CHAPTER ONE

INTRODUCTION

The role of money is an economy is very important proper and well planned management of money directs, determins and enhance the health and productivity of total financial sector and the performance of finanacial sector affect the grown of economy. Economic liberalization policy of the government has encouraged the establishment and growth of financial institution of Nepal.

Financial Institutions means financial markets and its players and opening of all types of depository institutions and other non-depository financial institutions to the private sector. Depository institutions include commercial banks, development banks, finance companies, co-operative banks etc. Other financial institutions include life and non life insurance companies pension funds/provident funds/retirement funds, mutual funds, unit trusts, mutual saving banks, mutual funds, savings and loan associations, credit unions, mortgage banks money market mutual funds, deposit insurance corporation/company and so on. In most developing and transition economies, the financial sector is dominated by the banking sector which is a largest mobilize of deposits and provider of credit.

Financial institution play an important role in financial market (It consists of agent, brokers, institutions and intermediaries purchaser and seller of securities) and there has been a phenomenal growth of non banking financial intermediaries. Such institutions are considered as the way of monetizing economy by the process of demand and supply of money assets through saving and loans. "Financial institute facilitate the saving and borrowing process, and in so doing, maximize the wealth of the institution owners. Unlike non financial business, which enter the money an capital market to satisfy only their own needs. Institution deal in the financial market to satisfy the needs of the business. Money is regarded as a commodity which is borrowed and lent to facilitate the timely employement of real economic resources. Money is brokered, refined and accounted for by processes and traded by non financial business "

Finance Company is non bank financial institution ,which is one of the largest most diverse non depository institution on that have developed world wide. Finance company is the fast growing service oriented institution in Nepal. Finance companies play an important role in funding economic activities. "Any institutions other than a bank that makes load to the businesses or individuals" Generally finance companies, for example, raise funds via debt promises from the wholesale finance market and on lend them to the borrowers. Real estates finance companies specialize in channeling funded to homeownership Leasing companies specialize in providing finance for equipment and vehicles. In each of these cases, financial institutions provide a highly specialized service that concentrate on informational efficiency.

As per the view of Raymond P. Kent a distinguishing feature of finance companies generally depend upon borrowing to obtain most of their loan funds rather than by taking deposits or selling stocks or "shares" of some kind. When possible the typical finance company obtains substantial share of its loans funds by long term borrowing in addition to the equity investment of its proprietors or stockholders and the reminder by short term borrowing that is especially depended upon to take care of fluctuations in the loan demands of its own customers for much of their short-term borrowing. Finance Company relies on the commercial banks as lenders. But the larger companies also borrow extensively in the open market be selling short term promissory notes to all individuals and institutions that are willing to buy, and they shift substantial amounts of their borrowings back and forth between commercial banks and the open market in consideration of the availability of money and the terms of which they may borrow from the two sources.

Finance companies are a significant factor in the consumer and commercial credit financial market. Finance companies serve as financial intermediaries by purchasing wholesale quantities of money and then reselling it to individual consumers and businesses in retain quantities at retail prices.

Finance companies have been established in many developing nations but they are principally concerned with consumer financing and are not an important sources of finance for industries, new or old. So, many are affiliated with banks and other commercial groups to take advantage of high interest financing opportunities.

Finance companies are non-depository consumer financial intermediaries. They obtain funds by selling securities and lending the proceeds to finance installment sales (sales finance companies) or outright cash loans (consumer finance companies). Because finance companies can establish offices nationally, they have become prime target for acquisition by bank holding companies. And also encouraging private sector participation in the country's development endeavors.

In the words of Mr. Rabi Chandra Man Pradhan, the President of Nepal Finance Company Association (NFCA) in an exclusive interview with The Kathmandu Post National Daily said that the increasing trend of finance companies and its customers has set a healthy competition between them and has widen their products or services in the recent days. The recent issuance of Bank and Financial Institution Ordinance 2060 and the several directives issued by Nepal Rastra Bank have added more complexities and are costing their business dear.

Dr. Manohar K. Shrestha, "Finance companies have to established, organized managed and operated with a professional team to mixing innovative ideas with money experience. The financial performances of the finance companies vary from each other in terms of their profitability dividend payment and market price".

1.1 Background of the Study

The financial sector has made every interested professionals and investors or every one have their specific goals attended to take tangible financial advantages or benefits from the efficient functioning of the financial system.

Financial sector is the backbone or engine of growth of any economy. It mobilizes and allocates financial resources most productively and efficiently and includes investments.It helps to investor in choosing the investment alternatives in generating the income. And also Increases employment opportunities and productivity, achieves growth targets and attains overall macro-economic development in global financial system, each country has to reforms its financial sector's. The reform process should be properly sequenced. Nepal initiated financial sector reforms in mi-1980s and HMG/N and Nepal Rastra Bank have been implementing comprehensive financial sector reform programme since 2001.

So to develop economic condition of the country we must develop whole financial sectors of the country which will be possible when there is proper implementation of the financial sector reforms programme which are set by Nepal Rastra Bank.

Financial sector reforms means gradual liberalization of financial markets and its players and opening of all types of depository institution includes, commercial banks, development Banks, Finance companies, co-operative banks etc. Other financial institution includes life and non life insurance companies, pension fund, provident fund/retirement funds, mutual funds, unit trusts mutual savings banks, mutual funds, savings and loan Associations, credit union mortgage banks, money markets mutual funds. Deposit insurance corporation/ company, credit Guarantee corporation, company, and so, on. In most developing countries financial sector is dominated by banking sector which is not enough to develop whole economy of the country. So, this study includes both depository and non-depository financial institution of Nepal, ARB Directives toward them and their effectiveness.

1.2 Development of Financial Sectors in Nepal

"The history of banking in Nepal may be described as component of the gradual and orderly evolution in the financial and economic sphere of the Nepalese life. Even now the financial system is still in the evolutionary phase. The existence of unorganized money market consisting of land-lords, shahukars (rich merchants), shopkeepers and other indigenous individual money lenders have acted as barrier to institutionalized credit. These institutions although quite underdeveloped could still mobilize funds from a wide range of different sources. For many years, the indigenous individual wealthy agriculturist, Landlords, merchants and traders conducted some banking activities along with their other business occupations. The activities were fragmented and mostly localized" (40 Years of NRB; 1996:29).

The commercial bank was established in 1937, named as the Nepal Bank Limited, which was in-corporate as a semi-government organization with an authorized capital of Rs. 10 million of which 51 percent share was owned by the government and rest by the private share-holders. It started its business with collection of Rs. 170.200 from public deposits. Latter, the Nepal Rastra Bank was found as a central bank on 1955, which helped to make banking system more dynamic.

With the establishment of Nepal Rastra Bank, the process of banking development started to gain momentum. Used NRB Act, 1955 another commercial bank i.e., the Rastriya Banijya Bank was set up in 1966 under the Rastriya Banijya Bank Act 1965. It is the fully state owned and providing banking facilities. These two commercial banks with 319 branches in the kingdom are from the largest group of financial institutions.

Today, Nepal can speak proudly in the remarkable growth and progress in the banking industry. Nepal has opened its door to foreign commercial bank namely Nepal Arab Bank Limited came into existence on May 17, 1984 under Commercial Bank Act 1974 as a joint venture bank. It has the authorized capital of Rs. 30 million. 50 percent share is held by Union Bank of Middle East Dubai, 20 percent by Nepal Industrial Development Corporation. National Insurance Corporation and Securities Marketing Centre and rest by the general public. Similarly, in February 1986, Nepal Indosuez Bank was established as a joint venture of Indosuez Bank, France and public shareholders with an authorized capital of Rs 120 million. Nepal Grindlays Bank, then after established in December 1986. This is also another joint venture between the Grindlays Bank of the U.K., the Nepal Bank Limited and the general public.

In Nepal there are massive entrances of foreign banks as the country followed economic liberalization. The Himalayan Bank and Nepal SBI Bank were established in 1993 as a joint venture bank with Pakistani Bank and Bank of India respectively, Nepal Bangladesh Bank and Everest Bank were established in 1994 as a joint venture with Bangladesh Bank and Punjab National Bank respectively. Bank of Kathmandu as a joint venture bank with Thailand Bank establish in 1995. Similarly other joint venture banks in Nepal are Bank of Ceylon as a joint venture with Srilanka Bank. Establish in 1995. These banks have been contributing in the expansion of banking industry in Nepal.

In the beginning most of the bank came into existence as a joint venture bank but at present situation some of the bank has converted into fully stated owned. Other banks like Lumbini Bank Ltd. Nepal industrial and Commercial Bank Ltd. Machhapuchhre Bank Ltd., Kumari Bank Ltd., Laxmi Bank Ltd., and Sidhartha Bank Ltd. are established without joint venture.

The entry of foreign commercial banks functions led to rapid growth of banking system. The government's liberalization policy led to a dozen of commercial banks actively playing in the financial market of the counter.

Suggestion for the development of banking in the country on the basis of area approach is being made by the policy makers recently. The central idea behind this is that, depending on their area of operation and location, commercial banks could be assigned particular areas where they act as pace setter in providing integrated banking facilities. The establishment of Commercial and Industrial Bank in Birantnagar, Lumbini Bank in Narayangarh, Machhapuchhre Bank in Pokhara are some of the example in the promotion of regional banking industry of the country. Similarly The introduction of Nepal Development Bank from the private sector in exemplary in the history of banking in Nepal Many of these banks have shown tremendous progress in term of deposits, lending or in customer base within a short period of time. In addition the government has also introduced five regional development banks, which have boost up the income of poor in rural area" (Vaidya; 2001: 151).

NRB issues directives from time to time and Financial Institutes are supposed to follow the rules and regulations and directives. NRB has issued 10 directives in 2001 and 2002. But in this study, only the selective directives i.e. Directive number 1 to 4 are highlighted among 10 directives and some performance rates and cash flows for measurement of financial standards of finance companies.

Financial sector is the backbone or engine of growth of any economy. It mobilizes and allocates financial resources most productively and efficiently and induces investment, increases employment opportunities and productivity, achieves growth targets and attains overall macro-economic development in a global financial system, each country has to reform its financial sector. The reform process should be properly sequenced.

The reform or liberalization of financial sector is a continuous process. It takes a long period to complete the process of financial reform. Even in a most developed financial market. Innovation in financial products and services takes place, which necessitates the changes in rules and regulations in the financial markets. The financial sector reform of Nepal was initiated in mid-1980s and it is still being continued. The financial sector reform process in Nepal has been analyzed in three phases, which are as follows:

The first phase of the financial sector reform was initiated in mid-1980s under the liberal economic policy of HMG/N, under this policy, HMG/N first opened up the banking sector to foreign investors. In 1984, the Nepal Arab Bank Limited was established as the first joint venture commercial bank of the country. The bank was established with 50percent equity participation of a foreign bank. The establishment of this joint venture bank brought foreign investment in the banking industry and modern banking practices and technical skill. The Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. The banking operations of these three international commercial banks helped the economy to get modern banking services. It enhanced the competitive environment in the banking sector especially in the Kathmandu valley where more than 50 percent of the economic activities of the country take place.

In July 1985, commercial banks were allowed, for the first time, to accept current and fixed deposits on foreign currencies (US dollar and sterling pound) Before May 26, 1986; the interest rates of commercial banks were totally controlled by Nepal Rastra Bank (NRB), the central bank of Nepal. Both deposits and lending rates were being heavily regulated by NRB. On May 26, 1986, NRB deregulated the interest rate regime and authorized commercial banks to fix interest rates at any level above its minimum prescribed levels. These bold steps of NRB had a far reaching impact in the development of the financial sector of the country, which was clearly evidenced in the growth of the assets and banking activities of commercial banks. Effective 29 may, 1986, the liquidity requirement was also lowered to 9 percent from 25 percent (NRB; 1996).

Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. The emphasis was laid on increased financial intermediation, deepening of financial markets and increase in the role of market forces in the financial system. The auction mechanism was introduced for the first time to sell treasure bills (NRB; 1996).

1.3 NRB Directives

Directives relating to the financial institutions regulation and prudential norms comprise ten directives which are as follows:

1. The provision of minimum capital fund to be maintained by the commercial banks .
2. The provision of loan classification and loan loss provisioning on the credit.
3. The provision relating to single borrower limit.
4. The provision of accounting policy and the structure of financial statements to be followed by the commercial banks.
5. The provision of reducing the risk on activities of the commercial banks.
6. The provision of institutional good governance to be followed by commercial banks.
7. The provision of implementation schedule of Regulatory Directives issued in connection with inspection and supervision of the commercial banks.
8. The provision of investment on shares and securities.
9. The provision of submission of statistical data to the Nepal Rastra Bank, Banking Management Division and Inspection
10. The provision of sale and re-registration of foundation shares of commercial banks.

1.4 Objectives of the Study

- To find out whether NRB Directives are implemented or not by the FIS.
- Searching positive and negative impact of capital adequacy and its relation with capital structure of FIS.
- To analyze impact of directive of single borrower limit.
- To analyze whether FIS can manage risks
- To analyze loan and loan loss provision, relation between total loan and advances with NPA and NPL.
- To analyze CIC is effective or not for lending sector of financial institutions.

1.5 Significance of the Study

Nepal Rastra Bank directives and its impact on FIS is the subject of this research study. The directives of NRB subject control the financial institutions in the country. NRB issues directives to the commercial banks from time to time in order to maintain stability in the financial market. The directives are issued on the basis of monetary policies and the success of the monetary policies of the country depends on the directives of the central banks and its central role. So, it is important to make the research on the directives. In the process of economic development, NRB has necessary to issue the directives from time to time to meet the commercial banks objectives. The commercial banks are supposed to follow the rules and regulations laid down by the NRB. This research though small but has tried to go insight about the effects of the directives to the commercial banks and the implementation by them. The directives of the central bank hold a central role in obtaining the success of the monetary policies. This research will also provide useful and meaningful references materials. Various suggestions will be presented to concerned all financial institutions of Nepal at the end of this research. Nepal Rastra Bank's officials will be more able to act effectively for the implementation of the directives can use such suggestion.

