CHAPTER – 1

INTRODUCTION

1.1 Background of the study:

Human activities are normally directed towards the well being of the people. Energy and efforts devoted by people in the society aim at enhancing material benefits to the community. To enable people to enjoy material benefits is possible only when production base is expanded. In other words this requires economic growth. In order to contribute in the process of economic development of the country banking industry has been established and operating to provide the financial resources to the economic activities.

A Commercial Bank is a financial intermediary which collects credit from lenders in the form of deposits and lends in the form of loans. The term Commercial Bank came about as a way to distinguish it from an "Investment Bank." The primary difference between a Commercial Bank and its counterpart is that a Commercial Bank earns revenue by issuing primary loans from its pool of deposits while an Investment Bank brings debt and equity offerings to market for a fee. Among its assets, including loans, a Commercial Bank holds a portfolio of other securities to generate proprietary income.

A broader definition of a Commercial Bank is any financial institution that receives, collects, transfers, pays, exchanges, lends, invests, or safeguards money for its customers. To accept money as deposits from its customers and to lend such collected fund to individuals, businesses and industrial communities are two major functions of a Commercial Bank.

Generally, an institution established by law, which deals with money and credit, is called Bank. The business providing financial services to consumers and financial institution is also known as Bank. It also provides loan, accept deposits, exchange money, transfer the money and checks account, which can be used like, money to make payments and purchases and give services. Without the growth of financial field, there is no chance to develop business and without the growth of business, the country cannot develop at any costs. Therefore for the

growth of economy, bank is very essential to mobilize resources all over the country. So banking sector plays vital role in the economic development of the country.

Bank came into existence mainly with the objective of collecting the idle funds, mobilizing them into productive sector causing an overall economic development. The bankers have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving.

In this thesis paper, researcher has confined her focus in investment functions of Nepal Credit and Commerce Bank Limited (NCC Bank) operating in Nepal since October 14, 1996. Analyzing investment policy and portfolio will be the focus of this thesis paper.

Investment, in its broadest sense, means sacrifice of present money for future financial gains. It is a general term and it has specific meanings for different specific investors.

To invest means to allocate resources into numbers of assets category. For an individual, investment might include the purchase of financial assets, such as stocks, bonds, mutual funds or life insurance policies. Investment might also include the purchase of real assets such as precious metals, house or a car or even collectibles which include diamonds, fine arts or numismatic coins and stamps. For an economist, investment refers to the increase in real capital in an economy, such as an increase in factories and machinery, or in its human capital—that is, a skilled and educated labor force. Economists restrict investment to “real” investment of the sort that increases national output in future. For bankers, investment means lending money to borrowers and allocating remaining funds in capital and money market.

In addition to keeping its money in own vault and its Bank Accounts, a typical Commercial Bank employs its fund in the following headings:

- Money at call and short notice,
- Bills purchased and discounted,
- Investments
- Loans and advances and
- Fixed Assets

Here, assets headings are placed in the order of their liquidity.

In the annual financial statements, Nepalese Commercial Bank disclose their fund employed in stocks, debentures, treasury bills, etc. in the heading “Investment”. However, investment in its broadest sense covers the financing of all items appearing in the “assets” side of balance-sheet. All these items construct a portfolio of a bank. Each portfolio component serves its own purpose.

Cash at vault and Money at call & short notice serves the purpose of liquidity, whereas, investment under loans and advances fulfills the objective of profitability. Remaining portfolio items such as investment in stocks, governmental securities and bills discounted serves both the purposes of liquidity and profitability.

The business of banking is one of collecting funds from the community and extending credit (making loans) to people for useful purposes. Loaning money has always been a basic function of Commercial Bank. After providing for its cash need, a bank normally seeks to loan as large a portion of its deposit and excess capital as it prudentially can. The remaining portion of its investible fund is placed in suitable securities.

“By accepting money deposits from savers and then lending the money to borrowers, banks encourage the flow of money to productive use and investments. This in turn allows the economy to grow. Without this flow, savings would sit idle in someone’s safe or pocket, money would not be available to borrow, people would not be able to purchase cars or houses, and businesses would not be able to build the new factories, the economy needs to produce more goods and grow. Enabling the flow of money from savers to investors is called financial intermediation, and it is extremely important to a free market economy” (Microsoft Encarta Reference 2005, 1993-2004).

Unfortunately, the loans and advances which constitute a heavy proportion in the assets side of balance sheet of a Commercial Bank are exposed to various risks such as default risk, market risk, liquidity risks, counterparty risks, etc. Hence, investment operation of Commercial Banks is very risky. For this, they have to pay due consideration while formulating their Investment Policy. Healthy development of any Commercial Bank depends upon its Investment Policy. A good Investment Policy attracts both borrowers and lenders, which helps to increase the

volume and quality of deposits, loans and investment. Wisely formulated Investment Policy builds up high yielding *portfolio* of bank's assets.

This study mainly focuses on the Investment Policy and portfolio behavior of private-sector Commercial Bank - Nepal Credit and Commerce Bank Limited (NCC Bank). The published annual reports of this bank signal the accumulation of non-performing assets which is not only a major problem of NCC Bank but also of all the Commercial Banks of Nepal.

In Nepal, banks are now operating in a fairly deregulated environment and are required to determine their own interest rate structure for deposits and loans. The yields on Treasury bills and other Government bonds are now market related. There is intense competition between banks for business on both sides of the balance sheet. This will bring about a narrowing of margins and spreads between assets and liabilities. These pressures call for structured and comprehensive risk management systems for the Bank to base business decisions in line with the Bank's strategies and objectives. NCC Bank recognizes the importance in having effective risk management systems to address these risks. The system involves a framework for measuring and monitoring interest rate, liquidity, investment and foreign currency risk on a continuous basis.

NCC Bank in the normal course of business is exposed to various assets and liability portfolios. NCC Bank is also exposed to major risks involving credit, interest rate, liquidity, foreign currency, investment and operational risk. The bank management recognizes the importance in having effective management systems to mitigate these risks. The system involves a framework for measuring the risk and monitoring the interest rate, liquidity, investment and foreign currency risk on continuous basis.

The objective of the Investment Policy of NCC Bank is to ensure that all investments in credit portfolio, securities, including investments in Government Bonds / Treasury Bills are made with appropriate authority, with appropriate diligence and in compliance with Nepal Rastra Bank's directives and guidelines. NCC Bank is permitted to make investments in foreign currency deposits and securities issued by financial institutions and government debt instruments remaining under the guidelines of Nepal Rastra Bank.

NCC Bank is permitted to make investments in debt instruments such as corporate debentures and or commercial paper as and when these securities become available.

The Bank is also permitted to invest in equity and or preference shares of entities that are required to meet mandatory or corporate obligations or in cases where such investments are strategic in nature or may result from a debt-restructuring proposal on a non-performing asset.

The permitted level of investments in various instruments of NCC Bank would normally be limited to the limit set by them.

1.2 Focus of the Study

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, the birthplace of LORD BUDDHA, 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 country through its 17 branches. The Bank has developed corresponding agency relationship with more than 150 International Banks having worldwide network.

Capital structure:

Authorized Capital - Rs. 2 billion
Issued Capital - Rs. 2 billion
Paid-up Capital - Rs.1.4 billion

The Bank is using Pumori Plus, the most commonly used software by Nepalese Banks. The Bank offers Any Branch Banking Service (ABBS) in all the Branches. Telex and SWIFT are other modes of communication for efficient and effective transmission of information. In order to facilitate the customers with state of art technology, Bank is providing Debit Card facilities under the SCT (Smart Choice Technology) Network jointly in consortium with 12 other member Banks. This facility enables the customers to withdraw cash from any of the 26 ATM

Terminals located at different parts of the country and to purchase goods from more than 250 shopping complexes and departmental stores under POS arrangement. The Bank is also providing SMS and Internet Banking facilities to its customers.

NCC Bank has strategic alliance with ICICI Bank, which facilitates our customers to remit their money to more than 670 locations of India through ICICI Bank branches and their correspondent Banks in India. NCC Bank's customers can affect their money transfer to India either through Speed Transfer Arrangement or through Demand Draft Arrangement. Under Speed Transfer Arrangement, money can be credited on-line to the beneficiary's account at more than 400 branches of ICICI Bank, India. Under Demand Draft Arrangement, the Bank can issue draft payable at more than 670 locations in India. The bank is globally connected through various prominent Banks in Asia, Europe and North America like American Express Bank, Standard Chartered Bank, UBAF etc.

Its services across the globe include remittance, draft arrangement, import and export business, guarantee etc.

Despite the strength of capital and foreign management, the bank's portfolio performed poorly during the past years. Till the end of FY 2064/65, the bank suffered an accumulated loss of 87.05 Crores. The Capital Adequacy position of the Bank till the end of FY 2063/64 was negative and the bank has been able to make the capital adequacy requirement adequate in FY 2064/65 as per the Directive of Nepal Rastra Bank.

As already stated, banks are "for profit" organization. Whatever may be changes in the management; bank should follow a sound Investment Policy and form an efficient portfolio to meet its profitability objectives. Therefore, in this thesis paper, researcher has focused her effort in analyzing the Investment Policy of NCC Bank and the effectiveness of its portfolio.

1.3 Statement of the Problem

With the introduction of liberalization policy by the Government, the banking sector has been growing dramatically and operating with unhealthy competition. However, due to political instability, government couldn't be able to pay sufficient attention in this sector. Regulation, supervision, and monitoring by government have been weakened in banking sector as like other sectors. Commercial Banks in Nepal have been facing various challenges and problems especially in lending and portfolio management.

“Without a clear sense of why investments are being made and how long-run goals are to be achieved, an investor is likely to pursue inefficient approaches that lead to unsatisfactory results” (Sharpe, 2003, P 13). Formulation of investment policy and construction of ultimate portfolio are two major steps in investment process. Entire investment leads to ineffective portfolio management if there is weakly designed Investment Policy.

Clarifying the Investment Policy of Commercial Banks, Diana Mc Naughton says, "Investment Policy should incorporate several elements such as regulatory environment, the availability of the funds, the selection of the risk, loans portfolio balance and term structure of the liabilities."

The directives and guidelines provided by Nepal Rastra Bank (NRB), Central Bank of Nepal, is the major policy statement for Nepalese Commercial Banks. A long term and published policy about their operation is not found in many banks. In case of NCC Bank, Investment Policy announced through Credit Strategy 2061, Credit Policy Guidelines 2061, Credit and Trade Finance Manual 2003, Investment Policy and Assets and Liability Management Guidelines 2008 and many such announced in annual general meetings (AGMs) are the major investment guidelines.

Implementation of Investment Policy creates portfolio. Thus sound policy leads into portfolio with desired results. The primary principal of Investment Policy such as Safety, Liquidity and Return on Investment could be achieved if the Investment Policy is designed efficiently. As Commercial Banks are ‘For Profit’ institutions, earning power of their assets should always be high. Assets quality of banks is directly related with their Credit Policy, Investment Policy and its implementation. NCC Bank, which is under our study, has more that 60% assets as loans and advances. So, it must follow a sound Credit Policy to achieve high yielding portfolio picture.

The portfolio performance of many Nepalese banks is not satisfactory. NCC Bank is not the exception of that. Some banks have low or negative earning assets. For NCC Bank, financial performance reported in annual financial reports shows improving trend, however, it is still not satisfactory due to huge amount of retained loss.

Thus, this study is mainly concentrated on the following specific problems of NCC Bank,

a) Is the Investment Policy of the bank well designed?
b) Does the bank follow the Investment Policy as per NRB directives?
c) What is the liquidity position of bank's portfolio?
d) What is the profitability position of bank's portfolio?
e) Are there any significant changes in portfolio management and performance of the bank after the fulfillment of Capital Adequacy position of the Bank?

1.4 Objective of the Study

The main objective of the study is to appraise the Investment Policy of NCC Bank and to evaluate its portfolio as well. The major objectives of the study are given below:

a) To evaluate the Investment Policy of the bank for loans and advances and that for investment on securities.
b) To analyze the investment portfolio of bank in ground of portfolio's liquidity, portfolio management, portfolio performance and portfolio's profitability.
c) To analyze how efficiently the resources have been utilized.
d) To evaluate changes in the portfolios after the improvement in the Capital Adequacy position of the bank.

1.5 Significance of the Study

This study mainly fills a research gap on the study of Investment Policy and portfolio of NCC Bank. Definitely, the study will provide a useful feedback to the policy makers of the bank and also becomes a useful reference for other Commercial Banks of Nepal and the Central Bank (NRB) for the formulation of appropriate strategies. This study evaluates the Investment Policy of NCC Bank and finds its loopholes and significantly contributes to make the policy sound.

On the other hand, portfolio of a bank is the result of investment policy. In this thesis, portfolio behavior of the bank has been analyzed and its portfolio performance has been evaluated. This will be beneficial to all the bankers and policy makers to evaluate their own portfolio.

1.6 Limitations of the Study

The benefits and limitations are the two faces of a same coin. Each and every research work has more or less limitations. Since, the study is focusing to fulfill the partial requirement course of M.B.S. of T.U. It will have some limitations. We have limited resources and it may be difficult to explore researcher to find out new aspect. Reliability of statistical tools used and lack of research experience are the major limitation and some other limitations can be enlisted as follows:

a) This study is simply a partial fulfillment of MBS degree and prepared within time constraint which weakened adequacy of the study.
b) This is a case study and findings of the study can't be generalized.
c) The whole study is based on limited data and information.
d) The whole study is mainly based on secondary data collected from the bank, which may not be far from limitation due to inherent characters.
e) Among many factors affecting investment decision, only certain factors such as liquidity, profitability, capital adequacy etc. have been considered.

Thus, overall financial position of the banks cannot be judged by this report and this study is only helpful for investment portfolio management only.

1.7 Chapter Scheme

This study has been organized into five chapters, each devoted to some aspects of study on investment policy and portfolio management of NCC Bank. The titles of these chapters are summarized below and the contents of each of these chapters are briefly mentioned here:

- Chapter-1 : Introduction
- Chapter-2 : Review of Literature
- Chapter-3 : Research Methodology
- Chapter-4 : Data Presentation and Analysis
- Chapter-5 : Summary, Conclusion and Recommendations.

The **first chapter** deals with introduction, which includes general background, focus of the study, statement of the problem, objective of the study, significance of the study and limitations of the study.

The **second chapter** is mainly focused with literature review that includes a discussion on the conceptual framework on investment analysis and review of major-studies relating with portfolio management.

The **third chapter** describes the research methodology used to conduct the present research. It deals with research design, sources of data, data processing procedures, population and sample, period of the study, method of analysis, financial and statistical tools and limitation of the methodology.

The **fourth chapter** deals with data presentation and analysis, which includes the presentation and analysis of the data and major findings of the study.

Ultimately, the **fifth chapter** includes the major findings and conclusion of the study which deals about the main theme of study and portfolio analysis and Investment Policy of NCC Bank with recommendation for improvement of Investment Policy and efficient management of investment portfolio.

The bibliography and annexure are also incorporated at the end of the study.

CHAPTER – 2
REVIEW OF LITERATURE

The investment decision has played an important role in banking sectors as well as other organizations. Effective investment decision encourages to each and every investor to invest their funds on profitable field in order to achieve high return. Before proceeding to descriptive study, the researcher made an effort to clarify, understand and explore the concept and theory of Investment Policy and Portfolio Management. The review of literature helps the researcher to avoid repetition in the same task. Every possible effort has been made to grasp knowledge and information that is available from libraries, document collection centers, other information managing bureaus and concerned Commercial Bank. This chapter helps to take adequate feed back to broaden the information base and inputs to the study. This part of the study will be directed to examine and review some of the related books, articles published in various newspapers, economic journals, news letters, related business magazines and websites.

Basically this chapter will encompass the followings,

(a) Review of Conceptual/Theoretical framework
- ***Investment policy***
- ***Investment policy: banking perspective***
  - ➢Loan and advances policy
  - ➢Investment in shares and debentures policy
- ***Portfolio structure***

(b) Review of Books

(c) Review of Nepal Rastra Bank Directives

(d) Review of related studies
- Review of research papers
- Review of articles
- Review of Ph. D. thesis
- Review of Master's Degree thesis

(e) Justification of the study/ Research Gap

2.1 Conceptual/Theoretical Framework

This part of review will be focused to explain the theoretical aspect of Investment Policy and Portfolio Management of the Bank. This is based on some empirical truths and process of banking transactions.

Investment is concerned with the management of an investor's wealth which are the sum of current income and the present value of all future income. Funds to be invested come from assets already owned, borrowed money and savings. Investors expect to enhance their future consumption possibilities by investing their savings in order to increase their wealth.

Bank came into existence mainly with the objective of collecting the idle funds, mobilizing them into productive sector causing an overall economic development. The bankers have the responsibility of safeguarding the interest of the depositors, the shareholders and the society they are serving.

Banks made a wide variety of loans to a wide variety of customers for many different purposes; from purchasing automobiles and buying new furniture, taking dream vacations or pursuing college education, to constructing home and office buildings. Loans may be divided as: real estate loans, financial institutional loans, agricultural loans, commercial and industrial loans, loans to individual, miscellaneous loans, lease financing receivables etc.- *Peter S. Rose "Commercial Bank Management"*

A Commercial Bank is business organization that receives and holds deposits of fund from others, makes loans or extends credits and transfers funds by written order of deposits *(Grolier Incorporated, 1984).*

Commercial Bank is a corporation, which accepts demand deposits subject to check and makes short-term loans to business enterprises, regardless of the scope of its other services *(American Institute of Banking, 1972: 345).*

The Purpose and History of Bank Capital Adequacy Regulation Broadly speaking, a bank can finance its operations in two ways, either with borrowed money or with funds provided by its owners. Borrowings (including deposits) generate contractual liabilities, which, if not paid when due, can cause the bank to fail.

Thus, accepting money as deposits and lending it to borrowers are two major functions of Commercial Banks. But to carryout later category of function, bank has to set sound policy.

Sound policy creates optimum portfolio of investment. In the following sections, investment policy and portfolio have been dissected to arrive at a clear concept.

J. K. Fancies' saying "An investment is a commitment of money that is expected to generate additional money. Every investment entails some degree of risk, it requires a present certain sacrifice for a future uncertain benefits. *(Investment Analysis and Management" 5th Edition (Singapore; McGraw-Hill Book 10- 199 1) P- 1).*

Cheney and Moses saying, "The investment objective is to increase systematically the individual's wealth, defined as assets minus liabilities. The higher the level of desired wealth the higher the return must be received. As investor seeking higher return must be willing to take higher level of risk. *(Fundamentals of Investment." (St. Paul. USA- West Publishing Company-1992. P'-13)*

2.1.1 Investment policy

Sharpe, Alexander and Bailey (2003) said that setting Investment Policy involves determining the investor's objective and the amount of his/her investible wealth. Setting Investment Policy is the initial step in entire investment process. This step in the investment process concludes with the identification of the potential categories of financial assets for inclusion into the portfolio. For active management of Investment Policy, a written 'Investment Policy Statement' should be prepared. This statement should include 'Mission Statement' which is nothing but long-run financial goals. 'Investment Objectives' should also be well cited in the statement. The amount of risk that an investor is willing to bear should be well incorporated in such document.

Investment policy is a form of long range strategic planning. If investment started without policy and clear-cut objective, investing may result in disaster. However, for knowledgeable, the investment process can be financially rewarding. Optimal investment decision plays a vital role in each and every organization. But especially for the Commercial Banks and other financial institutions, the sound knowledge of investment is the must because this subject is relevant to all surrounding that mobilize funds in different sectors in view of return. Advance sound knowledge is also required because investment function of banks creates portfolio of highly risky assets.

Effective credit management begins with oversight of the risk in individual loans. Prudent risk selection is vital to maintaining favorable loan quality. Therefore, the historical emphasis on controlling the quality of individual loan approvals and managing the performance of loans continues to be essential. But better technology and information systems have opened the door to better management methods. A credit manager can now obtain early indications of increasing risk by taking a more comprehensive view of the loan scenario. To manage their risks, bankers must understand not only the risk posed by each credit but also how the risks of individual loans and portfolios on loan are interrelated. These interrelationships can multiply risk many times beyond what it would be if the risks were not related. Until recently, few banks used modern portfolio management concepts to control credit risk. Now, many banks view the loan portfolio in its segments and as a whole and consider the relationships among portfolio segments as well as among loans. These practices provide management with a more complete picture of the bank's credit risk profile and with more tools to analyze and control the risk.

Credit management is like a portfolio management since banks are lending in various aspects. Their purpose may be the same that is to make huge profit but their way in lending in various aspects has made a portfolio. Thus credit management can be also called a loan portfolio management.

2.1.2 Investment policy: banking perspective

Diana Mc Naughton (1994) in her research paper *'Banking institution in developing markets'* stated that Investment Policy should incorporate several elements such as regulatory environment, the availability of funds, the selection of risk, loan portfolio balance and term structure of the liabilities.

According to *S. P. Singh and S. Singh (1983),* "The investment (credit) policies of banks are conditional, to great extent, by the national policy framework; every banker has to apply his own judgment for arriving at a credit decision, keeping, of course, his bank's credit policy also in mind".

They further stated, "The field of investment is more challenging as it offers relatively greater scope to bankers for judgment and discretion in selecting their loan portfolio. But this higher degree of freedom in the field of credit management is also accompanied by greater risk, particularly during recent years; the credit function has become greater complex."

James B. Bexley, (1987) express his views as, "Investment policy fixes responsibilities for the investment disposition of the banks assets in terms of allocating funds for investment and loan, and establishing responsibility for day to day management of those assets."

According to *Chandler L. V. (1973)*, "A banker seeks optimum combination of earning, liquidity and safety while formulating Investment Policy".

"A sound Investment Policy of a bank is such that its funds are distributed on different type of assets with good profitability on the one hand and provides maximum safety and security to the depositors and banks on the other hand. Moreover, risk in banking sectors tends to be concentrated in the loan portfolio. Therefore the banks investment policy must ensure that it is sound and prudent in order to protect public funds. Bank makes a variety of loans to a wide variety of customers for different purposes. Therefore no uniform rules can be laid down to determine a portfolio of a bank. The environment in which it operates influences the investment policy of the bank. The nature and availability of funds also differ widely from one region to another within the country. For example scope of a bank operating in Kalikot will be different from the scope of bank operating in Kathmandu. Therefore, the Investment Policy to be applied in Kathmandu may not be applicable to the bank operating in Kalikot" *(Baidhya, 1999: 46-47).*

Emphasizing the importance of Investment Policy, *H. D. Crosse (1963)* puts his view in this way, "Lending is the essence of commercial banking, and consequently the formulation and implementation of sound policies are among the most important responsibilities of bank directors and management. Well conceived lending policies and careful lending practices are essential if a bank is to perform its credit creating function effectively and minimize the risk inherent in any extension of credit".

He further adds, the formulation of sound lending policies for all banks should have adequate and careful consideration over community needs, size of loan portfolio, character of loan,

credit worthiness of borrower and asset pledged to security borrowing , interest rate policy, etc.

Investment policy provides the bank several inputs through which they can handle their investment operation efficiently ensuring the maximum return with minimum exposure to risk, which ultimately leads the bank to the path of success.

According to *Edward W. Reed, Richard V. Cotter, Edward K. Gill and Richard K. Smith (1980: 1-5),* "Commercial banks still remain the heart of our financial system holding the deposits of millions of persons, governments and business units. They make funds available through their lending and investing activities to borrowers, individuals, business firms and governments. Commercial banks are the most important type of financial institutions in the nation in terms of aggregate assets." The primary function of commercial banks is the extension of credit to worthy borrowers. In making credit available, commercial banks are rendering a great social service. Through their actions, production is increased, capital investments are expanded, and a higher standard of living is realized. Although the investment activities of commercial banks are usually considered separately from lending, the economic effects and social results are the same.

Reed et al. (1980: 195) added that "The rate of return on assets is a valuable measure when comparing the profitability of one bank with another or with the commercial banking system. A low rate might be the result of conservative lending and investment policies or excessive operating expenses. Banks could, of course, attempt to offset this by adopting more aggressive lending and investment policies to generate more income"

Investment policies include credit analysis and its principal purpose is to determine the ability and willingness of a borrower to repay a requested loan in accordance with the terms of the loan contract. Factors considered in credit analysis are capacity to borrow, characters (honesty, integrity, industry, morality, ability to create income, ownership of assets, economic conditions, etc. Loans are the most important assets held by banks and bank lending provides the bulk of bank income *(Reed et al, 1980: 203, 235).*

Thus generalizing the above arguments, the investment operation of bank includes lending money to borrowers and investing in different types of securities. We can say lending is the

primary investment activity and investment in different types of securities is the secondary investment activity of the commercial banks.

To comply with NRB’s directive for framed accounting, Nepalese Commercial Banks disclose their fund employed in stocks, debentures, treasury bills, etc. in the heading “Investment”. However, investment covers financing of all items appearing in the “assets” side of balance-sheet. All these items construct a portfolio of a bank. Each portfolio component serves its own purpose.

Cash at vault and Money at call and short notice serves the purpose of liquidity, whereas, investment under loans and advances fulfills the objective of profitability. Remaining portfolio items such as investment in stocks, governmental securities and bills discounted serves both the purposes of liquidity and profitability.

However, loans/advances and investment in securities dominate heavily the investment operation of banks. These contribute more than 80 percent in the income of banks.

Thus, a sound Investment Policy of banks should address the following assets categories for inclusion into the ultimate portfolio.

a) Loans and advances
b) Investment in securities

2.1.2.1 Loans and Advances Policy:

This policy is also known as Credit Policy of the bank. Credit policy guides the bank’s overall credit operation. The Credit policy is the primary means by which senior management and the board guide lending activities. Although the policy primarily imposes standards, it also is a statement of the bank’s basic credit philosophy. It provides a framework for achieving asset quality and earnings objectives, sets risk tolerance levels, and guides the bank’s lending activities in a manner consistent with the bank’s strategic direction. Credit policy sets standards for portfolio composition, individual credit decisions, fair lending, and compliance management.

