Banks specified as first class banks by NRB from time to time.
- Advances and facilities to be used for the purpose of importing specified merchandise by the following public corporation:

Table No. 7

Exemption in Single Obligor Limit

Name of the Corporation	Merchandise
Nepal Oil Corporation	Petrol, Diesel, Kerosene and LP Gas
Agricultural Input Corporation	Fertilizer, seeds
Nepal Food Corporation	Cereal

Group of Related Borrowers

As per NRB, the borrowers fall under a single group in the following circumstances:

- Where a company holds 25% or more shares in another company, then both or such companies or,
- Director of a company, shareholder of a private company and husband, wife, son, daughter-in-law, daughter, son-in-law, adopted son, adopted daughter, father, mother, brothers, and brother's wife, sisters of such director or shareholders residing jointly in the same house or separately as well as all other persons who are supported by such related persons. In addition, other companies in which such persons individually or by their relatives as above, separately or jointly, hold 25% or more shares, and such companies. Sister of wife and brother of wife have been excluded from the definition of a single group in the revised directives.
- Firm, company stated to be associated as a group, or members of such group, or
- Even if the director, shareholder or other relatives as specified above, holds, jointly or individually, less than 25% shares of another company, but the management of that other company is controlled by the following ways, then such companies:
  - By being Chairperson of the Board of Directors,
  - By being the Chief executive of the Company,
  - By appointing more than 25% of the directors.
- Where one borrower or company gives a gross guarantee to another borrower or company, then such companies.

The banks shall prepare records of the single borrower and related customers on half yearly basis and submit to NRB.

Separate Group:

Any organized institution or company owned fully or more than 50% by HMG shall be treated as a separate group.

Note:

In case a bank provides loan in excess of the single obligor limit to the borrowers or the group of related borrowers, then such excess amount should either be reduced to the required level or an additional capital charge is to be provided by the bank for the

excess amount within six months. In order to provide an extra capital charge, the bank is required to increase its core capital in accordance to the formulae provided by NRB.

2.2 Articles Review

"Recent financial crisis have revealed a number of data deficiencies, notably in pledged assets deposits held in financially week domestic banks & their foreign affiliates, valuation practices leading to bank valuation of assets being significantly difference from market value and complicating assessment of the realizable value of reserve assets. Similarly, public information is lacking in many countries on the off-balance sheet activities of the authorities that can affect foreign currency resources. There was lack of information on the authorities financial derivatives activities. Also observed was the inadequate information of actual and potential foreign liabilities of the monetary authorities & central government. FSR envisages for measures for mitigating this information and data gap problem as well. Nepal initiated FSR back in 1980s with donor initiative & assistance. In this process, some progress was made in terms of re-capitalization of the government banks, divestment, branch consolidation, introduction of new regulatory & prudential norms and cleaning up the B/S of bad loan locked bank. But the reform process was started in the later 1990s due to political instability and government's priority in areas other than financial system. In between, the country observed from very close by, the financial crisis in the neighboring religion. Keeping in mind the financial crisis and its effects in the Asian region, the NRB is now focusing its attention on the reform measures in the financial sectors as a drive towards new financial architecture."[25]

2.2.1 New Licensing Policy for Commercial Banks

Until the mid-1980s, Nepal financial sector was dominated by two large government-owned CBs (RBB and NBL), and competition in the financial system was enhanced only after the entry of three joint-venture banks (Nepal -Arab Bank Ltd., Nepal -

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[25] Khatiwada, Y.R. (April 30 2003 & May 7, 2003) *Banking Sector Reform in Nepal I & II: Implication for Corporate Governance* The Telegraph Weekly.

Indosuez Bank Ltd., and Nepal -Grindlays Bank Ltd.). As of mid-Jan 2009, 25 CBs existed in the country.

While forming its licensing policy, the NRB has given emphasis or policy issues rather than administrative control measures and has granted operating licenses to CBs that fulfill its policy criteria. A study undertaken in 1995 A.D. by the NRB, for instance, suggested that, there was growing concentration of CBs inside the Ktm. Valley, incentives in the form of lower paid-up capital should be provided to those banks that set up their head offices outside the Ktm. Valley. The NRB has been emphasizing on such types of policy -oriented issues in the licensing of CBs with the primary objective of promoting efficient intermediation by financial institutions through increased competition. In this regard, a new licensing policy for opening CBs was made effective from 18 May 2002. The main features of the policy are given below.

2.2.2 Paid – Up Capital

1. New CBs set up at the national level are required to have a minimum paid up capital of Rs. 2.0 billion.
2. Permission would be granted to set up a national level commercial bank with the head office in Ktm. Valley provided that it is a joint venture with foreign bank or foreign financial institution or it had a technical service agreement (TSA) with such a bank or financial institution for at least three years.

Generally, the promoters of the CBs could possess 70 percent of the total share capital and 30 percent is required to be sold to the several public. Foreign banks could invest a maximum of 67% of the total share of the CB of the national level. Also, if the foreign bank agreed to acquire at least 20 percent of the total share capital should required to be sold to the general public. This required to be sold to Nepalese promoters to invest at an optimum level.

3. The banks under operation and the banks already possessing operating licenses were required to extend their paid up capital to Rs. 2.0 billion by mid-July 2009. The paid-up capital should be increased by 10% every year up to FY 2008/09. The banks

to set up with participation of the foreign banks would be registered by fulfilling the legal formalities as per the Nepalese law.

4. The banks established outside the Ktm.Valley would be permitted to operate in the Ktm. Valley and all over the Kingdom provided that they performed satisfactory for at least three years, subsequently extended its paid-up capital to Rs.2 billion, and complied with all the other prescribed terms and conditions. These banks will not be permitted to open any types of office in the Ktm. Valley unless they are allowed to function there.
5. A minimum of 20% of the total share capital committed by the promoters need to be deposited with the application and another 30% after receiving the letter of intent at the interest-free account of the NRB. The bank should start operations within a year of receiving the letter of intent. The remaining amount agreed upon by the promoters would be paid within four months of the date of application whether to grant permission to set up the bank or not. If the decision is taken not to the establishment of bank, the NRB would present a written clarification to the applicant specifying the reasons.

2.3 Review of Related Studies

This segment primarily tries to find out major conclusions and recommendations of the previous studies by TU students which are related to the research undertaken by the author. There are many studies related to the central bank. But some studies have been conducted regarding the role of NRB as a supervisor of the overall financial sector of Nepal. An attempt has been made to provide a comparative perspective for evaluating and interpreting the significance of one's finding.

Ram Prasad Adhikari in his articles, Development of Banking and Financial Sector in past 25 Yrs, states that during the 90's the trend of CBs' branches expansion seems low than past due to the liberal policy followed by government and also NRB.[26] Thus, it is necessary to change the present policy of NRB for rapid branch expansion of CBs.

[26] Nepal Rastra Bank Samachar (2051) Kathmandu.

Uttam Bajra Bajracharaya has observed that NRB should encourage the CBs to extend long term credit in addition to the short and medium term credit so that the amount of credit will increase on one hand and large industries will established on the other. If the CBs find their resources inefficient for invest, raising interest rate on deposits should collect more deposit.[27] However, in the present change context the CBs have invested for fairy long term. Due to the liberal economic policy followed by NRB, interest rate are fixed by market mechanism. There is also high liquidity in the market and banks also have increased their NPA in their BS year by year.

Man Maya Shrestha has observed that the CBs are still following their traditional lending policies. They extended the loans on the basis of securities. But the people in our country are unable to provide sufficient securities. Therefore, the NRB should change the traditional lending policies.[28] At the present, CBs are offering a variety of credit model or schemes to the rural poor people viz. Small farmer Development Program, Intensive Banking Program. Banking with Poor, Grameen Bank Financial System, Deprived Sector Credit etc. through group securities. This proves NRB has already made an effort to avail credit the people without precious securities. In this context the program of getting loan due to lack of securities seems the secondary problem. While the lack of education and a proper banking habit among the people is the most important one. This is how the studies of the past are not so relevant in this changed context. This present study is carried out to fill the gap arisen out of changed with updated information.

Promod Shrestha in his articles "The Role of NRB in Reference to the CBs", has clearly viewed that all the CBs branches and financial institutions are established only in urban areas from where the huge population living in rural areas cannot get any banking facilities on one side and on the other the higher number of institutions established in urban areas are facing caught throat competition which may lead to the question of their

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[27] Bajaracharaya U.B. *The Performance of NRB on Resource Mobilization and Branch Expansion of Commercial Bank in Nepal, unpublished thesis submitted to TU, 1989.*

[28] Shrestha , M.M. *Role of Central Bank in Economic Development of Nepal, Unpublished Thesis, Submitted toTU. 1975.*

existence. He has viewed that CBs should establish branches as per need of the nation. He has emphasized that appropriate policy to establish branches in the rural areas should be followed. CBs and the financial institutions carrying similar functions should not be allowed to establish in close vicinity.[29] To encourage the banks to establish branches in rural areas, NRB should extend certain incentives to them.