A very good way of doing this would be by analyzing the progress made in NRB's Directives. The study of this kind could contribute in filling knowledge gap and throw the lift on NRB directives practices in the country.

In a highly developed and sound financial system all types of customers, whether larger or small, rich or poor, and local or foreigner get benefited with their suitable financial products and services and insurance policies. It helps the economy by mobilizing and allocation financial resources most productively and efficiently. It helps to induce investment, increase employment opportunities and productivity, achieve growth targets and attain overall macro-economic development.

The significance of this study is to determine whether the policies prepared by NRB are effective or not how do they help is increasing the financial situations of the country. These directives should focus on to accelerate the process of economic development, increase productivity and efficiency of investments. Provide new technology to the financial sector enable financial markets to mobilize savings and allocate credit more efficiency make financial products and survive reliable to more of the populations.

So, the study examine mainly all these things are effective in Nepalese financial markets by the directives of NRB. If not what should be done to improve financial institutions of Nepal.

1.6 Focus of the Study

In this study, the focuses of the study are as follows:

1. Provision of minimum capital fund to be maintained by Financial institutions.
2. Provision of loan classification and loan loss provisioning on the credits.

3. Provision relating to single borrower limit.

4. Provision of reducing the risk on the activities of Financial Institutions. The directives of NRB are implemented or not by the Financial Institutions.

1.7 Problems of the Study

In its past history various activities were undertaken by Nepal Rastra Bank. NRB Act 1955 gives the full authority to Nepal Rastra Bank. Financial institutions should be established and operate under NRB's rules and regulations. There are almost seventeen commercial banks: one of them is funded lately. In Nepal, even though the Financing to day is not healthy and sound. In developing country like Nepal, most people are not conscious about the banking system.

Some financial institutions have very low capital adequacy ratio while some banks have piled up non-performing assets (substandard, doubtful, bad loans). The people have been raising question over the correctness of credit classification and provisioning of some financial institutions. NRB issues directives. NRB has issued directives related to the banking prudential regulations to be followed by the banks. Likewise, Directive No.2 (2001) related to loan classification and provisioning, all commercial banks are suppose to categorized the loans disbursed to the customers into different groups on the basis of their past due periods. The loan classification and provisioning norms directs the financial companies classify the loans into six different categories in old provisions. The banks are categorizing the loans in to four different categories according to new issue. Each category of the loan amount requires certain percentage of it's to be provisioned for the probable loss. This amount is deducted by the profit of the bank. Similarly, other directives viz.., capital adequacy ration, single borrows limit, accounting policy, maintaining liquidity risk has also been changed which may also effect in banking operations.

Banks are not serious towards the research and development. Some times their loan portfolio is diversified. Most of the banks not have a single well-managed training centre. So, banks should focus on research, training and development. Most of the banks are in weak position. Government interference in functioning of banks is another interruption to obey regulations of banks directed by NRB. The change of government policies is directly link to change of management in these banks.

Similar other impacts may be observed because of the changes made in directives. The directives have potentials to examine the financial system of the nation, as they are the only tools of the NRB to supervise and monitors of the financial institutions. The directives in themselves are not that important unless properly implemented.

This study is going to find out whether the directive of NRB toward financial institutions is good enough to develop financial sector or not although the number of establishment of financial institutions are increasing.

1.8 Limitations of the Study

We have not sufficient data from various companies. Some new financial companies have data only for few years. So, under this study, the researcher may suffer data problems. Then for short listed companies comes in our study.

Under this study most of the data are taken from library department of Nepal Rastra Bank and Nepal Stock Exchange.

This study deals with the effectiveness of the directives issued by NRB toward the financial institutions of Nepal.

1. Most of data will be of secondary in nature. So, secondary data may or may not be corrected and will not reflect right scenario or the field through some secondary data are also used.

2. The study covers only a five year period i.e. from FY 2003 to FY 2007. Some data are not available for this whole period.

3. FIS and commercial bank as a whole included in this study, there is no any comparison with individuals.

4. Seventy-two finance companies and ninteen commercial banks.Among them 59 financial company & 17 commercial banks, as a whole included in this study and their performance are analyzed separately.

FIS assumption bias in the question of efficiency factor, like the NPA level is the measuring mechanism of their performances. This is the basic reason that the commercial banks do not pay heed to release the exact NPA information. However, whatever data are available from Nepal Rastra Bank (NRB), newspapers and articles, they are taken as a basis of the present study.

1.9 Organizations of the Study

The study is divided into five chapters each chapter is developed to analyze the effectiveness of directives provided by NRB towards financial institutions of Nepal titles of the chapters are as follows:

Chapter I	:-	Introduction
Chapter II	:-	Review of literature
Chapter III	:-	Research Methodology
Chapter IV	:-	Analysis and interpretation of data.
Chapter V	:-	Summary Conclusions and Recommendation.

Chapter I : Introduction

This chapter deals with the introductory part of the study, which includes introduction of NRB, Introduction of Financial Institution of Nepal Bank ground of the study Focus of the study, Statement of the Problems, Objective of the study, Limitation of the study, Significance of the study, Statement of Hypothesis and Organization of the study.

Chapter II : Review of Literature

This chapter deals with review of different literature in regard to the theoretical analysis and review of book article and thesis related to the study field. Therefore it includes conceptual frame work and other related studies.

Chapter IV : Data Presentation and Analysis

This chapter is the main part of the study which includes Analysis presentation and interpretation of data using financial and statistical tools. Similarly, this chapter also includes the major finding of the study.

Chapter V : Summary Conclusion and Recommendations

This chapter cover, Summary of the study conclusion and possible suggestions.

CHAPTER TWO

REVIEW OF LITERATURE

The entry of foreign commercial bank functions laid to rapid growth of financial system in Nepal. The government liberalization policy laid to a dozen of financial institution in Nepal.

This chapter includes the review of different books, articles and thesis which is divided into several parts. One of them is conceptual review, book review, article review, thesis review and financial performance review.

2.1 Conceptual Review

The history of banking development of Nepal dates back to 1937 with establishment of Nepal Bank Limited. The first commercial bank of Nepal is Nepal Bank Limited. There was Tejarath Adda, which was establishment with a view to extent credit to the public on the security of gold and silver, Up to 1955. The Nepal Bank Limited was the one and only financial institution and taking charge of all the business transaction of the government including currency exchange besides commercial banking functions.

“Against the background, an urgent necessity was felt for the establishment of a central bank dedicated to the development of banking and finance to promote trade and industry, to manage the circulation of national currency and to maintain exchange rate stability. Hence, the Nepal Rastra Bank Act 1955 was formulated.” (40 years of NRB; 1996:36).

“Nepal Rastra Bank (NRB) was established as a central bank of Nepal on April 36. 1956. The bank was empowered by Act to have direct control over banking institution within the country. It also took over the treasure functions of “Mulukikhana Adda” (Government Treasury) and started issuing currency in 1959; and also thus relieved the ‘Mal Addas’ (Revenue Offices) of their work in this connection” (40 Years of NRB; 1996: 37).

The Nepal Rastra Bank is responsible of management and supervision of the monetary and credit system of the country. This central bank has been given wide power under the various provisions of the following legalization. Nepal Rastra Bank Act 1955,. Commercial Banking Act 1974, Foreign Exchange Regulation Act 1962, Finance Company Act 1985. The provisions of this Act are applicable to domestic as well as joint venture banking institutions.

As a central bank, NRB issues directives from time to time to commercial banks and other financial institutions regarding banking operations.

According to Vaidya, the main objectives of the central bank are as follows:

a. To issue notes.

b. To promote the use of Nepalese notes in the country as the use of Indian currency was very popular in Nepal prior to its establishment.

c. To promote banking system thought out the country.

d. To advise the government with regards to fiscal and monetary policies for the economic development of the country. And

e. To facilitate in the transactions of government.

In order to achieve its goals and objectives, it must develop its own policies.

2.2 Functions of Nepal Rastra Bank

Besides objectives, Nepal Rastra Bank has some functions which should be known "As the country's central bank". This bank has sole right to issue currency notes and coins and is responsible to manage the country's foreign exchange reserves, This bank's other important functions include; developing banking and financial system in the country, rendering advice to the government on financial and economic matters, mobilizing capital and managing public debt. The bank also acts as banker to the government besides serving as lender of least the resort. As in various other developing countries, the bank undertakes a number of developmental functions that are intended to support the country's efforts towards accelerated developmental of the overall economy" (40 Years of NRB; 1996: 195).

As a central bank, the Nepal Rastra Bank has been carrying out all the important functions of the central banking as in the other developing countries. The following are the functions executed by the Nepal Rastra Bank are as follows:

2.2.1 Statutory Functions/ Basic Functions

a) **Issue of note**

The NRB has sole right to issue bank notes. This is the basic function. It is the final authority of notes. The NRB issued bank notes for the first time on 19th February 1960. NRB Act 1955 has prohibited other banks to issue currency. It has the power to control and manage the issued notes. The issue of notes in Nepal is based upon the proportional reserve system. Before the establishment of NRB, the government treasures i.e., Saddar Mulukikhana Adda. carried this function.

b) Banker to the Government

The NRB performs all the banking business on behalf of the government. It operates and maintains all the cash balances of the government with no interest paying. It carries out exchange, remittance and other banking operations on behalf of the government. It purchases and discounts and rediscounts the treasury bills of the government. The NRB plays the advisory role in planning, financial and economic policy, internal resource mobilization, agriculture credit and industrial situation to the government.

c. Foreign Exchange management and control

The one of the important functions of NRB is control of foreign exchange. The 'Foreign Exchange Control Act' was regulated in October 1960. The Act also equipped the bank for bringing about the use of single currency through out the kingdom Prior to May 14, 1960. Foreign exchange transaction was also by quoting exchange rates for US dollar, Sterling pound and Swiss Franc in term of Nepalese rupees. The exchange rates between Indian and Nepalese rupees are also fixed by NRB. Nepal Rastra Bank is the only authority to controls the receipts and payments of the foreign currencies. “It fixes the value of the rupee against all currencies. It has also authorized all the commercial banks to fix the value of rupee according to the foreign exchange market” (Vaidya; 2001: 91). NRB will either purchase or sell convertible foreign currency only at the time of intervention.

d) Banker’s bank

Nepal Rastra Bank acts as a promoter, adviser, controller and bank of all the commercial banks in the country. NRB surveys and research for new bank branch establishment, area of credit expansion and make available of necessary data for the development and promotion of banking system in the country. Being a central bank, the commercial banks are directed and controlled by NRB. As the bank of the banks, the commercial banks have to deposit a certain percentage of their deposits on the NRB and to take necessary advises.

e. Control of credit

Another important function of Nepal Rastra Bank is the control of credit. This function helps to maintenance of economic stability and to meet the different economic conditions of the country. The NRB controls the credit by applying both mechanism of credit control, qualitative and quantitative. The bank uses the policies of bank rate and reserve requirement under the quantitative mechanism. The bank applies the interest free loan policies and directs the credit policies and re-finance under the qualitative mechanism.

2.2.2 Developmental Functions

a) Banking promotion board

NRB has set up a Banking Promotion Board in 1968 in order to develop a banking system in the country. This main objective is to promote banking activities all over the country through creation of awareness among the general public about the services provided by banks both in term of deposit mobilization and credit extension. The banking promotion board organized a first ten days national level banking development seminar in Kathmandu in January 1969 with purpose to generate public awareness, to exchange ideas and opinions and to innovate new ideas in the field of banking.

b) To assist the banking system

As a central bank, NRB plays dynamic role in the development and promotion of banking industry in the country. "It can regular all the banks to open branches in the remote areas of the country on the one hand and motivates the public to bring rural banks in the country such as Eastern Rural Development Bank or Far Western Rural Development Bank" (Vaidaya; 2001:92).

c) Supervision of the bank

The NRB Act 1955 has empowered the NRB to supervise and control the commercial banking operations and to direct necessary movements. In beginning period NRB used to inspect the commercial bank only once a year and scope was limited to the foreign transaction only6. Later on, the bank prepared a comprehensive manual for inspection with many objectives. Generally, NRB inspects the commercial banks by on site and off site method. The NRB watches the banks and financial institutions through the different publication.

d. Financing in priority sector

"Nepal Rastra Bank is the final authority that can regulate to the commercial banks to finance in priority sector (like agricultural sector, small scale industries, etc) at confessional interest rates set by the government which is happening in Nepal as well" (Vaidya; 2001: 92). Agricultural and Industrial sectors lack finance on one side and on the other side commercial banks have unutilized resources. So, the directives issued by NRB to commercial banks in 1974 to invest at least 5 percent of their total deposit liabilities in priority sector.

e. Training facility

In order to develop the skill of staff working in different banks, there is needed to well management and better performance. NRB organizes different training programs at its training unit, Banking Training Centre. The centre provides training on difference subjects such as money and banking, agriculture credit, audit and reconciliation and industrial finance etc.

In this way, NRB helps in controlling and extending banking system. It helps to facilitate the people living in different rural areas of nation. The bank has also provided supervision and inspection to develop the banking system. Thus NRB has been performing all these function to develop the banking system as well the economy of the nation with stability.

2.3 Role of Nepal Rastra Bank

As a central bank of Nepal, Nepal Rastra Bank has crucial role to perform to promote and develop banking system in Nepal. A central bank is set up with the objectives of monetary stability and economic development in the country. According to the Dahal and Dahal, to achieve those objectives, there are many tools to perform. Some of them are presented below:

2.3.1 Developmental and Promotional Role

The NRB has been making appropriate rules and regulations for the growth and expansion of banking sector. Similarly NRB plays a role for the development of capital market, mobilization of scattered capital for development activities (public debt), flow of credit to the priority sector, deprived sector and the educated unemployed etc. NRB made investment to set up Security Exchange Centre and Citizen Investment Trust. NRB provides refinance facility for the development of agriculture and industry. It manages public debt, open branches in rural sector and makes the banks invest in priority and deprived sector. NRB has promoted Rural Development Banks and Credit Information Bureau. NRB gives refinance at confessional rate to commercial banks to revive sick units and to invest in priority sector.