Credit policy should provide a realistic description of where the bank wants to position itself on the risk/reward spectrum. It needs to provide sufficient latitude for a bank to respond to good business opportunities while concurrently controlling credit risk. In normal circumstances, a bank should be able to achieve portfolio objectives and respond to changing market conditions without triggering a limit. Limits should not be so conservative that insignificant changes breach them, nor should they be so liberal that they have no practical effect. For the policy to be an effective risk management tool, it must clearly establish the responsibilities of those involved in the lending process.

Policies should be periodically reviewed and revised to accommodate changes in the bank's strategic direction, risk tolerance, or market conditions. Policy review should consider the organizational structure, breadth and complexity of lending activities, capabilities and skills of lending personnel, and strategic portfolio quality and earnings objectives. Changes in regulations and business conditions also need to be considered. In addition to providing an opportunity for change, the review should evaluate how well the policy has guided lending decisions. For example, a high volume of exceptions indicates that many loan decisions are being made outside the policy. This could mean that the bank is assuming more risk than is desirable or that the policy is too restrictive. If the bank's policy is too restrictive, easing it could increase business opportunities without unduly increasing risk. Conversely, the absence of exceptions may indicate that the policy is too vague, and a tightening of the policy could strengthen the controls on loan quality. All policy reviews should include the organizational unit responsible for assessing compliance with policy.

Since the largest proportion of a bank's assets portfolio is taken by loans and advances, healthy development of any bank depends heavily upon its Credit Policy. A sound and viable Investment Policy can attract both borrowers and lenders, which helps to increase the volume and quality of deposits, loans and investments. The loan provided by Commercial Bank is guided by several principles such as length of time, their purpose, profitability, safety, etc. These fundamental principles of commercial banks' investment are fully considered while making investment policy. Investment through loans and advances to borrowers is risk inherent. For this, commercial banks have to pay due consideration for risk management while formulating Investment Policy. Emphasizing upon bank's Investment Policy *H.D. Crosse* stated, "The Investment Policy should be carefully analyzed". Commercial bank should be careful while performing the credit creation function. Investment policy should ensure

minimum risk and maximum profit from lending. Modern portfolio management of bank assets has fundamentally changed the requirements for individuals using this technique: their backgrounds, their training, and their skills in using available resources. While traditional credit training, remains necessary, today's portfolio manager augments this background with knowledge of early-warning systems, alternative structures to better set risk/return parameters, and more.

Traditional training focused on the individual loan. Traditional credit training focused on the analysis of a firm's management, operations, and financial structure as the basis for determining a borrower's creditworthiness; now training programs incorporate not only these techniques, but also that elusive element called a bank's credit culture.

In essence, a bank's credit culture was a series of written and unwritten rules about which types of customers, industries and credit profiles were acceptable. This culture ultimately dictated the structure and composition of the bank's total portfolio.

Protection measures against portfolio losses focused on loan loss reserves based on moving-average formulas. Concentration risk was to be avoided, but there were always special customers for whom expectations could be made. If the formulas were correct, then overall expected losses in the portfolio would be covered by reserves. But those formulas and expectations were not always so accommodative. As a result, certain concentrations would invariably lead to extraordinary, or unexpected, losses that were charged to income in the year of their incurrence.

Portfolio management looks at the impact of loans individually, collectively and comparatively. Modern portfolio management techniques have supplemented those unwritten rules with portfolio analysis and policies that establish limits on exposure by country, by obligor, by industry and so on. These limits are derived from a specific focus on the technical aspect of these assets class—a segmentation of the credit product and an analysis of the effect of combining credits into portfolios. Credit portfolios can now be evaluated on the basis fundamental as well as quantities portfolio analysis (This is now being further institutionalized in terms of required capital as defined in the updated Basel Capital Accords.)

A well designed Credit Policy should properly address the following six core principles:

1) Principle of Liquidity

It is not enough that the loan will come back; it is also important that the advances granted to the customer must come on demand or in accordance with the agreed terms of repayment. The source of repayment must be definite.

Liquidity is the ability of a firm to satisfy its short-term obligations when they become due for payment. It implies the ability to produce cash on demand. People deposit money at the bank in different account with confidence that the bank will repay their money when they need. Such deposits are repayable on demand or on the expiry of a specified period. In either case, the banker must be ready to meet these liabilities. Otherwise, he will suffer in his credit, which is the very foundation of his business.

Nevertheless, a bank utilizes its deposit liabilities for the purpose of granting loans and advances. To maintain depositors' confidence towards bank, the bank must grant such loans and advances which are as liquid as possible. That is why commercial bank should grant loans and advances of short-term nature. Discounting first class bill of exchange, financing customer's current assets through Overdrafts and Cash Credit facilities generally fulfils this liquidity principle. Investment on industrial fixed assets under term loans is illiquid in nature. Matching the maturity of loans and deposits will assist in managing the loan portfolio's liquidity position. So, a bank's Credit Policy should pay due attention towards the liquidity of loans and advances.

2) Principle of safety

"Safety First" is most important principle of good lending. The Credit Policy formulated by banks should be capable enough to secure its investment. The banker should ensure that the borrower has the ability and will try to repay the advances as per the agreement. When a bank lends, then the bank should confirm on their lending whether they are safe or not. The bank shall ensure that the advances when granted to the right customers and is utilized in such a way that the advances are safe for all time.

In this connection, before granting a secured advances, bank should ensure carefully consider the margin of safety offered by security concerned and possibilities of fluctuation in its value.

Credit policy should be devised in such a way to keep the higher margin of safety for secured loans. The bank should never invest its funds in the collateral of those securities which are too volatile i.e., which are subject to too much depreciation and fluctuations because a little difference may cause a great loss. Security means adequate collateral having good value, which can be easily sold off if required at any point of time. The bank should accept such type of securities, which are commercial, durable and marketable having fair market value.

3) Principle of profitability:

The main goal of bank is to earn profit. For this, the bank is required to increase its investment without letting the fund remain idle. The bank should try to invest only on those projects from which it can ensure good and timely interest income. But bank never should forget its own liquidity condition while lending huge number of loans. Secured and long term loan can give good income.

To fulfill the stakeholders' expectations, it must meet sufficient profit. Main contributor towards a bank's profit is 'interest income' derived by granting loans and advances. Hence, the credit policy of a bank should be aimed at yielding higher interest income. However, such income should be reasonable. Interest rate levied on different loan headings is an indicator of the profitability level of loan portfolio.

Banks credit operation should be profitable to cover the full prudential provisioning, for allocation to capital and reserves, which is essential for any bank to maintain its competitive viability and expand its lending operations, to give reasonable dividends to shareholders and to give the depositors with reasonable return on their money, banks should earn profits.

All the above facts indicate that it is necessary for the banks to make sure that their lending operations are sufficiently profitable.

4. Principle of Diversification

The bank should not concentrate on only one sector while extending the loan. It should try to diversify its investment. It should mobilize its resources on various collateral, various assets, different business and different individuals and organization. This will help to reduce the banks risk in greater extent.

Therefore, the principle of diversification is guided by the fact: "Do not put all eggs in a single basket". The credit policy should avoid excessive concentration of loans and advances in single sector of economy, single geographical area and single borrower or group of borrowers. It should aim at spreading the advances as widely as possible over the different industries and different localities. This would enable banks to compensate any losses which might arise as a result of unanticipated factors adversely affecting particular industries and/or particular localities. In this respect, banks having wide branches network can well exercise the credit diversification. It is also advisable for a banker to advance moderate sums to large number of borrowers than advance large sums to a small number of borrowers.

Nepal Rastra Bank has also directed banks not to avail fund based credit facilities to a single borrower exceeding 25 percent of core capital and non-fund based credit facilities to a single borrower exceeding 50 percent of core capital. This limit is called single obligor limit (SOL) of a bank. The central bank has also circulated instruction to regulate concentration of credit to such borrowers who are operating in a single economic sector.

5. Principle of Purposive

Loans and advances policy of a bank should clearly cite the purposes for which it will advance credit facilities. From the viewpoint of security, a banker should always be known that why a customer needs loans. If a borrower misuses the loan granted by the bank, it can never repay and bank will possess heavy bad debts. Therefore, in order to avoid this situation each and every bank should demand and examine all the essential detailed information about the scheme of the project or activities, before lending. NRB directive no. 2 has required 100% provision for such loans which are diverted from the purposes other than that indicated by the borrower at the time of application. Hence, banks should develop post credit supervision practices to monitor the use of loans and advances.

6. Principle of National Interest

Even when an advance satisfies, all the above principles it might not be suitable if it does not take into account the national interest. Banks are required to grant advances on those sectors, which are priorities by the government on time to time in meeting the national requirements. The bank should invest on such sectors as per the government or Nepal Rastra Bank.

Bank's credit policy should not contradict the national interest. In addition to its own profitability objective, the bank should also consider the national interest. Even though the bank cannot get maximum return from such investment, it should carry out its obligation towards the society and the country. The Bank is required to invest on such sectors as per the Government and Nepal Rastra Bank's instruction. Investment on government bonds, priority and deprived sector lending are the examples of such investments.

7. Policy for Risk Management

Bank Credit Policy should also incorporate all the aspects of risk management. Risk is a condition in which there is a possibility of an adverse deviation from a desired outcome that is expected or hoped for. Risk can be broadly divided into:

Credit Risk	**Financial Risk**	**Non-financial Risk**	**Intrinsic Risk**	**Systemic Risk**
Default risk	Liquidity risk	Reputation risk	Deficiencies in Appraisals	Trade restrictions
Exposure risk	Counter- Party risk	Regulatory risk	Excess dependency in collateral	Economic Sanctions
Recovery risk.	Transactional risk	Deficiencies in loan policies and procedures	Absence of post sanction Surveillance	Govt. policies
	Country risk	Absence of credit concentration limits	State of the economy	

Credit Risk is one of the primitive forms of risk. A bank assumes Credit Risk when it advances a loan – it accepts that there is a risk of the borrower not servicing interest or repaying back the loan as per the agreed terms and conditions. In order to assure itself against such risk, a bank performs a detailed credit analysis, to assess the probability of default (or repayment). This is why credit risk is also called default risk. Risk can not be avoided, rather it should be managed. Predictable loss is a cost not a risk. Risk Management is the process by which risks

associated with a financial institution's activities are identified, assessed, monitored and controlled.

- Risk Control Method includes:
  - Risk Avoidance- when an organization refuses to accept the risk (rejection of a loan proposal).
  - Risk Reduction- Consists of all techniques that are designed to reduce the likelihood of risk (preventive-frequent monitoring) or the potential security of those risks that do occur (collateral)

Credit Risk Management has to be considered while formulating the Credit Policy to fulfill the following objectives.

- To minimize the losses
- To be competitive in the market despite various risks and stringent regulatory limits
- To apply risk based pricing for maximizing the return and for optimum utilization of capital
- To develop quality & diversified loan products
- To develop sound lending policies and a rigorous appraisal system
- To develop effective post sanction surveillance mechanism.

Credit Policy also includes the techniques of credit risk analysis. There are various techniques for Credit Risk Analysis. However, bank can use:

- Classical Analysis (Judgmental Credit Analysis)
- Modern Analysis Process (Quantification Credit Analysis) or
- A Combination of both

Classic Credit Analysis Process is an expert system "art" that relies on the subjective judgment of trained and experienced professionals. In reaching their subjective judgment, credit Officers are assisted by various analytical techniques for evaluating the likelihood that the potential borrower will meet an agreed debt obligation.

The classic **6cs** of credit are the foundation of Classic credit Risk analysis process.

(i) **Character** - Characteristic of the borrower, honesty and attitude

(ii) **Capacity** - Legal existence, management, business-cash flow

(iii) **Capital** - Financial condition of the borrowes' net worth

(iv) **Collateral** - Security, Pledged assets, insurance coverage.

(v) **Conditions** - Economic environment

(vi) **Compliance** – Compliance with laws and regulations

Modern Analysis Process is a system that helps in quantification of the Credit Risk. The following are some of the models used in quantification of the credit risk.

- Credit scoring Model
- Internal Risk Rating System
- Market Value based Credit Risk Models and
- Portfolio Diversification Models

Some of the common (combined) analysis models used widely for analyzing credit risk associated in lending by a bank are:

- The **CAMPARI MODEL**
- The **FINANCIAL ANALYSIS MODEL**
- The **FIVE PILLAR ANALYSIS MODEL**

Under the **CAMPARI MODEL**, the broad criteria set for lending in all types of projects are as follows:

- **C**haracter :The person involved
- **A**bility :Can they achieve what is promised ?
- **M**argin :Is the return reasonable for the risk ?
- **P**urpose :What is the need for money ?
- **A**mount :How much is needed ?
- **R**epayment:How and when will the bank get its money back ?
- **I**nsurance :How is the lender adequately secured if the plans do not work out?

Under the **FINANCIAL MODEL,** the anlaysis of the financial statements is carried on.

i) ***Balance Sheet Analysis*** : Under this, the post financial figures are studied so as to derive a present trend with regard to the Balance Sheet and other financial statements .

ii) ***Financial Projections*** : This analysis is pursued to ascertain where the business will stand in future.

Some of the common financial analyses to be studied before granting a loan are:

- *Cross - Sectional Analysis* : The comparison of different unit's financial ratios at the same point in time
- *Time – Series Analysis* : The evaluation of the unit's financial performance over time period
- *Combined Analysis* : Combination of cross - Sectional and Time-Series Analysis.

Under Financial Analysis technique Ratio Analysis Tool is used to analyze the risk. Ratio can be broadly divided into five Categories

A. Profitability Ratio:

1. Return on Capital Employed (ROCE)

B. Turnover and Efficiency Ratio:

1. Capital Turnover Ratio
2. Profit Margin Ratio
3. Fixed Assets Turnover Ratio
4. Current Asset Turnover
5. Inventory Turnover
6. Debtors Turnover
7. Gross Profit Margin

C. Liquidity or Working Capital Ratios

1. Current Ratio
2. Quick Ratio / Acid Test Ratio

D. Coverage Ratio

1. Interest Coverage Ratio
2. Loan Repayment Coverage Ratio

E. Capital Structure or Stability Ratio

1. Debt – Equity Ratio
2. Net Worth to Total Asset

2.1.2.2 Policy for Investment on Securities

As per the need, Bank may invest its funds in government securities both on primary and secondary market up to the desired level and limit is not fixed for such type of investment due to the risk free investment opportunity.

To the possible extent, investment in government securities shall be made on regular basis and the maturity of the same should be as possible as fall on every month so that the liquidity cycle in maintained.

Investment in various categories of the government securities may further be limited to certain percentage of total deposit. The short term investment relatively yield lower rate of interest. On the other hand, long term investment, though yield relatively higher rate of interest, will be tied up for the longer period of time and thereby exposes to interest rate risk and high cost of liquidation incase of the contingency scenario.

It is not unusual for commercial banks to invest its fund in stock exchange securities like governmental securities, semi-governmental securities, industrial securities, etc. In Nepalese bank's formatted accounting system, these investments are disclosed in the assets heading 'Investment' of the balance sheet.

Investment on securities serves the purposes of both liquidity and profitability. Principles that influence a bank in rating securities to include them into ultimate portfolio are:

(1) Safety of capital

(2) Easy marketability

(3) Stability of price

(4) Stability of income.

The banker should always bear in mind that in buying these securities is not its primary objective to gain by a possible rise in the prices of these securities. Consideration should be given to this factor only if it is satisfied with the safety and stability of capital. Generally commercial banks prefer governmental securities than investing in shares and stocks of joint stock companies. The reasons are manifold as per the following table:

Table – 2.1: Comparison of govt. securities with joint stock companies' securities:

S.N.	Governmental Securities	Joint Stock Companies' Securities
1	Repayment of capital is ensured because this depends upon the creditworthiness of whole nation.	In case of ordinary stock exchange securities, safety of investment is entirely dependent on the creditworthiness of a single unit.
2	The yield from a governmental security is steady and reasonable.	The yield fluctuates with income stream of the joint stock company under consideration.
3	Governmental securities are easily saleable without causing a glut in their market prices.	In case of ordinary industrial securities, sale of a large block of shares is likely to depress their prices.

(Source: Shekhar, 2005, P-14)

According to *KC Shekhar and Lekshmy Shekhar (2005)*, a sound investment policy should aim at attaining the following objective:

1. Investment should be as liquid as possible. Inclusion of government bonds with various expiries into the portfolio will satisfy this objective
2. Portfolio should be profitable.
3. It should ensure the security of capital.
4. Gain through price appreciation should not be taken as prime criterion of investment.

2.1.3 Portfolio Management

Portfolio Management is viewed as an integral between Issuers and Investors to ensure that the Bank is not stuffed with substandard assets. It is believed that diversification in investment styles, asset classes and industry sectors are key to successful portfolio management. Active Portfolio management is a dynamic process that requires ongoing focus in the optimal utilization of funds in the profitable assets.

The portfolio of a bank can be thought of as a mix of money market and capital market and instruments. In addition to keeping its money in own vault, a typical commercial bank employs its funds in following headings:

(1) Money at call and short notice,

(2) Bills discounted,

(3) Investments in securities &
(4) Loans and advances,

Which is a general picture of a entire portfolio of a bank grouped on the basis of liquidity. However, this thesis intends to cover two major portfolio categories:

(1) Investments and loans and advances including bills purchased and discounted
(2) Investment on securities.

The profitability of the bank depends on the management of the above assets.

2.1.4 Some Important Terms

Deposits

The word deposit means the amount in a current, saving or fixed account of a bank or financial institution, which are collected from the customers. The efficiency of the banks depends on its ability to attract deposits. Deposits are collected from the depositors or customers of general public. Therefore, the main source of funds that a bank usually uses for the generation of profit is deposit.

Loan and advances

A bank is always willing to lend as more as possible since they constitute the large part of the revenue. But the banks have to be careful while providing loans and advances since they may turn into bad debts. The commercial bank hardly lends money for a long period of time that can be collected at a short period of time. Banks provides the loan in the various forms, over draft, cash credit, direct loans and discounting bills of exchange. This is the primary source of income and most profitable asset to a bank.

Assets

Assets are the important properties of the firm and represent economic resources. All the assets should be measured in monetary term, which help to earn future benefits for organization such as: debtors, marketable securities, bills receivable, goodwill, patents etc. in the firms. There may be tangible and intangible assets as well as fixed and current assets to run the activities properly and smoothly.

Liabilities

Liabilities are the amount debt payable in future by the firms or the banks to their creditors. Liabilities represent the obligations to make payments through cash or bank or provide goods and services in future; e.g. creditors, bills payable, loan outstanding expenses.

Balance Sheet

Balance sheet is a financial statement which is prepared at the end of each accounting year which contains assets, liabilities, share capital. Generally it shows the actual financial position of the firm or organization. In other hand we can say that it shows especially 3 things;

a) Nature and value of assets

b) Nature and value of liabilities and

c) The position of shareholders' funds.

Investment on government securities share and debentures

This is the secondary sources of income to the bank the commercial banks make investment on government securities shares and debentures and earn some interest and dividend.

Investment on the other company's share and debentures

The commercial bank invests their excess fund to the shares and debenture of the other companies. This situation comes when there is excess of funds than required and if there is no any alternative opportunity to invest in the profitable sectors.

Off-Balance sheet transaction

Off - Balance- Sheet transaction covers the contingent liabilities, these activities are not recognized as assets and liabilities in balance sheet. They are letter of credit (LC), bills purchase, guarantee, commission, bills for collection etc. These activities are very important, as they are good sources of profit to the bank though they have risk.

2.2 Review of NRB directives

Nepal Rastra Bank, as the central bank, has regulatory authority to monitor the credit policy and portfolio of commercial banks operating in Nepal. Nepal Rastra Bank Act, 2058 has empowered Nepal Rastra Bank to regulate, monitor and control the overall functions of banks and financial institutions of Nepal. Using this empowerment, NRB issues directives, circulars and instructions to the banks and financial institutions.

One of the major tools that influence the investment policy and portfolio of a bank is monetary policy which is announced every year. It influences the amount of fund available in bank for investment.

On Ashadh 2062, NRB has issued 16 'unified directives' to all banks and financial institutions of Nepal, which are effective since 2062/04/01. They are called unified directives because, prior to this, NRB used to issue separate directives to commercial banks, development banks and finance companies and micro finance companies separately. These directives have consolidated the functions of overall financial institutions of Nepal. NRB has issued Directive No 17 on 2064/04/10 regarding Provision for Deprived Sector Lending.

Nepal Rastra Bank introduced new consolidated directives in accordance with the BFI Act. The consolidated directives are guided under NRB Act 2058 and Basel II principles as well. The new Directives included regulatory measures of international standards and practices in the areas of: Capital adequacy; loan classification and provisioning; credit concentration and single obligor limits; accounting policies and formats of financial statements; management and minimization of risks; good corporate governance; policies relating to compliance with the directives issued after the inspection and supervision; investment policies; reporting requirements; provisions for the purchase and sale of promoter shares; regulation on consortium financing; regulations on credit information and blacklisting; provision for statutory reserve requirements; policies on branch expansion; policies on interest rates; and policies on financial resources generation. It is hoped that adherence to these directives would ensure financial stability and discipline thereby helping Nepalese banking industry to flourish in the country. Banks & financial institutions are responsible for comply these directives according to NRB Act 2058.

The following directives are related with investment policy and portfolio matters of commercial banks.

<u>Directive No.</u>	***<u>Subject</u>***
1.	Capital Adequacy Requirement
2.	Classification of loans and advances and provision for loan loss.
3.	Provision regarding single obligor limit and loans limit for single sector of economy.
8.	Investment

13. Maintenance of Liquidity (Mandatory cash reserve)

15. Provision relating to interest rate

17. Provision for Deprived Sector Lending

The main extracts of the above directives are as discussed below:

2.2.1 Directive no. 1

Capital Adequacy

The NRB Directive no. 1 states about the Capital Adequacy Norms for financial institutions indicating the requirements of maintaining the Capital Fund to the prescribed ratios. The directives are said to be based on the internationally accepted norms of Basel committee which was established by the central bank governors of the group of ten countries in 1975.

The Basel committee on banking supervision is a committee of banking supervisory authorities.

The Capital Adequacy Ratio is derived on the basis of Total Risk Weighted Assets. The capital adequacy ratios to be maintained by commercial banks till FY 2064/65 were as follows:

Core Capital : **5.5%** of the Total Risk Weighted Assets

Total Capital Fund: **11%** of the Total Risk Weighted Assets

However, NRB has issued directive to implement the Capital Accord- Capital Adequacy Framework 2007 from FY 2065/66. All the banks have to calculate the capital requirement based on the Basel II approaches. Basel committee on banking supervision has developed a new capital accord, which is popularly known as Basel –II.

The new capital accord has been introduced basically for the protection of depositors by preserving the integrity of capital in banks.

The framework has developed the following three pillar approaches for maintaining capital adequacy of the banks.

- **Pillar I : Minimum capital requirement**
  - Credit risk
  - Operational risk

- Market risk

- **Pillar II: Supervisory review process**
  - Bank's own assessment of capital adequacy
  - Capital above the regulatory limit
  - Supervisory review and intervention

- **Pillar III: Market discipline**
  - Disclosure requirements and recommendations

As per the above directives the Bank has to maintain the total capital fund of 10% of Total Risk Weighted Assets.

2.2.2 Directive no. 2:

Classification of loans and advances and provision for loan loss:

Classification of Loan and Advances shall be on the basis of aging of outstanding principal amount of loan and advances.

Pass (performing)

- All loans and Advances not over due and overdue up to 3 months.

- Provisioning requirement is 1%.

Sub-Standard

- Loans and Advances overdue from 3-6 months.

- Provisioning requirement is 25%.

Doubtful

- Loans and advances overdue from 6 months to 1 Year.

- Provisioning requirement is 50%.

Loss

- Loans and Advances overdue for more than 1 Year.

- Least probability of recovery or considered unrecoverable and those having thin possibility of even partial recovery in future.

- Provisioning requirement is 100%

- Substandard, Doubtful and loss assets are to be classified as Non Performing Assets.

- Assets classification and Loan Loss Provision has to be done in each quarter and the report to be submitted to Nepal Rastra Bank with in one month of the quarter end.

Additional Provision for pass loan:

Loan and Advances against gold and silver, FD receipts, HMG bonds be classified as pass loans. However, if FD and NSB bonds are used to secure loans for other purposes, classification as mentioned above is to be applied.

Additional Provision for Loss loan:

Loans and Advances under following conditions have to be categorized under loss loan although they are not overdue.

- No security at all or securities is not in line in the agreement with the bank
- If the borrower has been declared bankrupt.
- If the borrower is absconding or can't be found.
- If the purchased or discounted bills not realized with in 90 days from date due.
- If the non funded facilities like letter of credit and guarantee converted into funded facilities.
- If the loans and Advances are not utilized from the borrowed purpose.
- If initiation as auctioning of the collateral has passed six months and if recovery process is under litigation.
- If the loans and Advances are granted to the blacklisted borrower.
- If project or business is not in condition to operate or not in operation.
- If credit card loan is not written off with in 90 days from due date.

Additional provision for term loan:

On the entire amount of outstanding loan on the basis of past due period of overdue installment i.e. if single installment is not paid with in stipulated time, all the remaining outstanding installments have to be considered for provisioning.

Provision for Off-Balance Sheet items:

If the Off- Balance Sheet items are converted into On- Balance sheet liability of the bank, then classification will have to done as per overdue period as mentioned above.

