Management of Credit Exposure against Loan Loss Provisioning and Profitability of Commercial Banks:
A Comparative Study of Nepal Bank Ltd. and Everest Bank Ltd.

A THESIS PROPOSAL

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CHAPTER I
INTRODUCTION

1.1 Background of the Study

A financial institution is the lifeblood of economic development of the country. In the study the word investment conceptualized the investment, savings of income or other collected fund. The term investment covers a wide range of activities. It is commonly known fact that an investment is only possible where there is adequate saving. If all the incomes and savings are consumed to solve the problem of hand to mouth and to the other basic needs. Then there is no existence of investment. Therefore, both saving and investment are interrelated. Investment policy is an important ingredient of overall national economy development because it ensures efficient allocation of fund to achieve the materials and economic wellbeing of the society as a whole. In this regards, joint venture bank investment policy push drives to achieve priority of commercial sectors in the context of Nepal's economic development.

Commercial banks are major financial institutions, occupying an important place in the economy of a country because the deposits collected by them provide much needed capital for the development of industry, trade, and commerce and other sectors, thereby contributing to the economic growth of the nation. Investment in the actual sense refers to the sacrifice of current dollars for future dollars. Investment involves two attributes, time and risk. The sacrifice takes place in the percent and is certain. The element of time predominates (for example government bonds). In other case, risk is more dominant (for example call option on common stock). In yet others, both time and risk plays a dominant role.

Lending is the most important function of a commercial bank. For lending procedure, bank has to make some banking practices such as transferring property in bank's name. The transfer is temporarily made for a loan price & interest. Lending money is nowadays becoming main resources of revenge to the bank and also involves high risk too. Bank will not provide loan unless it has sufficient sources to the borrower that will be needed in case of future recovery.

Dahal(2002) observed that Loans and advances dominate the asset side of balance sheet of any bank. Similarly earnings from such loans and advances occupy major space in the income statement of the bank. However, it is very important to be reminded that most of the bank failures in the world due to shrinkage in the value of loan and advances. Hence loan is known as risky assets. Risk on non-repayment of loan known as risky asset. Risk of non-repayment of loan is known as credit risk or default risk.

Going through loan granting provision, bank will through safety of funds, purpose of loans, security for loans, profitability spread of loan portfolio etc. besides this, the character of person receiving credit, the capacity of borrower to utilize the fund, the percentage of borrower stake in the business are the basic elements which measures the quality of borrower and ultimately the quantity of the loan.

The lending policy of a firm provides the framework to determine whether or not to extend credit and how much credit to extend. The lending policy decision of a bank has two broad dimensions; lending standards and lending analysis. A firm has to establish and use standards in making lending decision, develop appropriate sources of loan and methods of loan analysis.

Rose (2002) noticed that Effective management of the loan and the credit function is fundamental to a bank's safety and soundness. Loan management (LM) is the process by which risks that are inherent in the credit process are managed and controlled. Because review of the LM process is so important, it is a primary supervisory activity. Assessing LM involves evaluating the steps bank management takes to identify and control risk throughout the credit process. The assessment focuses on what management does to identify issues before they become problems.

1.2 Introduction of the Selected Banks

1.2.1 Everest Bank Limited (EBL)

Everest Bank Limited was registered on November 17, 1992, come into operation on October 18, 1994 with an objective of extending professionalized, and efficient banking services to various segments of the society. Today the bank has grown to become one of the leading banks in Nepal.

Punjab National Bank (PNB) joined hands with EBL as a Joint Venture in 1997 and turned it around to a highly profitable bank. There has been no looking back since then. PNB provides top management support under the Technical Service Agreement. PNB joint venture partner of EBL one of the largest nationalized bank in India having 114 years of banking history, holds 20 per-cent equity.