2.3.2 Regulatory Role

Nepal Rastra Bank Act 1955 has given regulatory authority to NRB. It has regulated banks mainly in the area of capital investment, credit and foreign exchange. It makes rules regarding licensing, operation, audit etc. NRB coordinates the functions of financial institutions.

2.3.3 Supervisory Role

As a central bank, NRB acts as supervisor by reviewing, inspecting the functions of all financial institutions, on site and off site. It guides for proper implementation of its rules. NRB takes necessary action in case of violation. And it recommends the ways to strengthen their financial position. Hence, Supervisory role is essential for controlling the cheating and extending the banking.

2.4 Development of Financial Sectors in Nepal

“The history of banking in Nepal may be described as component of the gradual and orderly evolution in the financial and economic development of the Nepalese life. Even now the financial system is still in the evolutionary phase. The existence of unorganized money market consisting of land-lords. Shahukars (rich merchants), shopkeepers and other indigenous individual money lenders have acted as barrier to institutionalized credit. These institutions although quite underdeveloped could still mobilize funds from a wide range of different sources. For many years, the indigenous individual, wealthy agriculturist, Landlords, merchants and traders conducted some banking activities along with their other business occupations. The activities were fragmented and mostly localized," (40 Years of NRB, 1996; 29)

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With the establishment of Nepal Rastra Bank, the process of banking development started to gain momentum.. Used NRB Act, 1955 another commercial bank i.e., the Rastriya Banijya Bank was set up in 1966 under the Rastriya Banijya Bank Act 1965. It is the fully state owned and providing banking facilities. These two commercial banks have 319 branches in the kingdom, are from the largest group of financial institutions.

Today, Nepal can speak proudly in the remarkable growth and progress in the banking industry. Nepal has opened its door to foreign commercial bank namely Nepal Arab Bank Limited came into existence on May 17, 1984 under Commercial Bank Act 1974 as a joint venture bank. It has the authorized capital of Rs. 30 million. 50 percent share is held by Union Bank of Middle East. Dubai, 20 percent by Nepal Industrial Development Corporation. National Insurance Corporation and Securities Marketing Centre and rest by the general public. Similarly, in February 1986, Nepal Indosuez Bank was established as a joint venture of Indosuez Bank. France and public shareholders with an authorized capital of Rs 120 million. Nepal Grindlays Bank. Then after established in December 1986. This is also another joint venture between the Grindlays Bank of the U.K., the Nepal Bank Limited and the general public.

In Nepal there are massive entrances of foreign banks as the country followed economic liberalization. The Himalayan Bank and Nepal SBI Bank were established in 1993 as a joint venture bank with Pakistani Bank and Bank of India respectively, Nepal Bangladesh Bank and Everest Bank were established in 1994 as a joint venture with Bangladesh Bank and Punjab National Bank respectively. Bank of Kathmandu as a joint venture bank with Thailand Bank establish in 1995. Similarly other joint venture banks in Nepal are Bank of Ceylon as a joint venture with Sri-lanka Bank. Establish in 1995. These banks have been contributing in the expansion of banking industry in Nepal.

In the beginning most of the bank came into exits as a joint venture bank but at present situation some of the bank has converted into fully stated owned. Other banks like Lumbini Bank Ltd. Nepal industrial and Commercial Bank Ltd. Machhapuchhre Bank Ltd., Kumari Bank Ltd., Laxmi Bank Ltd., and Siddhartha Bank Ltd. are established without joint venture.

The entry of foreign commercial banks functions led to rapid growth of banking system. The government’s liberalization policy led to a dozen of commercial banks actively playing in the financial market of the counter. Suggestion for the development of banking in the country on the basis of area approach is being made by the policy makers recently. The central idea behind this is that, depending on their area of operation and location, commercial banks could be assigned particular areas where they act as pace setter in providing integrated banking facilities. The establishment of Commercial and Industrial Bank in Birantnagar, Lumbini Bank in Narayangadh, Machhapuchhre Bank in Pokhara are some of the example in the promotion of regional banking industry of the country. Similarly The introduction of Nepal Development Bank from the private sector in exemplary in the history of banking in Nepal Many of these banks have shown tremendous progress in term of deposits, lending or in customer base within a short period of time. In addition the government has also introduced five regional development banks, which have boost up the income of poor in rural area" (Vaidya; 2001: 151).

Hence, NRB issues directives from time to time and Financial Institutes are supposed to follow the rules and regulations and directives. In issuing directives of 2001 and 2002 there are ten directives. But in this study, only the selective directives i.e. Directive number 1.5 are highlighted among 10 directives and some performance rates and cash flows for measurement of financial standards of finance companies.

Financial sector is the backbone or engine of growth of any economy. It mobilizes and allocates financial resources most productively and efficiently and induces investment, increases employment opportunities and productivity, achieves growth targets and attains overall macro-economic development in a global financial system, each country has to reform its financial sector. The reform process should be properly sequenced,

The reform or liberalization of financial sector is a continuous process. It takes a long period to complete the process of financial reform. Even in a most developed financial market. Innovation in financial products and services takes place, which necessitates the changes in rules and regulations in the financial markets. The financial sector reform of Nepal was initiated in mid-1980s and it is still being continued. The financial sector reform process in Nepal has been analyzed in three phases, which are as follows:

The first phase of the financial sector reform was initiated in mid-1980s under the liberal economic policy of HMG/N, under this policy, HMG/N first opened up the banking sector to foreign investors. In 1984, the Nepal Arab Bank Limited was established as the first joint venture commercial bank of the country. The bank was established with 50 percent equity participation of a foreign bank. The establishment of this joint venture bank brought foreign investment in the banking industry and modern banking practices and technical skill. The Nepal Indosuez Bank Limited and Nepal Grindlays Bank Limited were established in 1985 and 1987 respectively as joint venture commercial banks. The banking operations of these three international commercial banks helped the economy to get modern banking services. It enhanced the competitive environment in the banking sector especially in the Kathmandu valley where more than 50 percent of the economic activities of the country take place.

In July 1985, commercial banks were allowed, for the first time, to accept current and fixed deposits on foreign currencies (US dollar and sterling pound) Before May 26, 1986, the interest rates of commercial banks were totally controlled by Nepal Rastra Bank (NRB), the central bank of Nepal. Both deposits and lending rates were being heavily regulated by NRB. On May 26, 1986, NRB deregulated the interest rate regime and authorized commercial banks to fix interest rates at any level above its minimum prescribed levels. These bold steps of NRB had a far reaching impact in the development of the financial sector of the country, which was clearly evidenced in the growth of the assets and banking activities of commercial banks. Effective 29 may, 1986, the liquidity requirement was also lowered to 9 percent from 25 percent (NRB, 1996).

Under the Structural Adjustment Program of the IMF, the financial sector was further liberalized in 1987. The focus of NRB was placed on indirect monetary control. The emphasis was laid on increased financial intermediation, deepening of financial markets and increase in the role of market forces in the financial system. The auction mechanism was introduced for the first time to sell treasure bills (NRB, 1996).

When NRB strengthened its regulation and supervision of banking and financial institutions. Commercial banks were required to increase their capital adequacy ratio (CAR) gradually. They were required to maintain CAR of 2.5 percent by mid-July 1989 and 3.0 percent by mid-July1990. Regulation on single borrower limit was also introduced. There were some new regulations issued on refinance policy and reserve requirements. The Finance Company Act was enacted in 1986 to increase competition in financial markets and especially for the merchant banking and leasing services and to provide loans for hire purchase, term finance and housing construction. But finance companies were not established during the first phase of the financial sector reform NRB, 1996 regulation.

There was a new development on the capital market opened its floor for corporate share trading in November 1994. The Securities Exchange Center (SEC) also started to provide some merchant banking services. The trading in the capital market was limited due to listing of very few company's shares in the SEC. There was a limited transaction of government securities. The activities of contractual saving institutions such as the Employees Provident Fund (EPF) and insurance services sector did not make any new initiatives (NRB Annual Reports).

After the restoration of democracy, the democratic governments under its open and liberal economic policy gave more emphasis on the liberalization of the financial sector. As a result, the Nepalese financial sector has grown very rapidly since 1990s. There has been a dramatic rise in the number of banking and non banking financial institutions. Till mid-July1990, there were 5 commercial banks, 2 development banks, 2 insurance companies, and other few financial and quasi-financial institutions. As at mid-July 2000, there were 11 commercial banks, 2 development banks, 5 regional rural development banks (RRDBs), 44 finance companies, 2 insurance companies, 29 savings and credit co-operative societies and 30 NGOs licensed by NRB and few other financial and quasi financial institutions (EPF, Deposit Insurance and Credit Guarantee

Corporation, Citizens Investment Trust, Nepal Stock Exchange Limited, Securities Board, Insurance Board, Credit Information Bureau). There has been a tremendous increase in the volume of financial transactions and financial markets as well.

The commitments of HMG/N in the financial sector liberalizations the needed boost in the confidence of the private sector for the establishment of commercial banks in the private sector. The Himalayan Bank Limited and Nepal SBI Bank Limited were established in 1993 and Nepal Bangladesh Bank Limited and the Everest Bank Limited in 1994. All of them were established ad joint venture commercial banks. The Nepal Housing Development Finance company was established in the public sector as the first finance company under the Finance Company Act 1986. Soon after the establishment of the first finance company, five finance companies were established in the private sector in 1993. The rural development banks were established in five development regions to pro9vide microfinance services to the poor and the ultra-poor women. To provide limited banking services in the un-banked rural areas, saving and credit co-operative societies started to get operating licenses from NRB since 1993 and by 1195, there were 10 such financial institutions. Even the NGOs got licenses for micro-credit operations in 1994 and within two years' period, 30 NGOs got operating licenses to undertake limited banking transactions. The separate act for development banks was felt necessary and it was enacted in 1996.

The establishment of finance companies not only improved competition in the deposit and credit services, they also helped in the capital market through listing their shares. Their shares are being traded along with the shares of commercial banks. They have been providing merchant banking services such as underwriters and market makers.

To make the financial sector more liberal, the current account convertibility is very important; Nepal received the article VIII status of the IMF on May 340,

1994. The move towards financial liberalization helped the country to revive this status. Under this status, Nepal is obliged to keep the commitments towards the current account convertibility.

NRB further liberalized the restrictive measures for providing banking and non-banking financial institutions and especially development banks and finance companies more freedom in their business operations. The commercial banks were required to increase CAR to 3.5 percent at mid-July 1991 and 4.0 percent at mid-financial government enterprises under the policy of indirect monetary control and Nepal entered into the Enhanced Structural Adjustment Facility (ESAF) in October 1992. NRB laid more emphasis on open market operations as main monetary policy instrument (NRB, 1996).

Under the financial sector reforms, 3 joint venture commercial banks were established and they started to provide modern banking services to their customers. They started to compete with Nepal Bank Limited (NBL) and Rastriya Banijya Bank (RBB). Only fully owned and another 51% owned by HMG/N and among themselves to provide modern and efficient banking services. As a result, they attracted most of the good clients/customers (depositors and borrowers) of the RBB and NBL. They were already ailing even before the establishment of joint venture commercial banks. Because of new developments, their financial, managerial and organizational problems became more specious, To study their financial, managerial and organizational problems and to prescribe necessary recommendations, NRB sought the financial and technical help of the UNDP and the study team presented the Commercial Banking Problem Analysis and Strategy Study (CBPASS) reports.

The CBPASS I recommended HMG/N to address the following critical areas:

1. Gull repayment of Government guaranteed loans to state-owned enterprises and removal of lending obligations
2. Partial re-capitalization of NBL and RBB.

3. Establishment of a New Rural Finance Institution to assume priority sector lending of NBL and RBB.

To strengthen and improve their performance, HMG/N provided Rs 443 million for the re-capitalization of NBL and RBB. HMG/N provided Rs 3.12 billion for provisioning and repayment of bad debts. HMG/N made payment of Rs 660 million for the government guaranteed bank loans to public enterprises.

The CBPASS II report identified four critical areas where RBB and NBL had to make necessary improvements.

1. The CBPASS II report had revealed that an estimated 5 percent of the assets of NBL and 8 percent of RBB were problem loans and the recovery of these problem loans would significantly improve their liquidity, profitability and capital base.
2. Both NBL and RBB earned a negative spread on all new loans. Their capital and ability to earn profits to meet essential obligations would continue to be at risk until lending practices are improved.
3. NBL and RBB faced critical human resource issues- overstaffing, lack of skills, demoralized staff, ineffective utilization of human resources, and counter-productive work culture.
4. Their low cost sources of funding i.e. current and savings accounts were found eroded and valuable customers were defecting to JB banks. Their cost structure was very high and it was nearly 4% of their assets. The reason for this higher administrative cost was overstaffing of 40 to 50 percent in the branches. Critical branch-level information was not available and other data unreliable and untimely.

The CBPASS II report recommended following new systems for full implementation by the Board and Top Management of NBL and RBB:

1. Prompt approval of changes.

2. Timely commitment of required financial and human resources.
3. Active support of new systems.
4. Active monitoring of implementation.
5. Adherence to new systems and practices.
6. Removal of key obstacles.
7. Recognition of improved results.

They also recommended for 3 years or more of technical assistance required to fully addressing operational weaknesses of NBL and RBB to make them healthy and effective banking institutions. They also cautioned the concerned authorities to continue the institutional process in the near future to avoid another government sponsored financial restructuring program.

Both the CBPASS I and CBPASS II reports were implemented half-heartedly by concerned authorities. Both Banks were re-capitalized but their management and organizational structures could not be improved. HMG/N continued borrowing from NBL and RBB. They started to be run as any government enterprises. As a result, their financial health started to deteriorate and the HMG/N. NRB and the Top Management of NBL and RBB became just silent spectators and waiting for more serious financial, managerial and organizational problems in the future.