Above studies were conducted in an atmosphere of controlled regime. Presently, CBs enjoy much freedom in their operation. The findings of above studies may indicate certain aspect of the expansion of branch of CBs, but are not relevant to our study. Prior to 1990, certain policies of NRB on banking development scheme, interest subsidy, interest free loan, and loss compensation policy were in existence. They were in specific boundaries before the liberalization, which could not be incorporated, in the foregoing studies. The present study focuses on the policies of NRB in commercial banking development after liberalization. Thus, the present study is more relevant than the above studies & following two studies are also more related in the present context.

Kamal Prakash Kalathoki in his dissertation has concluded that NRB's role in the banking development in the country has not been effective. His major suggestions are:

i. To increase more bank deposit; Deposit Insurance Scheme, Workers' Saving Scheme will be beneficial. The insurance Scheme will prove safe for depositor. Again for unbanked areas the management of weekly or monthly moving bank will also be helpful for deposit collection & increasing the banking habit of the people in rural areas.
ii. NRB should persuade the banks to maintain the spread gap of 5% & it should also reintroduce the loss compensation scheme and interest free loan to the newly established CBs especially in remote area at least for certain year. It should be able to manage various training programs as per the requirement of the CBs to make their staff able to satisfy their customer and increase their efficiency.

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29 Mirmire, Bankers Club, NRB, Kathmandu, Baishakh 2052 PP. 195-197.

He suggested further, there should be regular meeting & communication with the banks to sort out the problems and to make programs successful.[30] He suggested for deposit collection but now, the main problem is, there is not good investment opportunity in the market.

Santos Pandey recommended in his dissertation[31] that even the concerned authority of NRB urged the CBs were implementing the directives. He had observed that NRB undertakes both on-site and off-site supervisions to ensure that the directives are properly and fully followed. The monitoring aspect has been strengthened by various types of penalties laid down by NRB for the non-compliance of the directives. He further recommended to NRB are:

i. The new directives of NRB are very good and meet the international standards. They will become irrelevant if they are not implemented properly. His study has been observed that the CBs have been raising questions on the timing of the directives and NRB believes that they are making excuses out of this. In this context, his study strongly recommended to NRB to hold meeting with the CBs and listen to their complaints. If the complaints are relevant and acceptable, the directives have to be amended so that they become implementable or else, convince the CBs that such complaints have no meaning and that NRB is right.

ii. Also, NRB should not only issues directives for the sake of issuing them but a proper homework needs to be done to combat the problems associated with the directives. It should not happen like the directives related to L/C, where prior study was not done and within a few days of the issuance of the directives, they had to be amended.

iii. NRB has to strengthen the functioning of its CIB so that the CBs receive the details of the blacklisted borrowers in quick time. This will reduce changes of creating bad quality assets on their BS.

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[30] Kalathoki, K.P. *A Study on Nepal Rastra Bank's Role for the banking development in Nepal" an unpublished thesis submitted to T.U. 2000.*

[31] Pandey, S. (2002) *A study on NRB directives Implementation and Impact on commercial Bank, A case study of Himalayan Bank Limited.*

iv. NRB should be more practicable while issuing the directives. The directives should not be issued to meet the international standards only but also, they need to be applicable in the context of Nepal & it should try and avoid ambiguity in the directives, which are found there in the present directives. It should come up with the straightforward directives leaving no loopholes that can be manipulated.

The review of Supervision Handbook[32] stresses that there is a need to be clear on the need for supervision of the banks. Financial arena needs to know the key elements that need to be supervised and the role of central bank in doing so effectively. Banks are generally associated with different types of risks and they have to be aware of such risks for many reasons including the supervisory requirement of the Central Bank. The Central Bank as well as the commercial banks also needs to know the globally practiced process of Supervision framework. The Bank of England, the first central bank of the world through the Centre for Central Banking Studies publishes handbooks from time to time aiming at different sectors of the economy. Amongst those handbooks, this is one which is mainly aims at the central bankers.

In the handbook, Ware (1996) explores some basic principles of banking supervision. First of all, it addresses the general question of why banks need to be supervised, and sets out the basic aims of supervision. One has to see if NRB has the same aims when it comes to supervising the commercial banks. The book then examines the nature of banking risks. Next, the key areas of prudential supervision are discussed – namely, capital adequacy, liquidity, asset quality, risk concentration, management and systems and controls. The need for an effective infrastructure for supervision, not least in respect of the legal and accounting environment, is noted. From this, one can see if our nation has the same kind of infrastructure. And the relative contributions of off-site and on-site supervision are briefly discussed. The book seeks to introduce the nature and concepts of supervision to those for whom the subject may be comparatively unfamiliar, and hence, it would be helpful for this research study.

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[32] Ware D. (1996) *Basic Principles of Supervision.*

Banks and their activities are generally subject to much closer official supervision than other kinds of businesses; the reason lies in their role and nature. The discussion on the roles and nature of banks shall justify the much closer and in depth supervision of the banks.

2.4 Website Review

Mahat[33] says, "Information provided by banks to the central bank play vital role for the purpose of evaluation and analyzing the economic, monetary and financial activities of the nation. Directives issued by the Nepal Rastra Bank (NRB) from time to time require the banks to submit various statistical returns to NRB at various time intervals".

According to him, Banks raise resources mainly by accepting deposits from public. The depositors, especially retail depositors, cannot effectively protect themselves, as they cannot collect much information on the operations of the bank. Even if they collect the information, most of them cannot analyze and interpret it properly. It will also be impossible for the depositors of a bank to coordinate with each other in order to protect their interest. Business conducted by banks usually looks obscure to the outsiders. It is widely believed that instability of one bank would have contagion effect in the economy of a nation. Therefore, inspection and supervision department of NRB has high degree of oversight in the banking sector. In this connection, this department may ask the banks to provide some data, document, records or particulars.

Norms regarding submission of information by the banks and financial institutions to NRB are meant for ensuring good corporate governance, transparency, protection of the interest of depositors, and analysing the economic, monetary and financial activities of the nation. Although it is the duty of banks to submit statistical returns and other information demanded by NRB on time, NRB was experiencing difficulty in timely collection of such information and returns. To ensure the compliance of norms, the regulators should have a legal mechanism to ensure compliance of its regulations. They should also have recourse available if their regulations are not followed or violated. In this context, Banks and financial Institutions Ordinance, 2004 has introduced the

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[33] Mahat L.D. http://www.kantipuronline.com/kolnews.php?&nid=9783

imposition of severe penalties to the errant banks and their office-bearers. This provision is expected to improve the information efficiency of banks and financial institutions.

Section 74 (1) of the ordinance provides for penalty to the banks and financial institutions violating the provisions of NRB Act, the ordinance, rules or by-rules framed under the ordinance, and the orders and directives issued by NRB. The penalty ranges from cautioning or warning the errant banks and financial institutions in writing to the suspension or cancellation of their license.

Section 74 (2) of the ordinance is more specific to the banks and financial institutions deficient in providing information, records and document ~ ~ to NRB within prescribed time frame. This section empowers NRB to impose severe cash penalty to the deficient institution at the rate of Rs 100,000 per day for the first week of default; Rs 125,000 per day for the second week of default; and Rs 150,000 per day thereafter. If a bank or financial institution defaults in submission of information or document ~ ~ by 30 days, it may be imposed penalty of Rs 3,975,000.

While heavy penalty as explained above may improve the efficiency of banks and financial institutions, uniform amount of penalty to all banks and financial institutions irrespective of their size may not be justifiable. For example, share capital of a financial institution may range from Rs 10 million to Rs 1,000 million. If a financial institution with capital base of Rs 10 million delays in submission of information by 75 days, it may have negative capital after imposition of penalty by NRB.

Section 74 (4) of the ordinance provides for penalty to the office-bearer of banks and financial institutions violating the provisions of NRB Act, the ordinance, rules or by-rules framed under the ordinance, and the orders or directives issued by NRB or making delay in submitting the document, data, particulars or records to the NRB and its officers. Such a person can be penalised by issuing a letter of caution or warning; issuing suspension order; imposing cash penalty up to Rs 500,000; stop payment of all

facilities due to him/her including salary and allowances; and removing him/her from the office.

The technique of improving information efficiency of banks and financial institutions can be applied in the capital market as well. It is widely believed that there is a deficiency in the flow of information in our capital market. Information deficiency in the capital market is one of the reasons for determination of share price by excessive speculation. Prevailing securities law requires the listed companies to submit various financial and non-financial information within a prescribed time frame. The regulating authorities are experiencing default and delay in submission of such information by a large number of listed companies. They may learn lesson from the Banks and financial Institutions Ordinance, 2004 and introduce the regulation for imposing serious penal action to the management of the errant companies. This may lead to increased tendency of the listed companies complying with legal provisions and persuade the management for the flow of timely information in the capital market.