Provision for realization of Principal and interest:

- Not allowed by overdrawing current account or by extending the limit on an overdraft facilities.
- Where a system in a bank exists as to recovery of principal and interest by

debiting the customers' account and recovery is made as such resulting in overdraft, which is not settled with in one month, such overdrawn principal amount shall also be liable to be included under the outstanding loan and such loan shall be down graded by one step from its current classification. Interest income should be recognized as per Directive no 4.

Additional Provision for loan granted against personal guarantee:

- For loan against personal guarantee, details of free assets (not mortgaged/hypothecated to other banks or financial institution) equal to amount of advances granted must be taken.

- If the said loan falls under category of standard, sub-standard and doubtful assets, then additional 20% of original provisioning is required. Similarly, classification of such loan and advances shall be prepared separately.

2.2.3 Directive no. 3: Provision regarding single obligor limits and loan limit for single sector of economy.

Existing Provision and Time Frame to meet new Regulation

Time Frame	Fund Based	Non Fund Based
From Ashad 2060	25% of Core Capital	50% of Core Capital

Relaxation on Single Obligor Limit

- Loans and Advances granted against the security of FDR, other deposit, NSB Bonds and unconditional Guarantee provided by World Bank, ADB, International Finance Corporation including other multilateral organization and against unconditional guarantee issued by Internationally Rated Banks having rating of at least A+ by reputed rating agency or bank specified as first class bank by NRB.

- Loans and Advances granted by A class licensed institution to following public sector undertaking for import of following goods.

i) Nepal Oil Corporation

ii) Nepal Food Corporation

Definition of Group Related Borrowers

- Where a company holds 25% or more share in other company, then the both companies.
- A person, firm, directors of a company, shareholders of a private company, partners of partnership firm, proprietor and spouse , spouse daughter, adopted son and daughters, parents,

step mother, brother and sister who have supported by such director, shareholders, partners, proprietor residing jointly in same house or separately.

- The company in which the person mentioned under above individually or jointly holds 25% or more shares.

- The director, shareholders or other relatives as mentioned above individually or jointly holds less than 25% share of other company but the management of the another company is controlled by such person in either of following ways:

i) By being the chair person of BOD

ii) By being the chief Executive of the company

iii) By appointing more than 25% of the directors.

-Cross Guarantee provided by one customer/company to other customer/company, then both the customer/company should be considered as one.

- Firms, companies stated to be associated as a group or members of such group.

Returns:

Half yearly returns of customers fall under one group to BFI Regulation Department and Bank Supervision Department of NRB.

Not considered as single group:

All companies fully owned by the government or in which the government has majority ownership (more than 50%) be treated as separate entity.

Single Sector

Means Sum total of loans and advance, guarantee and commitments and letter of credit granted to the customers of one sector of the economy.

If the loans and advances granted by banks are concentrated into single sector, then NRB can direct to provide/raise additional capital as above.

Provision for monitoring of credit concentration:

Bank has to monitor the loans and advances granted to single sector by segregating the following two categories:

Category 1:

For loans and advances aggregating to 50% to 100% of Core Capital granted to single sector, quarterly monitoring shall be done by bank itself.

Category 2:

Loans and advances granted to single sector exceeding 100% of core capital should be endorsed by BOD and the same decision of BOD shall be intimated to Bank and Financial Institution Regulation Department and Bank Supervision Department of NRB.

For the purpose of this directive, NRB has identified following; each as a sector of economy:

1. Agriculture
2. Mines
3. Production
4. Construction
5. Metallic production, machinery and electronic tools fabrication
6. Transportation equipment production
7. Transport, communication, and public utilities
8. Whole and retail trading
9. Finance insurance and real estate
10. Services: Tourism and Hotel
11. Other services
12. Consumer loans
13. Local government
14. Other

Thus, this directive has directed commercial banks to develop their own policies to diversify the loans and advances as far as possible. However, in case Nepal Rastra Bank directs, the banks shall provide cent percent additional loss provisioning to minimize the concentration risks. The directive has directed commercial banks to exercise principle of diversity while advancing loans.

2.2.4 Directive no. 8:

Investment policies

This directive is related to the investment of financial of financial institutions in shares, bonds and debentures. Following are them major provisions laid in this directive:

1. Banks may invest their resources on government bond, NRB bond, shares and debentures of organized companies only after approval of such investment policy from board of directors.
2. There is no restriction to invest on government bond and Nepal Rastra Bank bond.
3. Investment is allowed to be made on the shares and debentures of those companies whose shares are sold to public and listed in Nepal Stock Exchange.
4. Banks may invest in shares and securities of any organized institutions not exceeding 10% on own core capital and not exceeding 30% of core capital in the portfolio of shares and debenture investment. However the bank may invest upto 20% of its core capital in the company in which it has financial interest.
5. For banks, there is no ceiling to underwrite shares and debentures of organized institutions.
6. Banks shall arrange for half-yearly review of investment portfolio. With respect to such review, a statement from the internal auditor of the bank certifying that the investments are made as per the existing investment policy and as per this directive shall be obtained and shall be approved by BOD within one month. Banks may invest in shares and securities of any organized institutions not exceeding 10% on own core capital and not exceeding 30% of core capital in the portfolio of shares and debenture investment.
7. Valuation of shares and debentures: The shares and debentures should be valued at lower of the purchase price or market price. The valuation should be carried out on half yearly basis. Any short-fall in market value of the investment should be debited from profit loss account and transfer such amount to provision for anticipated loss in investment.
8. Banks are prohibited to invest in securities and hybrid capital instruments of other banks and financial institutions except in micro-finance companies.

The Bank has to formulate Investment Policy incorporating the above Directives of NRB to have better assets and liability management.

2.2.5 Directive no. 13:

Maintenance of Liquidity (Mandatory cash reserve)

Mandatory cash reserve determines the amount of investible fund that is available with a bank. This directive has directed commercial banks to reserve 5.5% of their total deposit liabilities excluding margin and foreign currency deposit on ordinary account maintained at NRB.

2.2.6 Directive no. 15:

Provision relating to interest rate

This directive is related with product pricing. Fixation of interest rate by central bank has been completely deregulated since 2046/05/12 (12/08/1989).

The major arrangement regarding the interest rate and interest income in this directive no. 15 as follows:

1. Banks are free to fix their interest rate to be paid on deposits and to be levied on loans and advances.
2. Any changes made on such interest rates should be made public through national daily newspaper.
3. The interest income should be recognized on the basis of cash receipt only. Interest earned but not collected in cash should be transferred into interest suspense account but not into interest income account. Such suspended interest should be recognized as income in the year when it is realized.

2.2.7 Directive no. 17:

Provision for Deprived Sector Lending

This directive is related with provision regarding lending to the Deprived Sector. Deprived Sector means low income and socially backward women, tribes, lower cast, blind, hearing impaired and physically handicapped persons, marginal and small farmers, craftsmen, labour and squatters family. All credits extended for the operation of self employment oriented micro enterprises for the upliftment of economic and social status of deprived sector upto the limit specified by NRB is termed as Deprived Sector Lending. The maximum mandatory limit for lending to Deprived Sector fixed by NRB is 3% of total Loans and Advances.

2.3 Review of training/technical papers:

Banking industry is developing rapidly during these days in Nepal. So, training and development of personnel involved in banking sectors is carried out time to time.

In this section, the researcher has tried to present some technical aspects of credit policy of commercial banks contributed by some trainers.

Mr. Nirmal Dahal, a trainer from *Himalayan Bank Limited* has presented a paper- *Credit policy on "Credit Management"* training program conducted on Butwal, Rupandehi.

The main extracts of the paper is as follows:

1. The credit policy of a bank is guided by its credit philosophy which may be value driven or current profit driven or market share driven.
2. The credit policy should reflect the bank's lending philosophy, identifying preferred loan qualities, identifying preferred loan qualities and establishing procedures for granting, documenting and reviewing loans among other things.
3. Changing times and market situation require changes in the credit policy. It is important that credit policy be updated routinely to reflect current circumstances and their relevance as a control tool.
4. The components of a loan policy are:
    - **Introduction:** It expresses the bank's credit philosophy. It should reconcile the bank's commitment to loan quality with the degree of aggressiveness the bank seeks in its lending activities. This section presents the bank's loan policy as a guide with exception permitted where permitted.
    - **Objectives:** This section sets forth the bank's external and internal mission. Statements about the perceived market niche, desired profitability, perceived business role and maintenance of the public confidence are mentioned in this section. It may also include desired size of the loan portfolio in relation to total deposits or total assets.
    - **Strategies:** This section mentions the risk management strategies in concrete terms. The management of transaction risks and portfolio risks should be well addressed in this section. This section may quantify the desired mix of loan portfolio (consumer loan, business loan, term loan, etc.). Even though statutory ceiling is always there imposed by central bank for concentration risks, a bank may have in-house limit for this purpose.
    - **Lending authorities and approvals:** This section defines the credit authorities and their limits. Credit authorities may be vested on committees or on individuals or a combination of both. Generally, the highest credit authority is the BOD.
    - **Credit standard:** This section will define various loan products offered by the bank, desirable and undesirable loans, acceptable collateral and credit apprising methods. In this section is defined the types of collateral acceptable to the bank.

The collateral should be in tangible form; either fixed assets or current assets. The section also defines the coverage/margin of safety required for the exposure of the bank. The section covers the valuation/evaluation methods, insurance and mortgage aspects. Responsibilities and procedure for appraisal of credit application will be defined. This section will also give a brief outline of the factors to be considered while appraising the loan requests.

- **Credit operation:** This will define the follow of credit functions; business development & analysis, credit evaluation and analysis. Credit execution and administration and credit review. The section will also define the function of the departments in the credit flow including marketing, analysis, administration, monitoring and follow ups, recovery and credit review (audit).

2.4 Review of related studies

For achieving the objective of this thesis paper, research papers, articles, journals, master degree thesis and Ph.D. thesis have been consulted to find the research gap. The review of such related studies has been presented in the following sections.

2.4.1 Review of research papers

Dr. Govind Bahadur Thapa (1994: 29-37) has expressed his view that the commercial banks including foreign joint venture banks seem to be doing pretty well in mobilizing deposits. Likewise, loans and advances of these banks are also increasing. But compared to the high credit needs particularly by the newly emerging industries, the banks still seem to lack adequate funds. The banks are increasing their lending to non-traditional sectors along with the traditional sectors.

Out of the different commercial banks, Nepal Bank Ltd. and Rastriya Banijya Bank are operating with a nominal profit and also turning towards negative from time to time. Because of non-recovery of accrued interest, the margin between interest income and interest expenses is declining. These banks have not been able to increase their income from commission and discount, through traditional off-balance sheet operations. On the contrary, they have got heavy burden of personnel and administrative overheads. Similarly, due to accumulated overdue and defaulting loans, profit position of these banks has been seriously affected.

On the other hand, the foreign venture banks have been functioning in an extremely efficient way. They are making huge profit year after year and have been distributing large amount of loans and dividends to its employees and shareholders. Because of their effective persuasion for loan recovery, overdue and defaulting loans have been limited resulting in high margins between interest income and interest expenses. Similarly, concentration of these banks to modern off-balance sheet activities and efficient personnel management has added to the maximization of their profits.

Mr. Shiba Raj Shrestha (1998) has given a short glimpse on the "Portfolio management in commercial banks; theory and practice". Mr. Shrestha has highlighted following issues in the article. The portfolio management becomes very important both for individuals as well as institutional investors. Investors would like to select a best mix of investment assets subject to the following aspect:

- Higher return, which is comparable with alternative opportunities available according to the risk class of investors.
- Good liquidity with adequate safety of investment.
- Maximum tax concession.
- Economic, efficient and effective investment mix.
- Flexible investment.
- Certain capital gains.

In view of above aspect, following strategies can be adopted:

- Do not hold any single security i.e.; try to have a portfolio of different securities.
- Do not put all the eggs in one basket i.e.; to have a diversified investment.
- Choose such a portfolio of securities, which ensures maximum return with minimum risk or lower return but with added objective of wealth maximization.

However, Mr. Shrestha has also presented following approach to be adopted for designing a good portfolio and its management:

- To find out the investible assets (generally securities) having scope for better returns depending upon individual characteristics like age, health, need, disposition, liquidity, tax liability, etc.
- To find out the risk of the securities depending upon the attitude of investor toward risk.
- To develop alternative investment strategies for selecting a better portfolio that will ensure a trade-off between risk and return, so as to attach the primary objective of wealth maximization at lower risk.
- To identify securities for investment to refuse volatility of return and risk.

Mr. Shrestha has presented two types of investment analysis techniques i.e.; fundamental analysis and technical analysis to consider any securities such as equity, debentures or bonds and other money and capital market instruments. He has suggested that the banks having international network can also offer access to global financial markets. He has pointed out the requirements of skilled manpower, research and analysis team and proper management information system (MIS) in any commercial bank to get success in portfolio management and customer's confidence.

According to Mr. Shrestha, the portfolio management activities of Nepalese commercial banks at present are in nascent stage. However, on the other hand, most of the banks are not doing such activities so far because of following reasons: -

- Unawareness of the clients about the service available.
- Hesitation of taking risk by the clients to use such facility.
- Lack of proper techniques to run such activities in the best and successful manner.
- Less developed capital market and availability of few financial instruments in the financial market.

Dr. Sunity Shrestha (1993 in her research, *"Investment planning of commercial banks in Nepal",* has made remarkable efforts to examine the investment planning of commercial banks in Nepal. On the basis of the study she concludes that bank portfolio (loans and investment) of commercial banks has been influenced by the variable securities rates. Investment planning of commercial banks in Nepal is directly traced to fiscal policy of government and heavy

regulatory procedure of the central bank (Nepal Rastra Bank). So the investments are not made in professional manner. Investment planning and operation of commercial banks in Nepal has not been found satisfactory in terms of profitability, liquidity, safety, productivity and social responsibility. To overcome this problem, she has suggested, "commercial banks should take their investment function with proper business attitude and should perform lending and investment operation efficiently with proper analysis of the projects".

2.4.2 Review of articles

In this section, effort has been made to examine and review of some related articles in different economic journals, World Bank discussion papers, magazines, newspapers and other related books and publications.

The article of *Patrick F. Reidy* provides an overview of the credit portfolio management function, structural alternatives, the skills necessary for its effective implementation, and a final word on training and compensation. The focus is on corporate credit portfolios, as these often present the largest concentration challenges though they can be easily modified.

Modern portfolio management of bank assets has fundamentally changed the requirements for individuals using this technique: their backgrounds, their training, and their skills in using available resources. While traditional credit training, remains necessary, today's portfolio manager augments this background with knowledge of early-warning systems, alternative structures to better set risk/return parameters, and more.

Traditional training focused on the individual loan. Traditional credit training focused on the analysis of a firm's management, operations, and financial structure as the basis for determining a borrower's creditworthiness; now training programs incorporate not only these techniques, but also that elusive element called a bank's credit culture.

In essence, a bank's credit culture was a series of written and unwritten rules about which types of customers, industries and credit profiles were acceptable. This culture ultimately dictated the structure and composition of the bank's total portfolio.

Protection measures against portfolio losses focused on loan loss reserves based on moving-average formulas. Concentration risk was to be avoided, but there were always special customers for whom expectations could be made. If the formulas were correct, then overall expected losses in the portfolio would be covered by reserves. But those formulas and

expectations were not always so accommodative. As a result, certain concentrations would invariably lead to extraordinary, or unexpected, losses that were charged to income in the year of their incurrence.

Portfolio management looks at the impact of loans individually, collectively and comparatively. Modern portfolio management techniques have supplemented those unwritten rules with portfolio analysis and policies that establish limits on exposure by country, by obligor, by industry and so on. These limits are derived from a specific focus on the technical aspect of these assets class—a segmentation of the credit product and an analysis of the effect of combining credits into portfolios. Credit portfolios can now be evaluated on the basis fundamental as well as quantities portfolio analysis. (This is now being further institutionalized in terms of required capital as defined in the updated Basel Capital Accords.)

Mr. Tirtha Upadhyay in his article *"Little to Bank On"* in Nepali Times (Searched through website) number 155, he has expressed a sheer disappointment towards the new management of two giant government owned commercial banks i.e. Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB) undertaken by the American Management Company. These two banks have the largest portfolio among all the commercial banks. Due to various reasons including political pressures the portfolio of both the banks were messed up and were subjected to reformation. With an alarming height of NPLs in both the banks, overall economy was dangerously menaced. Hence as a remedy of this menace, expertise of international standard were sought to regularize the portfolio and bring down the NPLs to 5 % ultimately. In this regard, the article opens,

"It would be owe that the honeymoon period of the new foreign management of Nepal Bank Ltd (NBL) and Rastriya Banijya Bank (RBB) are over, stakeholders have begun to have doubts about reforms. Even though an official report on the reform process over the past year is awaited, it looks like Nepal Rastriya Bank is getting impatient with the results. While making its monetary policy public recently, Governor Tilak Rawal expressed dissatisfaction with the slow paces of reform."

It also laments central Bank i.e. Nepal Rastra Bank for the shortcomings of such reforms for regularization of non-performing assets of Commercial banks and further adds :

"The Rastra Bank can’t be absolved of its responsibility either, as the contractors were hired without adequate spadework. Bad loans amassed by these banks were not analyzed, classified and realistically valued, to be agreed with the new managers. This left room for ambiguity and

dispute. The new management made a smart move by making provisions to check non-performing assets in the period prior to their takeover. NBL and RBB managements claim that they have recovered over Rs 1 billion each from delinquent borrowers. The loan administration process has been streamlined, accounts are updated and the latest audited financial statements are available. But since all bad and doubtful debts were provided for, the new management could ride over mounting non-performing assets and highlight its success, however slight that may have been."

Citing the recovery problem, the article speaks as ;

"The major problem with loan recovery is inadequacy of information available within the banks about borrowers, including cash flows, quality of security, management and financial information, industry environment, marketability of collateral, etc. Very little seems to have been achieved after the new management took control in creating borrowers' profiles that could be relied upon for developing recovery or exit strategies."

The article is, then concluded by throwing a light on how one Nepalese Individual is burdened by the uncalculated move of NRB in this regard"

The Nepali public would be burdened with an additional debt of over Rs 2 billion - the cost of the banking reform - which was financed by a World Bank loan. NBL and RBB are not liable for the repayment of this loan, and it goes unrecognized in their books. This could be a classic example of innovative accounting and might draw the attention of NRB, which is advocating implementation of International Accounting Standards in the banking industry. "

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

According to him NPL for a bank is like a developing cancer in a human body, which will collapse the whole bank if not managed in time. This is an important discipline in banking to prevent whole NPL or avoid situations for a loan to turn into NPL. The loan for a bank is most important to generate revenue for operational expenses as well as to provide return to the shareholder.

When a loan advanced from good money turns into a bad loan the chance of shareholders return as well as survival of a bank stands in a stake. Ailing bank can't portray its better image in the public. And no bank can operate its business without the deposit from the public. When public start loosing their confidence on the bank and don't keep their deposit in the bank, that bank will start counting its finger for collapse.

A loan disbursed as good loan doesn't turn into bad over the night. It has certain course to turn into bad. An efficient bank management can recover the loan before turning it into bad and can save itself from the un-unwanted debacle.

A general survey reveals following reasons why a good loan turns into bad:

Situational Problem

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

Intentional Problems

- Intention to cheat the bank.
- Intention to flee without settling the loan.
- Malicious act of both the bank-staff and borrower.
- Intention to auction the property, which is in least requirement, borrower.

- To show other creditors to his bankruptcy, which is unmanageable.
- To relieve from other debts.
- To waive interest/ penal interest or avail discount on loan if paid in latter stage when bank offer such facilities.

A borrowing may reflect one or all above signals causing harm to the bank's business. There are few chances of cure to protect bank from an intentional defaulter. But for the defaulter caused by situations we can re-schedule, re-structure their facilities and help them to meet their debt obligation as per the cash flow they are having.

For a genuine loan which was disbursed with all good spirit may turn into bad if it is not monitored properly and corrective measures are not taken in time. The signals of such failure appear to borrower first and then consequences fall upon the shoulder of a bank. When a good loan, with all effort to protect it, turn into bad and borrower ability is not enough to serve from other source, then borrower also tries to hide the information from the bank and wants to be relieved temporarily. Such situations give some signals to the bank and these signals are called danger signals.

He added that a formula Know Your Customer (KYC) is to be always taken into consideration. A bank must be clever and must collect information greater then a borrower require for commencement of business and to be more rigid to give the loan than to give his own money without any security. When a borrowing unit is not able to serve the debt from the source explored, the documentations are merely a decree to enforce legal action against him. But what gets realized when everything is lost. A jail and punishment doesn't satisfy the interest of bank.

A basic know how of NPL management is to prevent a loan to turn into loss. Therefore every possible measure is to be implemented to keep a loan portfolio intact. Periodic meeting with the borrower and market information is must to check the exposure against a particular business sector.

Similarly, if it is due to changes in the business environment and other factors a rescheduling and restructuring approach to be followed to protect both the bank and borrow. A bank never wants to make a borrower, a squatter. The bank equally tries to protect its interest by any means.

The security given by a borrower may be ample for the exposure. But the borrower from other source of business may not be able to generate substantial earning to service the debt. Bank has all options to auction the property and liquidate the loan. While doing so, realization from the auction of property is always less than the value of an asset. This neither serve the purpose of bank nor the borrower, additionally will cause loss both the bank and borrower. A well doing family may turn to squatter if all the assets so auction at low value.

Dr. Sunity Shrestha (1998: 23-27) in her article, *"Lending operation of commercial banks of Nepal and its impact on GDP"*, has presented with the objectives to make an analysis of contribution of commercial bank's lending to the gross domestic product (GDP) of Nepal. She has set hypothesis that there has been positive impact of lending of commercial banks to the GDP. In research methodology she has considered GDP as the dependent variable and various sectors of lending viz. agriculture, industrial, commercial, service and general and social sectors as the independent variables. A multiple regression technique has been applied to analyze the contribution. The multiple regression analysis has shown that all the variables except service sector lending has positive impact on GDP. Thus, in conclusion she has accepted the hypothesis i.e.; there has been positive impact on GDP. She has accepted that there has been positive impact by the lending of commercial banks in various sectors of economy, except service sector investment.

Mr. Dev Lal Kishi (1996: 27-32) in his article, *"The changing face of the banking sector and the HMG/N recent budgetary policy"*, concluded that following an introduction of the reform in the banking sectors as an integrate part of the liberal economic policy, more banks and finance companies have come up as a welcome measure of competition. Slowly and steadily, the two government controlled banks, Nepal Bank Limited and Rastriya Banijya Bank have also shown an improvement of non-performing loans and are taking steps to adopt improved technology. However, higher economic growth with social justice bringing an significant benefit to the poor are yet to be achieved as envisaged by the HMG/N.

Mr. Prabhakar Ghimire (1999) has published an article in which he has mentioned that most of the commercial banks of Nepal are ready to pay the penalty in spite of investing on rural, priority sector, poverty stricken and deprived areas. In the directives of Nepal Rastra Bank it is clearly mentioned and directed that all the commercial banks (under NRB) should invest 12 % of its total investments to the priority sectors. Out of this 12 %, they should invest 3 % to the

lower class of countrymen. However these commercial banks are unable to meet the requirements of NRB.

In the light of above, foreign joint venture banks use to justify that they don't have any network among these priority areas. So, if investment is made to these areas, operation cost will be very high, that exceeds the penalty if investment won't be made. That is why they are interested in paying penalty rather than investing in priority sectors.

Mr. Bodhi B. Bajracharya (1990: 93-97) in his *article "Monetary policy and deposit mobilization in Nepal",* has concluded that mobilization of domestic savings is one of the prime objectives of the monetary policy in Nepal and commercial banks and the more active financial intermediary for generating resources in the form of deposit of private sector and providing credit to the investor in different sectors of the economy.

F. Morris (1990) in his discussion paper, "Latin America's Banking System in the 1980^{s}" has concluded that most of the banks concentrated on compliance with central bank rules on reserve requirements, credit allocation and interest rates. While analyzing loan portfolio, operating efficiency and soundness of bank investment management has largely been overlooked. The huge losses now found in the bank's portfolio in many developing countries are testimony to the poor quality of this oversight investment function.

He further adds that mismanagement in financial institutions has involved inadequate and overoptimistic loan appraisal, lower loan recovery, high risk diversification of lending and investments, high risk concentration, connected and insider lending, loan mismatching, etc. This has led many banks of developing countries to the failure in 1980^{s}.

2.4.3 Review of Ph. D. thesis

Dr. Sunity Shrestha (1993) has conducted a study on *"Investment planning of commercial banks in Nepal"* with the objectives of:

- To evaluate the financial performance of commercial banks in Nepal.
- To examine the investment of commercial banks of Nepal with reference to securities, loans & advances.

- To establish the relationship of bank portfolio variables with the national income and interest rates.

The research was conducted on the basis of primary and secondary data of commercial banks.

The research findings are summarized as: -

- The general trend of commercial banks asset holding is growing. Deposits have been a major source of funds. The excess reserve levels of the banks allow idle money and loss of opportunity. Debt equity ratio is very high, greater than 100%.
- The return ratios are on the average higher for foreign joint venture banks than for the Nepalese bank but return of asset found to be statistically same. Risk taking attitude is higher in foreign joint venture banks. The total management achievement index is higher in case of foreign banks in comparison to the Nepalese banks.
- The hypothesis that the commercial banks have non-professional style of decision making in investment has been accepted. The investment of commercial banks in shares and securities is normal and not found to have strategic decision towards investment in shares and securities. Yield from the security has been found to be satisfactory.
- Investment in various economic sectors shows industrial and commercial sector taking higher share of loan till 1990.
- Investment in various sectors has a positive impact on the national income from their respective sectors.
- Lending in priority sector showed cottage and small industry sector sharing higher loans.
- Priority sector lending showed positive impact on the national income.