At mid-July 1998, the number of commercial banks reached 15. There were 2 development banks and 5 regional rural development banks. There were 29 co-operatives and 30 NGOs licensed by NRB for limited banking transactions. The capital Market increased due to listing the shares of commercial banks and finance companies. The insurance activities also increased because of the entry of new insurance companies in the private sector.

Financial sector reforms introduced in the last one and a half decades made significant improvements in certain sectors such as liberalization of interest rates, creation of a basic regulatory and supervisory frameworks, development of a longer-term government securities market, secondary market of government securities, establishment of several types of banking and financial institutions, functioning of stock exchange, competitive environment in the insurance services due to establishment of more insurance companies etc. But serious problems remained with two largest commercial banks (RBB and NBL) and two largest development banks (ADV/N and NIDC). The World Bank, the IMF and the Asian Development Bank (ADV) found some weaknesses in NRB's regulatory and supervisory capacity to effectively and efficiently regulate and supervise banking and other financial institutions. There were Government mandates seriously distorting operating incentives of the banking sector. Commercial banks requirement to lend in the priority and deprived sector, problems in opening of new branches to private banks, and restrictions on entry of foreign banks in the financial market.

Taking into account these serious problems in the financial sector, HMG/N adopted the Financial Sector Strategy Statement in December 2000. It has clearly mentioned about the needs for the strengthening and autonomy of NRB so that it can regulate and supervise commercial banks and financial institutions. It has pointed out the needs for the enactment of new NRB Act to increase the independence and authority of NRB to supervise of financial institutions and take over the management of troubled banks and severely punish those financial institutions, which are found engaged in serious irregularities. It has also pointed out the need of having the Deposit Taking Institutions Act, which is an umbrella act of all deposit taking institutions. Some of the main elements of financial sector reform strategy published by HMG/N in December 2000 are as follows:

1. Implementing restructuring plans for the to large commercial banks-the RBB and NBL
2. Identifying restructuring strategies for the two development banks. ADV/N and NIDC.

3. Strengthening banking sector regulation and accounting and auditing standards.

4. Strengthening the NRB's supervisory capacities and its ability to enforce compliance with prudential regulations.

5. Improving the regulation and supervision on non-bank deposit taking institutions.

6. Modernizing the legislative framework with a view to reducing legislative overlap and segmentation and fragmentation

7. Strengthening corporate governance and the framework for loan recovery.

8. Phasing out the role of NRB and commercial banks in providing directed credit.

As per the commitment of HMG/N to reform RBB and NBL, the Nepal Banking Reform Project was started by HMG/N and NRB with funding assistance from the World Bank (IDA) and DFID (UK). The KPMG Barents Group, the international expert team associated with the Banking Reform Project, started the reform project since 15 November 1999. They completed their study in FY 1999.00 They broadly recognized that Nepal's financial sector still faced following systemic problems:

1. poor bank governance
   - Political interference and
   - Insider lending
2. Lack of rational banking strategies as well as modern skill and international banking experience to support them.
3. Lack of independent, capable supervision.
4. Weak financial and management information
5. Weak legal and accounting practices

6. Difficult and deep-seated issues of RBB and NBL to be addressed

The KPMG Barents review of the RBB and NBL found that both banks were deeply impaired in virtually all areas of their operations.

1. Overall bank governance and management weak by modern standards.

2. Deep flaws in lending process, loan files and loan portfolio.

3. Primitive financial accounting with large pockets of “double counting”, unsubstantiated assets, and major items that should be written off by international standards.

4. No business strategies, weak planning and budgeting processes, lack in foundation, follow-up, rewards and penalties.

5. Low morale of employees, low pay scales, low skill and counter-productive union oriented activities.

6. Primitive management information, record keeping and control systems

The governance and management of RBB and NBL took politically driven decisions. They had negative net worth and insufficient capital adequacy. Their human resource management was found extremely weak in all areas. Their situation was clearly worse than in 1992 when the CBPASS report revealed their financial, managerial and organizational problems and weaknesses.

The KPMG Barents Group recommended following actions to be taken for RBB and NBL.

1. Support Government efforts to create an independent, commercially-run banking system and declare banking reform policies fostering sound banking system

2. Upgrade Board, senior management and staff skill, capabilities and processes.

3. Design and invest in comprehensive bank restructuring programs.
4. Support and assist in implementing long-range plans to correct environmental weaknesses
5. Support central bank strengthening and independence and provide full enforcement powers.
6. De-Politicize and commercialize the banking system.

The KPMG report concluded that loans assets of RBB and NBL were highly overstated and extremely risky. As a result, both of them were technically insolvent. As of mid-1998, they had losses of around US$450 million, which was equivalent to around 46% of the annual budget of HMG/N or 8.6 percent of GDP. The assessment confirmed that the management of two banks was basically dysfunctional. It recommended the reduction of the role of HMG/N in the financial sector as a direct owner of banking and financial institutions beginning with RBB and NBL.

As per the recommendation of the KPMG report, NRB removed the NBL Board on March 8, 2002, on account of failure to manage the bank properly and replaced it with an NRB appointed Board. In mid-July, the management of NBL was handed over to ICC Bank Ireland. For RBB, an international banking expert has been selected after Deloitte Touche Tohmatsu broke the contract. There are several international and domestic banking and financial expert have already completed HRD Plan, Loan Policy and Guidelines, Computerization Policy and Programs, Portfolio Review and Loan Recovery and Restructuring of RBB and NBL. Both of them have implemented VRS plan and reduced their staff considerably.

HMG/N has enacted the NRB Act 2002, the Debt Recovery Act 2002 and the Banking and Financial Institution Ordinance, 2004; The Public Debt Act and the Foreign Exchange Regulation Act were amended in 2002. The draft of the Secured Transaction Ordinance has been sent of HMG/N for its approval, which would address the weaknesses in the legal enforcement mechanism and judiciary capacity. The Credit Information Bureau is going to be established as a public limited company. The Debt Tribunals have already started its operation. The Asset Management Company is going to be established. The ADB has completed the Studies of ADV/N and NIDC and has recommended for the Restructuring of ADB/N and privatization of NIDC. NRB has issued prudential regulations to all banking and financial institutions including micro-finance development banks. The supervision manuals both for on-site and off-site have been prepared and implemented. The NRB has started the re-engineering process. The first phase of VRS is complete and the second phase of VRS has been announced. There is a special drive for the improvement of professionalism in the bank. The bank is going to formulate its long-term strategic plan in the near future. It will turn the central bank into a modern central bank.

There has been new development in the financial markets as well; new money market instruments are being introduced. The activities of the inter-bank call money market are increasing. The secondary market for government securities and company shares is being expanded. The repurchase agreements (Repos) have helped to expand secondary market of government securities. The holders of government securities can turn their securities to liquid assets. Commercial banks have introduced credit cards and debit cards. Some of them have even managed to provide ATM and electronic banking services. The clearing-house is going to be automated in the future and the modern payment, clearing and settlement system, which is one of the most important elements of the modern financial system.

Even the insurance services sector has developed with the establishment of joint-venture insurance companies. There are altogether 17 life and non-life insurance companies in the country. They have been competing and trying to attract their customers with new and innovative insurance products and services. The number of listed companies in the Nepal Stock Exchange reached 111 and the market capitalization, as of mid-February 2004 stood at Rs. 39.11

billion. The trading of shares has increased tremendously. Several companies have issued preference shares and debentures. It clearly shows that new financial instruments are being introduced.

As a result of these financial sector reforms and new financial sector developments, as of mid-March 2004, the number of commercial banks reached to 17, There were 56 finance companies, 14 development banks, 11 micro-finance development banks, 34 savings and credit co-operative societies and 44 financial intermediary NGOs. The number of insurance companies increased to 17. Development banks and especially rural micro-finance development banks (RMFDBs) have trained to fill up the gaps created by the closure of commercial bank and ADV/N branches due to law and security problems (Maoists' insurgency). All districts of the Terai (low land) region and few hill districts have been already covered by these newly established RMFDBs.

The deposits/GDP ratio of commercial banks rose to 44.9 percent at mid-July 2003, which were only 34.1 at mid-July 1998. Likewise, the credit/GDP ratio increased to 27.4 from 22.8 during the same period. But the total liquid fund/total deposit ratio declined to 20.2 from 33.6. The capital adequacy ratio improved to 5.8 from 4.8 during the same period. The deposits of the banking sector rose to Rs. 189.39 billion from Rs. 9084 billion. The total gross insurance premium increased to Rs. 2.93 billion in FY 2002-03 from 0.57 billion in FY 1992-93.(NRB, AR, 2004).

NRB has also published articles like following:

1. Strengthening of NRB's regulatory and supervisory functions.
2. Restructuring and privatization of RBB and NBL
3. Enhancing competition in the banking sector.
4. Implementing international accounting standards in NRB.

2.5 Article Review

2.5.1 Regulations to Financial Institutions in Nepal

NRB for Easier Monetary Policy:

It has focus on this topic about the Cash Reserve Ratio with a view to enhance investment and economic activities by reducing cost of capital. But this announces has taken at a time of slow down economic. NRB excess liquidity has now come down to Rs. 2.8 billion from Rs. 5 billion last year.

The CRR for current account in the Nepalese currency has been reduced from 8 to 7 and fixed account from 6 to 4.5 which has effected from December 2000/2001. But there is no change in cash involved position, which remains at 3% similarly, refinancing rate for foreign currency for export business has brought down to 2% from 4% and the refinancing with sick industries has scale down to 3% from 4.5%. Likewise, refinancing rate to rural development banks for export in Nepalese currency has been down to 4.5% from 5.5% and all the other refinancing rate has been scaled down to 5.5% from 6.5% (Business Age Vol. 3, Change by NRB).

Kapil Prasad Lohani, in his article has focused on NRB guidelines to banking sector. He pointed that the central bank has shown great hurry in issuing directives and guidelines, as a result, there is negative impact in the banking sectors. He has further focused that NRB has issued 6 directives to comply the financial institutions of Nepal with international banking norms, to reduce the non performing assets of the bank by discouraging the bad loans and one of these directives was issued to increase the capital base of the Nepalese commercial institute. But these six directives have to be revised due to Nepalese environment and also added more directives for banks sustainability and growth (Business Age Vol. 4).

According to Financial Institutions Act 1974, they are as follows:

a) Capital adequacy Ratio (CAR)

Capital adequacy Ration is the relationship between shareholders fund (capital fund) to total risk weighted assets of the bank capital adequacy ratios calculated on a quarterly basis. The shortfall should be covered within next six months when there is minimum core capital is not met. The higher the CAR, the less levered the banks and safer from depositors point of view. Distribution of dividend, expansion of branches, distribution of loans, and availing refinance from Nepal Rastra Bank etc is not allowed until fulfillment of Car shortfall.

b) Capital Fund

Capital fund of a new Financial Institutions which must have minimum paid up capital is Rs.250 million to operate all over Nepal except Kathmandu valley and Rs 1000 million to operate all over Nepal including Kathmandu. By mid July 2009, existing all banks require to raise capital fund to Rs 1000 million through minimum 10 percent paid-up capital increment every year.

c) Cash Reserve Ratio

Banks are required to maintain minimum cash reserve as per NRB regulation from 22 July 2002 cash at till 2 percent of total deposits balance at NRB, 7 percent of current and savings deposits and +5 percent fixed deposits. Cash Reserve Ratio is not mandatory for foreign currency deposit and for margin deposit.

d) Reserves

Banks should transfer 20 percent of their net profit to general reserve and they are to transfer 25 percent of exchange fluctuation gain to Exchange Fluctuation Reserve if there is any gain from revaluation of assets. Interest spread reserve should be created to deposit interest income

e) Branch and counter expansion

Financial Institutions establish with Head office in Kathmandu should have one main branch office in Kathmandu. They are required to open two branches outside the Kathmandu valley financial institutes should be approached from NRB to open branch or counter.

f) Interest Spread

Weighted interest spread between lending a rate and deposit rate should not exceed 5 percent. Interest income in excess of 5 percent spread on bi-annual basis should be retained in the bank as Interest Spread Reserve and no dividend can be given out of this fund.

g) Interest rate

DFI can fix interest rate on deposits and loans and should be published in the local newspapers and communicated to Nepal Rastra Bank. There is allowing of 0.50 percent deviation from the published rate on all types of loans and deposits.

h) Directive Credit

F.I.S must extend a certain percentage of loan and advances in the deprived and priority sector. Currently deprived sector lending should be at least 0.25 percent to 3.00 percent depending on the FIS and priority sector lending at least 12 percent inclusive of deprived sector lending to their total credit portfolio. The FIS has to pay penalty at the highest lending rate in case of shortfall in deprived and priority sector.

i) Loan classification and provisioning

A FIS is required to classify their loan on the basis of overdue ageing schedule and provide on a quarterly basis as follows:-

Types	Provision Requirement	Criteria
Pass	Principle overdue upto 3 months	1%
Substandard	Principle overdue upto 6 months	25%
Doubtful	Principle overdue upto 1 Year	50%
Bad	Principle overdue upto above 1 year	100%

2.5.2 Sectorial Credit Limit

NRB required banks to monitor its credit portfolio in following ways

a) **Level 1:** Sector where credit of a bank ranges from 50-100 percent of core capital.

b) **Level II:** Sector where credit of a bank is above 100 percent of core capital.

2.5.3 Single Borrower's Limit

Single borrower's limit refers to the maximum credit limits that can be extended to customer, firm, companies of a same group. Such limit is 25 percent of core capital to fund and 50 percent of core capital to non-funded. The bank that enjoys credit limit more than that should bring it within the limit by mid-July 2003. There should be assigned 30 percent additional a FIS does not observe risk weight to such credit portfolio if above limit.

2.5.4 Other Regulations

a) FIS are prohibited to purchase and sale of goods with transactions motive.

b) No allow of purchasing of fixed assets for not of own use.

c) No permission to act as the managing agent.

d) There is prohibition on extending facilities to the director or the member of his undivided family.

e) FIS are prohibited on extending credit facilities to the shareholder holding more than 1 percent share and to his undivided family.

f) FIS are prohibited on extending credit facilities against the security of own share.

g) FIS are prohibited on extending business credit facilities to the employees and their undivided family.

h) FIS are prohibited on extending credit to the company where the director or the members of his undivided family have 10 percent stake.

i) FIS should not declare and distribute of dividend to share holders before complete amortization of preliminary expenses. Accumulated loss and before appropriation of fund for capital adequacy, reserves and provision.