CHAPTER THREE

3. RESEARCH METHODOLOGY

3.1 Introduction

Research is common parlance that refers to a search for knowledge. As per the Webster International Dictionary, research is "a careful critical inquiry or examination in seeking facts and principles; diligent investigation in order to ascertain something"[34]

According to Kothari, "Research Methodology is a way to systematically solve the research problem". It is understood as a science of studying how the research is done scientifically. In it we study the various steps that are generally adopted by a researcher, studying the research problem among with the logic behind them.

This chapter looks into the research design, nature and source of data, data collection procedure and tools and technique of analysis. A research methodology helps us to find out accuracy, validity and suitability.

This study is basically concerned with examining the supervisory role of NRB and its impact on the Commercial Banks. So, the purpose of this chapter is to outline the method followed in the process of analyzing them.

3.2 Research Design

"A Research design is the arrangement of continuous collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure"[35]

As aforesaid, the main objective of this dissertation is to study the roll of NRB for the commercial banking development in Nepal. It is important to discuss jointly about NRB and its commercial banking policies. For this purpose descriptive as well as analytical

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[34] Saravanavel P. (1990) *Research Methodology* Allahabad: Kitab Mahal
[35] C R , Kothari, (1992) *Quantitative Technique* New Delhi:Vikas Publishing House

research design has been followed. Data collected for the purpose of the study have been systematically analyzed. The selection of this type of research design has become necessary keeping in view the quantity and quality of information that are available.

3.3 Source of Data

This study is primarily based on the secondary source of data. So, the necessary data for the study are collected mainly from the concerned institutions. The study is concerned with the supervisory role of NRB. For this purpose, commercial banking statistics, annual reports, quarterly economic bulletins published by the NRB time to time, the commercial banking bulletins published by the selected CBs. Other secondary source of information compiled from the Bank & Financial Institution regulation Department, previous studies and reports, Journals and other published & unpublished related documents as well as reports for central library of TU, Nepal Commerce Campus Library, NRB Library are the basic data source. A separate bibliography presented at the end would give a full idea of the sources consulted for this study.

3.3.1 Data Collection

The study uses two major sources of data. They are as follows:

Primary Data

Secondary Data

"The primary data are those data which are collected for the first time and thus characterized by its originality. The secondary data, on the other hand are those, which have already been collected by someone else for some other purpose and have already been passed through the statistical process"[36] .

The study is based on both primary and secondary data. Primary data is collected through the following ways:

- Questionnaires prepared by the researcher
- Visits to the site of data

[36] C.R Kothari, *Research Methodology: Methods & Technique* New Delhi:Wiley Eastern.

- Schedules
- Personal interviews with the concerned authorities who are the major source of data.

Books on central banking publication of the NRB and many others related materials had been studied. The collected data are arranged systematically in the in the particular tabular form according to the need of the study.

Likewise, for the purpose of the study, data is also taken in an unstructured manner, discussion among the personnel's of NRB, commercial banks and related financial institutions. The purpose of such interviewing was to drive primary information regarding their attitude towards existing policy. The decision made from the informal meeting, discussions and seminar held with other national and international financial community is also included in the study.

The research also refers various other sources of secondary data. The major sources of secondary data are as follows:

- Supervision Department of Nepal Rastra Bank
- Regulation Department of Nepal Rastra Bank
- Directives of Nepal Rastra Bank
- Published Unaudited financial report of Laxmi Bank,
- Published Unaudited financial report of Nepal Investment Bank.
- Published Unaudited financial report of NCC Bank.
- Published and unpublished bulletins, reports of Nepal Rastra Bank
- Published studies, reports and articles of various authors
- Journals and other published and unpublished reports from Shanker Dev Campus Library and Nepal Rastra Bank Library
- Thesis, research of various past students of Tribhuwan University
- Website of Nepal Rastra Bank
- Website of Bank of International Settlements
- Various other websites and periodicals

3.3.2 Population and Sample

Out of total 25 Commercial banks, the study focuses only on three banks – Laxmi Bank, Nepal Investment Bank and Nepal Credit & Commerce Bank.

3.3.3 Methods of Data Analysis

The researcher mainly uses two types of tools in order to analyze the collected data. The tools are as follows:

- Financial Tools
- Mathematical Tools

For financial tools, the major source is the guideline laid down by the Central Bank is used. They are as follows:

- **Capital Adequacy Ratio**

  Commercial banks should hold adequate capital according to safeguard the money of the depositors. NRB has specifically given the minimum required capital adequacy ratios to be maintained by the commercial banks. These ratios are based on the total risk weighted assets.

  $$\text{Capital Adequacy} = \frac{\text{Core Capital + Supplementary Capital}}{\text{Total Risk Weighted Assets (TWRA)}}$$

- **Loan Classification and Provisioning**

  NRB in its guidelines have classified loans depending upon its aging. Each loan class needs to maintain certain percentage of provisioning given in the directive laid down by the Central Bank. Also, the main indicator of Credit position of a bank is given by NPL

  $$\text{Non performing loan to Total loan} = \frac{\text{Non Performing Loan}}{\text{Non Performing Loan + Good Loan}}$$

  It is to be noted that Non performing loan includes sub-standard, doubtful and bad loan.

- **Single Obligor Limit**

  The models and formulas laid down in the directives of Nepal Rastra Bank is used as guideline for calculating the Single Obligor Limit of the selected Commercial Bank.

Similarly, in order to provide a clearer picture of the study the researcher have used statistical tool as well. Data obtained through prepared questionnaire is used in order to perform the percentile analysis of the research.

CHAPTER FOUR

4. DATA PRESENTATION AND ANALYSIS

4.1 Directive No. 1: Capital Adequacy Ratio

A Capital of a bank is the sum total of all the contributions made by the shareholders and the promoters. Total Capital of a bank is the sum of Core Capital and Supplementary Capital.

The Central Bank has assigned risks to various types of assets depending upon its liquidity and risk. Higher weight is given to those assets with high risk and liquidity and vice versa. Along with the liquidity and weight, NRB also takes into consideration, various international standards to assign the weight.

Capital Adequacy Ratio is basically the ratio of total capital fund to the total risk weighted assets. The central bank has revised the capital adequacy requirement of the banks over recent years. The rate required for core capital adequacy ratio has increased from 4.5% in the year 2058 to 6% in the year 2063. Similarly the rate required for total capital adequacy ratio has increased from 9% in the year 2058 to 12% in the year 2063. It should be noted here that the shortfall of supplementary capital can be fulfilled by adding more core capital fund. But, shortfall of core capital cannot be compensated by adding more supplementary capital.

This ratio mainly deals with the asset side of the balance sheet of the commercial banks. In order to compute the Capital Adequacy Ratio, total risk adjusted weight needs to be computed first. For calculating the TRWA, both the on-balance sheet assets and off-balance assets need to be considered.

The details of the Capital Fund maintained over various periods of several Banks are as follows:

Table No. 8

Capital Adequacy Ratio of Laxmi Bank for the period 2061-2064

(in thousands)

LAXMI BANK	2061	2062	2063	2064
Core Capital	**270783**	**326254**	**556348**	**604343**
Paid-up Capital	275000	330000	549789	609839
Preference Share	0	0	0	0
Capital Adjustment Fund	0	0	0	0
Capital Reserve Fund	0	0	0	0
Share Premium	0	0	0	0
Debenture Redemption fund			0	0
Proposed bonus share				0
General Reserve	0	207	2297	7590
Dividend Equalization Reserve				
Profit/Loss Account	-4217	-3953	4262	25404
Excess Investment and SOL			0	
Goodwill				-36408
Investment in associates				-2082
Supplementary Capital	**1241**	**8322**	**18216**	**35095**
General Loan Loss Provision	1241	7759	17509	34358
Exchange Equalization Reserve	0	563	707	737
Asset Revaluation Reserve	0	0	0	
Hybrid Capital Instrument	0	0	0	
Subordinate Term Debt	0	0	0	
Other Free Reserve	0	0		
Total Capital	**272024**	**334576**	**574564**	**639438**
On Balance-sheet Assets	192669	845551	1873839	2998151
Off balance transaction	10634	22048	98556	87348
Total Risk Weighted Assets	**203303**	**867599**	**1972395**	**3085499**
Core Capital to TRWA (%)	**133.19**	**37.60**	**28.21**	**19.59**
Total Capital to TRWA (%)	**133.80**	**38.56**	**29.13**	**20.72**
Required Core Capital to TRWA (%)	**5**	**5.5**	**5.5**	**6**
Required Total Capital to TRWA(%)	**10**	**11**	**11**	**12**
Surplus / Deficiency Core Capital	**128.19**	**32.10**	**22.71**	**13.59**
Surplus / Deficiency Total Capital	**123.80**	**27.56**	**18.13**	**8.72**

(Source: Website of Laxmi Bank)