The secured loan analysis showed commercial loan as being very important followed by social and industrial loans. The loan loss ratio has been found to be increased with low recovery of loan. Demand of bank credit has been found to be affected by the national income and lending and treasury bill rate. The investment of commercial banks on government securities has been observed to be affected by total deposit, cash reserve requirements and treasury bill and lending rates. Interest rates, lending rate, deposit rate were found to constitute a set of significant variables affecting the bank portfolio composition.

2.4.4 Review of Master's degree thesis

Before this, several thesis works have been conducted by various students regarding the various aspects of commercial banks such as financial performance, lending policy, investment policy, interest rate structure, resources mobilization, capital structure, etc. Some of them, as supposed to be relevant for the study are presented below.

Mr. Susheel Chandra Mahat (2004) conducted a study on *"Investment policy of Nepal Bangladesh Bank Limited"* with the objective of:

- To find out the Non Performing Assets position of the bank,
- To evaluate the portfolio management of the bank,
- To find out the bank's investment on priority sector,
- To analyze deposit utilization and it's relationship with total investment and net profit of the bank, and

The study was conducted on the basis of secondary data. Major findings of the study were as follows:

1. The proportion of non-performing assets on total loan and advances of the bank is more than the satisfactory level. It should be less than 5% to be graded as internationally A grade commercial bank. For the Nepalese context also, NPA should be in single digit to be considered as satisfactory. The NPA level of the bank is higher than these standards. So, the management of the bank should give its due attention in time to manage the NPA level within the satisfactory level.
2. The loan and advances portfolio of the bank is not satisfactory. The lending is not properly diversified. Half of the loan from total portfolio is given to industrial sectors. Bank is unable to explore the new and profitable sectors for the lending purpose. So, the bank has very risky portfolio of loan and advances. If industrial sector will not function properly, its impact to the bank will be huge.
3. Bank is not fulfilling its priority sector investment requirement every year, during the study period. In the course of failure to fulfill the directive credit requirement, bank is subject to penalty, which affects the profitability of the bank. The average priority sector lending of the bank is less than required 12% landmark.
4. The relation of total deposit is positive to total investment i.e. if total deposit increases, bank's loan and advances, investment on government securities, shares and debentures

of other companies also increases. But the bank's investment, in the form of loan and advances and other investments, has not positive relation to total net profit of the bank. Bank's total profit is irrespective to its total investment.

Mr. Pravakar Dhungana (2002) conducted a study on *"Investment policy of Nepal Bangladesh Bank Limited & other Joint Venture Banks (Himalayan Bank Limited & Nepal State Bank of India Bank Limited)."* with the objective of:

- To study fund mobilization and investment policy with respect to fee based off-balance sheet transaction and fund based on balance sheet transaction.
- To evaluate the liquidity efficiency of assets management and profitability position.
- To evaluate the trends of deposit utilization towards total investment and loan & advances and its projection for next five years.
- To evaluate the growth ratios of loan & advances and total investment with respect to growth ratios of total deposit and net profit.
- To study the various risks in investment.

The study was conducted on the basis of secondary data. The research findings of the study are:

- The liquidity position of NBBL is not better than that of HBL and NSBL.
- NBBL is in better position regarding its on balance sheet activities. The ratios of NBBL are highly variable which reveals NBBL has not followed stable policy.
- NBBL is not better regarding off-balance sheet transactions. The ratios of NBBL are highly variable also. The position of NBBL is moderate in OBS transaction.
- The profitability position of NBBL is comparatively not better than that of HBL but better than that of NSBI.
- The credit risk ratios and interest rate risk ratios of NBBL is higher than that of HBL and NSBI.
- NBBL has not maintained adequate capital in relation to the nature and condition of its assets, its deposit liabilities and other corporate liabilities.
- NBBL has maintained high growth rate.
- Deposit collection position, lending position, investment position and net profit position of NBBL is not better in comparison to HBL but better than NSBI.

Mr. Lila Prasad Ojha (2002) conducted a study on *"Lending practices: A study on NABIL Bank Ltd., SCB Nepal Ltd. and Himalayan Bank Ltd."* with the objective of:

- To determine the liquidity position, the impact of deposit in liquidity and its effect on lending practices.
- To measure the bank's lending strength.
- To analyze the portfolio behavior of lending and measuring the ratio and volume of loans and advances made in agriculture, priority and productive sector.
- To measure the lending performances in quality, efficiency and its contribution in total income.

The study was conducted on the basis of secondary data. The research findings of the study are:

- The measurement of liquidity has revealed that the mean current ratio of all the three banks is not widely varied. All of them are capable in discharging their current liability by current asset.
- The measurement of lending strength in relative terms has revealed that the total liability to total assets of SCBNL has the highest ratio. The high ratio is the result of high volume of shareholder equity in the liability mix. Himalayan Bank Ltd. has high volume of saving and fixed deposits as compared to current deposit resulting into low ratio of non-interest bearing deposits to total deposits ratio compared to the combined mean.
- SCBNL's tendency to invest in government securities has resulted with the lowest ratio of loans and advances to total assets ratio whereas NABIL Bank Ltd. has highest due to steady and high volume of loans and advances throughout the years.
- The ratio of investment to investment and loan and advances has measured the total portion of investment in total of investment and loans and advances. The mean ratio among the banks does not have deviated significantly.
- The loans and advances and investment to deposits ratio has shown that NABIL Bank Ltd. has deployed the highest proportion of its total deposits in earning activities. This is the indicative of that in fund mobilizing activities NABIL Bank Ltd. is significantly better.
- The absolute measures of lending strength have revealed that the mean volume of net assets and deposits is highest in SCBNL with moderate variation. The volume of net assets of Himalayan Bank Ltd. is the least due to the low share capital, reserves and

surplus in its capital mix. But the volume contributed by Himalayan Bank Ltd. in case of loans and advances is highly appreciable as compared to its net assets. The volume of loans and advances contributed by NABIL Bank Ltd. is the greatest in five years of study period. The mean investment of NABIL Bank Ltd. is the highest but the investment on government securities of SCBNL is the highest.

- The portfolio analysis has revealed that the flow of loans and advances in agriculture sector is the lowest priority sector among these commercial banks. The contribution of all the banks in industrial sector is appreciable. The contribution made by Himalayan Bank Ltd. in industrial sector is the greatest and that of SCBNL is the least.
- The lending in commercial purpose is highest in case of NABIL Bank Ltd. and least in case of SCBNL. SCBNL has highest contribution in service sector lending. It has contributed 25.47 % of its total credit in general use and social purpose.
- The measurement of efficiency in lending has revealed that the loan loss provision to loans and advances analysis shows that NABIL Bank Ltd. has the highest mean ratio. According to Nepal Rastra Bank directive, the loan loss provision indicates the provision made against the performing loan (pass loan and sub-standard loan) only. It indicates that the volume of sub-standard loan in the loan mix of NABIL Bank Ltd. is higher and the volume of non-performing loan in the mix of NABIL Bank Ltd. is likely to increase in coming future.
- The mean ratio of interest income to total income has concluded that the contribution of interest income in total income is higher in case of Himalayan Bank Ltd. and lower in case of SCBNL. The interest expenses to total deposits ratio indicate that the cost of fund in Himalayan Bank Ltd. is the highest and that of SCBNL is the least.
- The total income to total assets ratio measures the earning power of each rupee employed by the bank. NABIL's ratio in this case is the best. The ratio of total income to total expenses reflects the earning capacity of a rupee of expenses. The productivity of expenses in SCBNL is the best.
- The performance of SCBNL is significantly better than other two banks in case of profitability. EPS is highest in case of SCBNL.

Mr. Shiba Raj Laudari (2001) conducted a study on *"A study on investment policy of Nepal Indosuez Bank Ltd. in comparison to Nepal SBI Bank Ltd."* with the objectives of: -

- To examine the liquidity, asset management and profitability position and investment policy of NIBL in comparison to Nepal SBI bank ltd.

- To study the growth ratios of loans and advances and investment to total deposit and net profit of NIBL in comparison to Nepal SBI bank ltd.
- To analyze relationships between deposit and investments, deposits and loan & advances, net profit and outside assets of Nepal Indosuez Bank Ltd. in comparison to Nepal SBI Bank Ltd.

The study was conducted through secondary data. The research findings of the study are as follows: -

- Current ratios for both the Banks is satisfactory.
- Although cash reserve ratio (CRR) is managed by both banks as per Nepal Rastra Bank directives, both banks have not paid sufficient insight toward cash management. Their cash reserves have fluctuated in a high degree
- Nepal SBI Bank Ltd. has increased investment in government securities where as Nepal Indosuez Bank Ltd. has decreased.
- Nepal Indosuez Bank Ltd. has maintained both current ratio and cash reserve ratio better than Nepal SBI Bank Ltd. But its cash and bank balance, investment in government securities and loan and advances in comparison to current assets are lower than that of Nepal SBI Bank Ltd.
- Deposit utilization of Nepal Indosuez Bank Ltd. is less effective than that of Nepal SBI Bank Ltd. Further Nepal Indosuez Bank Ltd. has invested lesser amount on government securities and shares and debenture than that of Nepal SBI Bank Ltd.
- Nepal Indosuez Bank Ltd. did a better performance in return on total assets and loan and advances and interest earning, but it paid lower interest amount to working fund.
- The analysis of growth ratios shows that growth ratio of total deposit, loan and advances, total investment and net profit of Nepal Indosuez Bank Ltd. is less than that of Nepal SBI Bank Ltd.
- The trend value of loan and advances to total deposit ratio is decreasing in case of both the banks. The trend value of total investment to total deposits ratio is also decreasing in case of both the banks.

Mr. Upendra Tuladhar (2000) conducted a study on "*A study on investment policy of Nepal Grindlays Bank Limited in comparison to other Joint venture Banks of Nepal"* with the objective of:

- To study the fund mobilization and investment policy with respect to fee-based off-balance sheet transaction and fund based on-balance sheet transactions.
- To study the liquidity, efficiency of assets management and profitability position.
- To evaluate the growth ratios of loan and advances and total investment with respective growth rate of total deposit and net profit.
- To perform an empirical study of the customers' views and ideas regarding the existing services and adopted investment policy of the Joint venture banks.

The study is mainly based on secondary data and in some aspects of the study primary data are also collected through questionnaire survey of 100 respondents. The research findings of the study are as follows:

From the analysis of primary data concerning in which sector should JVBs invest; 28.37 % respondents emphasized on educational sector to be invested by these JVBs as the potential investment sector. Consequently poverty stricken and deprived sector was given second priority (26.24 %), whereas industrial sector (18.44 %), tourism sector (16 %), agricultural sector (16 %), and construction sector (4.25 %) are given third, fourth, fifth and sixth priority respectively.

From the analysis of secondary data, following conclusions were drawn:

- Nepal Grindlays Bank Ltd. has maintained consistent and successful liquidity than NABIL Bank Ltd. and Himalayan Bank Ltd.
- The mean of total investment to total deposits ratio of Nepal Grindlays Bank Ltd. is higher than the other JVBs. The mean of the loan and advances to total deposits ratio of Nepal Grindlays Bank Ltd. is less and inconsistent than NABIL Bank Ltd. and Himalayan Bank Ltd.
- Loan and advances to working fund ratio of Nepal Grindlays Bank Ltd. was found less than the mean ratio of other banks. Investment on government securities to working fund ratio of Nepal Grindlays Bank Ltd. had the highest mean ratio than NABIL Bank Ltd. and Himalayan Bank Ltd. during the study period.
- It was found that total Off-balance sheet operation to loan and advances ratio of Nepal Grindlays Bank Ltd. is found to be of highest mean ratio than that of NABIL Bank Ltd. and Himalayan Bank Ltd. It means Nepal Grindlays Bank Ltd. used to perform highest

off-balance sheet operation than the other two JVBs ie; used to give priority to provide letter of credit, guarantee and others(eg:- trade finance) excessively than to others.

- The mean of investment on shares and debentures to total working fund ratio of Nepal Grindlays Bank Ltd. was found less than NABIL Bank Ltd. but higher than Himalayan Bank Ltd.
- The profitability position of Nepal Grindlays Bank Ltd. is higher than NABIL Bank Ltd. and Himalayan Bank Ltd. as well as it use to provide interest to the customers for different activities consistently.
- The volume of growth ratio of loan and advances of Nepal Grindlays Bank Ltd. is found higher than that of NABIL Bank Ltd. but lower than Himalayan Bank Ltd. It indicates that all the JVBs used to provide loan and advances in increasing manner.
- From the analysis of growth ratio of total investment it is found that Nepal Grindlays Bank Ltd. and NABIL Bank Ltd. have negative growth ratio ie; they used to reduce the investment during the study period. But it is increasing in the case of Himalayan Bank Ltd.
- The growth ratio of net profit of Nepal Grindlays Bank Ltd. seemed to be more satisfactory than NABIL Bank Ltd. but in case of Himalayan Bank it seemed to be very high.

Mr. Prem Bahadur Shahi (1999) conducted a study on *"Investment policy of commercial banks in Nepal"* with the main objectives of:

- To evaluate the liquidity, asset management efficiency and the profitability and risk position of Nepal bank limited to the Joint venture banks.
- To discuss fund mobilization and investment policy of Nepal bank limited in respect to its fee based off-balance sheet transaction and fund based on-balance sheet transaction in comparison to the Joint venture banks.
- To find out the empirical relationship between various important variables ie; deposits, loan and advances, investment, net profit, etc. and compare them with the Joint venture banks.
- To analyze the deposit utilization trend and its projection for next five years of the Nepal bank limited and compare it with that of the Joint venture banks.
- To provide a package of workable suggestions and possible guidelines to improve investment policy of Nepal bank limited and the Joint venture banks based on the

finding of the analysis, for the improvement of financial performance of Nepal bank limited in future.

The research was conducted mainly on the basis of the secondary data. The research findings of the study are as follows: -

- The liquidity position of NBL is comparatively better than that of the JVBs. Highly fluctuating liquidity position shows that the bank has not formulated any stable policy. It can also be conducted that NBL has more portions of current assets as loan and advances but less portion as investment on government securities.
- The mean ratio of loan and advances to total deposit of NBL is slightly lower than that of the JVBs. Likewise NBL's ratios seem to be more variable than that of the JVBs. The mean ratio of total investment to total deposit of NBL is lower than that of the JVBs. The mean ratio of investment on government securities to total working fund of NBL is slightly lower than that of the JVBs. The mean ratio of total off-balance sheet operation to loan and advances of NBL is found significantly lower than that of JVBs. So it was concluded that NBL is comparatively less successful in on-balance sheet as well as off-balance sheet operations than that of the JVBs. It hasn't followed any definite policy with regard to the management of its assets.
- Profitability position of NBL is comparatively not better than that of the JVBs. It indicates that NBL must maintain its high profit margin in future.
- There is comparatively higher risk in NBL than that of the JVBs regarding various aspects of the banking function.
- From the analysis of different growth ratios it can be concluded that NBL has not been more successful to increase its sources of funds, ie; deposits and mobilization of it. ie; loan and advances and total investment. Similarly it seems to have failed to maintain high growth rate of profit in comparison to that of other JVBs.
- It has been found that there is significant relationship between deposits and loan and advances. There is negative relationship between deposits and investment in case of NBL and positive in case of the JVBs.
- NBL has higher trend analysis values of loan and advances and deposit, but lower trend values of net profit and total investment in comparison to the JVBs for next 5 years.
- Highly fluctuating ratios of NBL show that it has not formulated any stable policy to maintain its liquidity in a consistent manner.

High portion of cash and bank balance in NBL shows its negligence and inefficiency in its best utilization. It has not considered the cost of fund and its opportunity costs. Higher percentage of loan loss ratios shows that NBL is weak in credit collection. There is absence of a sound credit collection policy. NBL has not followed innovative approach toward lending. Poor quality of loan due to lack of necessary skills of project appraisal, improper collateral evaluation, irregular supervision, etc. is a severe problem for the bank's success.

2.5 Justification of the Study / Research Gap

Going through the review of various books, articles, publications and also the unpublished research works previously done in this field, it is understood that investment policy was evaluated on the basis of portfolio behavior and financial performance of the banks. None of the researchers have taken policy statements directly to study the investment policy.

Predicting investment policy on the basis of financial statements may lead into false interpretation. Investment policy aims at creating high yielding portfolio structure. So, portfolio structure should be analyzed side-by-side to evaluate the policy's effectiveness. This type of study is not found in the past.

Furthermore, there is not any comprehensive research regarding the investment policy and portfolio management of Nepal Credit and Commerce Bank Limited. Here, investment policy and portfolio management are two separate sections for comprehensive study. However, researcher has tried to include both topics in this thesis paper so as to bridge the research gap.

This study covers the more recent financial data, literature and NRB directives/circulars and literature so that the recent issues and scenarios can be highlighted.

CHAPTER – 3

RESEARCH METHODOLOGY

Research methodology refers to sequential steps adopted by researcher to achieve the objectives laid down in the research. It describes the methods and processes applied in the entire subject of the study. Research Methodology is a way to solve the research problem systematically and more precisely scientifically. It is necessary for the researcher to know not only the research methods/techniques but also the methodology. Researchers not only need to know how to develop certain indices or tests, how to calculate the mean, the mode, the research techniques, but they also need to know which of these methods or techniques are relevant and which are not, and what would they mean and indicate and why.

The topic of the problem has been selected as "Investment Policy and Portfolio Management of Nepal Credit and Commerce Bank Limited". The sole objective of this study is to evaluate the Investment Policy of Nepal Credit and Commerce Bank Limited and to analyze the existing portfolio. In order to reach and accomplish the objectives of the study, different activities are carried out and different stages are crossed during the study period. For this purpose, this chapter aims to present and reflect the methods and techniques those are carried out and followed during the study period. This chapter deals with research design, sources of data, data collection, processing and tabulating procedure and methodology.

3.1 Research Design

A research design is a framework or devise for a study that guides the collection and analysis of data. It is the plan, structure and strategy of investigations conceived so as to obtain answers to research questions and to control variances. A true research design is basically concerned with various steps to collect the data for analysis and draw a relevant conclusion. It is the arrangement of conditions for collection and analysis of data that aims to combine relevance to the research purpose with economy in procedure.

This research is merely a case study research. It views Nepal Credit and Commerce Bank ltd. as a whole. A case study not only uses the sources and techniques of historical study but also

employs several techniques and sources of data for examining the current aspects of the phenomena under study (Shah, 1972). According to Wolf and Panta (2005), to conduct a case study research, the investigator gathers pertinent data about the present status, past experiences and environmental forces that contribute to the individuality and behavior of the unit. They further added that after analyzing the sequences and inter-relationships of these facts, he or she conducts a comprehensive study of social unit as it functions in society. The research design for this thesis is shown below:

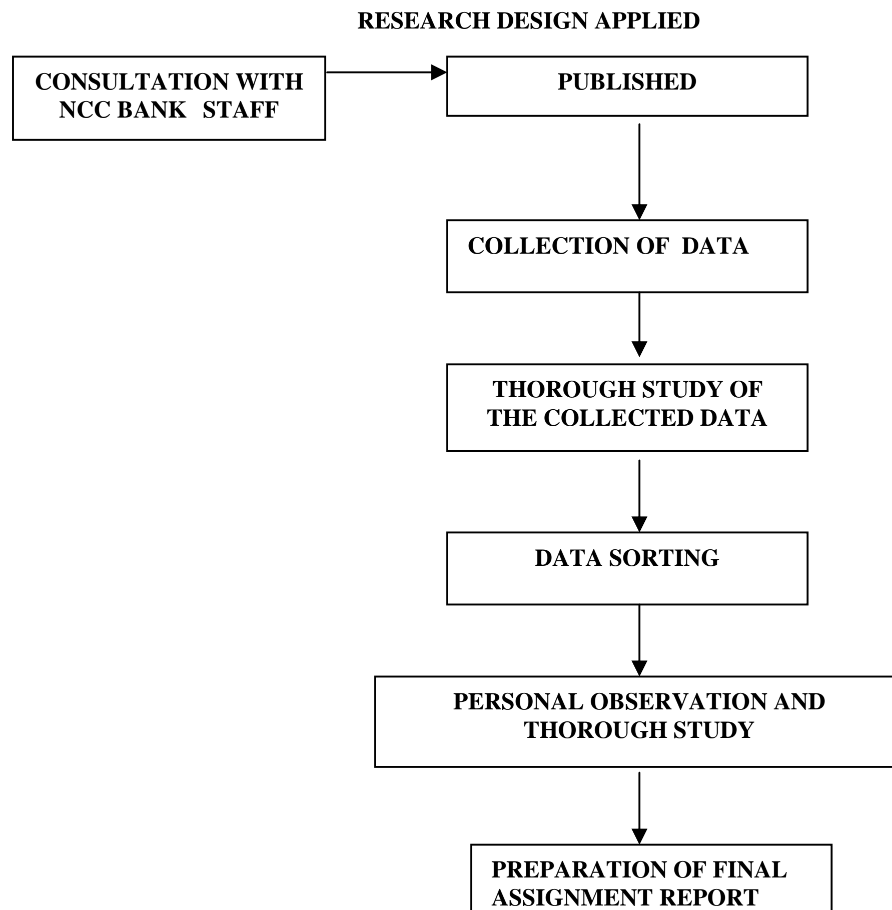


Figure 1 : Research Design Applied

Procedure

For the preparation of this research, following procedure is followed.

Conception

Definition

Planning

Implementation

Termination

a. Conception phase:

For the appropriate topic, various interaction with friends, college library visit, net surfing was done. After making this effort the topic **"Investment Policy and Portfolio Management"** was chosen.

b. Definition Process:

In the definition phase, certain vision to be carried out for research was developed, the description of the problems and the research topic were analyzed. After that, the aim of the research was listed out.

c. Planning phase

Planning is very important phase. In this phase, the methodology to gather information was developed, reference books and reports were collected and the overall work schedule was prepared. Appropriate bank for the topic was selected.

d. Implementation phase

The real work started in this phase. The bank "Nepal Credit and Commerce Bank Ltd" was visited. Various types of credit that NCC Bank is financing were scrutinized. The concept on types of credit, the documentation process in lending, and the factor to be considered while lending was acknowledged from verbal interaction with the staff members. The effort made by the staff in managing investment portfolio was observed. Finally, the annual financial reports of the bank were collected.

e. Termination phase

The final assignment report was edited, printed and binded with a copy of collected information and then was submitted to the college.

As per above diagram, first of all the necessary data related with NCC Bank were collected from NCC Bank Ltd. Collection of data consists of compiling useful information to quantify and analyze to ascertain the conclusion of the research. Then a thorough analysis of all the data collected was made. After that, necessary data were sorted and analyzed in a systematic manner.

Some financial and statistical tools have been applied to examine facts and descriptive analysis techniques have been adopted to evaluate Investment Policy and its influences on the investment portfolio of NCC Bank.

3.2 Population and Sample

The population refers to the industries of same nature and its services and product in general.

Sample is taken from the total population, which are as follows:

1. Nepal Bank Ltd (NBL)
3. Rastriya Banijya Bank Ltd. (RBB)
4. Agriculture Development Bank Ltd. (ADBL)
4. Nabil Bank Ltd (Nabil)
5. Standard Chartered Bank Nepal Ltd. (SCBNL)
6. Nepal Investment Bank Ltd. (NIBL)
7. Himalayan Bank Ltd. (HBL)
8. Nepal SBI Bank Ltd. (NSBIBL)
9. Nepal Bangladesh Bank Ltd. (NBBL)
10. Bank of Kathmandu Ltd. (BOKL)
11. Everest Bank Ltd. (EBL)
12. Nepal Credit and Commerce Bank Ltd. (NCC Bank)
13. Nepal Industrial and Commerce Bank Ltd. (NICBL)
14. Machhapuchhre Bank Ltd. (MBL)
15. Kumari Bank Ltd. (KBL)
16. Lumbini Bank Ltd. (LUBL)
17. Laxmi Bank Ltd. (LBL)
18. Siddhartha Bank Ltd. (SBL)
19. Global Bank Ltd. (GBL)
20. Citizen International Bank Ltd. (CBL)
21. Bank of Asia Ltd. (BAL)
22. Prime Bank Ltd. (PBL)
23. Sunrise Bank Nepal Ltd.(SRBL)
24. Nepal Merchant Bank Ltd. (NMBL)
25. Development Credit Bank Ltd. (DCBL)

There are twenty five commercial banks operating in Nepal. The reason for selecting NCC Bank for our study has been justified in Statement of Problem section of chapter-I and Research Gap section of Chapter 2.

This is a case study research of Investment policy and portfolio management of NCC Bank. So, an extensive study of a single unit NCC Bank will be conducted.

3.3 Sources of data

3.3.1 Primary Data

Primary Data are the original data gathered for the research project in hand. This data is collected for meeting the specific objective of the study. As the research design was based mostly on the exploratory design, primary data source was one of the vital sources of collection. Primary Data was collected from the customers and the staff of NCC Bank. Data or information regarding Investment Policy and Portfolio Management was collected by making the set of questions and was taken verbally.

3.3.2 Secondary Data

Secondary sources of data refers to the readymade data and report, which is already published by the concerned organization, or data that has been compiled by others. Secondary data is thus defined as the data collected earlier for a purpose other than one currently being pursued. Secondary data are the brochures, annual reports, published reports and statements, published official documents, etc. Secondary data have been collected from following sources:

The annual reports of NCC Bank are the major sources of data for the analysis of portfolio. However, besides the annual reports of the subjected bank, the following sources of data have also been used in the course of the study:

- Nepal Rastra Bank Directives.
- Economic Survey (Published by Ministry of Finance)
- Banking and Financial Statistics.
- Books and Articles.
- Previous Dissertations.
- Website related to Investment Policy & Portfolio Management.

Formal and informal talks with the officials of the bank were also helpful to obtain the additional information of the related problem.