2.6 Thesis Review

In context of Nepal, Nepal Rastra Bank is central bank of Nepal. There are many studies related to central bank. But, some studies have been conducted regarding the role of NRB in economic development of Nepal and a few studies are conducted on the NRB role for banking development. During this research there is only one research has found which is related to the NRB Directives. In this thesis, there is reviewed only that thesis which is related to NRB’s Directives to develop the commercial banks.

Santosh Pandey, in his thesis, has observed that the changes in NRB Directives have made the impact on the commercial banks. Because of new directives, banks have to increase the operational cost and dividends to shareholders and bonus to the employees are scaled down due to decrease in profits of banks. He has also observed about the protection of deposits of public because of reduction in the loan exposure. He further sates that due to new directives, its foresight results lead to bank financially healthy and stronger in future. Finally, he laid down about the changes in directives will bring prosperity to the shareholders, depositors, employees and the economy to the country as a hole. He suggested, in his thesis, to NRB that the NRB should issue directives after being proper homework. NRB must strength then the functioning of its Credit Information Bureau. NRB should be practical and should issue directives to be applicable in context of Nepal, not only to meet the international standards. Otherwise complaints from commercial banks may arise. However, in the present context, the commercial banks have to comply such directives and maintain its policies. And, NRB has directed commercial hanks to obey such rules and regulation; otherwise NRB will take action as per NRB Act, 1955.

Above study is based on the impact of directives to commercial banks and this study consists only three directives among ten directives. Presently, NRB has issued directives relating to banking regulations and prudential comprises ten directives. The findings of above study may indicate the certain impact of the new directives to the commercial banks and maintaining rules of directives by Himalayan Bank Limited. The present study focuses on the five directives including previous studied three directives of NRB and studies on rules maintaining by Nabil Bank Limited and Nepal SBI Bank Limited. Thus, the present study is more relevant than the above study. This study will also carry out to fill the gap, which was lack in the previous study.

Resham Raj Pathak’s Study

Mr. Resham Raj Pathak studied, "A comparative study on financial performance between Nepal Grindlays Bank Ltd and Himalayan Bank Ltd." In 2001 by using secondary data form 2050/051 to 2055/056

The main objectives of his study were as follows:

1. To analyze the financial strength and weaknesses of this two joint venture banks namely Nepal Grind lays Bank Limited and Himalyan Bank Limited.
2. To examine the financial performance.

3. To study the comparative financial position of the two joint venture banks
4. To provide a package of suggestions and possible guideline to improve banking business based on the findings of the study.

Some major findings of his study among others were as follows:

1. NGBL is seemed relatively better than that of BHL although both the banks liquidity position is not satisfactory.
2. Both the banks have been efficient in utilizing most part of their total assets in profit generating purpose but comparing both banks. NGBL has better performance than BHL for utilizing assets.
3. Return on investment comparatively decided that BHL has idle deposit, due to the lower return as compared with NGBL.
4. NGBL seems much better in terms of offering dividend to its shareholders as compared with HBL.
5. Comparatively operating and non-operating income of NGBL has higher percentage than HBL.
6. The major expenses for both the banks are interest payment. BHL is paying more interest and commission than NGBL Comparatively.

Hari Prasad Acharya's Study

Mr. Acharya has studied in his master's degree thesis titled on "An Evaluation of Financial Performance of Nepal Insurance Co. Limited" on 1998, his major findings are as follows:

1. Liquidity management is in very weak position.
2. The company can't manage its outstanding premium efficiently.
3. The credit worthiness of NICO is decorating with its re-insurers.

4. The company cannot control its operating expenses at the minimum level.

5. The company was able to earn the net profit at satisfactory level.

6. From the profitability point of view, the performance of NICO is generally satisfactory.

7. The net profit can't be increased proportionately with the increase in net worth.

8. The total assets are in increasing trend.

9. The company is able to invest sufficient fund to various investment sectors.

10. The company cannot increase its fixed assets at satisfactory level.

11. There is no stability inflow of funds & out flow.

12. There is no any adequate and advance planning for the use of funds and its sources.

Shova Palikhe's Study

Miss Palikhe studied performance evaluation of finance company (A case study of Annapurna finance Co. Ltd. Pokhara) by using data of only one finance company for the period by 2050/051 B.S. to 055'056 B.

Some findings of her study through secondary data among others were as follows:

1. Liquidity position of the company is satisfactory.

2. To find out the empirical relationship between various important variables i.e. deposits loan and advances, investments, net profit etc. and compare between the selected finance companies.

3. To analyze the deposit utilization trend and its projection for next five years of the concerned finance companies.

4. To conduct hypothetical test to find weather there is significant difference between the various ratios of selected finance companies.

Some findings of his study among others were as follows:

1. The liquidity position of AFCO is comparatively better than that of other Finance Companies. Highly fluctuating liquidity positions shows that the company has not formulated any stable policy.
2. Profitability position of NSMCO is comparatively not better than that of the selected finance companies.
3. NSMCO seems to have unable to keep adequate capital fund.
4. NSMCO has not been more successful to increase its NP, EPS and DPS in comparison to others Finance Companies.
5. KFCO is weaker in total investment by mobilizing total deposit and NSMCO has been failed to achieve proper amount of return by mobilizing the debt funds.
6. NSMCO has higher trend values of loan and advances and lower negative trend value of net profit. Similarly, KFCO’s trend value is lower in case of total investment than that of other Finance Companies.

Mr. Suraj Adhikari’s Study

Mr. Adhikari studied in his study “Analysis of financial Performance of National Finance Company Limited” on 2000; some findings besides others are as follows:

1. Both deposit and loans and advances are increasing but their increasing percentage comparing to the previous year's shows that these increase are in decreasing percentile and it has been the case with loan and advances and investment.

2. The increase in operating profit compare to year 1998 for because of the fact that the expenses for both the years where almost the same and there was increase in income in year ending 1999

3. Liquid assets to deposit ratio has been well above 19% for all the previous five years.

4. Deposit was more than 10 times of the net worth of NFCL.

5. Dividend per share has been increasing continuously from Rs. 12 in year 1995 to Rs. 22 in year ending 1999.

6. Loan and advances to deposit ratio has been continuous decline.

7. Investment to deposit has been increasing over the years.

2.7 Financial Performance Review

Nepal Rastra Bank issues directives form time to time to enhance the strength of the Financial Institutions. The tools described in the directives' main objectives are to control and monitor the financial institutions of the country. NRB has been issuing directives into four different parts i.e., Directives relating to banking regulations and prudential norms, Credit Information Bureau (CIB), Foreign Exchange, and List of forms, formats and tables. In present situation, NRB issues directives regularly and comes out with new directives.

Directives relating to the banking regulation and prudential norms comprise ten directives which are as follows:

1 The provision of minimum capital fund to be maintained by the commercial banks.

2: The provision of loan classification and loan loss provisioning on the credit.

3: The provision relating to single borrower limit.

4: The provision of accounting policy and the structure of financial statements to be followed by the commercial banks.

5: The provision of reducing the risk on activities of the commercial banks.

6: The provision of institutional good governance to be followed by commercial banks.

7: The provision of implementation schedule of Regulatory Directives issued in connection with inspection and supervision of the commercial banks.

8: The provision of investment on shares and securities.

9: The provision of submission of statistical data to the Nepal Rastra Bank, Banking Management Division and Inspection and Supervision Division.

10: The provision of sale and re-registration of foundation shares of commercial banks.

Out of the ten directives, this research work is limited to the following five directives:

1. Provision of Capital Adequacy Ratio :

The features of both debt and equity are called hybrid capital instruments.

a) Securities issued without collateral, can be fully paid-up instrument, preference in payment after depositors and creditors, participate at loss and can be converted into ordinary capital.

b) Instruments, which cannot be redeemable by the issuer without approval of NRB.

c) Perpetual or long-term preferred stock convertible to ordinary shares if profit-loss accepts is a negative.

d) Debt instruments and redeemable preference shares issued without collateral, has life minimum 5 years and is payable after depositors are subordinated term debts. Banks are required to amortize at 20% discount rate every year.

Banks make 100% provision if invested in securities not listed in the stock exchange.

2. Provision of loan classification and loan loss.

a) A bank is required to classify their loans and advances on the basis of ageing of the principle.

b) All loans and advances need to be classified into the following four types.

   i. Pass loan
   ii. Sub-standard loan
   iii. Doubtful loan
   iv. Loss

Pass loan is called performing loan and others are non-performing loans.

c) Commercial banks should classify on the basis of the following time table according to NRB Directives:

<u>For FY 2003/2004</u>

Pass: Loans not past due and past due upto 3 months.

Sub-standard : Loans and advances past due for a period of over 3 months to 1 year.

Doubtful: Loans and advances past due for a period of over 1 year to 3 years.

Loss: Loans and advances past due for a period of over 3 years.

<u>For FY 2004/2005</u>:

Pass: Loans not past due and past due upto 3 months.

Sub-standard: Loans and advances past due for a period of over 3 months to 1 years.

Doubtful: Loans and advances past due for a period of over 1 year

Loss: Loans and advances past due for a period of over 3 years.

<u>For GY 2006/2007</u>:

Pass: Loans not past due and past due upto 3 months.

Substandard: Loans and advances past due for a period of over 3 months to 9 months.

Doubtful: Loans and advances past due for a period of over 9 months to 2 years.

Loss: Loans and advances past due for a period of over 2 years.

<u>For FY 2007/2008:</u>

Pass: Loans not past due and past due upto 3 months.

Substandard: Loans and advances past due for a period of over 3 months to 6 months.

Doubtful: Loans and advances past due for a period of over 6 months to 1 year.

Loss: Loans and advances past due for a period of over 2 year.

d) Loans should be classified as loss in following cases:

i) No security or security not as per contract.

ii) Borrower has been declared bankrupt.

iii) Borrower cannot be found.

iv) Purchased or discounted bills are not repayable within 90 days from the due date.

v) Loan amount has not been used for the original purposes.

vi) Blacklisted borrowers.

The banks need to be classified 1% of pass loans to general loan loss provision and remaining three substandard, doubtful and loss with 25%,50% and 100% respectively should be provisioned for the possible losses.

Banks can re-schedule and restructuring loan if nonperforming loan receiver submit the external/internal reasons.

Insured priority sector credit and deprived sector credit will have to be provisioned at 25% of the provision percentage to loans loss.

3 Provision of Single Obligor Limit

a) As per NRB Directives, banks should classify into fund-based loan (Overdraft, Trust receipt, Term loans etc) and non-fund based loan (letter of credit, guarantees, commitments etc). The NRB has brought following limit:

Loans and advance	**P.C.(2005-2006)**	**P.C.(2006-2007)**
Fund based	50% of core capital	25% of core capital
Non fund based	75% of core capital	50% of core capital

b) Banks should not maintain above limit, when loan provided under guarantees of fixed receipts, banks deposits, government securities, NRB debentures and A-rated national and international banks.

c) Banks need to be provisioned additional capital charge less than 6 months, in case banks provide loan and advances out of limit.

4 Provision of accounting policy and structure of financial statements.

a) Banks need to take Shrawan-Ashad (mid-July/ mid August-mid June/ mid July) as a fiscal year.

b) Banks need to publish balance sheet, profit and loss account and cash flow statement in annual report after auditing according to the statutory from issued by NRB.

c) Banks need to publish financial statement including following subjects.

   i. Annually distributed. Recorded and written-of-principle and interest of loan and advances.

   ii. Reconcile Account according to past due.

   iii. Weighted Average interest Rate Spread of deposits and loans.

iv. Transactions related to on-balance sheet and off-balance sheet.

v. Classification of assets and liabilities as per NRB Directives relating reducing liquidity risk on the basis of maturity period.

vi. Collateral for borrowing loans.

vii. Other necessary documents to inform and understand balance sheet and P/I. account.

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vi) Collateral for borrowing loans.

vii) Other necessary documents to inform and understand balance sheet and P/L account.

6. Provision of reducing the risk on activities of commercial banks

As per NRB Directives, NRB has classified the risk related to commercial banks transactions into sectors:

a) Liquidity risk

b) Interest rate risk

c) Foreign exchange risk

d) Risk related to loan and investment

a) Provision of reducing liquidity risk

1. Banks need to classify time interval on the basis of payment period and maturity period.

    i. Assets and liabilities with maturity period from 0-90 days.

    ii. Assets and liabilities with maturity period from 91-180 days.

    iii. Assets and liabilities with maturity period from 181-270days.

    iv Assets and liabilities with maturity period from 271-365

    v Assets and liabilities with maturity period from above 1 year.

2. NRB has brought following directives for liquidity are as

    i. 7% of current and savings deposits liabilities and +.5% of fixed deposits liabilities should be balance at NRB.

    ii. 2% of total deposits liabilities should be cash in vault.

    iii. NRB has scrapped the provision of secondary reserves.

3. NRB in vault shall include only the local currency and foreign currency except clearing cheques.

4. Liabilities with unfixed maturity period.

    i. Core capita from current deposit and compensating balances need to include in time interval above one year.

    ii. Saving deposits should be taken as long-term liabilities.

b) Provision of reducing interest rate risk

1. As per NRB Directives banks need to classify time interval as follows:
    i. Assets and liabilities with maturity period from 0-90 days.
    ii. Assets and liabilities with maturity period from 91-180 days.
    iii. Assets and liabilities with maturity period from 181-270days.
    iv Assets and liabilities with maturity period from 271-365 days.
    v Assets and liabilities with maturity period from above 1 year.
2. Banks should include asset and liabilities of unfixed maturity period under the following provision:
    i. Assets should be including in 'A Floating Rate Loan with Interest Adjusted Periodically'.
    ii. Core capital from current deposit and compensating balances need to include in time interval above one year.
    iii. Saving deposits should be taken as long-term liabilities.
    iv. Examine of cash flows, Balance Sheets, and income statements of various institutions.