Since its establishment in the year 2059, Laxmi Bank has been successfully meeting the minimum necessary core capital adequacy ratio and total capital adequacy ratio. From the above data, during Laxmi bank has surplus capital than needed to oblige with the Central Bank directive. In the first year of its establishment, the bank seems to have enough fund and minimum investment (risk based). But in the second year, its total risk weighted asset increased from 203303 thousand to 867599 thousand. The more-than-four-fold increment in the risk weighted asset resulted in the decrement of ratios to almost one-forth. But still, the bank has enough capital bases. In the next few years also the bank seem to become more confident and as a result its TWRA is growing to a larger proportion than its growth in capital thereby further decreasing the capital adequacy ratio, yet the bank is complying with the NRB directives

Table No. 9

Capital Adequacy Ratio of Nepal Investment Bank for the period 2058-2062

(in thousands)

NEPAL INVESTMENT BANK	2060	2061	2062	2063	2064
Core Capital	**453657**	**506831**	**621931**	**710611**	**1161878**
Paid-up Capital	169985	169984	295293	295293	587738.5
Preference Share	0	0	0	0	
Capital Adjustment Fund	0	0	29529	59059	117832
Capital Reserve Fund					
Share Premium	0	0	0		
Debenture Redemption fund				42857	85714
Proposed bonus share					
General Reserve	233780	245205	268705	299239	345669
Dividend Equalization Reserve					
Profit/Loss Account	49892	91642	28404	14663	24924
Excess Investment and SOL				-500	

Goodwill					
Investment in associates					
Supplementary Capital	**125632**	**56758**	**76310**	**388768**	**417335**
General Loan Loss Provision	110196	40120	59698	70831	99040
Exchange Equalization Reserve	15404	16606	16580	17905	18264
Asset Revaluation Reserve	0	0	0	0	
Hybrid Capital Instrument	0	0	0	300000	
Subordinate Term Debt	0	0	0	0	300000
Other Free Reserve	32	32	32	32	31
Total Capital	**579289**	**563589**	**698241**	**1099379**	**1579213**
On Balance-sheet Assets	3172632	2901559.2	6703257.6	8589743	11584510
Off balance transaction	290958	373965	1190462.2	1246960	2048400
Total Risk Weighted Assets	**3463590**	**3275524**	**7893720**	**9836703**	**13632910**
Total Capital to TRWA	**13.10**	**15.47**	**7.88**	**7.22**	**8.52**
Core Capital to TRWA	**16.73**	**17.21**	**8.85**	**11.18**	**11.58**
Reqd. Core Capital Ratio	**4.5**	**5**	**5.5**	**5.5**	**6**
Reqd. Total Capital Ratio	**9**	**10**	**11**	**11**	**12**
Surplus / Deficiency Core Cap	**8.60**	**10.47**	**2.38**	**1.72**	**2.52**
Surplus / Deficiency Total Cap	**7.73**	**7.21**	**- 2.15**	**0.18**	**- 0.42**

(Source: Website of Nepal Investment Bank)

Similarly, in case of NIB, the bank has been successfully complying to the directives of NRB in most occasions except in one two rare cases.

In the year 2058, the bank had enough capital and comparatively less amount of capital was invested in areas with risk. This resulted in lesser TRWA which resulted in greater capital adequacy ratio. In the next year i.e. 2059 the bank further reduces its TRWA from 3463590 thousand to 3275524 thousand and Capital base from 579289 thousand to 563589 thousand hence resulted in even higher capital adequacy ratio.

In the year 2060, the bank suddenly invested a lot of its capital in areas with some risk. This activity of the bank increased its TRWA to more than double the previous amount. The bank also increased its capital base proportionately lesser in comparison to the TRWA. This resulted in reduction of its capital adequacy ratio. Even though the reduction did not cause shortfall in the core capital adequacy ratio, it resulted in shortfall in the total capital adequacy ratio forcing some punishment from the Central Bank.

In the next two years, the bank has been able to remain just above the required capital adequacy ratio of the Central Bank except in the year 2062 in which it demonstrated a 0.42% shortfall in its total capital adequacy ratio.

When a bank is just on the margin of obliging with the directive of NRB, it cannot further invest in areas with risk as this activity would increase its TRWA and thereby reduce the capital adequacy ratio. In such cases, the bank has to increase its capital base in order to make further investment.

Table No. 10

Capital Adequacy Ratio of NCC Bank for the period 2060-2064

(in thousands)

NCC BANK	2060	2061	2062	2063	2064
Core Capital	**249825**	**-150202**	**78824**	**185870**	**255847**
Paid-up Capital	350000	350000	490000	595000	693554
Preference Share	0	0	0		
Capital Adjustment Fund	0	0	0		
Capital Reserve Fund					
Share Premium	0	0	0		
Debenture Redemption fund					
Proposed bonus share					
General Reserve	13439	13439	13439	30481	30481
Dividend Equalization Reserve					
Profit/Loss Account	-113614	-513641	-424615	-439611	-468188
Excess Investment and SOL					
Goodwill					
Investment in associates					
Supplementary Capital	**207235**	**236223**	**190824**	**37360.5**	**148946**
General Loan Loss Provision	202859	228997	190824	35997	148946
Exchange Equalization Reserve	4376	7226	0	1363	
Asset Revaluation Reserve	0	0	0	0	
Hybrid Capital Instrument	0	0	0	0	
Subordinate Term Debt	0	0	0	0	
Other Free Reserve	0	0	0		
Total Capital	**457060**	**86021**	**269648**	**223230.5**	**404793**
On Balance-sheet Assets	3364485	3155075	3750677	6049768	6475417
Off balance transaction	666921	538766	393594	477740	868526
Total Risk Weighted Assets	**4031406**	**3693841**	**4144271**	**6527508**	**7343943**
Total Capital to TRWA	**6.20**	**-4.07**	**1.90**	**2.85**	**3.48**
Core Capital to TRWA	**11.34**	**2.33**	**6.51**	**3.42**	**5.51**
Reqd. Core Capital Ratio	**4.5**	**5**	**5.5**	**5.5**	**6**
Reqd. Total Capital Ratio	**9**	**10**	**11**	**11**	**12**
Surplus / Deficiency Core Cap	**1.70**	**- 9.07**	**- 3.60**	**- 2.65**	**- 2.52**
Surplus / Deficiency Total Cap	**2.34**	**- 7.67**	**- 4.49**	**- 7.58**	**- 6.49**

(Source: Website of NCC Bank)

The performance of NCC bank during the selected period does not seem attractive as it has most of the time fall shortfall in its obligation. Even though the bank has met its

obligation in the year 2058, it has since fall shortfall in both the required core capital adequacy ratio and total capital adequacy ratio. Even though the bank has been getting additional capital, its investment in areas of risk if proportionately higher than the increment received in capital. This actually resulted in shortfall in the capital adequacy ratio.

The data also shows that the bank has been incurring loss in the period of selected year. When analyzing the given table of capital adequacy ratio, Laxmi Bank and Nepal Investment Bank seem to comply with the NRB directive whereas NCC bank does not. NIB and LXBL both has surplus of capital fund in regard to the minimum core capital ratio and total capital ratio. But RBB and NBBL both have core capital and total capital fund which are less than the minimum needed as per the directive given by the Central Bank.

When a bank has adequate core capital and total capital a bank is considered to be stable and can easily meet its obligations in terms of the payment to be made to the depositors. When a bank does not have adequate capital or has capital adequacy ratio which is less than required, the bank can increase its ratio by either increasing its capital or decrease the risk weighted assets.

When a bank decides to increase the capital, it can increase its equity capital which increases the permanent capital of the bank. When a bank has excess capital and accumulated profit and general reserves it can become a burden in future. Bank can also issue new shares. This will increase the number of outstanding shares and would subsequently decrease the earning per share causing some loss to the shareholders.

When a bank does not meet the capital adequacy ratio, it cannot make further investments because investments increase TRWA. So, any extra deposits the bank attracts are either idle or invested in those areas which have zero risk. But the problem is that investing in areas which has zero risk nets less profits and may not even match the rates that have to be given to the depositors causing bank to incur loss.

Also, reducing TRWA is not easy. The bank has to withdraw its investments with risks such as loans, bonds, debentures and shares.

So, the easy way of increasing the capital fund is to increase the supplementary capital. Supplementary capital is a temporary source of capital. With the increase in capital, the bank can now make more investments there by adding further risk-weighted assets.

4.1.1 Remarks about Capital Adequacy Ratio

Capital of a bank is the total sum of the contributions made by all the shareholders of the bank. Total Capital of the bank is a sum total of Core Capital or first tier capital and Supplementary Capital or second tier capital

Capital Adequacy Ratio is the ratio of the total fund of the bank to the total risk weighted assets (TWRA) of the bank. The directive of the Central Bank generally requires a certain capital adequacy ratio with respect to the Total Risk Weighted Assets mainly to safeguard the hard-earned money of the depositors against any possible loss.

Banks are required to maintain capital adequacy in three ways; the core capital adequacy ratio, the supplementary capital ratio and the total capital adequacy ratio.

Capital adequacy ratio deals with the asset side of the balance sheet of the banks. For this purpose, the bank first calculates the TWRA by considering both the balance sheet assets as well as the off-balance sheet assets.