3.4 Data gathering procedure:

The information about the Investment Policy and Portfolio Management and historical data are required to ascertain the conclusion and recommendation for the problems identified in this Research.

Historical Information and current Investment Policy of NCC Bank has been obtained directly from the bank. Information about the additional provisions and procedures not included in the investment and credit policies have been gathered after conducting informal interview with the bank officials. These steps as stated above are considered as the primary sources of data and information.

The analysis of Portfolio is based on secondary data which are extracted from:

1. The Annual Reports of NCC Bank for the period of eleven years from fiscal year FY 2054/55 to FY 2064/65
2. Credit Policy - 2002, Credit Policy Guidelines- 2061 (2004), Credit Strategy – 2061 (2004) of NCC Bank, Investment Policy and Assets and Liability Management Policy, 2008
3. NRB publications such as Quarterly Economic Bulletins, Banking and Financial Statistics, Economic report, etc.
4. Websites of Nepal Stock Exchange Ltd.

Share Department and Management Information System Department of NCC Bank located at its Corporate Office, Bagbazaar, Kathmandu have been used as data bank. The researcher also visited concerned departments of Nepal Rastra Bank at Baluwatar to obtain NRB publications. The data on some aspect of these banks was obtained from the website of the Bank, NRB and Nepal Stock Exchange Ltd.

Some supplementary data and information and literature review have been collected from Central Library, Kirtipur, Library of Shanker Dev Campus and magazines. Other published and unpublished reports documented by the concerned authorities have been used to complete this thesis.

3.5 Data processing and analysis procedure:

Presentation and analysis of the collected data is the core of the research work. The collected raw data are first presented in systematic manner in tabular forms and are then analyzed by applying different financial and statistical tools to achieve the research objectives.

As already stated, the thesis paper has concentrated itself to analyze the investment policy and appraise the investment portfolio of NCC Bank.

3.5.1 Analysis technique of Investment Policy:

The Investment Policies and strategies of the bank have been collected and reviewed. Based on the review of all such documents relating with the credit policy, credit guidelines, credit strategy and investment policy for investment in securities following questionnaire have been filled up to appraise the credit policy and investment in securities policy separately:

Assessment of Credit & Investment policy

1. Is there credit policy in written form for loans and advances?
2. Were there such policies since the commencement of bank?
3. Have the objectives been defined in precise terms?
4. Has the policy addressed to encourage and discourage credit?
5. Has the policy defined the sectoral loan portfolio exposure?
6. Has the policy stipulated geographical diversification of credit?
7. Has the policy mentioned risk diversification methodology?
8. Has the policy quantified the desired mix of loan portfolio?
9. Does the policy encourage liquid loans such as working capital loan, discounting of bills, etc.?
10. Does the policy state the amount of collateral margin required for loans and advances?
11. Are lending authorities defined?
12. Are loan products defined of the policy?
13. Are responsibilities and procedures for appraisal of credit defined?
14. Has the policy addressed clear-cut provisions regarding the renewal, extension, restructuring, rescheduling of loans?
15. Is recovery of loans included in the policy?

Score '1' have been assigned to each 'YES' answer and '0' to each 'NO'. All scores have been totaled and converted into percentage. Based on the percentage scores obtained so far, the investment policy has been appraised as follows:

Scores (%)		Policy category
0 to 40	**-**	**Poor**
41 to 60	**-**	**Good**
61 to 80	**-**	**Very good**
81 to 100	**-**	**Sound**

Assessment of policy for investment in securities

1. Is there Investment Policy in written form for investment in securities?
2. Are there any provisions regarding limits of investment in Governmental Securities, NRB Bonds and ordinary stock exchange securities?
3. Has the policy tried at matching maturities of investments with liabilities?
4. Does the policy address mitigation of risks associated with each investment?
5. Does the policy encourage liquidity and profitability of the securities investment?

Score '1' have been assigned to each 'YES' answer and '0' to each 'NO'. All scores have been totaled and converted into percentage. Based on the percentage score obtained so far, the Investment Policy has been appraised as follows:

Scores (%)		Policy Performance
0 to 40	**-**	**Poor**
41 to 60	**-**	**Good**
61 to 80	**-**	**Very good**
81 to 100	**-**	**Sound**

3.5.2 Analysis technique for Investment Portfolio:

Investment portfolio has been analyzed on the following ground:

1. Portfolio's liquidity,
2. Portfolio management,
3. Portfolio performance,
4. Portfolio's profitability.

It has been appraised using the following tools:

1. Financial tools
2. Statistical tools

3.5.2.1 Financial Tools

Financial tools basically help to analyze the financial strength and weakness of a firm. Ratio analysis is one of the important financial tools that have been used in the study. A ratio is relation between two or more variables. It expresses the quantitative relationship between any two numbers. Ratio can be expressed in terms of percentage, proportion and as coefficient. Logarithmic graph and break-even chart are the graphic forms of expressing a ratio. Financial ratio is the mathematical relationship between two accounting figures. For commercial banks, ratio analysis is a part of the whole processes of analyzing their financial position. Even though there are many ratios to analyze and interpret the financial statement, only those ratios that are related to the investment operation of the bank have been used to complete this research. The following ratios related to the investment and credit management have been used in this study.

3.5.2.1.1 Liquidity Ratios

Liquidity refers to the ability of a firm to meet its short-term or current obligations as and when they fall due for payment. So liquidity ratios are used to measure the ability of a firm to meet its short-term obligations and from them the present cash solvency as well as ability to remain solvent in the event of adversities of the same can be examined *(Van Horne 1999).*

Inadequate liquidity can lead to unexpected cash short falls that must be covered at inordinate costs, thus reducing profitability. In the worst case, inadequate liquidity can lead to the liquidity insolvency of the institution. On the other hand, excessive liquidity can lead to low asset yields and contribute to poor earnings performance *(Scott 1992).*

To find-out the ability of banks to meet their short-term obligations, which are likely to mature in the short period, these ratios are calculated. As a financial analytical tool, following four liquidity ratios have been used to come into the facts and findings of the study.

(i) Cash Reserve Ratio (CRR):

Cash Reserve Ratio (CRR) is the one which the banks have to maintain with itself in the form of cash reserves or by way of current account with the Nepal Rastra Bank (NRB), computed as a certain percentage of its deposit liabilities excluding margin and foreign currency deposits. There is mandatory provision to maintain the CRR at certain level as per the directive of the central bank. The objective is to ensure the safety and liquidity of the deposits with the banks.

This ratio measures the relation of cash requirement for the payment of deposit liabilities. It is obtained by dividing cash at vault plus cash balance at NRB by total deposits excluding margin and foreign currency deposits. For the fiscal year 2064/65, banks have to maintain the 5% cash reserve with NRB at their current account as mandatory reserve. However, for the FY 2065/66 the banks have to maintain the 5.5% cash reserve with NRB.

(ii) Current Ratio:

This ratio shows the bank's short-term solvency. It shows the relationship between current assets and current liabilities. It is obtained by dividing current assets by current liabilities. This ratio can be calculated using the following formula:

$$\textbf{Current Ratio} = \frac{\textbf{Current Assets}}{\textbf{Current Liabilities}}$$

The widely accepted standard of current ratio is 2:1. But accurate standard depends on the circumstances of the business and the nature of business. But for Commercial Banks operating in developing countries like Nepal, the standard 2:1 is quite high to measure the liquidity performance.

Current Assets include:

1. Cash (Local currency and Foreign currency)
2. Balance with Nepal Rastra Bank
3. Balance with other domestic banks
4. Balance held abroad
5. Inter-bank lending
6. Bills purchased and discounted
7. 40% of loans, advances and interest receivable on loans and advances (assumption)
8. Investment on governmental securities
9. Advance payments and receivables/sundry debtors
10. Interest receivables on investment

11. Prepaid expenses
12. Staff loans and advances
13. Advance tax payment

Current Liabilities include:

1. Current deposit liabilities
2. 60% of savings deposit liabilities
3. Fixed deposit of less than year (if data available maturity-wise) or 40% of fixed deposit liabilities, in case the data is not available maturity-wise (assumption)
4. Other deposits
5. Bills payable
6. Borrowing
7. Expenses payable
8. Bonus payable
9. Dividend payable
10. Income tax payable

(iii) Liquid loan to total loan ratio:

It shows the proportion of liquid loan in total loan portfolio. While calculating this ratio, total of liquid loan is divided by total loan portfolio. The loan classified under pass loan category as per NRB Directives is included as liquid. The "pass loan" category as per the NRB's directive consists of such loans which are not past due and past due upto three months only. On the other hand, sub-standard, doubtful and loss loans are categorized as illiquid loans. Total loans include all loans and advances including bills purchase and discounting.

$$\text{Liquid loans to total loan ratio} = \frac{\text{'Pass' loans and advances including bills purchased and discounted}}{\text{Total loans and advances including Bills Purchased \& Discounted}}$$

(iv) Liquid investment to total investment ratio:

Under this the relation between liquid investment and total investment is measured. Here, liquid investments refer those investments on securities which can be traded in money market or in Nepal Stock Exchange. Numerator is taken at face value of the investment and denominator is taken at cost.

Liquid investment to total investment = $\frac{\text{Investment on marketable securities}}{\text{Total investment on securities}}$

3.5.2.1.2 Portfolio Management Ratios:

Portfolio management ratio measures the proportion and effectiveness of various assets and liabilities in balance-sheet. The proper management of assets and liability ensures its effective utilization of resources. The banking business converts the liability into assets by way of its lending and investing functions. Asset and liability management ratio measures its efficiency by multiplying various liabilities into performing assets. The following are the various ratios relating to asset and liability management, which are used to determine the efficiency of the concerned bank in managing its assets and efficiency in portfolio management

(i) Loan & Advances to Total Deposit Ratio (C/D ratio)

This ratio is also called credit-deposit ratio (CD ratio). It is calculated to find out how successfully the banks are utilizing their total deposits on loan and advances for profit generating purpose. Loans and advances are the highest yielding assets in a bank's portfolio. Greater ratio implies better utilization of total deposits at the cost of liquidity. This ratio can be obtained by dividing loan and advances by total deposit as under,

C/D ratio = $\frac{\text{Total loans advances including bills purchased and discounted}}{\text{Total deposit liabilities}}$

Total loans include all loans, advances, bills purchased and discounted. Total deposit liabilities include all deposit liabilities shown in the balance-sheet.

(ii) Loan and Advances to Total Assets Ratio:

Loan and advances is the major component in the total assets, which indicates the ability of bank to utilize its deposits in the form of loans and advances to earn high return. This ratio is computed to assess credit proportion in the total assets.

This ratio is computed by dividing loan and advances by total assets as follows:,

Loan and advances to total assets ratio = $\frac{\text{Loan and Advances}}{\text{Total Assets}}$

Here, the denominator includes all assets of on-balance sheet items and total assets include all loans, advances, bills purchased and discounted.

(iii) Investment on Stock and Securities to Total Assets Ratio:

This ratio shows the bank's investment in governmental securities, shares and debenture of the subsidiary and other companies. This ratio can be derived by dividing total investment on governmental securities, shares and debentures by total assets.

$$\text{Investment on securities to total assets ratio} = \frac{\text{Investment on Securities}}{\text{Total Assets}}$$

(iv) Investment on Government Securities to Total Assets Ratio:

This ratio shows that bank's investment on government securities in comparison to the total assets. Investment on Governmental Securities gives second line of defense for liquidity next to cash and bank balance. This ratio signifies the bank's portfolio management in relation to liquidity. This ratio is calculated by dividing investment on government securities by total assets.

$$\text{Investment on Government Securities to Total Assets Ratio} = \frac{\text{Investment on Government Securities}}{\text{Total Assets}}$$

(v) Total Off-Balance sheet items to Total Loans and Advances Ratio:

The off balance sheet operation shows the bank's efficiency in conducting modern off-balance sheet transaction in comparison to total loans and advances. Off-balance sheet operation includes issuance of letter of credit, letter of guarantee, irrevocable loan commitment, etc.. This ratio shows the proportion of fee-based off-balance sheet activities to fund based loan and advances of the bank. Now a days, fee-based off-balance sheet activities play an important role for the better performance of a bank. This ratio is calculated by dividing total off balance sheet items by loan and advances, which is stated as hereunder,

$$\text{Total Off-Balance sheet items to Loan \& Advances ratio} = \frac{\text{Total Off-Balance Sheet Items}}{\text{Loan and advances}}$$

3.5.2.1.3 Portfolio Performance Ratios

Portfolio performance ratios are activity ratios. Performance activity ratio measures the performance efficiency of an organization from various angles of its operations. These ratios indicate the efficiency of activity of an enterprise to utilize available funds, particularly short-term funds. These ratios are used to determine the efficiency, quality and the contribution of the assets included in the ultimate total portfolio towards profitability. The following activity ratios have been calculated to measure the performance efficiency of the bank to utilize its funds.

(i) Loan Loss Provision (LLP) to Total Loans and Advances Ratio:

The ratio of loan loss provision to total loans and advances describes the quality of assets that a bank is maintaining. Nepal Rastra Bank has directed the commercial banks to classify its loans & advances into the category of pass, sub-standard, doubtful and loss on the basis of the maturity of principal, to make the provision of 1, 25, 50 & 100 percentage respectively. The provision for loan loss reflects the proportion of non-performing loans in the volume of total loans and advances. This ratio is calculated by dividing the loan loss provision by total loans and advances as presented hereunder.

$$\text{Loan loss provision to Total Loan} = \frac{\text{Loan loss provision}}{\text{Total Loans and Advances}}$$

(ii) Non-performing Loans (NPL) to Total Loans & Advances Ratio:

This ratio measures the proportion of non-performing loans on the total volume of loans and advances. It is also called the NPA level. This reflects the quantity of quality assets that the bank have. Higher ratio reflects the bad performance of the bank in mobilizing loans and advances and bad recovery rate and vice versa. This ratio is computed by dividing the non-performing loans by total loans and advances as under.

$$\text{Non-Performing Loans to Total Loans \& Advances Ratio} = \frac{\text{Non-Performing Loans}}{\text{Total Loans and Advances}}$$

Here the numerator includes the loans categorized as substandard, doubtful and loss loans which require 25, 50 & 100 per cent provision respectively as per NRB directives.

3.5.2.1.4 Portfolio Profitability Ratios:

Profitability ratios are used to indicate and measure the overall efficiency of a firm in terms of profit and financial performance. For better performance, profitability ratios of firms should be higher. Following ratios have been computed to study the portfolio's profitability:

(i) Interest Income to Total Income Ratio:

This ratio measures the volume of interest income in total income of the bank. The high ratio indicates the high contribution made by the lending and investing activities and vice versa. This ratio can be computed by dividing interest income to total income presented as under:

$$\text{Interest Income to Total Income Ratio} = \frac{\text{Interest Income}}{\text{Total Income}}$$

The higher the ratio, the greater is the dependency of bank towards risky assets for profitability.

(ii) Interest Expenses to Total Expenses Ratio:

This ratio measures the portion of total interest expenses in the volume of total expenses. The high ratio indicates the low operational expenses and vice versa. This ratio is computed by dividing interest expenses by total expenses:

$$\text{Interest Expenses to Total Expenses Ratio} = \frac{\text{Interest Expenses}}{\text{Total Expenses}}$$

(iii) Yield Rate of Loan Ratio:

This ratio is calculated to find out the percentage of interest earned from total loans and advances. Higher ratio implies better performance of the bank in terms of interest earning on its loans and advances. It is calculated by dividing total interest income by average of opening and closing balances on loans and advances account. Thus;

$$\text{Yield rate of loans} = \frac{\text{Total Interest Income}}{\text{Yearly moving average of balances of loans and advances.}}$$

Here, loans and advances include bills purchased and discounted.

(iv) Cost of Deposit Ratio:

This ratio is calculated to find out the percentage of interest paid on deposit liabilities. This ratio can be calculated by dividing total interest expenses by yearly moving average of all deposit liabilities;

$$\text{Total interest paid to total deposit ratio} = \frac{\text{Total Interest Paid}}{\text{Yearly moving average of Total Deposit Liabilities.}}$$

(v) Return on Total Assets Ratio (ROA):

This ratio measures the overall profitability of all total assets. It is also known as return on assets (ROA). This ratio is calculated by dividing net profit/ (loss) by total assets. This can be mentioned as,

$$\text{Return on total assets ratio (ROA)} = \frac{\text{Net Profit (Loss)}}{\text{Total assets}}$$

(vi) Return on Equity Ratio (ROE):

This ratio measures how efficiently the bank has used the funds of the owners. This ratio is calculated by dividing net profit/loss by total equity capital (net worth). This can be stated as,

$$\text{Return on equity ratio (ROE)} = \frac{\text{Net Profit (Loss)}}{\text{Total Equity Capital}}$$

Here, total equity capital includes shareholder's reserve including profit and loss account and share capital i.e. ordinary share and preference share capital.

(vii) Earning per Share (EPS):

EPS refers to net profit divided by total number of shares outstanding. The amount of EPS measures the efficiency of a firm in relative terms. This ratio is computed by dividing total net profit (loss) by total number of shares outstanding.

$$\text{Earning per Share (EPS)} = \frac{\text{Net Profit (Loss)}}{\text{Total Number of Shares Outstanding}}$$

3.5.2.2 Statistical Tools

Some important statistical tools are used to achieve the objective of this study. In this study statistical tool such as mean, standard deviation, & coefficient of variation have been applied for analysis.

3.5.2.2.1 Mean

A mean is the average value or the sum of all the observations divided by the number of observations and it is denoted and given by the formula:

$$\overline{X} = \frac{X}{N}$$

Where, $\overline{X}$ = Mean of the values.

N = Number of Pairs of Observations.

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

3.5.2.2.2 Standard Deviation

The standard deviation measures the absolute dispersion. It is said that higher the value of standard deviation the higher the variability and vice versa. Karl Pearson introduced the concept of standard deviation in 1823 and this is denoted by the small Greek letter (read as sigma).

The formulas to calculate the standard deviation are given below:

$$\dagger\ X\sqrt{\frac{x^2}{N}}$$

Where, x = ($\overline{X}$ - X)

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

3.5.2.2.3 Coefficient of Variation

The standard deviation calculated in the above formulas gives an absolute measure of dispersion. Hence, where the mean value of the variables is not equal, it is not appropriate to compare two pairs of variables based on standard deviation only. The coefficient of variation measures the relative measures of dispersion and compare two variables independently in

terms of their variability. The coefficient of variation (C.V.) is given by the following formula and this gives the percentage.

Coefficient of variation (C.V.) $\frac{\dagger}{\overline{X}}$ x 100

These three statistical tools have been used side-by-side along with financial ratio analysis to measure trend and consistency.

3.5.2.2.4 Trend Line

Trend lines have been inserted to in the graph of major financial ratios analysis. These lines help to understand the trend followed by the selected variables. These lines have been inserted with the help of Microsoft Excel (spread sheet) software of computer. Some of the lines are linear and some are two degree polynomial.

CHAPTER – 4

PRESENTATION AND ANALYSIS OF DATA

4.1 Introduction

This chapter deals with the presentation, analysis and interpretation of relevant data of NCC Bank in order to fulfill the objectives of this study. To obtain best result the data have been analyzed according to the research methodology as mentioned in third chapter. ”A report can be worthless if interpretation is faulty, even if valid and reliable data have been collected”. (Pant P.R.1998).

“The data after collection has to be processed and analyzed in accordance with the outline laid down for the purpose at the time of developing the research plan (Kothari C.R. 1990)”. The purpose of this chapter is to analyze and interpret the data related to investment policy and portfolio management. Data analysis is the relationships or differences supporting or conflicting with original or new hypothesis should be subjected to statistical tests of significance to determine with what validity data can be served to indicate any conclusion.

With the help of this analysis, efforts have been made to highlight the Investment Policy and the Portfolio Management of NCC Bank as well as the lacking in the Credit and Investment Policies of Bank. For analysis, the researcher uses the different types of analytical methods and tools such as financial ratio analysis plus other statistical analysis.
Previous chapters provided the concept, bases, inputs, analytical plan and frame work of the study. In this chapter, the data collected from various sources have been presented and analyzed to measure the various dimensions of the problems of the study and in major findings of the study are presented systematically.

4.2 Analysis of investment policy

Investment Policy analysis has been carried out in three steps. Firstly, investment policy has been appraised using appraisal score. Secondly, policy analysis has been carried out by

studying the content of policy related documents. Thirdly, bank's policy has been compared with the directives issued by Nepal Rastra Bank.

4.2.1 Policy Appraisal Score:

As discussed in chapter III of the report, different components of the investment policy have been examined to see whether the investment policy includes minimum necessary issues or not.

Table – 4.1: Appraisal score of investment policy

Policy	Score obtained	Maximum possible score	Percentage	Result
Loans and advances policy (credit policy)	13	15	87%	Sound
Policy for investment on securities	4	5	80%	Sound
Aggregate score	**17**	**20**	**85%**	**Sound**

(Source: Appendix 1)

Based on the review of policy related documents, credit policy of NCC Bank scored 13 points out of 15. Thus the loans and advances policy falls under sound category.

Similarly, the investment in securities policy of banks scored 80% score indicating sound status.

Thus out of total 20 points, overall policy obtained 17 points which is 85% of total score. The overall investment policy is classified as Sound.

4.2.1.1 Analysis of Credit Policy

It is found that bank has been using credit policy 2002 as major investment policy for investment on loans advances, Off Balance Sheet items, bills purchased and discounting. The objective of this policy was to define clear-cut policy of bank on credit and trade finance matters so as to enhance quality of assets. It also aimed at developing common understanding on the issue on credit and trade finance related matters to develop uniformity amongst all the branches and departments of the bank.

The bank formulated Credit policy guidelines – 2061 (2004), which is more precise and has wider coverage. The objectives of the Credit Policy Guidelines are to support to extend

qualitative lending and to improve quality of services in credit operation area. Major contents of these policy guidelines are objectives, strategies, credit products, product pricing, credit operation, risk dispersion, audit and compliance focus. To support objectives of credit policy guidelines, Credit strategy – 2061 (2004) has been made effective for implementation.

The content of the policies with regard to the principles of liquidity, profitability, safety, purposive, national interest, and diversity is as analyzed as under

1. Credit policy for liquidity:

The credit policy of the bank has encouraged lending to trade finance and short term nature financing. Investment under this sector of economy is of short-term nature and thus supports liquidity of portfolio. As per the credit policy 2002, bank aimed at reducing long term loan outstanding from 22% to 15%. Long term loans are not current assets for banks. To improve liquidity and thereby increase proportion of performing loans, credit policy 2002 aimed at increasing trade finance from 19% to 33% of total loan portfolio.

2. Credit policy for profitability:

Return to the Bank is a major objective of this credit policy because it is the essence of making a Bank financially viable. (NCC Bank, Credit policy guidelines 2061, P-12). To ensure the profitability, policy is designed such that credit products yield high. According to credit policy guidelines 2061, pricing is generally determined considering cost of funds, extent of risk, business condition, tax implication, volume of business and so on.

For banks, major pricing decision is determined by the interest rate of loans & advance and interest to be paid to depositors. Similarly commissions and charges for bank guarantees, letter of credit, remittance, collections, bills purchase. etc. are another aspects of pricing policy.

It has been observed that the Bank is applying interest rates on both lending and deposits higher than the market rate than its competitors. Bank may loose prime customers in case of lending if lower interest rate is not offered to them.

3. Credit policy for safety or security:

Amount and quality of collateral securities required to obtain credit facilities from bank is clearly spelled out in the policy. Normally, funded facility should be covered by 167% of the collateral security of project, fixed assets, current assets, personal guarantees as well. Collateral coverage requirement for prime clients who intend to use non-funded facilities of bank guarantees is 50% of the facility amount.

Collateral valuation procedure is also cited in the policies. Professional property valuators will be assigned the valuation job. As per the credit strategy 2061, to arrive at the distress value of the landed collateral, 60% weightage shall be provided to the market value and 40% weightage shall be assigned to the value fixed by governmental authorities. However, valuation method of current assets is not incorporated in the document.

Thus, bank has made such policy which will sufficiently cover its lending.

4. Purposive credit policy:

Principle of purposive while extending lines of credit emphasizes on proper utilization of bank's credit. Loans and advances policy of a bank should clearly cite the purposes for which it will advance credit facilities. For NCC Bank, its policy statement has clearly mentioned the encouraged and discouraged credit facilities. 'Know Your Customer (KYC)' practice quoted the policy documents will help bank to identify customers who may misuse its credit facilities.

However, clear-cut policy statement about the purposive principle of credit policy is not found.

5. Principle of national interest:

As per the credit policy guidelines – 2061, the bank shall put effort to support the cottage and small industries that are being encouraged by government as a means to increase employment, to improve living standard and to acquire business and technical skills to grow into larger enterprises.

While pricing the products, bank has set lower interest rate in priority sector and deprived sector lending. Similarly to encourage export, exporters can borrow from bank at the lowest interest rate.

Thus bank's policy has also tried to address national interest as much as it can.

6. Credit policy for diversification:

To reduce the risks inherent in lending, loans and advances should be diversified as much as possible. Economic sector wise diversification, geographical diversification, maturity wise diversification are some methods of diversification.

Credit policy – 2002 and credit strategy - 2004 has pointed out the economic sector wise dispersion policy as follows:

Table 4.2: Sector wise lending policy of NCC Bank

Sector	Actual 2002	Policy 2003	Actual 2004	Policy 2005
Industry	44%	45%	42%	43%
Service	27%	25%	28%	25%
Trading and others	29%	30%	30%	32%

(Source: Credit policy - 2002 and Credit policy guidelines - 2061 (2004), NCC Bank)

Credit policy guidelines – 2004 has quoted the provisions regarding industry exposure ceiling in the loan portfolio. The policy is such that bank may impose credit-ceiling towards a particular sector of economy to attain and maintain a loan portfolio that is well diversified. This policy is in line with NRB directive.