2.8 Development of Finance Companies

2.8.1 Development of Finance Companies in Developed Countries

The concept of financial companies in USA began with the concept of consumer finance companies in the early days. Consumer finance companies were developed to perform the second function of the consumer credit, that is, to provide adds in time of financial emergency. They made loans in the early years of their existence primarily to low-income borrowers who found it impossible to obtain credit elsewhere. For that purpose in USA the firs comprehensives small-loan legislation was passed in Massachusetts in 1911, and New Jersey followed suit in 1914. In the next year such legislation was passed in New York, Ohio and Pennsylvania. A few years after the development of consumer finance companies, another type of institution, the sales finance company, was developed to finance the sale of durable goods on installments. The big growth of sales financing came with the rapid development of the automobile industry. The first corporation to finance auto sales, organized in 1915, was immediately swamped with business shortly there after, the commercial credit companies developed a plan to finance automobile sales. It developed its automobile sales financing activities rapidly and is today one of the major companies in the sales finance field. General Motors Acceptance Corporation was incorporated in 1919 to do sales financing. Many other sales finance companies were established especially during 1920-33.

CHAPTER THREE

RESEARCH AND METHODOLOGY

Research is the investigating by planning, structuring with strategy to find out the problems and to control the variance. Research refers of knowledge, which may be scientific research or systematic research for pertinent information on a specific topic. Research has significance to solve various operational and planning problems of business and industries. "The purpose of research is to discover answers to questions through the application of scientific procedures. The main aim of research is to find out the truth which is hidden which has not been discovered at yet" (Kothari; 1990: 7).

The history of research of methodology gives the student the necessary training in gathering materials and arranging or card indexing them, participation in field work when required and also training in techniques for the collection of data appropriate to particulars problems, in the use of statistics, questionnaires and controlled experimentation and in recording evidence, sorting it out and interpreting it. (Kothari; 1990: 12-13).

This study is basically concerned with examining the impact of Nepal Rastra Bank's guidelines in the commercial banking. The following methodology will be used in the study:

- Conduct direct interviews with the concerned banks to find out the existing problems and situation regarding NRB's Directives.
- Conduct structured interviews regarding benefits and weaknesses of the NRB's Directives.

3.1 Research Design

"A research design is the arrangement of the conditions for collection and analysis of data in a manner that aims to combine relevance to the research purpose with economy in procedure" (Kothari; 1990: 39). This study has used descriptive and exploratory type of research design. The selection of this type of research has become necessary keeping in view the quantity and quality of information that available. This study evaluates the impact of directives of Nepal Rastra Bank with the help of maintained research design.

3.2 Population and Sample

There are 25 commercial banks, 58 development banks, 5 rural development banks and 78 finance companies are operating in Nepal. Out of all these, study comprises 17 commercial banks as a whole and 59 financial companies as a whole.

3.3 Sources of Data

Primary Data:

The first hand data is known as primary data.

Secondary Data:

The second hand data is called secondary data.

The researcher uses only one type of sources of data collection: Secondary Data

Data are collected from following bulletin:

1. Golden Jubilee issue of Nepal Ratra Bank Samachar- 2061/062
2. Nepal Rasta Bank Website: www.nrb.org.np, Statitics, Banking and financial Statistics- No 51 July, 2008.
3. Employees of Nepal Rastra Bank, Baluwatar, KTM
4. Quarterly report of Financial Statistics- issued by Nepal Rastra Bank
5. Nepal Rastra Bank Directives.
6. Various magazines such as Banking Promoting, MIRMIRE ARTHIK LEKH BISESANSK, business age etc.
7. Various related websites.

8. Related articles published in news letters, magazines, News paper and books

3.4 Data Collection Techniques

Since the research work is for overall commercial banking & finance companies required. Hence, secondary data were obtained from Nepal Rastra Bank through personal contact with the employees and searching websites. Further NRB Directives and related guidelines in this regarding various books, journals and articles were collected through friends, Daily News Papers, Websites and business related information disseminated to the researcher' organization through concern authorities.

3.5 Data Analysis Tools

The data so collected are arrayed in order and identified in order to meet the research objectives. The arrayed information is presented in the work systematically in a descriptive manner and in diagram and graph, wherever necessary. For analysis basically Financial and statistical analysis are used.

3.5.1 Financial Tools

To avoid any complexities in the comprehension of the text and subject matter, a simple financial tool called Ratio. This simply compares one component of the information to another component of the information so as to predict the health of the over all system. Literally, 'Financial analysis is the process of identifying the financial strength and weakness of the firm by properly establishing relationship between the items of the balance sheet and profit and loss account'.

3.5.2 Ratio Analysis

Ratio analysis helps to define the relative strength of any two or more variables. It the most commonly used tools in the financial analysis tools.

a) **Loan and advances to Deposit ratio (CD Ratio):**

Since the commercial banks are exposed to risk assets, their liquidity position, profitability and repayment capacity is determined through the ratio called CD ratio. This ratio highlights the possibility of the banks for liquidity and profitability trade off. A benchmark of 80% CD ratio is the ideal ratio regarded in Nepalese sector, which is commonly beloved to balance the fact that banks having higher CD ratios may expose to the insolvency of bankruptcy risk in case NPLs are generated. This ratio is calculated as below,

$$\text{CD Ratio} = \frac{\text{Total Loans and advances}}{\text{Total Deposits}}$$

NPA to total Loan and advances:

This ratio is used to know what the situation of the commercial banks in overall to the Non Performing loans in knowing percentage of non- Performing loans to total loans and advances, we may be aware what are the possibilities of rollover of the funds exposed to Risk assets. This ratio is calculated as,

$$\text{NPL to total Loan n advance} = \frac{\text{Non Performing Loans}}{\text{Total Loans n advances}}$$

NPL to Total Deposit Ratio:

This ratio tells the volume of Non Performing Loan (NPLs) compared to total deposits. This ratio is calculated to ascertain the repayment capacity of the banks to its depositors. This ratio is calculated as below,

$$\text{NPL to Total Deposits} = \frac{\text{Non Performing Loans}}{\text{Total Deposit}}$$

Statistical Tools

Statistical tools are the mathematical techniques used to explain the collected and arrayed numerical data. "Statistical Analysis is one particular language, which describes the data and makes possible to talk about the relations and the difference of the variables." S.P. Gupta, Stastical Method. (New Delhi: Sultan Chand and of the variables." S.P. Gupta, Statistical Method. (New Delhi:

Sultan Chand and Publishers, 1997 p.21). To make the numerical values meaningful, following statistical tools are used,

1. Karl Pearson's Correlations Coefficient

"Correlation" is a quantitative index, a standard statistical measurement of the degree of relationship or association between two sets of numbers (variables) to describe how closely they track or are related to one another. The notion does not necessarily imply causation since no direction of influence is known or can be assumed. In fact, often both variables are "caused" by some other independent variable(s) not being measured. The concept has been in wide use across the sciences since the 1880's when first popularized by Sir Francis Galton, explaining the relationship between children's height to that of their parents. It is perhaps the most widely used single analytic procedure in the behavioral sciences. Correlation is most commonly measured to in shorthand by the symbol "r"). It is calculated as a number ranging between-1.00 and +1.00. A measure of +/- 1.00 represents a perfect positive or negative correlation, indicating that the two sets of numbers form an identical pattern.

Calculated as,

$$r = \frac{N\sum XY - (\sum X)\times(\sum Y)}{\sqrt{N\sum X^2 - (\sum X)^2}\times\sqrt{N\sum Y^2 - (\sum Y)^2}}$$

Where,

r	=	Correlation
N	=	Total No. of year
X	=	Dependent variable (NPA)
Y	=	Independent Variable

Interpretation of simple correlation coefficient

- It lies always between +1 and -1
- Where r= +1, there is perfect positive correlation

- Where r=-1, there is perfect negative correlation
- Where r=0, there is no correlation
- Where r lies between 0.7 to 999 (-07 to -999) there is high degree of positive or negative correlation).
- Where r lies between 0.5 to 0.699, there is a moderate degree of correlation.
- Where r is less than 0.5, there is low degree of correlation.

2. Multiple correlations:

"The study of relationship among the three variables simultaneously (i.e. at the same time) is the multiple correlation. In multiple correlations, all the give variables are studied at one time by taking one variable as dependent and all the remaining variables as independent (or factors) on a dependent variable (or factor) is studied. (Shrestha and Silwal, Statistical Methods in Management, Taleju Prakashan, IInd Edition, p. 331).

3. Regression Analysis:

Regression Analysis can be defined as, "A statistical technique used to find relationships between variables for the purpose of predicting future values"

Or,

"Regression analysis is a tool used by economists and others to estimate the relationships among a dependent variable Y and one (or many) independent variable (s) X. The purpose of regression analysis is the "best fit" data points from a graph"

It helps in predicting the value of Dependable Variable Y based on change on independent variable X. In equation it is denoted as,

$Y = a+bx$

Where, value of a, b are constant and they decide the value of Y with the change in value of X.

4. The tools used in data presentation and analyses of the directives of NRB are described as follows:

- Capital Adequacy Ratio:

Capital adequacy of a bank refers to the maintenance of sufficient amount as capital fund in comparison to various variables such as Total Deposit, Total Assets and Risky Assets etc. Banks have to maintain capital adequacy according to the directives of Nepal Rastra Bank.

Capital Adequacy Ratio = Total Capital Fund/Total Risk Weighted Assets

- Loan loss provision

Financial institutions have to deposit some funds as provision which helps for the recovering of bad loans. These provisions are kept according to the directives of NRB.

Total loan loss provision = Pass loan provision + Renewed loan provision + Substandard loan provision + Doubtful provision loan + Loss loan provision

Net loan = Total loan – Total Provision

- Single Borrower Limit

The sum of money which can be borrowed by a individual group, person and organization which is limited by the NRB directives according to core and total capital is defined as single borrower limit.

Requirements of single borrower limit:

<u>For new provision fund base:</u>

Capital Requirement = 25% of core capital

<u>For new provision non fund base:</u>

Capital Requirement =50% of core capital

For old provision fund base:

Capital Requirement =35% of total capital

For old provision non fund base:

Capital Requirement =50% of total capital

- Provision of reducing risk on activities of financial institutions

According to NRB directives, NRB has classified the risk related to finacial institution into the sectors easy liquidity risk, interest risk, foreign exchange risk, risk related to loan and investment. Balance should be kept at NRB for reducing risk are as follows:

1. 7% of current and saving accounts.
2. 4.5% of fixed deposit accounts.
3. 2% of total deposit should be kept in cash in vault.
4. Net provision = 30% of core capital

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1 Data Presentation and Analysis

The main objectives of this chapter are to review and present the NRB's Directives and its impact on the financial institution. In this regard, directives no. 1-5 issued by NRBS Super Report Banking and Financial stats and quarterly Economic bullet presented are analyzed.

The impact and implementation of directives are collected from different NRB's supervision and inspection divisions respectively are also analyzed on percentile basis.

4.1.1 Provision of minimum capital fund to be maintained by the commercial banks & finance companies.

Capital is the excess of assets over liabilities and can be defined as the wealth, which employed for the production. Total capital fund is the sum of the core capital and supplementary capital. Core capital is the first tier and supplementary capital is the second tier capital. As per NRB’s directives the financial institutions maintained its capital fund as shown below.

Capital adequacy ration is the ratio of shave holder’s fund or total capital fund of the financial institutions to the total risk weighted assets (TRWA)

$$\text{Capital Adequacy Ratio} = \frac{\text{Total capital Fund}}{\text{Risk weighted Assets}}$$

Generally, core capital content paid up capital, general reserve, retained earning and other reserves, which are not separated in cash flow and balance sheet. Supplementary capital contents only loan loss provision.

Table No. 4.1
Total Capital Fund of Finance Companies

(In Million)

Fiscal Year	2003	2004	2005	2006	2007	2008
Total core Capital (I)	1203.6	1533.8	2008.5	2329.8	2661.2	2888.4
Total supplementary Capital (II)	285.9	395.1	653.6	875.4	992.6	1118
Total capital fund (I+II)	1489.5	1928.9	2662.1	3205.2	3653.8	4006.4

Source: Banking and Statistics, NRB-51

According to table, core capital and supplementary capital are in increasing position. And also capital fund is rise,so that, there is problem of over capitalization in finance companies and less investing, profit earning opportunities in the market.

Table No. 4.2
Total Capital Fund of Commercial Bank

(In Million)

Fiscal Year	2003	2004	2005	2006	2007	2008
Total core Capital (I)	67292	8230.2	10202.5	11814.6	-1020.7	-19458.1
Total supplementary Capital (II)	-	-	-	-	-	-
Total capital fund (I+II)	6729.2	8230.2	10202.5	11814.6	-1020.7	-19458.1

Source: Banking & Statistics of NRB, no.51 (2008)

There is no loan loss provision shown in cash flow of commercial bank for above table so, supplementary capital is not shown in the table. In above table, core capital, and capital fund is rise in year 2006, afterthen it shows negative figure.

Financial institutions should maintain such capital adequacy ratio according to the NRB Directives in order to protect the depositor's money against the Financial Institutions failure. Banks are required to maintain capital adequacy in three different ways the core capital adequacy ratio. Capital adequacy deals only with the asset side of the balance sheet of the Financial Institute. The

TRWA is calculated under consideration of both the on-balance sheets assets and the off balance sheet assets.