The central bank has assigned certain risk weigh to each asset category of the bank. The assignment of the risks to each asset is done on the basis of the liquidity and risk of the asset. Higher the liquidity and risk of the asset higher the risk weight is. The central bank follows certain international standard such as Basel Committee to assign a risk weight.

With the improvement of the directives according to the evolving financial picture of the country, Nepal Rastra Bank has been able to efficiently safeguard the money of the depositors.

It is to be noted that the shortfall in the Supplementary Capital can be compensated by the use of the excess amount of Core Capital. However, the shortfall of Core Capital cannot be compensated by the excess amount of Supplementary Capital.

When a bank has shortfall (as per the directive) of Capital fund with respect to TWRA, it can either decrease its TWRA or increase its capital.

If the bank decreases its TWRA, it has to draw its money from investing in financial instruments such as shares and debentures which has high risk factors and invest them in an area which has zero risk factor or keep it idle. Since investing in areas with high risk factor fetches high return to the bank and investing in areas with low risk factor fetches low return, this activity will eventually causes some loss to the bank.

Another possibility is to increase its capital. Capital can be increased by increasing just the core capital, increasing just the supplementary capital or to increase both.

Increasing Core Capital has some negative impacts. With the increase in equity capital, there will be an increase in the permanent capital, which can become a burden in future when the bank has more capital in accumulated profit and general reserves. Also, with the issuance of new shares, the earning per share (EPS) decrease as the number of shares outstanding would increase thereby causing subsequent loss to the shareholders.

So a good way of increasing the capital is to increase the Supplementary Capital provided that the Core Capital is beyond threshold. The Supplementary Capital is the temporary source of Capital and it can be increased by financial instruments such as debenture.

With excess capital funds, banks can afford to invest more in areas with risk factors thereby increasing TWRA.

With the changing directives, the total Capital fund as per the latest directive is 12% of the TWRA with the condition that at least 6% of the Capital fund need to come from the Core Capital.

4.1.2 Analysis of the Questionnaire

The questionnaire regarding the Capital Adequacy Ratio was given to the management of different commercial banks. There were total of 15 respondents. The response from each personnel is tabulated as shown in Appendix and the necessary percentile analysis is done for the obtained result.

The following result is derived from the questionnaire percentile analysis.

1. Is the directive necessary?

   In response to this question, all the respondents felt that it is necessary to have this directive.

2. What role does Capital Adequacy play?

   According to the respondents, 100% felt that it safeguards depositors' money, 20% felt that it increases the borrowing capacity of the bank while 60% felt that it protects bank from bankruptcy.

3. How did bank adjust the change in the directive issued by NRB? (capital adequacy ratio has been increased from 8%, 9%, 10% to 12% recently)

   100% of the respondents said that the bank increased Core Capital while 20% said that the bank increased both Capitals.

4. Are you satisfied with the 12% Capital Adequacy Ratio set by NRB?

   According to the respondents, 80% felt that it should be decreased. while 20% are satisfied with the present ratio.

5. Who will benefit more from this change in the directive?

   In response to this question, all the respondents felt that the depositors would benefit most from the change in the directive. Similarly, 33.33% also felt that the bank as a whole would benefit.

4.2 Directive No. 2: Loan Classification and Provisioning

A Capital of a bank is the sum total of all the contributions made by the shareholders and the promoters

Table No. 11
Loan Classification and Provision of Laxmi Bank for the year 2064

Classification of loan	Ashadh End 2064				
	Insured	Other	Total	Reqd prov.	Act prov.
Good (1%)		2681652	2681652	26817	34358
Substandard (25%)		13578	13578	3395	3840
Doubtful (50%)		1852	1852	926	926
Bad (100%)		29062	29062	29062	29061
Total	**0**	**2726144**	**2726144**	**60199**	**68185**

(Source: Nepal Rastra Bank, Supervision Department)

Table No. 12
Loan Classification and Provision of Laxmi Bank for the year 2061-64

LAXMI BANK	2061	2062	2063	2064
Classification of Loan and Advances				
Pass (A)	2681652	1750929	775943	124121
Non-performing Loan (NPL) (B)	44492	0	0	0
Substandard	13578		0	0
Doubtful	1852		0	0
Loss	29062		0	0
Provision (C)	68185	17509	7759	1241
Total Loan (D=A+B)	**2726144**	**1750929**	**775943**	**124121**
Total Loan - Total Provision (D-C)	**2657959**	**1733420**	**768184**	**122880**
Credit growth	**55.70%**	**125.65%**	**525.15%**	
Loan Loss Provision	**68185**	**17509**	**7759**	**1241**
Pass	34358	17509	7759	1241
Sub-standard (E)	3840	0	0	0
Doubtful (F)	926	0	0	0
Loss (G)	29061	0	0	0
Additional Provision	0	0	0	0
NPL to Total Loan (B/D)	**1.63%**	**0.00%**	**0.00%**	**0.00%**
Net NPL to Total Loan (B-(E+F+G))/D	**0.39%**	**0.00%**	**0.00%**	**0.00%**

(Source: Nepal Rastra Bank, Supervision Department)

The data shows that Laxmi bank has a good credit department since most of its loans fall in the "Good" category. This actually helps the bank a lot. When the loan is in the "Good" category, the provision required is just 1% of the loan amount. This reduces the total provision to be made which actually helps to increase the profit of the bank. The bank has always made the necessary required provision.

The important point to consider here is that NPL to Total loan of Laxmi bank has been almost equivalent to the ideal condition. The standard ratio is anything below 5% and the bank has been so far successful.

At the same time, the credit growth of the bank is also pretty impressive. It is quite easy to have a good credit growth but the important point is to have most of the credits or loan in the "Good Loan" category.

Another point to observe here is that the credit growth of the bank in the year 2059 is more than 500%. This is the main reason why its capital adequacy ratio is decrementing.

Table No. 13

Loan Classification and Provision of Nepal Investment Bank for the year 2064

	Ashadh End 2064				
Classification of loan	**Insured**	**Other**	**Total**	**Reqd prov.**	**Act prov.**
Good (1%)	150734	10005399	10156133	100431	99040
Restructure Loan (12.5%)		16157	16157	2020	2019
Substandard (25%)		822	822	206	212
Doubtful (50%)		74942	74942	37471	37558
Bad (100%)	3349	201761	205110	205110	188279
Total	**154083**	**10299081**	**10453164**	**345237**	**327108**

(Source: Nepal Rastra Bank, Supervision Department)

Table No. 14

Loan Classification and Provision of Nepal Investment Bank for the year 2060-2064

NEPAL INVESTMENT BANK	2064	2063	2062	2061	2060
Classification of Loan and Advances					
Pass (A)	10156133	7157132	5804696	2583230	2227592
Non-performing Loan (NPL) (B)	297031	181435	117092	130295	201434
Substandard	16979	10839	22031	17232	37375
Doubtful	74942	63879	3594	3482	164059
Loss	205110	106717	91467	109581	0
Provision ©	327108	208442	149647	149101	110196
Total Loan (D=A+B)	**10453164**	**7338567**	**5921788**	**2713525**	**2429026**
Total Loan - Total Provision (D-C)	**10126056**	**7130125**	**5772141**	**2564424**	**2318830**
Credit growth	**42.44%**	**23.92%**	**118.23%**	**11.71%**	
Loan Loss Provision	**327108**	**208442**	**149647**	**149101**	**110196**
Pass	99040	70831	57207	36382	20170
Sub-standard (E)	2231	2728	2491	2089	8329
Doubtful (F)	37558	29896	457	1649	81697
Loss (G)	188279	104987	89492	108981	0
Additional Provision	0	0	0	0	0
NPL to Total Loan (B/D)	**2.84%**	**2.47%**	**1.98%**	**4.80%**	**8.29%**
Net NPL to Total Loan (B-(E+F+G))/D	**0.66%**	**0.60%**	**0.42%**	**0.65%**	**4.59%**

(Source: Nepal Rastra Bank, Supervision Department)

NIB also has most of the loan in the category of “Good Loan”. It also has a noticeable figure of loan of the category “Bad”. This loan requires the provision of 100% there by

decreasing the profit of the bank. During the period of study, the bank has been successfully keeping check in the NPL to Total Loan ration there by keeping it below 5%.

The credit growth figure is also pretty healthy keeping in view of the fact that its NPL to Total Loan ratio also is in good position.

The bank further benefits if it can reduce the Bad Loan to some manageable figure.