Geographical diversification policy is lacking in the bank.

4.2.2 Compliance of bank's policy with NRB's Directives:

Nepal Rastra Bank, the central bank has urged commercial banks to formulate their own credit policy and implement it effectively. The role of the central bank in policy formulation is limited within the regulatory framework. There is no representation of NBR in the BOD of the commercial bank, which is ultimate authority for policy formulation. NRB is following open market policy and encouraging healthy competition amongst commercial banks. This is due to liberalization policy of the state.

However, the policy of the banks should be in line with the NRB directives. In the credit policy guidelines – 2004, it is clearly stated that the bank will comply the relevant and applicable provisions of central bank's directives, company act, bank and financial institutions act or any other acts and directives in force. This is the compliance commitment of the bank.

1. Directive no. 1: Capital Adequacy

The NRB Directive no. 1 states about the Capital Adequacy Norms for financial institutions indicating the requirements of maintaining the Capital Fund to the prescribed ratios. The directives are said to be based on the internationally accepted norms of Basel committee which was established by the central bank governors of the group of ten countries in 1975.

The Basel committee on banking supervision is a committee of banking supervisory authorities.

The Capital Adequacy Ratio is derived on the basis of Total Risk Weighted Assets. The capital adequacy ratios to be maintained by commercial banks till FY 2064/65 were as follows:

Core Capital : **5.5%** of the Total Risk Weighted Assets
Total Capital Fund: **11%** of the Total Risk Weighted Assets

However, NRB has issued directive to implement the Capital Accord- Capital Adequacy Framework 2007 from FY 2065/66. All the banks have to calculate the capital requirement based on the Basel II approaches. Basel committee on baking supervision has developed a new capital accord. which is popularly known as Basel –II.

The new capital accord has been introduced basically for the protection of depositors by preserving the integrity of capital in banks.

The framework has developed the following three pillar approaches for maintaining capital adequacy of the banks.

- **Pillar I : Minimum capital requirement**
  - Credit risk
  - Operational risk
  - Market risk
- **Pillar II: Supervisory review process**
  - Bank's own assessment of capital adequacy
  - Capital above the regulatory limit
  - Supervisory review and intervention
- **Pillar III: Market discipline**
  - Disclosure requirements and recommendations

As per the above directives the Bank has to maintain the total capital fund of 10% of Total Risk Weighted Assets.

2. Directive no. 2: Classification of loans and advances and provision for loan loss

NRB directive no. 2 requires classification of loans and advances into pass, sub-standard, doubtful and loss category on the basis of expiry. Such policy is also incorporated in the banks policy guide lines. The annual financial statements also contain such classification from FY 2057/58 onwards. However, it could not ascertain whether the classification is done on the basis of expiry. Furthermore, compliance is not the field of study of this thesis. This directive also requires additional loan loss provision of 20% for loans and advances secured by personal

guarantees. Hence, bank's policy of accepting personal guarantees as security is weakening profitability policy.

3. Directive no. 3: Provision regarding single obligor limits and loan limit for single sector of economy

Directive no. 3 requires credit diversification. Through this directive, central bank has directed commercial banks to develop internal policies and measures to monitor the concentration of funded and non-funded facilities in different sectors of economy. It also has imposed ceiling to the amount of loans that can be extended to a single borrower.

In line with this bank has been using Credit policy 2002, credit policy guidelines 2004 and Credit strategy 2004 as policy guidelines.

4. Directive no. 8: Investment

The written policy for investment on securities was not available earlier. However, based on the practices developed on the banks, it can be concluded that the investment policy is not at acceptable level because there is huge proportion of unmarketable securities. NRB has restricted to invest on shares of those companies which can not be traded in open market. But bank's portfolio still includes such shares.

Due to inclusion of poorly performing companies' shares in investment portfolio, its performance is very poor. As per the financial statement of FY 2063/64, bank's investment on shares was NPR166,423,349/- at cost. However, market value of the same was NPR 88,774,182/-, a depreciation of 46.65 % in value. As per NRB Directive, the shortfall in value should be provisioned by debiting the profit loss account. The Bank has formulated Investment Policy and Assets Liability Management Guidelines, 2008 during FY 2064/65. As per that policy the Bank has initiated to dispose off the shares of companies being held by NCC Bank. Accordingly, the Bank has disposed off the shares of National Hydro Power Company Ltd. during FY 2064/65. The Bank has been able to earn a profit of NPR 37,194,546/-. However, bank's investment on NRB treasury bills and NRB bond is satisfactory. Such investment is fulfilling both the purposes of liquidity and profitability. The total outstanding of such investment at the end of FY 2064/65 is NPR 1,735,593,743/- which is 21.06% of total assets of the Bank.

From FY 2064/65, the Bank has been following the policy guidelines to improve the performance of investment portfolio and to maximize the interest income.

5. Directive no. 15: Provision relating to interest rate

This directive has link with profitability policy of the bank. According to the directives, banks are free to fix their interest rate to be paid on deposits and to be charged on loans and advances. Any changes on such rates should be made public through national daily newspaper. In line to this provision, NCC Bank publishes the changes notification in news papers on quarterly basis.

Similarly, this directive has directed banks to recognize interest income on cash basis only. Any unrealized interest income should be parked into interest suspense account. It is found that bank had unrealized interest income of NPR 90.27 Crores as on FY 2063/64. However, the Bank has been able to reduce Interest Suspense to NPR 62.17 Crores on FY 2064/65.

4.3 Investment portfolio analysis

After analyzing the investment policy, investment portfolio has been studied. While appraising the portfolio, all the items appearing in the balance-sheet and profit loss statement are taken into consideration. The investment portfolio has been evaluated on the basis of the following aspects:

1. Portfolio's liquidity,
2. Portfolio management,
3. Portfolio performance and
4. Portfolio's profitability,

4.3.1 Liquidity of bank's portfolio:

A commercial bank must maintain its satisfactory liquidity position to satisfy the credit needs of the community, to meet demands for deposits withdrawal, pay maturity obligation in time and convert non-cash assets into cash to satisfy immediate needs without loss to the bank and without consequent impact on long-run profitability of the bank. To measure the liquidity position of the bank, the following measures of liquidity ratio has been calculated and a brief analysis of the same has been done as below.

4.3.1.1 Cash Reserve Ratio (CRR)

Cash Reserve Ratio (CRR) is the one which the banks have to maintain with itself in the form of cash reserves or by way of current account with the Nepal Rastra Bank (NRB), computed as a certain percentage of its deposit liabilities. The objective is to ensure the safety and liquidity of the deposits with the banks.

This ratio measures ready availability of cash in relation to total deposits collected from the customers. It is obtained by dividing cash in hand plus cash deposited at NRB by total deposits liabilities. There is mandatory provision to maintain the CRR at certain level as imposed by the central bank. From the fiscal year 2065/66, banks are to maintain the 5.5%.

The CRR of NCC Bank has been calculated in annexure II and tabulated below:

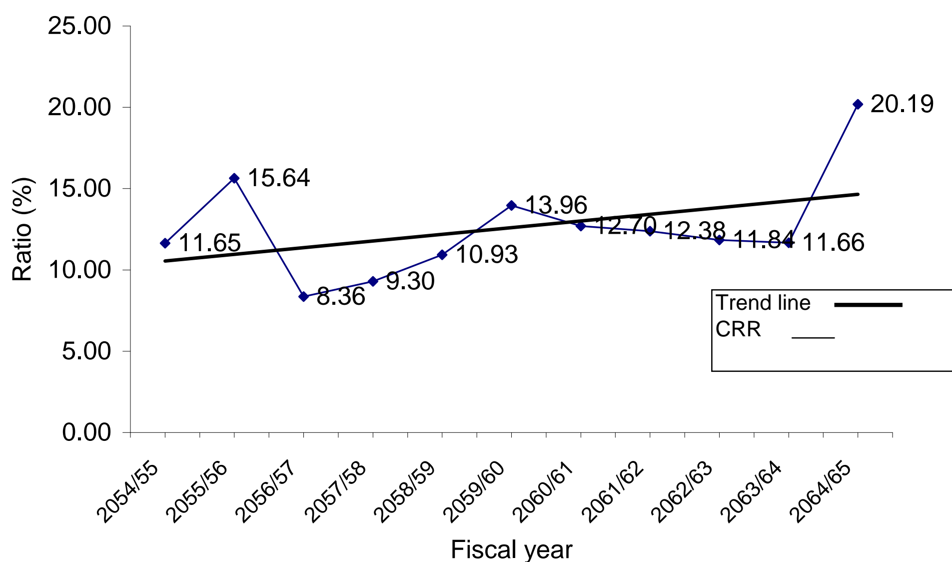
Table: 4.3 – Cash Reserve Ratio (CRR)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
11.65	15.63	8.36	9.30	10.93	13.96	12.70	12.38	11.84	11.66	20.19	12.60	3.20	25.43

(Source: Appendix 2)

The Cash and NRB balance is divided by total deposit liabilities to derive the CRR. As per NRB Directives, the Bank has to maintain 5.5% of total deposit liabilities excluding Margin and Foreign Currency deposit at NRB. However, in this analysis, the Cash Reserve Ratio has been calculated taking Cash and NRB Balance and total deposit liabilities which shows the strong liquidity position of the Bank. The above calculation reveals that the bank is holding cash and bank balances more that mandatory provision. 12.60% average CRR with 3.20 S.D indicates sufficient level of liquidity to meet urgent obligation. Current mandatory requirement is 5.5%.

Figure: 4.1: Trend line for Cash reserve ratio.



The trend shows the upward tendency. The Bank is holding more liquidity because of lack of investment opportunities.

4.3.1.2 Current ratio

This ratio indicates the ability of bank to meet its current obligation. This is the broad measure of liquidity position of the bank's portfolio.

This ratio shows the banks short-term solvency. It shows the relationship between current assets and current liabilities. The current ratios of NCC Bank are given in the following table

Table – 4.4: Current ratio

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
1.25	1.43	1.39	1.35	2.16	1.10	0.99	0.82	0.84	0.71	0.82	1.17	0.41	35.35

(Source: Appendix-3)

The above table shows that the current assets of NCC Bank have exceeded current liabilities during the study period from FY 2054/55 to 2059/60. The ratio from FY 2060/61 to 2064/65 shows that the current liabilities have exceeded the current assets. The highest ratio is 2.16 in 2058/59 while the lowest ratio is 0.71 in the year 2063/64 with an average ratio of 1.17 during the study period. The ratio shows the decreasing trend till the FY 2063/64 while it has increased in the FY 2064/65. The coefficient of variation (C.V.) between the ratios for the study period is 35.35% which shows the inconsistency of current ratios during the study period. In general, the current ratio analysis of the bank over the eleven year's period indicates that the bank has been able to meet its short-term obligations and has satisfactory liquidity position. But its capacity to meet such obligation is decreasing. Though the optimal standard of current ratio should be 2:1, the conventional measure of liquidity is not applicable in banking business.

Figure: 4.2: Trend line for Current ratio.

4.3.1.3 Liquid loans to total loans ratio:

Liquid loans consist of those loans which are categorized under 'Pass' loans as per NRB's directives. Total of 'Pass' loans is divided by total loans to analyze the liquidity of loan portfolio. The following table shows the ratio and is extracted from annexure – 4.

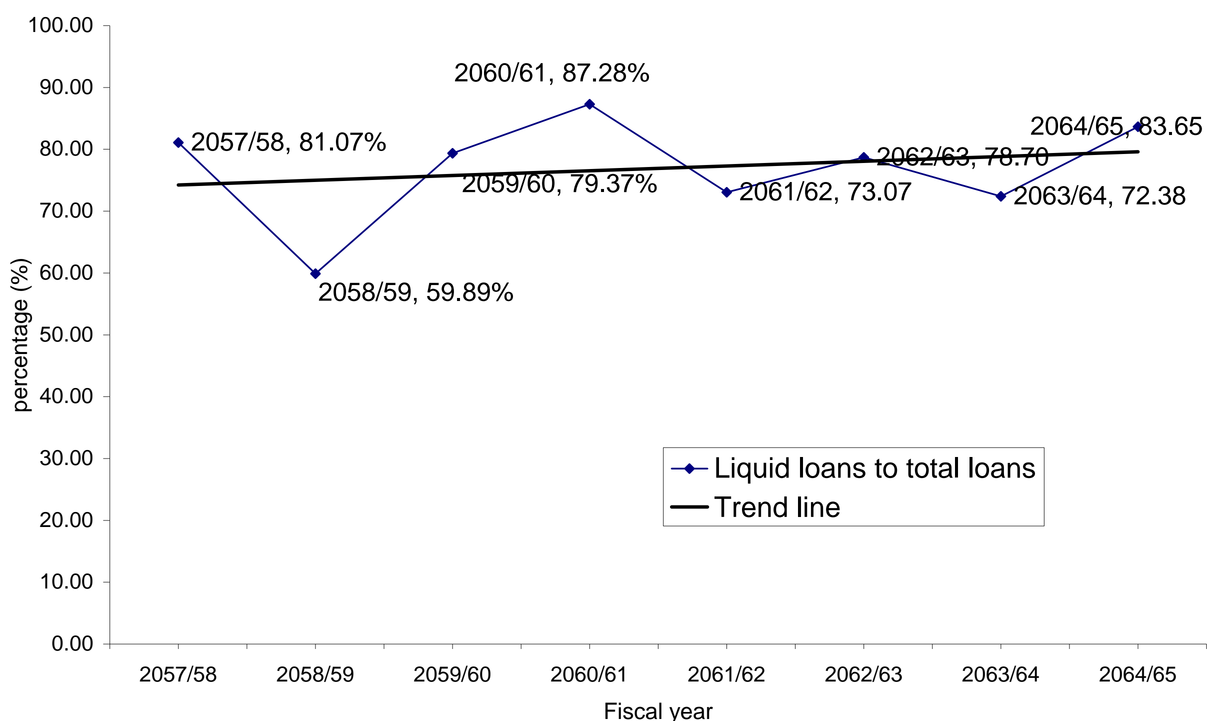
Table 4.5: Liquid loans to total loans ratio:

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
-	-	-	81.07	59.89	79.37	87.28	73.07	78.70	72.38	83.65	76.93	8.49	11.04

(Source: Appendix: 4)

The relevant data is not available for FY 2054/55 through 2055/57 as there was no provision of presenting such data in Annual Report. However, the last 8 years data are enough to cast a picture of liquidity of loan portfolio. From the above table, it can be analyzed that proportion of liquid loans to total loans remained at 76.93% at an average. The lowest ratio is 59.89 on FY 2058/59 and highest is on 2060/61 with value 87.28%.The bank is not managing its credit portfolio properly and it shows bank's weak position in monitoring and recovery of loans.

Figure: 4.3 Trend line for liquid loans to total loans



Liquid loans to total loans ratio shows the relation between liquid loans and total loans. Higher the ratio means the strong liquidity position of the bank if compared with total loan portfolio. For developing countries like Nepal, Commercial Banks have to deal with short term loans for which the liquidity of their loan portfolio should always be in higher side; tentatively above 90% at all times. The above Table shows that the liquidity of loan portfolio was not satisfactory during initial years. However, it is showing an improving trend due to the well management of Credit Portfolio. The proportion of liquid loan increased from 59.89% at FY 2058/59 to 83.65% at the FY 2064/65.

4.3.1.4 Ratio of investment on marketable or liquid securities to total securities

Liquid investment on securities is divided by total investment on shares, bonds and debentures to arrive at this ratio. Liquid investment refers to investment on those securities which can be traded easily in money market or in NEPSE. Value of investments is taken as per NRB's directive. Following table shows the proportion of liquid securities to total securities. (Source: appendix 5)

Table 4.6: Ratio of investment on marketable or liquid securities to total securities

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
12.59	75.73	75.68	70.79	79.08	82.45	93.42	93.14	85.99	93.23	95.53	77.97	8.76	11.24

(Source appendix 5)

The lowest of the ratio was 12.59% during FY 2054/55 and the highest was in 2064/65 with value 95.53 %. Mean of the ratios is 77.97%. However, the ratio started increasing since FY 2058/59. During FY 2054/55, it is observed that only 12.59% of the securities are liquid and 87.41% of the securities are not marketable. It shows the wastage of capital and resources. However, the trend shows improving liquidity of investment on securities.

4.3.2 Portfolio management ratios:

This ratio measures the efficiency of a commercial bank in its fund mobilization. A commercial bank must be able to manage its assets properly to earn high profit maintaining the appropriate level of liquidity. Asset management ratio measures the efficiency of the bank to

manage its assets in profitable way satisfactorily. The asset management ability of NCC Bank has been analyzed by applying the following ratios.

4.3.2.1 Loan & Advances to total deposit ratio (C-D ratio):

This ratio measures the extent to which the bank is successful to mobilize its total deposit on loan and advances for the purpose of income generation. A high ratio indicates better mobilization of collected deposits and vice versa. But it should be noted that too high ratio might not be better from liquidity point of view. This ratio is calculated by dividing loans and advances by total deposits (detail in Appendix-6).

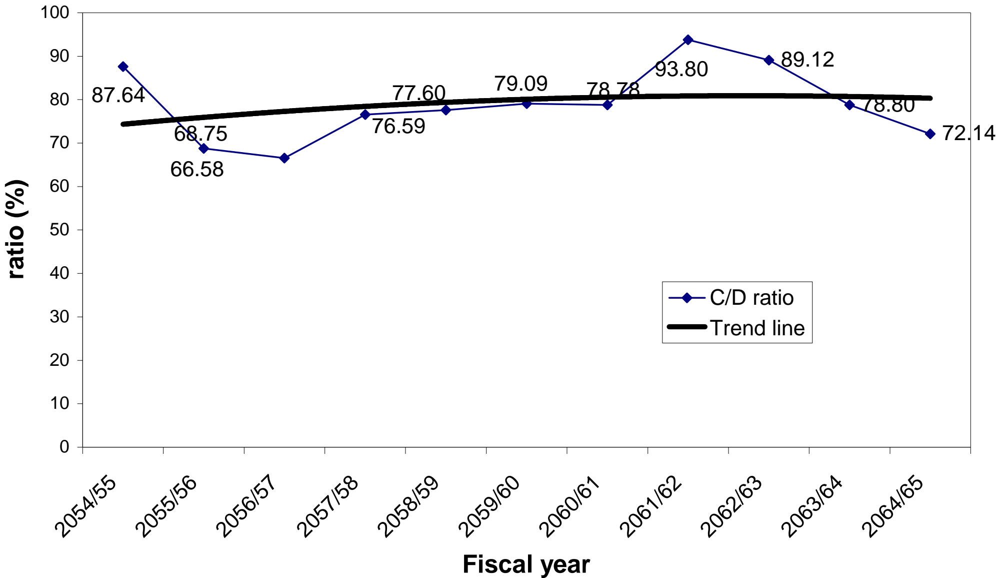
Table – 4.7: Loans & advances to total deposit ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
87.64	68.75	66.58	76.59	77.60	79.09	78.78	93.80	89.12	78.80	72.14	79.77	9.07	11.37

(Source: Appendix-6)

Figure 4.4: Trend line for C/D ratio

Following figure shows the trend followed by bank's CD ratio. Trend line is second degree polynomial



The above table and figure show that loan & advances to total deposit ratio of the bank was highest 92.41% in FY 2061/62. Since then, the trend showed decreasing order. The mean of the ratios is 79.77% with 9.07% C.V. between them, which shows that the ratios are moderately consistent over the study period.

The optimum level of C/D ratio differs from country to country. 70 % of C/D ratio is taken as standard for banks operating in developing countries. From this point of view, the loan & advances to total deposit of the bank is satisfactory up to FY 2056/57 whatever may be the case during the initial period. Loan and advances is the proportion of bank's investment into the most risky assets. High level of risk is not desirable for commercial banks as any default can create the liquidity problem. In the other hand, lower CD ratio indicates inability of investing the fund in profitable portfolio which will reduce the profitability of the bank.

4.3.2.2 Loan and advances to total assets ratio:

Loan and advances of any commercial bank represent the major portion in the volume of total working fund. This ratio measures the volume of loans and advances in the structure of total assets. The high degree of this ratio indicates the good performance of the bank in mobilizing its funds by way of lending function. However, in its reverse side, the high degree of this ratio is representative of low liquidity ratio. Granting the loans and advances always carries a certain degree of risk. Thus this asset of banking business is regarded as risky assets. This ratio measures the management's attitude toward risky assets. The low ratio is indicative of low productivity and high degree of safety in liquidity and vice versa.

This ratio also shows the credit risk taken by the bank towards mobilizing is funds into different types of assets. This ratio reflects the extent to which the banks are successful in mobilizing their total assets on loans and advances for the purpose of income generation. This ratio is computed by dividing loan and advances by total assets i.e. total working fund

Table 4.8: Loans & advances to total assets ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
62.45	53.67	52.84	60.40	70.28	70.28	70.82	92.41	91.78	84.85	64.08	70.35	13.94	19.81

(Source: Appendix-7)

The above Table shows that the ratio ranges from the minimum of 52.84% in 2056/57 to the maximum of 92.41% in 2061/62. The mean of the ratio is 70.35% and the C.V. between them is 13.94 which show the ratios are moderately consistent over the study period. This shows that loan and advances comprise 70.35% in average of the total asset of the bank.

Loans and advances is the most risky and most productive asset of the bank. High ratio suggests high risk and eventually high return to the bank. So, NCC Bank has taken optimum risk towards the mobilization of its fund to risky assets.

4.3.2.3 Investment on securities to total assets ratio:

This ratio measures the contribution made by investment on securities in total assets of the bank. Besides mobilizing its major portion of funds in the form of loans and advances, banks invest their funds in purchasing different types securities. They do so mainly to utilize the excess funds for income generation. A high ratio indicates better mobilization of fund as investments on securities and vice versa. This ratio is calculated by dividing investment on securities by total assets.

Table 4.9: Investment on securities to total assets ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
3.78	12.00	7.51	6.58	6.92	8.52	8.62	5.79	9.20	20.49	23.06	10.22	6.11	59.73

(Source: Appendix-8)

The above Table explains that the ratio has various magnitudes with arithmetic mean of 10.22 and standard deviation of 6.11 throughout the study period. The ratio has an increasing trend.

Investment on securities is the risk free investment for the commercial banks. It is the lowest yielding assets. However, it supports liquidity. This ratio shows the proportion of risk free assets in the total asset of bank.

4.3.2.4 Investment on government securities to total assets ratio:

This ratio measures the contribution made by investment on government securities in total assets of the bank. Besides mobilizing its major portion of funds in the form of loans and advances, banks invests their funds in purchasing different types government securities. They

do so mainly to utilize the excess funds for income generation without taking more risk and to maintain the adequate level of liquidity since these securities are more liquid assets than loans and advances. A high ratio indicates better mobilization of fund as investments on government securities and vice versa. This ratio is calculated by dividing investment on government securities by total assets.

Table 4.10: Investment on government securities to total assets ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
0.48	8.85	5.51	4.13	4.88	6.52	7.69	7.97	8.11	19.22	21.06	8.58	6.19	72.11

(Source: Appendix-9)

The above Table explains that the ratio has various magnitudes with arithmetic mean of 8.58 and standard deviation of 6.19 throughout the study period. The ratio has an increasing trend.

Investment on government securities is the risk free investment for the commercial banks. It is the lowest yielding assets. However, it supports liquidity. This ratio shows the proportion of risk free assets in the total asset of bank. Analysis shows that bank has invested less into low productive and risk free sector.

4.3.2.5 Total Off-Balance sheet items to loan & advances ratio:

This ratio shows the proportion of fee-based off-balance sheet activities to fund based loan and advances of the bank. Now a days fee-based off-balance sheet activity plays an important role for the better performance of a bank. These fee based activities are very much dependent on mode of operation, management strategy, banking network with foreign banks, etc. A commercial bank should not concentrate only on fund-based activities such as loan and advances, investment on different sectors and so on. Rather, it should pay its attention to increase fee-based off-balance sheet activities. Income generated through the fee-based off-balance sheet activities constitutes a significant proportion in the total income of most of the commercial bank's income statement. A high ratio indicates the higher OBS transaction and vice versa. This ratio is computed by dividing total OBS outstanding by total loan and advances (detail in appendix no.10).

Table 4.11: Total Off-Balance sheet operation to Loan & Advances ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
37.08	36.28	36.29	46.56	27.72	21.70	21.45	31.12	27.89	25.07	27.69	30.81	7.61	24.70

(Source: Appendix- 10)

The above Table explains that the ratios are ranged inconsistently with C.V. of 24.70% and S.D. of 7.61, average stands at 30.81%. From the above calculation, it is revealed that the ratios are not consistent during the study period and has shown fluctuating trend.

Lower ratios mean lesser focus of management team over the non-funded business. The analysis of the ratios shows that off -balance sheet operation of the bank is in decreasing trend. It may be due to increasing competition in the banking sector or bank is not getting enough attention towards non-funded business. The non-fund based business of the bank is not satisfactory.

4.3.3 Activity or Performing Ratios:

In this section, the lending efficiency in terms of quality and turnover is measured. Here different ratios are used to analyze the lending efficiency of the bank. For this purpose the relationship of different variables of balance sheet and profit and loss account have been established. The following ratios are analyzed for this purpose.

4.3.3.1 Loan loss provision to total loans and advances ratio:

The ratio of loan loss provision to total loans and advances describes the quality of assets that a bank is holding. NRB has directed the commercial banks to classify loans and advances into pass, sub-standard, doubtful and loss category and the provision has to be made on loans at 1, 25, 50 & 100 percentages respectively from the income. Loan loss provision set aside for performing loans is defined as General Loan Loss Provision and loan loss provision set aside for non-performing loan is defined as Specific Loan Loss Provision. Loan loss provision on the other hand signifies the cushion against future contingency created by the default of the borrowers. The low ratio signifies the good quality of assets in the total volume of loans and advances. The high ratio signifies the relatively more risky assets in the volume of loans and

advances. These ratios show how efficiently the bank is managing its loans and advances and the effort for timely recovery of loans. This ratio is calculated by dividing the loan loss provision by total loans and advances.