Table No. 4.3

TRWA of Finance Company and Commercial Banks as 2007/08

(In Million)

Particulars	Finance Companies (Rs.)	Commercial Bank (R)
Total on-balance sheets assets (I) Total off balance sheets assets (II)	27170.74 -	305,526.3 -
Total Risk weighted Assets (I+II)	27170.74	305526.3

Source: Supervision Report of NRB (2008)

Table 4.4

Capital Adequacy Ratio of Finance Company and Commercial Bank as of 2007/08

(In Million)

Particulars	Finance Companies			Commercial Banks		
	Minimum requirements	Actual figure	Short fully excess	Minimum requirements	Actual figure	Short fall / Excels
Total Core capital	1129.1	2888.4	1759.3	8394.8	(20987)	12592.2
Total supplementary capital	1129.1	1888	758.9	8394.8	36106.6	27711.8
Total capital fund	2258.2	4006.4	-	1678.9	15129.6	-
TRWA	-	27170.74	-	-	305526.3	-
Capital Adequacy ratio	12	14.75	5.75	12	5	(7)
CARWRT care capital (%)	6	10.35	5.85	6	7	1
CARWRT Supp. Capital (%)	4	5	1	4	12	8

The new provisions of the NRB directives have made to increase the core capital and supplementary capital to meet the required total capital fund has maintained its capital adequacy of with excess of contributed of it by the core capital by the supplementary capital. Likewise, the minimum requirement of capital adequacy ratio with respect to both core capital and supplementary capital is 4.5%. The shortfall of supplementary capital can be capital adequacy ratio is negative in commercial Bank.

Due to NRB Directive effectiveness capital invested in finance companies and economical banks are increasing year by year.

In the year 2007 and 2008 the capital invested is in negative figure due to losses of commercial banks because of owner capitalization and misses utilization of capitals which shows defects in capital structure of commercial Banks.

Similarly; finance companies are also over capitalized. There is lack of proper investment opportunities is finance companies. So, NRB has to apply good guideline for capital structure

+ve Impact:

- Reduce risk of public money
- Safe guard for public.
- Strong controlling tool used by NRB for financial institution.

-ve impact:

- Only 6% of core capital is not enough to cover whole risk involved in public deposits in financial institution.
- NRB's Directive is silent for capital structure of financial institutions.
- Over capitalization in financial sectors.
- Compensated by the express amount of core capital. But a shortfall in the core capital can not be compensated by the excess amount of supplementary capital.

In order to see the impact of the directives it should be compare the new arrival directives that previous directives. There was capital adequacies for 8% and capital adequacy with respect to core capital and supplementary capital were 6% each. As per new directives, banks are required to increase its capital fund to maintain the figures given by NRB directives i.e., 9% for FY 2003\2004 contributed by 4.5% each by both core capital and supplementary capital.

4.2 Provision of Loan Classification and Loan Loss (NOT)

4.2.1 Provisioning on the credits

It is the primary functions of any Financial Institutions to receive deposits from public and give loan to concerned people. Earning from such loans and advances occupy a major space in income statement of the financial institutions. The liabilities side of the balance sheet of any Financial Institutions is dominated by loan and advances. As it can be seen that 42.19% of the total assets is covered by loans, advances and bills purchased as of FY 2003/2004 of the total assets is contributed by loans advances and purchased. The profit of the Financial Institutions depends on the interest received from the loan borrowers and paid to the depositors. Financial Institutions may unable to repay tot depositors money when financial institutions fail to collect the loan amount.

One of the main purposes of NRB's new directives related to loan classification and provisioning is to protect the loan of It's as per new directives issued by NRB. Financial Institutions should Institutions their loan on four different categories while previous directives show the same loans and advances were categorized into six different categories. It consists.

Table No. 4.5

Classification of Loan and Provision of Loan of Finance Companies for the year 2006 and 2007

(In Lakh)

Particulars	Provision % requirements	2006		2007	
		Loan	Provision	Loan	Provision
Pass	1	132791.51	1333.99	166070.40	1694
Substandard	25	2758.81	602.30	2500.60	1149.53
Doubtful	50	2742.54	1110.68	2539.99	1667.46
Loss	100	6422.51	5809.86	6365.67	6503.07
Other loans		1485.69	161.80	1031.04	779.54
(I) Total provision			9018.66		11793.6
(II) Total loan		146201.06		178507.70	
Net loan (II, I)		137182.40		166714.10	

Source: Supervision Report of NRB (2008)

As a whole, NPL was 8.64% in previous year of finance companies but only 6.67% in this year which seems good. Total provision of finance companies is 11793.6 in which provision for good loan is only 1694 which is 14.36% of total provision and provision for bad loan is 85.64% which is Rs. 10099.6(Rs. in lakhs).

The heart of financial institution is loan department. This detective of NRB helps to manage lending policies of FIS. Most of commercial lending are is worse position de to lack of lending policy. So, provisioning loan is safeguard for Financial Institutions.

+ve impact:

- Saves commercial bank and finance company from liquidation.
- Prevent FIS from high volume of bad loans.
- Gives lifeline to FIS and saves FIS for at least five years from liquidation.
- NPL of finance companies are decreasing.

-ve impact:

- Freeze large sum of money and FIS loose investment opportunities.
- Provision 1% for good loans is also worse concept of NRB which Jam unnecessary amount of money
- High percentage of provision for bad loans.

Provision amount is year 2008 is increasing than in 2004, which means proportions of bad loans, is increasing and also financial institutions investment opportunities also decreasing. So NRB has to focus on regulation for proper lending also not for only providing loan only.

According to about data pass loans are increasing which are good loans and 1694 millions is felt for provision for year 2008, which is not so good. If can loose investment opportunities of the FIS. Similarly provision for substandard doubtful.. NRB directive is some how effective in long term stable growth in financial sectors.

Table 4.6

Net Loan of Commercial Bank for the year 2007

(In Million)

Particulars	up to End of 2007
(i) Total provisions	34587
(ii) Total loans	151916
Net loan (ii)-(i)	117329

Source: Banking & Financial Statistics of NRB (2008)

Commercial Banks are also provisioning 23% of total loan, which is not so good. Being 23% of total loan amount is freezing in Banks provision which loss banks can profit earning and investing opportunities.

Table 4.7

Net Loan of Finance Companies for the year 2006, 2007 &2008

(In Million)

Particular	2006 (Rs)	2007 (Rs)	2008 (Rs)
Total Provision (I)	9018.66	11793.6	1118
Total Loan (II)	146201.06	178507.70	20038
Net loan (II-I)	137245.4	166714.10	18920

Source: Supervision Report of NRB (2008)

The following data of FY 2006/ 2007/ 2008 shows the impacts of changes directives related to loan loss provisioning from new provision. This differences and shown more clearly though the use of multiple bar diagram. It is presented below separately.

This is because the period rd the loan has been changed under new provision that 'indicative of substandard' and 'substandard' loan have been brought into this one category. Decrease in the amount of doubtful loans due to the new provision fall under.

For the loss loan and doubtful loans, there is an increased in the amount of loss loan due to previously categorized doubtful loans with a past due of over there years but less then five years now fall in the category of loss loan.

The provision of loan means the net profit of the banks will come down by such amount. Increase in loan loss provision decrease in profit result to decrease in dividends at all.

Due to arrival of new financial institutions have to suffer less profit. The impact of this directive will decrease profit of bank in coming years and decrease profitability at all. But it's positive impact is that is strengthens the financial conditions of the financial institutions by controlling suffer it only for short term while the good financial condition and safety of loans will make financial institution prosperity resulting increasing profit for long term.

4.2.2 Performance evaluation by NPA of commercial Banks

From the NPA evaluation, we can find percentage of total NPA toward the total deposit from the following table

Table No.4.8

NPA to Deposit Ratio

Year	Deposit	NPA	%
2003	154,861	25907	16.73%
2004	181,737	30880	16.99%
2005	185,104	31357	16.94%
2006	203,911	32227	15.80%
2007	233,708	28962	12.39%

According to above table, the percentage of NPA is decreasing year by year, which is due to the effectiveness of NRB directives. It means commercial banks are able to recover loan in time

Table No.4.9

NPA to Loan & Advances Ratio of Commercial Banks

(In million)

Year	Loan & Advances	NPA	Ratio (%)
2003	96,296	25907	26.90
2004	109,163	30880	28.29
2005	113,251	31357	27.69
2006	124,522	32227	25.88
2007	139,980	28962	20.69

According to table,The NPA of commercial banks toward total loan is decreasing which shows good performance of commercial banks.

Formula of Karl Pearson's Correlations Coefficient

$$r = \frac{N\sum XY - (\sum X) \times (\sum Y)}{\sqrt{N\sum X^2 - (\sum X)^2} \times \sqrt{N\sum Y^2 - (\sum Y)^2}}$$

Where,

r = Correlation

N = Total No. of Year

X = Dependent Variable (NPA)

Y = Independent Variable (Deposit and Loan &Advances)

Table 4.10

Calculation of Correlation Coefficient between NPA and Deposits of Commercial Banks

(In Million)

Year	NPA	Deposit (Y)	XY	X2	Y2	Correlation
2003	25907	154,861	4,012,048,462	671,193,374	23,981,960,293	
2004	30880	181,736	5,612,089,993	953,592,928	33,028,300,821	
2005	313557	185,104	5,804,361,659	983,280,263	34,263,490,816	0.397
2006	32226	203,911	6,571,387,002	1,038,560,192	41,579,801,954	
2007	28961	233,707	6,768,551,820	838,774,274	54,619,335,780	
N = 5 ( )	|431531	959,319	28,768,438,936	4,485,401,031	187,472,889,664	

With the increase/decrease in Deposits, NPA is affected very less. In fact generation of NPA is not fully correlated with the deposits. Trend of Deposits from year 2003 to 2007 is in increasing order has been reached to RS 233707.80 million in 2007 whereas NPA has been started from Rs. 25907.40 in 2003 and ahs mounted to pick on .

The % of NPA on Deposit and Loan and advance is decreasing in year 2007 so it is because of directive of NRB.

4.2.3 Performance Evaluation through Non Performing Loans

The position of performing and non-performing loans having the Finance Companies is another indicator to measure the performance of Finance companies. If Finance Companies have high volume of NPLs and low volume of NPLs that indicate better performance of Finance Companies and vice-versa. Loans are categories into two parts. They are as follows:

- Performing Loans
- Non-Performing Loans

Table No. 4.11

Position of Performing and Non Performing Loans

(In Million)

Fiscal Year	LFCOs			Total Loan
	Performing Loans	Non Performing Loans	Non Per.as % of Total Loans	
2000/01	202.71	10.66	5.00	213.37
2001/02	278.18	5.01	1.77	238.19
2002/03	361.81	8.12	2.20	368.93
2003/04	378.22	13.55	3.46	391.77
2004/05	463.66	15.14	3.16	478.8
2005/06	459.15	39.13	7.85	498.28
2006/07	443.45	45.89	9.38	489.34
2007/08	336.58	17.70	5.00	354.28

Sources : Table No. 1 & 2

As shown the above table, the average performing loans of LFCOs have Rs. 336.58 million which ranged from Rs. 202.71 million (2000/01) to Rs. 463.66 million (2004/05) .

The Average NPLs as percentage of total loans of LFCOs have 5% which ranged between 1.77% (2001/02) to 9.38% (2006/07).

Percentage of NPL on total Loan is decreasing in year 2007/08, which is good. It shows finance companies are able to re collect the lended loan.

4.2.4 The Effect of Non-Performing Loans on Net Profit

Correlation and regression analysis has been carried out to examine the effect of NPLs on NPAT. Beside, significance of results have been tested at live percent level of significance with the help of F-statistics and results of test and analysis are presented in Table No. 4.22

Table No. 4.12

Regression of Net Profit on NPL (Regression equation: Y = a+bx)

Group of Finance companies	No. of obsv.	Regression Coefficient		r	R^2	F
		A	b			
LFCOs	8	7.27	(0.06)	(0.213)	0.045	2.741

Source: Table No. 2

As the above table shows that the effect of NPL on NPAT, LFCOs have been found as expected. The correlation and regression is negative and one rupee increase in NPL impacts too the average rupee 0.06 decrease in NPAT holding the other factors remain unchanged but the F-statistics for regression is not significant at 5 percent level of significance. The value of coefficient of determination (R^2) of the variables of the Finance Companies are also very low i.e., 0.045, which shows low explanatory power of the variables but from the LFCOs , the ILFCOL has been found positive correlation and regression as well as the F-statistics for regression is significant at 5 percent level of significance.

4.3 Provision of Single Borrower Limit

Single Borrower limits are the limit which should not be more than the one set by authorities to lend maximum amount of loan to a single or a group of borrower. The bank gives loans to various sectors for the long-term survival of the survival of the financial institution by receiving deposits from general public. So depositors' deposits are the major portions of the bank's liability and the loan and advance of the bank to the borrowers is the major portions of the bank's liability and the loan and advance of the bank to the borrowers is the major portion of the bank's liability and the loan and advance of the bank to the borrowers is the major portion of the total assets. Therefore the financial institution should be more repayment of the deposits to the depositors, which result in the liquidation of the financial institution with a view to safeguard the depositors' money and protect the financial institution from bankruptcy. NRB has been issuing directives from time to time under the prudential norms. The directives related to single barrower limits' main objective is to set up limits on the maximum amount of loan that can be lend to single borrowers. The new directives where as these limits were based on the total capital fund as per old provision.

Table 4.13

The total core capital of Comparative chart of the Single Borrower Limit of New Provisions

(In Million)

Limits	2003	2004	2005	2006	2007	2008
Fund base 25% and 0% of total core capital	-	-	-	582.5	665.3	722.1
Non fund based 50% & 75% of Total core capital	902.7	1150.35	1506.38	1165	1330.6	1444.2

According to NRB Directive 2062 for new provision, single borrower limit should be 25% of total core capital and 50% of total core capital for fund base and non fund base respectively for the year 2006 to 2008 and 0% of total core capital for fund base, 75% of total core capital for non fund base for the year 2003 to 2005.