Table No. 15

Loan Classification and Provision of NCC Bank for the year 2064

Classification of loan	**Ashadh End 2064**				
	Insured	**Other**	**Total**	**Reqd prov.**	**Act prov.**
Good (1%)	41216	5451428	5492644	54617	148946
Restructure Loan (12.5%)	0	0	0	0	
Substandard (25%)	2628	44577	47205	11365	11308
Doubtful (50%)	3535	61755	65290	31319	31349
Bad (100%)	8266	398497	406763	400564	400563
Total	**55645**	**5956257**	**6011902**	**497865**	**592166**

(Source: Nepal Rastra Bank, Supervision Department)

Table No. 16

Loan Classification and Provision of NCC for the year 2060 - 2064

NCC BANK	2064	2063	2062	2061	2060
Classification of Loan and Advances					
Pass (A)	5492644	4117253	2695585	1723731	2342555
Non-performing Loan (NPL) (B)	519258	600047	700827	1154557	546894
Substandard	47205	139464	379416	706264	300172
Doubtful	65290	278671	226711	119274	222923
Loss	406763	181912	94700	329019	23799
Provision	592166	445666	399154	558016	202859
Total Loan (D=A+B)	**6011902**	**4717300**	**3396412**	**2878288**	**2889449**
Total Loan - Total Provision (D-C)	**5419736**	**4271634**	**2997258**	**2320272**	**2686590**
Credit growth	**27.44%**	**38.89%**	**18.00%**	**-0.39%**	
Loan Loss Provision	**592166**	**445666**	**399154**	**558016**	**202859**
Pass	148946	96026	96837	19794	22560
Sub-standard (E)	11308	31762	93987	149566	46724
Doubtful (F)	31349	136948	113630	59637	109776
Loss (G)	400563	180930	94700	329019	23799
Additional Provision	0	0	0	0	0
NPL to Total Loan (B/D)	**8.64%**	**12.72%**	**20.63%**	**40.11%**	**18.93%**
Net NPL to Total Loan (B-(E+F+G))/D	**1.26%**	**5.31%**	**11.73%**	**21.41%**	**12.69%**

(Source: Nepal Rastra Bank, Supervision Department)

NCC bank does not seem to have a good and efficient credit policy. Even though it has been increasing its credit growth during the selected period, a considerable amount of

credit falls under “Loss” category. Because of this it has to contribute more to the Loan Loss Provision which resulted in less profit.

The bank always had NPL to Total Loan ratio of more than the standard norm of 5%. The credit position of the bank is clearly understandable from the fact that majority of provision it makes for Loan loss is for the “Loss” category of loan.

4.2.1 Remarks about Loan Loss Provision

A commercial bank generally accepts deposits from one party and disburses loans and advances to another party. A commercial bank generally profits from the spread of the difference between the interest rate given to the depositors and the interest rate received from loans.

An observation of the balance sheet of the commercial bank clearly reflects that deposit it draws consists of the major portion of the liabilities of the bank. Similarly, loans and advances consist of the major portion of its assets.

Since the spread commercial bank enjoy between the interest rates given to the depositors and interest rates taken from the borrowers, the failure of activity in any one party severely affects the other party.

The point to be noted here is that the loans and advances of the bank which is made by using the money of the depositors, which is a liability to be repaid later, carry a considerable risk. This risk factor is so dangerous that it can bring a bank to some degree of bankruptcy.

The failure of a bank to repay the depositor can force Central Bank to stop the bank from accepting further deposits and making further investments. This ultimately may lead the bank to file a bankruptcy thus affecting all the parties from depositors, shareholders and employees. Therefore, borrower’s risk or the risk of non-payment of the loans is one of the major risk commercial bank faces.

One of the main objectives of the Central Bank is to protect the money of the depositors. When majority of the loans and advances made by the bank comes from the depositor's money, there is a probability of facing the possible risk mentioned above. The directives issued by central banks has put some check on loan classification and provisioning so that the borrower's risk is minimum.

As said earlier, majority of the loans and advances made by a bank comes from the depositor's money. Therefore, the money of the depositors is under some degree of risk. But the return they get is much lower than the risk faced. At the same time, the shareholders of the bank are not exposed to the loans and advances while getting handsome dividends.

The timely modification of the directives has caused a major change in this regard and has played a leaping role in safeguarding the depositor's money.

The new directives have revised the classification of the loan by revising the aging of the loans and the provisioning to be made against such classifications. With this, the provisioning to be made is slowly increased there by decreasing the profit of the bank. This results in less or no dividends to the shareholders. A decrease in the dividends may sometime affect the reputation of the bank and its stock value.

In fact, during last decade, the commercial banks did not realize the fact that they were playing with the depositor's money. With only a small portion of the total loan exposure contributed by the capital, the shareholders were exposed to very less risks compared to the depositors. With the modified directives, there will be a good contribution from the shareholders as well.

The new directives have reduced the risks of the depositors and will help strengthen the financial health of the banks. Also, the directives will caution the banks while providing loans to their clients. Hence, on a long-term basis, banks will enjoy a better cushion

against the disbursed loans with huge capital and also, improve their financial strength with adequate provisioning.

4.2.2 Analysis of the Questionnaire

The questionnaire regarding the Loan Classification and Provision was given to the management of different commercial banks. There were total of 15 respondents. The response from each personnel is tabulated as shown in Appendix and the necessary percentile analysis is done for the obtained result.

The following result is derived from the questionnaire percentile analysis.

1. Is this directive necessary?
   All the 20 respondents felt that it is necessary to have this directive
2. What impact has this change in the directive brought?
   In answer to this question, 90% of the respondents are of the view that it actually increased provisions for the loan loss and 10% felt that it decreased provisions for the loan loss.
3. How did the bank cope with this change?
   The entire respondent said that the bank imposed strict measures for credit disbursal. 40% of the respondent also said that the bank strengthened monitoring and follow ups.
4. What impact did the shareholders had by this change?
   The change in this directive had a major effect to the shareholders as 80% respondents said that the shareholders got lesser dividends. They also said that their EPS decreased while 20% said that the shareholders suffered capital loss.
5. Is the change in the loan classification good for Commercial Banks and its sound financial health? If not, what?
   In response to this question, 66.66% of the respondents said that it is good while 33.33% said that it is only partially good.

4.3 Directive No. 3: Single Obligor Limit

Table No. 17

Single Obligor Limit for the year 2060 - 2064

SINGLE OBLIGOR LIMIT (SOL)	2060	2061	2062	2063	2064
NEPAL INVESTMENT BANK Core Capital	453657	506831	621931	710611	1161878
SOL - Fund Based	113414.3	126707.8	155482.8	177652.8	290469.5
SOL - Non Fund Based	226828.5	253415.5	310965.5	355305.5	580939
NCC BANK Core Capital	249825	-150202	78824	185870	255847
SOL - Fund Based	62456.25	-37550.5	19706	46467.5	63961.75
SOL - Non Fund Based	124912.5	-75101	39412	92935	127923.5
LAXMI BANK Core Capital		270783	326254	556348	604343
SOL - Fund Based		67695.75	81563.5	139087	151085.8
SOL - Non Fund Based		135391.5	163127	278174	302171.5

(Source: Nepal Rastra Bank, Supervision Department)

4.3.1 Remarks about Single Obligor Limit

Single Obligor limit is the maximum amount of loan that a bank can lend to a single borrower or a group of borrowers. One of the main activities of a bank is to collect deposits and disburse loans. Banks have to be very careful while disbursing loans because failure to make repayment to their depositors may lead to the liquidation of the bank. When a bank disbursed a huge amount of loan to a single party which turns out to be financially unhealthy, there can be huge problem for the bank. Failure to collect the loans may force banks to compensate the depositors from their own capital or declare insolvency.

Disbursement of loans to the borrowers exposes bank generally to three kinds of risks: Credit Risk, Yield Risk and Liquidity Risk. Banks should try to control these risks. There are mainly two ways of reducing these risks. First way is to diversify the investments so that failure in one area does not bring the bank down to liquidation. Second way is to limit the maximum amount of loan that can be provided to one borrower or a group of related borrowers so that bankruptcy of one group does not affect much to the survival of the bank.

Central bank has made provision that banks can give loan only up to certain percentage of its core capital to a single borrower. If any single borrower exceeds the given threshold, the bank has to either increase its core capital or ask the borrower to repay certain percentage of the loan so that the loan amounts to be within the limit mentioned in the directive.

The core capital of the bank as seen previously under the capital adequacy norms, comprises the common equity, preference share, share premium, general reserves and accumulated P/L account. Common equity and preference share issues require time, operating costs and economic volumes to be increased. Moreover, issuance of any one of these instruments will increase the expense on one hand and tend to decrease the EPS. General reserve funds and accumulated P/L account do not increase in the middle of the year as it is an amount which is apportioned from the profit of the bank after the final financial reports are prepared for the entire fiscal year.

Hence, the only way for the bank is to reduce the loan exposure of the client. Doing this will, on one hand, have adverse effect on the reputation of the bank and on the other hand, the profitability of the bank will also come down for there will be a reduction on the interest income of the bank, which is a major contributor of any commercial bank's profit.

4.3.2 Analysis of the Questionnaire

The questionnaire regarding the Loan Classification and Provision was given to the management of different commercial banks. There were total of 15 respondents. The response from each personnel is tabulated as shown in Appendix and the necessary percentile analysis is done for the obtained result.

The following result is derived from the questionnaire percentile analysis.

1. Is this directive necessary?

   All the respondents felt that it is important to have a check in the amount of loan a bank can give to a single party.