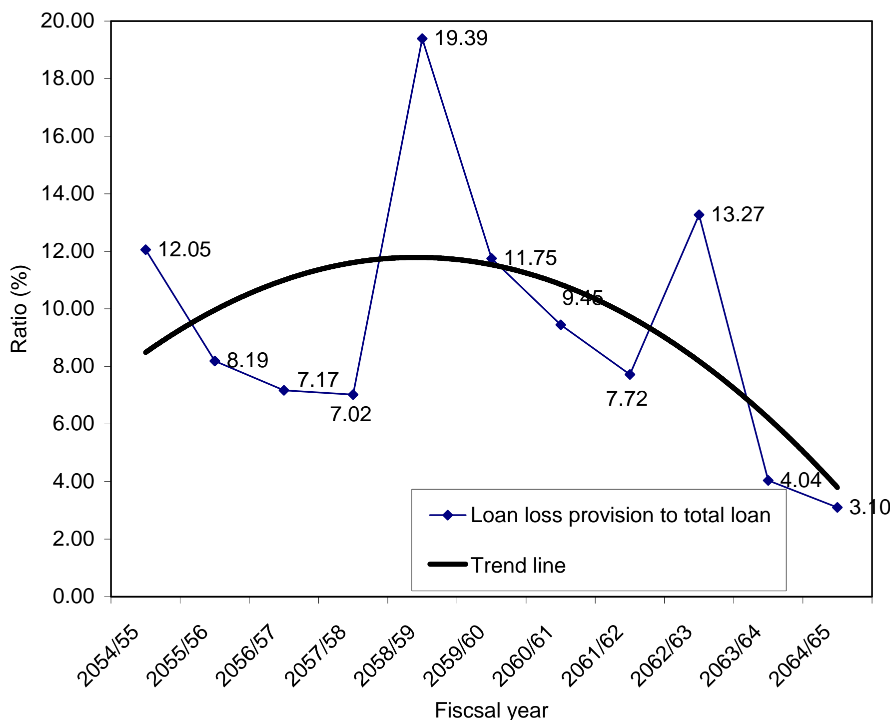
Table 4.12 Loan loss provision to total Loans & Advances ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
12.05	8.19	7.17	7.02	19.39	11.75	9.45	7.72	13.27	4.04	3.10	9.38	4.59	48.94

(Source: Appendix-11)

The above Table shows that the C.V. between ratios is 48.94%, which indicates that the ratios are fluctuating and not consistent with the increasing trend. The mean ratio stood at single digit 9.38%. The loan loss provision is the cushion against future defaults by borrowers. But in short-term, it affects on the profitability of the bank. However, the bank's loan portfolio is improving from FY 2063/64 as compared to earlier period. Higher ratio is the indicative of the lower quality of productive asset. Ratio of more than 1% indicates that the bank has alarming proportion of non-performing loan.

Figure: 4.5: Trend line/graph of loan loss provision to total loans



The above figure exhibits that the ratios for the study period have increasing trend at earlier period and then in decreasing trend. It reached maximum at FY 2058/59 and lowest to 3.10% in 2064/65. Decreasing ratios indicate efficiency of management in maintaining loan loss provision.

4.3.3.2 Non-performing loans to total loans and advances ratio:

This ratio indicates the NPA level of the bank. This ratio measures the proportion of non-performing loans on the total volume of loans and advances. This reflects the quantity of quality assets that the bank have. Higher ratio reflects the bad performance of the bank in mobilizing loans and advances and bad recovery rate and vice versa. A high level of non-performing assets is a sign of problems. However, this needs to be looked at in the context of the type of lending being done - some banks lend to higher risk customers than others and therefore tend to have a higher proportion of non-performing debt but will make up for this by charging higher interest rates to borrowers. This ratio is computed by dividing the non-performing loans (loans under category substandard, doubtful and loss) by total loans and advances.

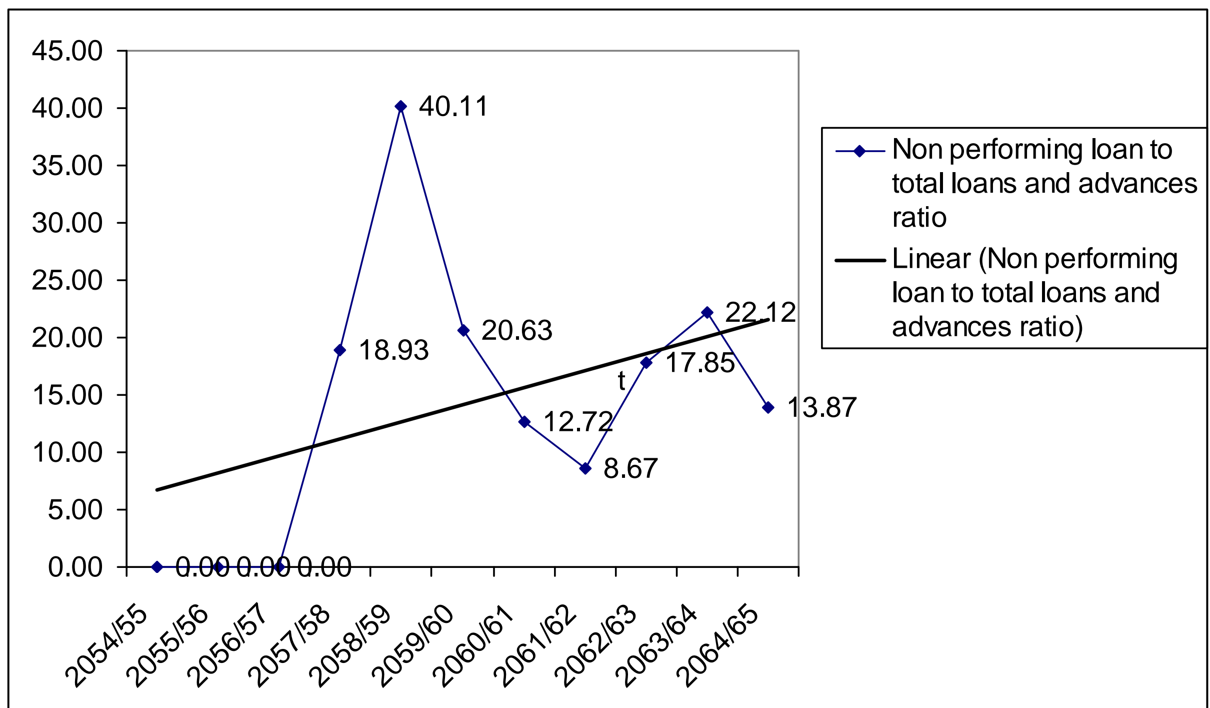
Table 4.13: Non-performing loans to total loans & Advances ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
-	-	-	18.93	40.11	20.63	12.72	8.67	17.85	22.12	13.87	19.36	9.49	49.03

(Source: Appendix-12)

The above table shows that the ratios during the study period are at increasing trend in the initial years of operation reached maximum of 40.11% at the FY 2058/59 and then afterwards show decreasing trend. Standard deviation & coefficient of variation suggest the inconsistency of the data. Mean of the ratio is 19.36%. Maximum ratio was during FY 2058/59. Data was not available for the first three years of study.

Figure - 4.6: Graph/trend line of Non-performing loans (NPL) to total loans ratio



The trend line suggests the decreasing pattern of ratio. Decreasing NPL level means increasing recovery and efficient management of NPL.

4.3.4 Profitability ratios:

The main objective of a commercial bank is to earn profit by providing different types of banking services to its customers. No bank can survive without profit. Profit is the indicator of efficient operation of a bank. Profitability ratios are the best indicators of overall efficiency. Higher profitability ratio shows the higher efficiency of a bank and vice versa. Through the following ratios, effort has been made to measure the profit earning capacity of NCC Bank.

4.3.4.1 Interest income to total income ratio:

This ratio measures the volume of interest income in total income of the bank. This ratio helps to measure the banks performance on how well they are mobilizing their fund for the purpose of income generation. This ratio also helps to measure the banks performance on other fee-based activities, since after investing functions fee based activities are the major source of banks income generation. The high ratio indicates the high contribution made by the lending and investing activities and vice versa. This ratio can be computed by dividing interest income by total income.

Table 4.14 Interest income to total income ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
68.41	74.73	92.17	84.51	87.46	94.28	89.07	88.14	88.75	86.51	81.78	84.90	7.54	8.88

(Source: Appendix-13)

The above table shows the ratios are consistent over the study period ranging from the minimum of 68.41% in 2054/55 to the maximum of 94.28 % in 2059/60. The mean of the ratios is 84.90 % and the C.V. between them is 8.88 %, which shows the consistency of the ratios over the study period. The ratios show over-dependency of bank towards risky assets. Mean ratio of 84.90% suggests that bank generated an average 14.09% other income during the study period. Other incomes are based on risk-free assets and on the services rendered by the bank. However, decreasing C/D ratio of the bank will help to decrease this ratio

4.3.4.2 Interest expenses to total expenses ratio:

This ratio measures the portion of total interest expenses in the volume of total expenses. The high ratio indicates the low operational expenses and vice versa. Interpreting in other way the high ratio can be due to the costly sources of funds. This ratio is computed by dividing interest expenses by total expenses.

Table 4.15: Interest expenses to total expenses ratio (%):

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
33.60	66.03	73.16	67.17	36.83	67.01	57.86	63.66	72.81	66.00	61.81	60.54	13.27	21.92

(Source: Appendix – 14)

Mean of the ratios is 60.54%. The above Table shows that ratios are inconsistent with S.D. 13.27 and C.V. 21.92. Lower ratios indicate higher operational cost and vice versa. The table suggests that for NCC Bank, interest expenses constitute lower proportion in total expenses implying higher operational cost. Interest paid to the depositors is the main expenses for the commercial banks. Another implication of this ratio is decreasing cost of fund.

4.3.4.3 Yield rate of loans ratios:

This ratio is computed to study the loan portfolio's earning rate. Total interest earned during each financial year is divided by yearly moving average of loans and advances. Denominator is taken as moving average of loans and advances to find the average loan outstanding throughout the year.

Table – 4.16: Yield rate of loans

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
15.22	14.61	16.27	12.46	9.93	13.93	12.00	13.90	11.93	12.70	11.07	13.09	1.88	14.39

(Source: Appendix 15)

Table – 4.17: Structure of interest rate of commercial banks

FY	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65
rate p.a. (overdraft)	10%-19%	10%-18%	10%-18%	10%-17%	11% - 17%	10-16%	6.5-15.5	6.5-14.5	6-14.5	6.5-13.5

(Source: Nepal Rastra Bank, website www.nrb.org.np)

The above Table is presented to show market interest rate structure. The overdraft rate has been taken to compare the yield rate of NCC Bank with the other Banks & Financial Institutions. In the interest rate range, higher end of interest rate is charged by finance companies and development banks where as interest rate charged by commercial banks lie towards the lower end. Mean of the end values is highest for the commercial banks.

This ratios computed in table 4.15 is indicative of earning power of the loan assets. The bank earned at an average rate of 13.09% during the study period. The earning rate lies around lower end of market interest rate. During FY 2055/56, the market rate for overdraft facilities in commercial banks ranged from 10% to 19%. NCC Bank earned at the rate of 14.61% during that year. Similarly during FY 2060/61, bank earned at the rate of 12.00% where as market rate was 10% - 16%. The lowest yield rate was during FY 2058/59 when bank earned at the rate of 9.93% despite the market range of 10% - 17%. It is due to parking of interest income into interest suspense account for non-realization in cash.

Thus, above analysis suggests bank to fix the interest rate in such a way to earn interest at least the average rate of commercial banks.

4.3.4.4: Cost of deposit ratio

This ratio measures the cost of deposit as a percentage of total deposit. A total of interest expenses is divided by moving average of total deposit to calculate these ratios. The calculation is tabulated below:

Table – 4.18 Cost of deposit ratio:

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
10.86	9.86	8.55	7.81	7.37	6.40	6.11	8.77	6.05	6.14	4.19	7.15	1.99	27.78

(Source: Appendix:16)

The average of the ratios is 7.15% with SD 1.99%, C.V. 27.78%. The ratios are showing decreasing trend.

Structure of interest rate of commercial banks during the study period is as shown below:

Table – 4.19: Structure of interest rate of commercial banks

FY	2055/56	2056/57	2057/58	2058/59	2059/60	2060/61	2061/62	2062/63	2063/64	2064/65
1 year FD	7.25-9.50	6-7.75	4.5-7.75	3.5-7	3-7	2.25-6.5	2.25-5	2.25-5	2.25-5	2.25-6

(Source: Nepal Rastra Bank, website www.nrb.org.np)

At an average, cost of deposit ratio is higher that the 1 year FD rate of all commercial banks. However, the cost of deposit of the Bank is decreasing from FY 2062/63 which signifies that the Bank has been able to maintain high rate of interest spread. The high rate of interest spread has contributed to the profitability of the Bank for the above years.

4.3.4.5 Return on assets ratio (ROA):

Return is the result of investment and it measures the profit earning capacity of the investible resources into different types of assets. If the banks total asset is well managed and efficiently utilized, return on such assets will be higher and vice versa. This ratio is calculated by dividing net profit/(loss) by total assets (detail in appendix no. 17). The following table shows the profitability position of NCC Bank with respect to total assets for the study period.

Table 4.20: Return on total assets ratio (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
(5.37)	1.52	0.16	0.43	(9.70)	1.69	0.05	(5.14)	(8.62)	(1.92)	6.05	(1.89)	5.08	(268.74)

(Source: Appendix - 17)

The above Table explains that the ratios are highly fluctuating during the study period. The bank incurred huge losses during the study period. Bank suffered huge amount of loss during FY 2058/59 due to high provision for Non Performing Loan and transfer of interest income to Interest suspense account. The Bank has been able to earn handsome amount of profit in FY 2064/65 due to recovery of bad loans which has contributed to reduce the accumulated loss. However, the Bank is suffering from accumulated loss. The negative Mean of the ratios also reflect that the bank is suffering accumulated loss till now.

4.3.4.6 Return on Equity (ROE):

This ratio measures the amount of profit that a rupee of shareholders fund has generated. The high ratio is indicative of high return to shareholders equity and vice versa. Positive ratios mean profit and negative ratios measure the quantum of loss suffered by the shareholders. This ratio is calculated by dividing net profit/(loss) by total shareholders fund

Table 4.21: Return on equity (%)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	58/59	59/60	60/61	61/62	62/63	63/64	64/65			
(32.45)	11.68	1.63	5.92	(113.48)	16.69	0.57	(50.38)	(79.36)	(16.58)	35.64	(22.15)	48.94	(220.94)

(Source: Appendix-18)

Return on equity (ROE) ratios are fluctuating during the study period with overall negative value. The ratio ranges between -113.48% in 2058/59 to 16.69% in 2059/60 with the mean ratio of -29.37%. C.V. between them is -159.70%, which shows that the ratios are more fluctuating and inconsistent during the study period.

4.3.4.7 Earning Per Share (EPS):

EPS refers to net profit divided by total number of shares outstanding. The amount of EPS measures the efficiency of a firm in relative terms. The figure is the indicative of the overall

good or bad performance of an organization. How far an organization is able to use its resources to generate profit is determined by the profit it has earned. This ratio is computed by dividing total net profit by total number of shares (detail in appendix no. 19).

Table 4.22: Earning per share (in NPR)

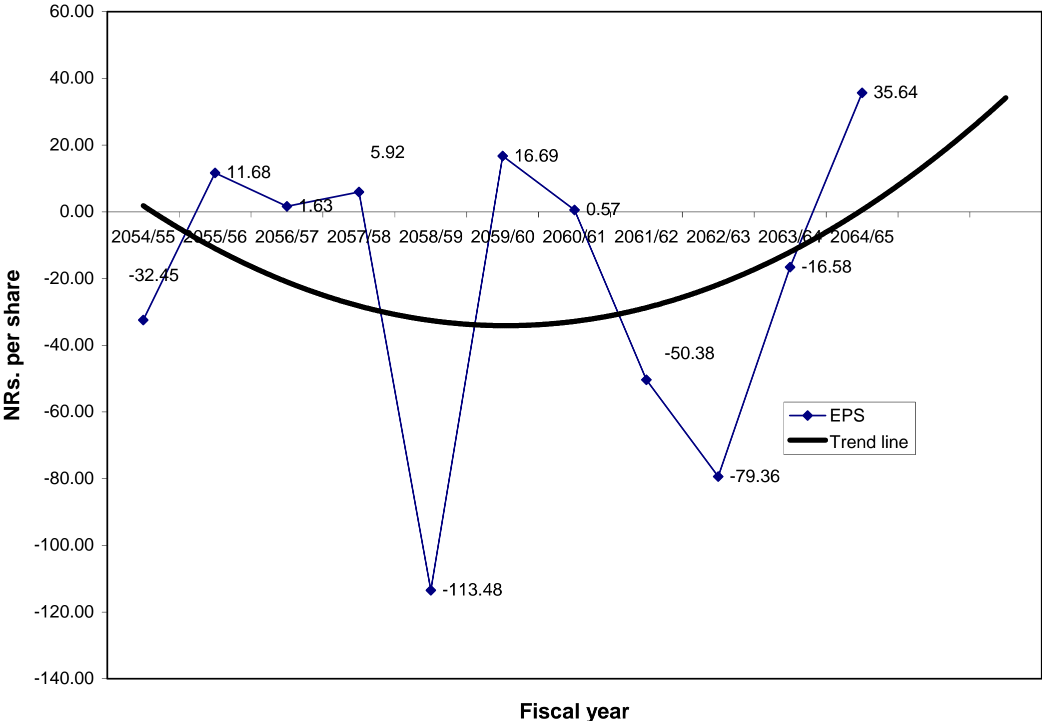
Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	59/60	59/60	60/61	61/62	62/63	63/64	64/65			
(32.45)	11.68	1.63	5.92	(113.48)	16.69	0.57	(50.38)	(79.36)	(16.58)	35.64	(20.01)	45.12	(225.49)

(Source: Appendix- 19)

Mean of the EPS is -20.01. It can be said share holders suffered loss of NPR 20.01 per share with SD of 35.64 and C.V. is -225.49%.

The shareholders have been suffered from loss due to negative earning per share. The above table shows that the shareholders have not been able to receive any return from the bank till Date. The face value of the share is NPR 100 and the shareholders have lost NPR 32.45 out of their investment of NPR 100 in FY 2054/55. However, the performance of the bank is satisfactory in terms of EPS in FY 2064/65.

Figure 4.7 Graph/trend line for EPS



In all Fiscal Years except for the FY 2064/65 the graph remained below X axis. EPS decreased sharply on FY 2062/63. The Trend is showing improving trend. The polynomial trend line suggests the EPS will continue to be positive from FY 2064/65.

4.3.5 Capital Adequacy Position

The Capital Fund of the Bank is important for the survival of the Bank. The investment in the risk assets is based on the capital fund of the bank. The Bank without having adequate capital fund can not invest in the risk assets as desired. The NRB has issued directives to banks & financial institutions to extend loans and advances on the basis of capital fund. The Capital Adequacy Positions of NCC Bank for the study period are as follows**.**

Table 4.23: Capital Adequacy Ratio (in %)

Fiscal Year											Mean	S.D	C.V. (%)
54/55	55/56	56/57	57/58	59/60	59/60	60/61	61/62	62/63	63/64	64/65			
17.20	17.20	12.60	11.70	3.70	4.80	3.99	4.20	(3.46)	(9.14)	11.09	6.72	8.25	122.77

(Source : Appendix - 20)

The capital fund of the Bank till FY 2057/58 was satisfactory and was below the requirement of NRB from FY 2059/60 to FY 2063/64. The Capital Fund of the Bank for the FY 2062/63 & 2063/64 was negative due to huge loss during these years. The above table reflects that the Capital Adequacy position of the Bank is fluctuating with decreasing trend. In FY 2054/55, the capital fund of the Bank was 17.20% which has decreased to negative of 9.14 % in FY 2063/64. The capital adequacy position of the Bank has been improved in FY 2064/65.

4.4 Major Findings of the Study

The preceding chapters have discussed and explored the facts and matters required for the various parts of the study. Analytical part, which is the heart of the study, makes an analysis of various aspects of the investment policy of commercial banks by using some important financial as well as statistical tools.

Having completed the basic analysis required for the study, the final and most important task of the researcher is to highlight findings and gaps of the study and give suggestions for further improvement. This would be meaningful to the top management of the bank to initiate action

and achieve the desired result. Accordingly, this would be beneficial to the other interested parties like shareholders, staff members and researcher. The objective of the researcher is not only to point weaknesses and mistakes but also to highlight the strength and suggest for further growth and improvement.

The main findings of this study have been derived on the basis of available financial data analysis of NCC Bank.

4.4.1 Findings from the analysis of investment policy:

Investment policy both related to Credit and Investment on Securities were thoroughly studied and contents mentioned in the policy were analyzed minutely. For simplicity of analysis, investment policy was categorized into two parts: investment policy for loans and advances and that for investment on securities. Major findings are as listed blow:

- It was found that bank has formulated a satisfactory loans and advances policy. Most of the credit related matters were found well incorporated in the policy documents. However, due to lack of written and clear-cut policy statement since the commencement of the bank, the investment portfolio deteriorated in terms of profitability. Formal credit policy 2002 was made effective on 2002 (2059 BS) After this, the portfolio also appeared improving
- There was not investment policy for investment on shares, bonds and debentures till the FY 2063/64. All the investments were used to make with the decision of the Treasury Manager and the Chief of the Bank. So, this category of investment operation was not well managed in the bank. As a result of this, there was significant proportion of unmarketable, illiquid and unyielding assets in securities portfolio of bank. Such assets were hampering the liquidity and profitability of banks. From the FY 2064/65, the Bank has been following the provision of Investment Policy for making investment in Government Securities, Shares and Debentures.
- Though there was not investment policy for investment on shares, bonds and debentures till FY 2063/64, the existence of clear-cut policy for credit operation has kept the overall investment operation as guided by acceptable policies

- Thus, to sum up, the study on invest policy suggested that the bank is following a **"Sound"** investment policy to conduct its investment function as suggested by policy scores.

4.4.2 Findings from the analysis of investment portfolio

Investment portfolio was analyzed with the help of financial ratio analysis and statistical tools. Different types of financial ratios have been calculated to analyze the following aspects of the portfolio:

1. Portfolio's liquidity,
2. Portfolio management
3. Portfolio performance
4. Portfolio's profitability

4.4.2.1 Findings from the liquidity ratios analysis

Liquidity of the portfolio was checked in three aspects (1) liquidity to meet daily cash requirement (2) liquidity of loan portfolio and (3) liquidity of investment on securities. Over all liquidity was checked with the help of current ratio. Major findings of the liquidity ratio analysis are pointed out below

- From the analysis of the cash reserve ratio, it can be said that the bank has maintained sufficient cash reserve to meet daily cash need. The amount of cash reserve ratio is guided by mandatory reserve ratio to be maintained by commercial banks as per the NRB's directive.

  For our study period, the mandatory CRR lies between 5% - 6%. Bank's CRR appears always above the mandatory provision. It is showing upward trendwhich indicates narrow investment opportunity in the country.

- Current assets of NCC Bank have exceeded current liabilities in average of the study period from 2054/55 to 2059/60. However, current liabilities exceeded current assets from the year 2060/61. The ratio shows the fluctuating trend during the period. The coefficient of variation (C.V.) between the ratios for the study period is 35.35%, which shows that the current ratios during the study period are not consistent.

In general, the current ratio analysis of the bank over the eleven years period indicates that the bank has been able to meet its short-term obligations and has satisfactory liquidity position. Standard current ratio of around 1:1 (for banks) was met all the times till the FY 2059/60. However, the ratio has declined from there onwards. The trend was imposing threat in the current ratio. It can be stated that the management has improved the portfolio's liquidity during 2058/59. From the above analysis, it can be stated that the liquidity position of the Bank has slightly weaken from FY 2060/61 if compared with the standard ratio of 1: 1.

- Liquid loans to total loans ratio reflects poor liquidity position of the loan portfolio. Table 4.5 shows that the liquidity of loan portfolio did not remain satisfactory in initial days. However, it is showing an improving trend as proportion of liquid loan stood at 83.65% at the FY 2064/65. The trend line has also supported this fact. The proportion of liquid loans was 59.89% only during FY 2058/59. But it has improved upto 83.65% on the last year of study. Therefore, it can be stated that the management has improved liquidity position of loan portfolio.
- Financial ratio of marketable or liquid securities to total securities indicated improving situation. Balance-sheet of NCC Bank contains the following share investment as illiquid investment:

1. Ordinary shares of Nepal Bank Limited
2. Ordinary shares of Rural microfinance development center
3. Ordinary shares of Shangrila housing and development Co. ltd.
4. Ordinary shares of Nepal Sri Lanka Merchant Bank Ltd.
5. Ordinary shares of N.B Insurance Co.Ltd.
6. Ordinary shares of National Hydro Power Co.Ltd.
7. Ordinary Shares of Credit Information Center Ltd.

It was found that during FY 2054/55, the bank purchased ordinary shares of Nepal Bank Limited amounting to NPR 9.66 Crores. The paid up capital of the Bank during that year was NPR 35.00 Crores. It was not wise decision of bank to invest 27.6% of capital on a single assets category from the principal of diversification.

As per NRB Directives, the Bank and Financial Institution had to divest their investment in shares of other Banks and Financial Institution by the fiscal year

2060/61 and if such investments are not divested, cent percent provisioning is required.