Table 4.14

The total core capital of Comparative chart of the Single Borrower Limit of New Provisions

(In Million)

Limits	2003	2004	2005	2006	2007	2008
Fund base 25% & 0% of total core capital	-	-	-	2953.7	-2550.4	-4864.5
Non fund based 50% & 75% of Total core capital	4979.6	6090.49	7549.77	5907.4	-5100.8	-9729

Source: Banking & Statistics of NRB No.51 (2008)

According to NRB Directive 2062 for new provision, single borrower limit should be 25% of total core capital and 50% of total core capital for fund base and non fund base respectively for the year 2006 to 2008 and 0% of total core capital for fund base, 74% of total core capital for non fund base for the year 2003 to 2005

Table 4.15

The total core capital of Comparative chart of the Single Borrower Limit of and Old Provisions

(In Million)

Finance Companies						
Limits	2003	2004	2005	2006	2007	2008
Fund base 35% of total capital	521.3	675.1	931.7	1121.82	1278.8	1402.2
Non fund based 50% of Total capital	774.8	964.5	1331.05	1602.6	1826.9	2003.2

Table 4.16

The total core capital of Comparative chart of the Single Borrower Limit of and Old Provisions

(In Million)

Commercial Banks						
Limits	2003	2004	2005	2006	2007	2008
Fund base 35% of total capital	2355.2	2880.6	3570.9	4135.1	-3570.6	-6810.3
Non fund based 50% of Total capital	3364.6	4115.1	5101.25	5907.3	-5100.9	-9729

Source: Banking & Statistics of NRB No.51 (2008)

Here is the comparison between old provision and new provision for single borrower limits where old provision takes total capital as base but new provision takes total core capital as base for both fund base and non-fund base loans.

Old one is far better than new one for the honest borrower who is honest and home good will in market.

New provision is good for those FIS where proportion of bad loans to wards total loan is high. So, finally old provision is better for business prospective.

+ve impact:

- Amount of single borrower limit is reduced by new directive of NRB, which is good for lending policy. There is a proverb don't keep all eggs in same basket so new directive is suite good from this point of view.
- Borrowers are encouraged to increase their own capital which can same landed amount of FIS.

-ve Impact:

- 10% of total borrower of Nepal is well-recognized businessman. Their business viability is good, there security is good and they can pay interest and principal in decline time. But these directives can not support of money which can hurt even a business man and also FIS.
- In new directive only care capital is included for calculation, which is not good because supplementary capital also can dominate core capital, also can dominate core capitals in some organization or in a business.

4.4 Provision of reducing the risk on the activities of financial institution

Risk is the change or possibility of meeting danger and suffering loss. Which outcomes may be the failure of any institution .Every bank involves in different activities, one of the primary activities of FIC is to collect deposit from general public and lend it to another party as loans. So, banks have to face credit risk, interest rate risk and liquidity risk. Price of securities is affected by such risk .

NRB has issued directives related to the reducing risk consisting liquidity risk, interest rate risk, foreign exchange risk and credit risk as possible as to protect the bank from sinking and from liquidation. Liquidity risk arises with no resale market. No developed market for the particular type of securities. This type of risk is the risk of being unable to sale or liquidates assets without or with nominal loss of value. Interest rate risk is the risk when there is adverse movement of interest rate in the market. Bank should take a view on interest rate moment. It should convert its short term securities to long term if management forecast fall in interest rate and when interest rate is raising all long term securities should be converted to short term, Credit risk is the risk of non-payment of interest and principle by the security issuer. The investor cans sell it at reducing price when market perceives such risk increased in the securities after purchase.

As per directive of NRB, there is needed to classify the assets and liabilities on the basics of maturity period to reduce the liquidity risk and interest rate risk. The classification of assets and liabilities of Nepal based on maturity period. From seeing the classification of assets and liabilities based on maturity period. The assets and liabilities cover same items as in balance sheets. Similarly, NRB has put forward the provision for balance at NRB in percentage/financial institution have to maintain a certain level of liquidity to total deposits liabilities in the form of cash and bank balance (primary reserve) and treasury bill and government/central bank bonds (secondary reserve). Primary reserve is cash Reserve Ratio (CRR) and the secondary reserve is the Statutory Liquidity Ratio. But as per newly arrival directives there is no provision of secondary reserve effective from 22 July 2002.

Table No. 4.17
Liquidity maintained by 18 commercial banks & 70 finance companies 2005/2006

(In Million)

Provision req.	Commercial Banks			Finance Companies		
	min. req.	**actual figures**	**shortfall/ excess**	**min. req.**	**actual figures**	**shortfall/ excess**
a) Balance at NRB :						
7% of current & savings deposits.	14096.7	201381.7	187285	743.2	10617.7	9874.5
4.5% of fixed deposits liabilities	3671.4	81587.1	77915.7	930.4	20676.3	19745.9
Total balance at NRB	17768.1	282968.8	265200.7	1673.6	31294	29620.4
b) Cash in vault : 2% of total deposits liabilities	355.4	5659.4	5304.0	33.47	625.88	592.41

Source : Banking and Statistics, NRB.

From above, it can be seen that both banks and financial institutions have to be maintained liquidity ratio. But both banks and financial institutions are maintaining minimum balance requirement of NRB.

Banks need to be maintained the same as of directive no. 2 related to loan classification and provisioning and directives no. 3 related to single borrower limit for reduction of risk related to credit and investment. That means banks need to classify the loans according to the NRB Directives into four categories to minimize loan risk and the given percentage should be provisioned for the possible losses. There should no excess amount of loans. If any exceeded amount banks and FIs should bring within the limits as provision of single borrower limits which are already defined more clearly in previous pages. All the risk should be properly analyzed so that repayment can be forecast in advance.

Table No. 4.18

Banks Net Position of Foreign Exchange of Finance Companies and Commercial Banks

(In Million)

Particular	Finance Companies					Commercial Banks				
	2003	2004	2005	2006	2007	2003	2004	2005	2006	2007
Core capital	2329.8	2661.2	3022.2	4314.8	4653.2	11814.6	-10201.7	-19139.5	-17752.1	-5173.3
Provision	30%					30%				
Net position	698.9	798.36	906.7	1294.4	1395.9	3544.4	-3060.2	-5741.9	-5325.6	-1551.9

Source : Banking & Statistics No. 48, 2007, p-3.

Statement shows decline of non banking assets of financial institutions which means decrease of non banking assets which is good sign for finance company where NRB's directive plays important role. There is only Rs.513 lakhs loan loss provision in financial sectors.

4.5 Regulation of CIC

Parties of various financials institutions must list the name of parties and their behaviors of particular party who is enjoying loan from bank and such party's limit must be greater than 10 lakhs. All of their activities are recorded in CIC.

This regulation can save financial institution from Lending in wrong sector which saves banks and financial institutions from wrong lending.

Positive impact:-

- Save financial institutions
- Give Record of black listed borrower.
- Give support for lending of financial institution.

Negative impact:-

- Hard to keep all records properly.
- Probable wrong information can support to wrong lending.

- **Major Findings**

Due to NRB Directive effectiveness capital invested in finance companies and economical banks are increasing year by year.

In the year 2007 and 2008 the capital invested is in negative figure due to losses of commercial banks because of owner capitalization and miss utilization of capital which shows defects in capital structure of commercial banks.

Similarly; finance companies are also over capitalized. There is lack of proper investment opportunities is finance companies. So, NRB has to apply good guideline for capital structure.

The heart of financial institution is loan department. This detective of NRB helps to manage lending policies of FIS. Most of commercial lending are is worse position de to lack of lending policy. so provisioning loan is sage guard for Financial Institutions.

Commercial Banks are also provisioning 23% of total loan, which is not so good. Being 23% of total loan amount is freezing in Banks provision which loss banks can profit earning and investing opportunities.

CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

This research is about NRB guidelines on financial institutions and its impact and implantations. The general directives have been taken as guidelines. The study includes five selective directives. i.e., directives no.1-5 among the sixteen directives related to financial institution regulation and prudential norms. There do exist 25 commercial banks and 78 financial companies in Nepal, in this study, all commercial banks and financial companies as a whole analyzed. Financial institutions have been categorized the loan amount include five different categories. The increasing loan loss provisioning amount decreases the profit of the banks. The change in the single borrowed limits brought down the limits of the fund base and non fund base loans, which results to reduce the loan exposure of the financial institutions. Due to the change in accounting policy, financial institutions have transferred 25% of total valuation gain to exchange fluctuation reserve. Financial institutions are following directives but in some cases such like supplementary capital and balance as NRB there is short fall. This short fall can be compensated by the excess amount of core capital in supplementary capital and 1% excess amount of total deposit in balance at NRB.

NPA plays vital role in financial sector. Financial system as a whole has been running in prudent medical concept, i.e. prevention is better than cure. Classification and categorization of loans and advances on aging basis (i.e. on the basis of period of loan overdue) are the genuine effort of NRB to assess the health of the credit portfolio of overall banks. More above, the loan loss provisioning is to be allocated for each classification i.e. 1%, 25%, 50%, 100% for pass, substandard, doubtful and bad respectively. This is one way to self induce the banks to maintain their credit portfolio healthy and balanced or otherwise financial institution may suffer a greater loss in terms of profitability.

As a whole, it can be seen that new directives are made with a view to protect the deposit of depositors and for the safetyness of lending policy of financial institutions, which enhance the financial strength of financial institutions. Even though it has adverse effect in profitability of the financial institutions but there decreasing profit will effect the financial institutions only for the short term. This study is related with commercial banks and finance companies of Nepal. So, the study will show the good and bad impact of directives toward them.

5.2 Conclusions

1. Generally, total capital means the sum of total core capital and supplementary capital which is divided by total risk weighted assets and this is known as capital adequacy ratio, which should be more than 4.5% according to NRB directives. And the capital adequacy ratio of commercial banks and finance companies are above 4.5% which means they are following NRB directives. The directives has both positive and negative impact, they are as follows:

    - Reduce risk of public money
    - Safe guard for public.
    - Strong controlling tool used by NRB for financial institution.
    - Only 6% of core capital is not enough to cover whole risk involved in public deposits in financial institution.
    - NRB's Directive is silent for capital structure of financial institutions.
    - Over capitalization in financial sectors.
    - Compensated by the express amount of core capital. But a shortfall in the core capital can not be compensated by the excess amount of supplementary capital.

2. According to NRB directives, loan is classified five categories in which they have to keep provision of 1%, 25%, 50% and 100% according to their crossed due date. Financial institutions are maintaining such provision also. This directives has also both positive and negative impact, they are as follows:

- Saves commercial bank and finance company from liquidation.
- Prevent FIS from high volume of bad loans.
- Gives lifeline to FIS and saves FIS for at least five years from liquidation.
- Freezes large sum of money and FIS loose investment opportunities.
- Provision 1% for good loans is also worse concept of NRB which Jam unnecessary amount of money

3. There is other directive for single borrower limit which is 25% of core capital on fund base and 50% of core capital on non-fund base according to new provision but according to old provision, 35% on total capital for fund base and 50% on total capital for non- fund base. Both finance companies and commercial banks are maintaining such reserve only commercial banks have negative capital fund due to negative retained earning in the year 2007 and 2008 indicates that they are not able to maintain this directives for this 2 years. These directives have both positive and negative effects, they are as follows:

- Amount of single borrower limit is reduced by new directive of NRB, which is good for lending policy. There is a proverb don't keep all eggs in same basket so new directive is suite good from this point of view.
- Borrowers are encouraged to increase their own capital which can same landed amount of FIS.

- 10% of total borrower of Nepal is well-recognized businessman. Their business viability is good, there security is good and they can pay interest and principal in decline time. But these directives can not support of money which can hurt even a business man and also FIS.
- In new directive only care capital is included for calculation, which is not good because supplementary capital also can dominate core capital, also can dominate core capitals in some organization or in a business.

4. All borrower who enjoys more than 10 lakhs amount as loan, they should register their name and address in CIC (Credit Information Centre) which gives completer information about them. The financial institutions should be sure about that information before lending to the borrower. Financial institutions can also get information about those borrowers who are black listed from CIC.

   - Save financial institutions
   - Give Record of black listed borrower.
   - Give support for lending of financial institution.

   - Hard to keep all records properly.
   - Probable wrong information can support to wrong lending.

5. Mostly financial institutions are suffering from non performing assets (NPA) and non performing loans (NPL). Securities against non performing loans after certain period transfer towards banks name those securities convert into NPA after transformation. When a person avoid to pay principal and interest in exact time, then he or she can cross the due dates of the loan, after that such loan is converted into NPL. Securities are transferred in financial institutions name only after "Panchakrit" valuation and auction. If any person did not take part in

auction, then only financial institution has right to convert those securities into their own name.

With the increase/decrease in Deposits, NPA is affected very less. In fact generation of NPA is not fully correlated with the deposits. Trend of Deposits from year 2003 to 2007 is in increasing order and has been reached to RS 233707.80 million in 2007 whereas NPA has been started from Rs 25907.40 in 2003and mounted to pick on

The % of NPA on Deposit and Loan as advance is decreasing in year 2007 so it is because of directive of NRB.

5.3 Recommendations

Regulation for capital adequacy gives securities for the depositors. Some commercial banks have negative retained earnings due to those earnings they have unable to follow NRB directives. NRB should increase the minimum requirement of capital adequacy as far as possible which will save the depositors money from liquidation, co-operatives and finance companies.

Regulation of NRB towards classification of loans and provisioning them is for the safetyness of the loan investment of financial sector. This direction is the safeguard for financial institutions from liquidation.

In other hand, provision are kept for good and bad loans, both freeze the money of financial institutions which can decrease investment opportunity, profit earning opportunity of the financial institutions. So, the provision should be kept for only bad loans not for good loans. In practice, provision is even kept for good loans also. So, NRB has to change its directives of keeping 1% provision for good loans. That’s why if the borrower is paying interest in time, revolving his/her limit and renewing the loan in time, then why should financial institution keep provision for such loan and freeze investable money. At last, NRB has given strong legal rights to financial institution to take action against black listed parties.

Single borrower limit should be fluctuating according to the situation. If the borrower has goodwill in the market, own good security, paying interest in time then according to previous character financial institution can lend such borrower according to mutual understanding. So, in case of single borrower limit, NRB has to implement a new directive for mutual understanding for special borrowers in case of single borrower limit.

CIC is the safeguard for financial institution. So, NRB has to make strength to credit information and financial institution also compulsory take CIC from the borrower before lending them.

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