2. What is the impact of this directive on the bank?

   In regard to this question 86.67% of the respondents felt that because of this directive the credit exposure of the bank is increased while the remaining 13.33% felt that the credit exposure of the bank actually decreased.

3. How did bank cope with the modification of this directive?

   Out of the total respondents, 80% said that their bank asked some of the clients to repay part of their loan and there by reduced loan exposure. Similarly 66.66% said that Core capital of the bank was increased, thus expense of the bank increased.

4. How did liquidity of bank change because of the change in the directive?

   Only 8 (53.33%) respondents answered this question. They all said that the liquidity of the bank increased as a result of the change in this directive.

5. How did the profitability of the bank change due to the change in the directive?

   For this question, 80% of the respondents said that the profitability of the bank decreased while 20% said that it actually increased the profitability.

4.4 Monitoring Aspect of Nepal Rastra Bank

4.4.1 Analysis of the Questionnaire

The questionnaire regarding the monitoring aspect of Nepal Rastra Bank was given to the officers of the monitoring authority. There were total of 20 respondents. The response from each personnel is tabulated as shown in Appendix and the necessary percentile analysis is done for the obtained result.

The following result is derived from the questionnaire percentile analysis.

1. What is the main objective of NRB in modifying its directive regarding Capital Adequacy Ratio (increasing from 9%, 10%, 11% to 12%)?

   In regard to the question of change in the capital adequacy ratio, among the respondents, 100% said that the change was done to improve the financial health of the bank as well as safeguard the money of the depositors. 20% of the respondents also said that it is done mainly to meet Basel Standard.

2. What is the main objective of NRB in modifying its directive regarding Loan Classifying and Provisioning?

   According to 75% of the respondents, Loan classification was revised in order to improve the financial health of the bank. Also, all the respondents felt that it is revised to safeguard the money of the depositors.

3. What is the main objective of NRB in modifying its directive regarding Single Obligor Limit?

   All the respondents said that Single Obligor Limit was changed to safeguard the money of the depositors. Also 75% said that it is revised in order to improve the financial health of the bank.

4. Do you think that NRB has brought the changes in the directives at the right time? Why?

75% of the persons participating in the questionnaire said that the changes to the directives are done at right time because depositors are at great risk. Another 25% said that the timing is right because increasing number of banks has brought malpractices in banking sector.

5. Do the banks readily comply with the directives?

   65% of the respondents said that the banks readily comply while 35% said that they comply partially.

6. How strictly does NRB take action for non-compliance of the directives?

   Among the total respondents 30% said that action for non-compliance is taken very strictly while 70% said that action for non-compliance is taken strictly.

7. What implications do the modified directives have?

   In regard to the implication of the directives, 85% felt that it actually fostered good banking environment while all of them believed that the depositors money is even more safeguarded.

CHAPTER FIVE

5. SUMMARY, CONCLUSION & RECOMMENDATIONS

5.1 Summary

The research mainly targeted the three directives issued by Nepal Rastra Bank. Among the seventeen commercial banks three banks were considered for the research. The research also tries to find out the possible repercussions of the directives and its modifications to the commercial banks. The research also analyzed the performance of the selected commercial banks in regards to the selected directives for the selected period. With the analysis the research tries to rate the performance of the selected bank as Good, Satisfactory and Bad. Along with these, the research also finds out through questionnaires how banks have been implementing the directives and how the Central Bank has been monitoring and supervising the directives and what are some of the impacts of the directives in the performance and activities of the commercial banks.

5.1 Conclusion

Some of the implications found out by the research are as follows:

- When the provisioning amount for loan is increased it decreases the profitability of the commercial bank.
- Commercial banks needed to increase the capital or decrease the TRWA in order to meet the new capital adequacy ratio.
- Change in the Single Obligor Limit reduces the loan exposure of bank by limiting the fund-based and non fund-based loans.
- The depositors' money is protected more by the change in the capital adequacy ratio and change in the loan classification.
- Increased demand for shareholder's contribution in the banks by foregoing dividends for loan loss provisions and various other reserves to increase the core capital.

- Shareholders may experience decrease in dividends and employees may experience lesser bonuses due to short term decrease in profitability which resulted because of the stringent directives.
- Overall loan exposure of the bank is reduced thereby decreasing the interest income but increasing the protection of the depositor's money.
- The overall impact of all the results of the change in the directives actually ensures that the bank pay proper respect to the depositors money.
- Even though the bank may face short term decreased profitability, the financial health of the bank will definitely improve in the long run which can be measured by various empirical values and other non measurable values such as faith of the depositors and trust of the shareholders and employees and overall improvement of the economy of the financial sector.

5.3 Recommendations

5.3.1Recommendations to Central Bank

The Central Bank has recently come up with new circular to the commercial banks to comply with the recently amended directive. The directive vows to improve the overall economy of the financial sector in the long run. It is in accord to various international norms and standards. In this regard, NRB has to take into consideration the following points.

- While coming up with new directives or modifying the existing directive NRB should do enough homework in order to launch it in the right time.
- NRB should also consult with the Commercial Banks about the need for modification.
- NRB should not succumb into international pressures from IMF or World Bank and issue the directive just for the sake of issuing it.
- NRB has to facilitate Credit Information Bureau so that all the commercial banks receive the updated list of the black listed borrowers as soon as possible. This helps to reduce the chance of creating bad quality assets in the bank's balance sheet.

- ☐ NRB should enhance the monitoring and supervision aspect of the directives and should timely publicize the reports.

5.3.2 Recommendations to Commercial Banks

- ☐ It is always wise and beneficial to comply to the guidelines rather that pay heavy penalty for non compliance.
- ☐ The bank has to expand its banking products in order to utilize the increased liquidity created due to the decrement in loan disbursement.
- ☐ The bank needs to have a strong Internal Audit Department in order to ensure that guidelines set by NRB are properly followed by the concerned departments.
- ☐ Credit disbursement of the banks need to be very seriously dealt with mainly because of the classification of loans and corresponding provisions to be made. It is to be kept in mind that more the provision to be kept less the profit to be obtained.
- ☐ Non performing loan of the bank should be reduced to less than 5% which ensures that provisions are kept in certain check.
- ☐ Core capital of the bank should be increased in order to have a firm cushion against credit risk. Also, increased core capital increase Single Obligor Limit (SOL).

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APPENDIX – I

QUESTIONNAIRE

Name:____

Position:____

Institution:_______________________________________

Address:____

Nepal Rastra Bank - Monitoring

1. What is the main objective of NRB in modifying its directive regarding Capital Adequacy Ratio (increasing from 9%, 10%, 11% to 12%)?
   - ☐ To improve the financial health of the bank.
   - ☐ To safeguard the money of the depositors.
   - ☐ To meet Basel Standard.
   - ☐ No objective.

2. What is the main objective of NRB in modifying its directive regarding Loan Classifying and Provisioning?
   - ☐ To improve the financial health of the bank.
   - ☐ To safeguard the money of the depositors.
   - ☐ To meet Basel Standard.
   - ☐ No objective.

3. What is the main objective of NRB in modifying its directive regarding Single Obligor Limit?
   - ☐ To improve the financial health of the bank.
   - ☐ To safeguard the money of the depositors.
   - ☐ To meet Basel Standard.
   - ☐ No objective.

4. Do you think that NRB has brought the changes in the directives at the right time? Why?
   - ☐ Right time because depositors are at great risk.
   - ☐ Right time because economy is not good at present.
   - ☐ Right time because increasing number of banks has brought malpractices in banking sector.
   - ☐ Wrong time.

5. Do the banks readily comply with the directives?
   - ☐ Yes readily comply.
   - ☐ No not at all.
   - ☐ Yes partially comply.

6. How strictly does NRB take action for non-compliance of the directives?
   - ☐ Very strictly.
   - ☐ Strictly.
   - ☐ Lenient.
   - ☐ Not at all.

7. What implications do the modified directives have?
   - ☐ Good banking environment.
   - ☐ Increase bank profit.
   - ☐ Safeguard depositor's money.
   - ☐ All of above.
   - ☐ No expectation.

Capital Adequacy

1. Is the directive necessary?
   - ☐ Yes.
   - ☐ No.

2. What role does Capital Adequacy play?
   - ☐ Safeguards depositors' money
   - ☐ Increases borrowing capacity of the bank.
   - ☐ Protects bank from bankruptcy.
   - ☐ No role.

3. How did bank adjust the change in the directive issued by NRB? (capital adequacy ratio has been increased from 8%, 9%, 10% to 12% recently)
   - ☐ Increased Core Capital
   - ☐ Increased Supplementary Capital
   - ☐ Increased both Capital
   - ☐ Decreased Risk Weighted Assets

4. Are you satisfied with the 12% Capital Adequacy Ratio set by NRB?
   - ☐ No, it should be decreased.
   - ☐ No, it should be increases.
   - ☐ Yes.