Despite the decision to dispose the shares of Nepal Bank Ltd. amounting to Rs. 96.6 Crores, the Bank has not been able to divest the same due to the legal restrictions i.e. the share has not been re-listed in NEPSE. However, the Bank has made provision on these shares in accordance with the accounting policy of the Bank and NRB Directives. The bank has taken the market price of last trading date for valuation of the shares of Nepal Bank Ltd. for the purpose of making provision for loss on Investment. The bank has requested NRB for the arrangement of re-listing of Shares of Nepal Bank Ltd. If the Bank could sell the shares of Nepal Bank Ltd., there would be huge impact in the profitability of the Bank.

The Bank has also initiated for the divestment of the shares of Nepal Sri Lanka Merchant Bank Ltd. amounting to NPR. 0.93 Crores.

The Management has sold the shares of National Hydro Power Company of NPR 1.5 Crores in FY 2064/65 and has been able to earn profit of NPR 3.71 Crores. The Management is also in the process of selling the shares of NB Insurance Co. Ltd. of NPR 1.5 Crores.

The bank is getting return on investment in the shares of Rural Micro Finance Ltd. since FY 2062/63 and the investment is also treated as investment in Deprived Sector Lending as per NRB Directives.

4.4.2.2 Findings from the analysis portfolio management ratios

- Loans and advances to total deposit ratio was calculated to study how well the loans and advances assets and deposit liabilities have been managed. 70 % of C/D ratio has been taken as standard for banks operating in developing countries like Nepal. From this point of view, the loan & advances to total deposit of the bank was satisfactory on FY 2055/56 and FY 2056/57 whatever may be the case during the initial days. However, the CD ratio has increased form FY 2057/58 to FY 2061/62. The highest ratio of 93.80% was in FY 2061/62 which is very risky situation to the Bank. Loan and advances is the proportion of bank's investment

into the most risky assets. High level of risk is not desirable for commercial banks as any default can create the liquidity problem.

- The loan and advance to total assets ratio ranges from the minimum of 53.67% in FY 2055/56 to the maximum of 92.41% in 2061/62. The mean of the ratio is 70.35% and the C.V. between them is 13.94 %, which shows the ratios are inconsistent over the study period. This shows that loan and advances comprises 70.35% in average of the total asset of the bank.

  The study shows that about 70% of the asset of the bank is comprised of loan and advances i.e. risk assets. Loan and advances is taken as the most risky and productive assets of the bank. High ratio reflects high risk and eventually high return to the bank. So, NCC Bank has taken optimum risk towards the mobilization of its fund to risky assets in order to maximize the return.

- Investment on government securities to total assets ratio has shown fluctuating trend in the initial period of the study and has increased from FY 2059/60. The mean of the ratio was found to be 8.58% with 72.11 C.V. between them, which indicates that the ratios are highly fluctuating and less consistent over the study period. This ratio shows the proportion of risk free assets in the total asset of bank. The analysis reveals that the bank has mobilized less amount of fund on government securities till FY 2062/63.The Bank has started to build up the volume of government securities from FY 2063/64. Considering, the asset is less productive, NCC Bank has invested less into low productive and risk free sector. However, as per Investment Policy formulated in 2008, the Bank has taken initiation to make the portfolio of risk free security in accordance with the provision of the Policy.

- The ratios of total off-balance-sheet items to total loans and advances are varying inconsistently with C.V. of 24.70% and S.D. of 7.61. The average percentage of off balance sheet items over loans and advances is 27.69%. The ratio shows decreasing trend. It might be due to increasing competition in the banking sector or bank was not paying enough attention towards non-funded business. In the other hand, NRB had imposed the restrictions on Single Obligor Limit to NCC Bank due to its

negative net worth in FY 2058/59 to 2061/62. The Bank was restricted to extend a limited amount of the loan against Letter of Credit and provide off- balance sheet facilities.

4.4.2.3 Findings from the portfolio performance ratios analysis:

- The Loan loss provision to total loans & advances ratios for the study period reflects two types of trend. During study period 2054/55 to 2057/58 it shows decreasing trend, value decreased from 12.05% to 7.02%. However, in FY 2058/59, it drastically increased to 19.39%. Then, again it is showing decreasing trend. In 2062/63, it increased to 13.27% and has decreased to 4.04% and 3.10% in FY 2063/64 and 2064/65 respectively. The ratio has ranged from 3.10% in 2064/65 to 19.39% in 2057/58 with an average of 9.38%. The C.V. between them is 48.94%, which indicates that the ratios are inconsistent with the increasing trend.

  As discussed in the research design, single digit ratio is acceptable for the study. Banks ratio remained 9.38% showing acceptable position. Decreasing trend suggests further improvement and recovery of non performing loans. It can be stated that the drastic increase during FY 2058/59 and FY 2062/63 is due to lower amount of provision set aside in the previous years.

- The data for non-performing loans was not available for three initial years of study period as there was no provision of publishing such information in the Annual Report of the Bank. Ratio of non-performing loan to total loans remained at 18.93%, 40.11%, 20.63%, 12.72%, 8.67%, 17.85%, 22.12% and 13.87% respectively during FY 2057/58 to 2064/65 respectively. Mean of the ratios is 19.36%. The C.V. between them is 49.03%, which shows that the ratios are inconsistent.

  The ratios reflect the proportion of non-performing loan of commercial bank and NPA is the major problem in recent years. The mean NPA level of NCC Bank is 19.36%, which is far higher than the standard. The ratios show increasing trend which indicates that the management of the bank is not giving due attention towards NPA management. The quantity of NPL was NPR 54.69 crores, NPR

115.45 crores, NPR 70.08 crores, NPR 60.00 crores, NPR 69.30 crores, NPR 105 crore, NPR 113 & NPR 73 crore in FY 2057/58, 2058/59, 2059/60, 2060/61, 2061/62, 2062/63, 2063/64 and 2064/65 respectively. The Bank has been able to reduce the accumulated NPL of NPR 115.45 crores NPR 70.08 crores by recovering NRs. 45.37 crores during the FY 2059/60. Similarly, NPL of NPR 10.08 crores was recovered during FY 2060/61 to reduce its size to NPR 60.00 crores. The current management of the bank has been able to reduce the NPA to 13.87% in FY 2064/65. The Management has fixed the target to reduce the NPA level to 5% within FY 2065/66. The Bank has been facing problem for extending its Branches due to higher percentage of NPA. As per NRB Directives, the Commercial Banks having NPA more than 5% are restricted to expand the branches.

4.4.2.4 Findings from the profitability ratios analysis

Profitability ratio analysis reflects poor profitability position of bank. The ratio analysis is presented below:

- The Interest income to total income ratios were more or less consistent over the study period ranging from the minimum of 68.41% in 2054/55 to the maximum of 94.28% in 2059/60. The mean of the ratios is 84.90% and the C.V. between them is 8.88%, which shows the consistency of the ratios over the study period.

  The contribution of the fee-based income, commissions, and foreign exchange trading gains was very low in the total income due to lower off-balance-sheet items to total loans and advances ratios. Higher ratios mean greater dependency of the income over risky assets such as loans and advances.

- Interest expenses to total expenses ratios were found to be fluctuating heavily. The lowest of the ratio was 33.6% on FY 2054/55. Pre-operating expenses and other similar heavy operation expenses caused lower ratio. The mean of the ratios is 60.54 % with 21.92% C.V., which shows the ratios were inconsistent over the study period.

Mean of the ratios 60.54% reflect that 39.46% of the expenses was for other expenses. The analysis indicates the higher operation cost. However, the decreasing trend of ratio indicates that cost of deposits is decreasing which is positive aspect.

- Yield rate of loan ratio was computed by dividing interest income be yearly moving average of loans and advances. This ratio was computed to evaluate earning rate of the loan assets. The bank earned at an average rate of 13.09% during the study period. The earning rate found around lower end of market interest rate. During FY 2055/56, the market rate for overdraft facilities in commercial banks ranged from 10% to 19%. NCC Bank earned at the rate of 14.61%. Similarly, during FY 2064/65, bank earned at the rate of 11.07% where as market rate was 6.5% - 13.5%. The lowest yield rate was during FY 2058/59 when bank earned at the rate of 9.93% despite the market range of 10% - 17%. It was due to parking of interest income into interest suspense account for non-realization of same in cash.

- Cost of deposit ratio was calculated by dividing interest expense by moving average of deposit liabilities. The mean of this ratio is 7.15 with S.D. 1.99 and CV 27.78%.

  The rate is for overall of interest paid for all interest bearing deposits. The cost of deposit ratio was compared with interest rate structure of commercial banks. It was found that bank was paying rate higher than the interest for one year fixed deposit. Cost of deposit is very higher than the market rate. However, the decreasing ratios reflect improving position.

- Return on assets (ROA) ratios are fluctuating during the study period with average of negative 1.89%. The ratio ranged from -9.70% in 058/59 to 0.05% in 2060/61. The C.V. between the ratios was -268.74% which show highly inconsistent.

  The return on assets of the bank is bad in average. It indicates the poor earning capacity of the banks assets and poor utilization of its assets.

- Return on equity (ROE) ratios are fluctuating during the study period with overall negative value which has been improved in FY 2064/65. The ratio ranges between (113.48)% in 2058/59 to 35.64% in 2064/65 with the mean ratio of (22.15)%. C.V. between them is 220.94% negative, which shows that the ratios were more inconsistent during the study period. The ratios indicate that the shareholders are suffering loss from their investment. During FY 2054/55, shareholders suffered loss of 32.45% on their investment. The Bank has suffered loss for five years and has generated profit for six years during the period of 11 years taken for this study. The Bank suffered huge loss of 113.48% in FY 2058/59 due to increase in Non Performing Loan as compared to other years of the study. However, the bank has been able to improve its profitability position in the subsequent years. The Return on Equity for FY 2064/65 is attractive as the shareholders have earned 35.64% on their investment. Despite the higher profit in the FY the Bank has not been able to provide return to the shareholders because of accumulated losses of the previous years.

- Earning per share of NCC Bank is unsatisfactory over the eleven years. The EPS of the Bank is negative during FY 2054/55, 2058/59, 2061/62, 2062/63 & 2063/64 due to loss. However, the EPS for the remaining years of the study period is positive with low amount. The investors are loosing the return on their investment in NCC Bank. During FY 2054/55, shareholders have lost NPR 32.45 per 100 rupees of investment. The Bank suffered huge loss during FY 2058/59 where EPS is negative of NPR 113.48.

  The EPS was clearly reflected in the share market also. The share was traded around NPR 90-95 per share during Jestha, 2063, five to ten rupees below its par value. However, the market price of share of the Bank has gone up during FY 2063/64 and had reached to NPR 700 above which is not supported by the EPS of the Bank. The market prices of shares of other Financial Institutions also are not fixed in accordance with the EPS.

4.4.2.5 Findings from the capital adequacy analysis

The Capital Fund of the Bank till FY 2057/58 was satisfactory and was below the requirement of NRB from FY 2059/60 to FY 2063/64. The Capital Fund of the Bank for the FY 2062/63 & 2063/64 was negative due to huge loss during these years.

The Bank had incurred huge loss in F. Y. 2058/59 due to the requirement of huge amount of loan loss provisioning which caused the negative net worth of the Bank in that Financial Year. It was because of this that the capital was seen as inadequate. In order to increase the capital and to make the net worth positive, in accordance with the directive of NRB, the Bank had issued Right Shares to promoter shareholders and raised the capital of NPR. 140 Million in F. Y. 2059/60. The Bank also issued the shares amounting to Rs. 210 Million to General Public during F. Y. 2060/61 as approved by NRB in accordance with the Capital Plan submitted to Nepal Rastra Bank. The shares were fully subscribed.

The Net worth of the Bank was still negative due to huge amount of carried-forward accumulated loss and the increase in non performing loan of the Bank. Due to negative net worth of the bank, NRB imposed the ceiling for mobilization of deposits and extending the loans.

In view of the negative Net Worth position of the Bank, the Bank has issued 1:1 Right Shares amounting to NPR 700 Million to its Shareholders on August 7, 2007 and collected the full amount.

With the collection of Right Share amount and recovery of the Non Performing Assets, the Bank has been able to make its capital fund adequate in FY 2064/65 which is 11.09%. Nepal Rastra Bank has removed all the restrictions imposed to NCC Bank. Now, there are no restrictions for mobilizing the deposits and extending the loans.

CHAPTER - 5
SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

In this chapter, summary, conclusions and recommendations have been dealt with for the benefit of the NCC Bank.

This chapter includes three major aspects of the study. Firstly, this chapter will summarize the entire research and analysis process. Secondly, conclusions of the research have been drawn in line to the objectives of the study. At last, recommendations have been made on the basis of analysis. Recommendations have been justified as and where necessary.

5.1 Summary

Nepal has twenty five Commercial banks competing with each other in their lending, borrowing and other banking activities. Commercial Banks in Nepal has been established with some specific objectives when the government adopted liberal economic policy. The Joint Venture Banks were established with the objectives of bringing foreign investment in the country in form of joint venture Capital, to mobilize the idle resources in a most effective way to maximize the wealth of the stakeholders, to develop Nepalese Banking sectors by sharing technical foreign service and management agreement and ultimately to produce the bankers in Banking Industries and to develop the capital market in the country, with the expectation, that these JVVS put their money in the shares of other companies operating within the countries.

Out of Twenty Five commercial banks operating in Nepal, researcher has taken Nepal Credit and Commerce Bank Ltd. as the subject of study. Researcher has confined her study to evaluate and analyze the investment policy and portfolio of the bank. The investment function of the Bank is major activities which contribute in the overall profitability of the Bank and subsequently contribute to the national income of the country.

The investment activities being major part of the bank needs concrete investment policy in order to have profitable and sustainable portfolio of the risk and risk free assets in the total

components of the assets of the bank. Implementation of the policy helps to create and maintain a portfolio as mentioned in the policy. After creation of portfolio, the regular monitoring and review of its performance is required for steady growth and to minimize the risk. Performance revision and performance evaluation can be reviewed by establishing the relation between the various related variables, for which financial ratio is computed. Hence in this thesis paper, researcher has first analyzed the investment policy and then evaluated the investment portfolio.

The study is based on secondary data obtained from bank's annual reports and financial statements, official records, official circulars, periodicals, journals and bulletins, various published reports and relevant unpublished master's thesis.

Investment policy was evaluated on the basis of appraisal score. Its analysis was carried out by deep study of contents of policy related documents. It was found that credit policy of the bank was sound and the policy was well formulated after 2002. Investment policy for investment in securities was poor in the initial years of the study and it is sound from the FY 2064/65 after the formulation of Investment Policy and Assets & Liability Management Guidelines, 2008. Aggregate policy was evaluated as sound.

Financial as well as statistical tools were used to analyze and interpret the data and information regarding investment portfolio. Under financial analysis, various financial ratios such as liquidity ratio, asset management ratio, performance ratio, profitability ratio and capital adequacy ratios were analyzed and interpreted. Mean, standard deviation and coefficient of variation were the statistical tools used in analysis.

Ratio analysis suggested poor performance of bank in terms of portfolio performance and portfolio's profitability. Liquidity ratios were acceptable. Portfolio management ratios have indicated moderate position.

Investment portfolio analysis has indicated improving position of bank after FY 2059/60.

5.2 Conclusion

Based on the analysis and interpretation, following conclusions have been drawn:

Investment policy

- Bank is following a sound credit policy from the year 2002 and has introduced Investment Policy in the year 2008. It can be concluded that, the existing investment policy of the Bank is acceptable. However, the provisions of the policies have to be followed strictly. In the meantime, it is also suggested to revise the Credit Policy 2002 to make it more standard. If the Bank had formulated the policies and complied well since the commencement, it would have led the bank as a leading commercial bank in Nepalese banking market. From the financial analysis of the Bank for the period from 2054/55 to 2057/58, it is observed that the Management Team of Bank of Ceylon, Sri Lanka could not perform well. However, the transfer of their ownership to the Nepalese Entrepreneurs in FY 2058/59, the new management team has put effort to give clear picture of bank's credit policy. However, the new management could not introduce investment policy covering entire investment portfolios. The bank has introduced Investment Policy and Assets & Liabilities Guidelines 2008, which has addressed the policies, required for the entire investment portfolios.

Investment portfolio:

- **Portfolio's liquidity:** Higher ratios of CRR and acceptable level of current ratio indicate the strong ability of bank to meet short term and mid-term liquidity position. Where as, decreasing trend of current assets and high level of illiquid loan and securities imposes threat in long term liquidity position.

  Generally, bank loans are deemed as payable on demand. If bank needs to revise its portfolio structure, loans and advances should be called back. Lower value of liquid loans to total loans ratio indicates lower probability of repayment of loans in time. Thus, portfolio restructuring will not be possible in such cases. This is also the case for NCC Bank. So, bank should try to improve the liquidity of entire portfolio.

- **Portfolio management:** The portfolio management ratios indicate satisfactory portfolio management. The CD ratio of the bank shows the bank's aggressiveness in

lending. Proportion of loans is increasing in total assets portfolio of the bank which is indicative of management's concentration towards profitability. On the other hand, the low yielding and risk free governmental securities also constitute a major proportion in total portfolio. It can also be concluded that management is not paying attention to increase OBS transaction.

- **Portfolio performance/activity:** Portfolio performance of the bank is very weak during the past years. However, the trend shows the fluctuating movements of non performing assets which is due to lack of adequate provision by management. NPL is the major factor that has deteriorated the performance of bank. So the management has to concentrate on recovery of NPL.

- **Profitability:** The weakest part of entire portfolio is its profitability. Parking of interest income as interest suspense and high provisions for NPL have deteriorated the profitability of bank. Another factor that is adversely affecting the profitability is higher cost of deposits. All the profitability ratios like ROA, ROE and EPS are negative and the bank has not been able to distribute dividends and bonus shares to the shareholders. This has decreased the confidence of investors in share market and consequently fetches the share price below face value in NEPSE.

- **Capital Adequacy:** The Capital Adequacy position of the Bank was below the requirement of NRB from FY 2059/60 to 2063/64 which had hindered the Bank to expand its business activities as NRB had imposed restrictions in deposit mobilization and extending loans and advances due to inadequate Capital Adequacy Ratio. However, the Bank has been able to meet its capital adequacy requirement in FY 2064/654 and NRB has removed all the restriction imposed to NCC Bank. The performance of the Bank in FY 2064/65 is commendable and it can be concluded that the Bank is moving towards positive direction and will be able to provide some returns to the shareholders within next 2 fiscal years.

It can also be concluded that bank has not utilized the resources efficiently during the study period. However, decreasing level of non performing loans suggests management's efficiency in managing non performing assets. Similarly, on the basis of total portfolio analysis, it can be

said that the financial performance of the bank is improving after the change in ownership and management during FY 2059/60.

5.3 Recommendations

On the basis of analysis and findings of the study, following recommendations have been made as suggestions to overcome the weaknesses and to strengthen the existing investment policy and portfolio of NCC Bank:

1) Review the Credit Policy:

The Credit policy of the Bank was formulated on 2002. After 2002 there have been numerous directives issued by NRB related to credit. Therefore, it is recommended to redesign the policy by incorporating the new changes. If bank's portfolio fails to perform well, revision is necessary in policy level. The credit market has been very competitive and the investment opportunities are limited. The Bank has to revise the policy accordingly to be more competitive and formulate new products to attract the borrowers. It is recommended to revise the credit policy so as to make consistent with banking market.

2) Implementation of Investment Policy

It is advised to implement the investment policy designed in FY 2064/65 effectively to maintain adequate portfolio of investment on securities. The Bank's securities portfolio contains illiquid and unyielding securities due to lack of investment policy in previous years. Hence, it is recommended to dispose such existing securities as soon as possible to improve the profitability position of the Bank.

3) Expand investment on government securities

Investment on those securities issued by government (i.e. treasury bills, development bonds, saving certificates, etc) are free of risk and highly liquid such as securities yields the low interest rate of particular maturity lowest risk in future and it is more better in regard to safety that other means investment. So NCC Bank is strongly recommended to give more emphasis to invest on government securities.

4) Comply Credit Policy while making investment decisions:

It is found the bank's credit policy has addressed most of the credit related issues. On the other hand, the portfolio analysis indicates that portfolio is not sound. Poor portfolio is the result of poor implementation of policy. Hence, it is advised to comply with all the provisions laid down in the credit policies while extending credit facilities to the borrowers in order to minimize the risks.

5) Develop strong internal control system.

Lack of policy compliance is due to poor internal control system. Poor internal control system results into increased operational risk and credit risk. It is observed that the performance of bank after taking ownership and management by Nepalese entrepreneurs is improving in certain areas like policy formulation and portfolio management. The management is advised to concentrate on management consolidation and internal control to improve portfolio performance and profitability.

6) Revise portfolio structure:

Since, profitability position of bank is poor, it can be concluded that existing portfolio is not optimum. Hence, bank is advised to revise existing portfolio structure and develop high yielding portfolio. Recovery of non-performing loans should be speed up and such recovered amount should be re-invested as per the policy.

Portfolio management is very much important for every investor. The term investment has included many parts of risk. So the effective portfolio management plays important role to divide total investment in different sectors so that risk is also divided into different secretors. It has been found that the Bank has been increasing total investment every year. So NCC Bank is strongly recommended to invest in different sectors and to follow a saying "don't keep all the eggs in the same basket".

The bank is also advised to examine carefully the portfolio management strategies to maintain equilibrium in the portfolio of loans and investment and make continuous efforts to explore new, competitive and high yielding investment opportunities to optimize the return. Bank must develop new lending products. Banking sector is going in consumer credit all over the world by financing the consumer goods. So, NCC Bank is recommended to focus on credit products

like personal housing loan, education loan, car loan etc. The bank must concentrate on customer oriented lending policy to sustain in the competitive banking business

7) Increase low cost deposit

It is recommended to mobilize the low cost deposit to minimize the interest expenses. The bank has to promote existing low cost deposit schemes such as Mahila Suraksha Khata, Bal Suraksha Khata, Jestha Nagarik Khata, Sharedhani Bachat Khata and Karmachari Bachat Khata and other savings accounts. For this bank should continue with the additional features attached with the existing saving products like medical insurance, free accidental insurance, free debit card services, locker facilities, SMS and internet banking services etc. As there is tough competition on the banking sector and economic activities in the country is not expanding, bank should introduce innovative products and services by adopting modern and high-tech based approaches to bank its products and services in order to sustain and grow further.

8) Increase off balance-sheet transactions

Interest income from loan and advances and investment has highly contributed in the total income of the bank. Income from other fee-based transactions has lower proportion. The portion of off balance sheet transactions is found decreasing in comparison to loans and advances. Now a days, most of the commercial banks are getting more benefits and increasing their earnings through the enhancement of the fee-based OBS transactions. So the bank is recommended to give more priority to increase the fee-based OBS transactions to generate more income.

9) Focus on NPA management:

The non-performing loan of the bank is still very high and it is above the acceptable level. So, the bank management is recommended to give due consideration towards the NPA management in time. The bank has to give its effort towards the recovery of the loan. For this bank has to form a strong task force for monitoring and recovery of bad loans which keeps the updated database of total loan and advances and its repayment trend. Bank is recommended to adopt the aggressive loan recovery and follow-up policy. Similarly, the improper project appraisal also increases the chances of default of the loan and advances. So, the bank is recommended to follow-up the scientific project appraisal approach and train the employee in the loan section accordingly.

10) Increase profitability to retain stakeholders' confidence:

The bank should be careful in increasing net profit to maintain the confidence of shareholders, depositors, customers and the general public. As commercial banks are for 'profit' organizations, their overall performance is judged on the basis of profitability. The overall profitability of the bank had been deteriorated during the periods of study and resulted into the sharp loss in the return to the shareholders except for FY 2064/65. The Bank has not been able to provide any returns to the Shareholders due to accumulated loss during the study period. The return on total assets, return on equity, earning per share all are negative in 5 years out of 11 years of study period. The main reasons for this are high proportion of non-performing assets and high cost of fund. High level of non-performing assets has created heavy loan loss provisioning and interest suspense. Therefore the bank is recommended to reduce NPL, decrease the cost of fund, lower the operating expenses and increase the business. It is also recommended to increase the income by enhancing the fee-based OBS transactions as well as utilizing the excess liquid funds.

11) Development of innovative products

The bank is recommended to adopt modern and high-tech based approaches to marketing by introducing new products and services. In the light of growing competition in the banking sector, the business of the bank should be customer oriented. It should strengthen and activate its marketing function, as it is an effective tool to attract and retain the customers. For the purpose, the bank should formulate new strategies to serve customers in a more convenient and satisfy them by optimally utilizing the modern technology and offering new facilities to the customers at competitive prices. The bank is also required to explore the new market areas. For these purpose, the bank should form a strong marketing and research department in its central level to deal with the banking products, places, price, promotion, process, people and physical evidences.

12) Services to rural areas and lower level people

As we know that most of commercial banks have provided their services only in Kathmandu valley. They should extend their services towards rural areas and preserve the banking and saving habits of the lower level people of nation. So NCC Bank is suggested not to be surrounded and limited with the interest and staff of big clients (i.e. multinational cos. large industry, NGOs, INGOs, etc.) but extend their product and services in every nook and corner of the country.

13) Expansion of the Branches

Economic growth of a country depends upon the high growth of the commercial banks. If the product and services of commercial banks expands all over the nation, the idle money from different areas can be collected and utilized for income generation purpose. So commercial banks should expand their branches not only in urban area but also rural area of the nation. But here commercial banks are centralized in the capital. So NCC Bank is recommended to expand their branches and provide effective banking product and services.

14) Suggestions to Researchers

Here, the researcher has used 11 fiscal years of secondary data, so further researcher are suggested to use entire fiscal years and to use not only secondary data but also primary data. The researcher has used only a bank (NCC Bank) limited financial and statistical tools in this study. But the further researchers are recommended to study more banks and apply more useful financial and statistical tools.