5. Who will benefit more from this change in the directive?
   - ☐ The depositors
   - ☐ The loan clients
   - ☐ The employee of the bank
   - ☐ The bank as a whole
   - ☐ Nobody

Loan Classification and Provisioning

1. Is this directive necessary?
   - ☐ Yes
   - ☐ No

2. What impact has this change in the directive brought?
   - ☐ Increase provisions for the loan loss
   - ☐ Decrease provisions for the loan loss
   - ☐ No effect.

3. How did the bank cope with this change?
   - ☐ Imposed strict measures for credit disbursal
   - ☐ Strengthened monitoring and follow ups.
   - ☐ Any other, please mention.

4. What impact did the shareholders had by this change?
   - ☐ Got more dividends
   - ☐ Got lesser dividends
   - ☐ Their EPS decreased
   - ☐ Suffered capital loss.

5. Is the change in the loan classification good for Commercial Banks and its sound financial health? If not, what?
   - ☐ Yes
   - ☐ No
   - ☐ Partially good (give reason)

Single Obligor Limit

1. Is this directive necessary?
   - ☐ yes
   - ☐ No

2. What is the impact of this directive on the bank?
   - ☐ Increased credit exposure
   - ☐ Decreased credit exposure
   - ☐ No impact
   - ☐ Any other, please mention.

3. How did bank cope with the modification of this directive?
   (Previously single obligor limit was 35% and 50% on Fund-based and Non-fund based credits respectively with respect to the Total Capital Fund. Now the limit has been fixed at 25% and 50% on both the categories, but it is based not on the total capital fund which included the Supplementary capital but only on the Core Capital. Also the "Group of related borrowers" has been slightly modified)
   - ☐ Bank asked some of the clients to repay part of their loan (and reduce loan exposure).
   - ☐ Core capital of the bank is increased, thus expense of the bank increased.
   - ☐ Interest income of the bank came down as loan amount decreased.

4. How did liquidity of bank change because of the change in the directive?
   - ☐ Increased
   - ☐ Decreased
   - ☐ No impact
5. How did the profitability of the bank change due to the change in the directive?
   - ☐ Increased
   - ☐ Decreased
   - ☐ No impact

APPENDIX – II

ANALYSIS OF THE QUESTIONNAIRE

Number of Respondents: 15

Nepal Rastra Bank – Monitoring

1. What is the main objective of NRB in modifying its directive regarding Capital Adequacy Ratio (increasing from 9%, 10%, 11% to 12%)?

Answer	Response	Percent
To improve the financial health of the bank	20	100.00
To safeguard the money of the depositors	20	100.00
To meet Basel Standard	4	20.00
No objective	0	0.00

2. What is the main objective of NRB in modifying its directive regarding Loan Classifying and Provisioning?

Answer	Response	Percent
To improve the financial health of the bank	15	75.00
To safeguard the money of the depositors	20	100.00
To meet Basel Standard	0	0.00
No objective	0	0.00

3. What is the main objective of NRB in modifying its directive regarding Single Obligor Limit?

Answer	Response	Percent
To improve the financial health of the bank	15	75.00
To safeguard the money of the depositors	20	100.00
To meet Basel Standard	0	0.00
No objective	0	0.00

4. Do you think that NRB has brought the changes in the directives at the right time? Why?

Answer	Response	Percent
Right time because depositors are at great risk.	15	75.00
Right time because economy is not good at present	0	0.00
Right time because increasing number of banks has brought malpractices in banking sector.	5	25.00
Wrong time	0	0.00

5. Do the banks readily comply with the directives?

Answer	Response	Percent
Yes, readily comply	13	65.00
No, not at all	0	0.00
Yes, partially comply	7	35.00

6. How strictly does NRB take action for non-compliance of the directives?

Answer	Response	Percent
Very Strict	6	30.00
Strict	14	70.00
Lenient	0	0.00
Not strict at all	0	0.00

7. What implications do the modified directives have?

Answer	Response	Percent
Good banking environment	17	85.00
Increase bank profit	0	0.00
Safeguard depositor's money	20	100.00
No expectation	0	0.00

Capital Adequacy Ratio

1. Is the directive necessary?

Answer	Response	Percent
Yes	15	100.00
No	0	0.00

2. What role does Capital Adequacy play?

Answer	Response	Percent
Safeguards depositors' money	15	100.00
Increases borrowing capacity of the bank.	3	20.00
Protects bank from bankruptcy.	9	60.00
No role.	0	0.00

3. How did the bank adjust the change in the directive issued by NRB? (capital adequacy ratio has been increased from 8%, 9%, 10% to 12% recently)

Answer	Response	Percent
Increased Core Capital	15	100.00
Increased Supplementary Capital	0	0.00
Increased both Capital	3	20.00
Decreased Risk Weighted Assets	0	0.00

4. Are you satisfied with the 12% Capital Adequacy Ratio set by NRB?

Answer	Response	Percent
No, it should be decreased	12	80.00
No, it should be increased	0	0.00
Yes	3	20.00

5. Who benefited more from this change in the directive?

Answer	Response	Percent
The depositors	15	100.00
The loan clients	0	0.00
The employee of the bank	0	0.00
The bank as a whole	5	33.33
Nobody		

Loan Classification & Provisioning

1. Is this directive necessary?

Answer	Response	Percent
Yes	15	100.00
No	0	0.00

2. What impact has this change in the directive brought?

Answer	Response	Percent
Increase provisions for the loan loss	13	86.67
Decrease provisions for the loan loss	2	13.33
No effect	0	0.00

3. How will banks cope with this change?

Answer	Response	Percent
Will impose strict measures for credit disbursal	15	100.00
Will strengthen monitoring and follow ups	6	40.00

4. What impact do the shareholders have by this change?

Answer	Response	Percent
Will get more dividends	0	0.00
Will get less dividends	12	80.00
Their EPS will decrease	12	80.00
Will suffer capital loss	3	20.00

5. Is the change in the loan classification good for Commercial Banks and its sound financial health? If not, what?

Answer	Response	Percent
Yes	10	66.66
No	0	0.00
Partially good (give reason)	5	33.33

Single Obligor Limit

1. Is this directive necessary?

Answer	Response	Percent
Yes	15	100.00
No	0	0.00

2. What is the impact of this directive on the bank?

Answer	Response	Percent
Increase credit exposure	0	0.00
Decrease credit exposure	15	100.00
No impact	0	0.00

3. How did bank cope with the modification of this directive?

(Previously single obligor limit was 35% and 50% on Fund-based and Non-fund based credits respectively with respect to the Total Capital Fund. Now the limit has been fixed at 25% and 50% on both the categories, but it is based not on the total capital fund which included the Supplementary capital but only on the Core Capital. Also the "Group of related borrowers" have been slightly modified)

Answer	Response	Percent
Bank asked some of the clients to repay part of their loan (and reduce loan exposure)	12	80.00
Core capital of the bank is increased, thus expense of the bank increased	10	66.66
Interest income of the bank came down as loan amount decreased	0	0.00

4. How did liquidity of bank change because of the change in the directive?

Answer	Response	Percent
Decreased	0	0.00
Increased	8	53.33
No impact	0	0.00

5. How did profitability of bank change because of the change in the directive?

Answer	Response	Percent
Decreased	12	80.00
Increased	3	20.00
No impact	0	0.00

APPENDIX – III

Schedule to Calculate Capital Adequacy Ratio

NCC BANK	2060	2061	2062	2063	2064
Core Capital					
Paid-up Capital					
Preference Share					
Capital Adjustment Fund					
Capital Reserve Fund					
Share Premium					
Debenture Redemption fund					
Proposed bonus share					
General Reserve					
Dividend Equalization Reserve					
Profit/Loss Account					
Excess Investment and SOL					
Goodwill					
Investment in associates					
Supplementary Capital					
General Loan Loss Provision					
Exchange Equalization Reserve					
Asset Revaluation Reserve					
Hybrid Capital Instrument					
Subordinate Term Debt					
Other Free Reserve					
Total Capital					
On Balance-sheet Assets					
Off balance transaction					
Total Risk Weighted Assets					
Total Capital to TRWA					
Core Capital to TRWA					
Reqd. Core Capital Ratio					
Reqd. Total Capital Ratio					
Surplus / Deficiency Core Cap					
Surplus / Deficiency Total Cap					

APPENDIX – IV

Schedule to Calculate Loan Classification & Provision

Classification of loan	Ashadh End 2064				
	Insured	Other	Total	Reqd prov.	Act prov.
Good (1%)					
Restructure Loan (12.5%)					
Substandard (25%)					
Doubtful (50%)					
Bad (100%)					
Total					

NCC BANK	2064	2063	2062	2061	2060
Classification of Loan and Advances					
Pass (A)					
Non-performing Loan (NPL) (B)					
Substandard					
Doubtful					
Loss					
Provision					
Total Loan (D=A+B)					
Total Loan - Total Provision (D-C)					
Credit growth					
Loan Loss Provision					
Pass					
Sub-standard (E)					
Doubtful (F)					
Loss (G)					
Additional Provision					
NPL to Total Loan (B/D)					
Net NPL to Total Loan (B-(E+F+G))/D					