Everest Bank has recognized the value of offerings a complete range of services and has pioneered in extending various customer friendly products such as home loan, education loan, EBL flexi loan, EBL property plus (future lease rental), Home equity loan, vehicles loan, Loan against share, loan against life insurance policy and loan for professional. The bank is providing customer friendly services. Everest Bank Limited was the first bank to introduce Any Branch Banking System (ABBS) in Nepal. All the branches of the bank are connected with ABBS which enables the customers to do all their transactions from any branches other than where they have their account.

The objectives of EBL is to be a Leading Commercial Bank with Pan Nepal presence and become a household name, providing wide range of financial products and services under one roof.

Everest Bank Limited (EBL) is providing customer-friendly services through its wide Network connected through ABBS system, enabling customers for operational transactions from any branches. The bank has 92 Branches, 116 ATM Counters & 28

Revenue Collection Counters across the country making it a very efficient and accessible bank for its customers, anytime, anywhere.

1.2.2 Nepal Bank Limited (NBL)

The then King Tribhuvan inaugurated Nepal Bank Limited on November 15, 1937 (Kartik 30, 1994). This marked the beginning of an era of formal banking in Nepal. Until then all monetary transactions were carried out by private dealers and trading center. In that era, very few understood or had confidence in this new concept of formal banking. Rising equity shares were not easy and mobilization of deposits even more difficult. This was evident when the bank floated equity shares worth NPR 2,500,000, but was successful only in raising NPR 842,000.

The total deposits for the first year was NPR 17,02,025 where current deposits was about NPR 12,98,898 fixed was about NPR 3,88,964 and saving was NPR 14,163. Loan disbursed and outstanding at the end of the first year was NPR 1,985,000. In 2007, Nepal Bank Limited appointed Mr. Rohit Ghambole as chief banker. He proceeded to invest in Tesco doughnut supplies from Yateley. This is widely blamed to be the reason of the 2007 financial market crash.

From the very conception and its creation, NBL was as joint venture between the government and the private sector. Out of 2500 equity shares of NPR. 100 face value, 60 per-cent was subscribed by the government and the balanced 40 per-cent was offered for the sale to private sector. There were only 10 shareholders when the bank first started.

Nepal Bank Limited has the following objectives:

a) Focus on building the positive net worth and meeting minimum capital requirement over the coming five years.

b) Focus on increasing the customer base and market share.

c) Maximize the potential/efficiency of bank's staff.

d) Focus on minimizing the risk associated with the business.

e) Focus on providing the world class business solutions.

f) Focus on increasing the sustainable profit.

1.3 Statement of the Problem

2 Today banking industry is one of the fast growing businesses in Nepal. After the liberalization policy was adopted by government, this banking sector has been growing dramatically. However due to political instability, government could not be able to pay sufficient attention in this sector. Regulation, supervision, and monitoring by government have been weekend in banking sector as like other sectors and also other types of non-business practices might have been occurred in this sector. Due to such type of non-business practices will hamper on this sector. Ultimately it effects on its activities of this sector. Commercial banks in Nepal have been facing various challenges and problems specially in lending. The problem in lending is rising due to an economic condition of the country, variation in government policies and due to the default borrowers. Credit exposure (i.e., total of loans and advances) relationship with LLP and profitability. Credit risk measured by ratio of non-performing loans to total loan and loan loss provision to non-performing loan negatively affect performance variables of ROA and ROE. Hence the more a bank is facing credit risk the more deterioration in performance it experiences. The effect of increase in ratio of total loan to total deposits significantly increases banks profitability

2.1 Objectives of the Study

The main objective of this study is to analyze the loan management of Everest Bank Limited and Nepal Bank Limited through a comparative study. The other specific objectives of the study are as follows:

- To analyze the association between bank deposits with lending (credit exposure) of sample banks;
- To examine the relationship of loan and advances with loan loss provisioning of sample banks;
- To determine the relationship between loan loss provision and non-performing loan of sample banks;

- To analyze the loan and advances ratio, in relation to profitability of sample banks;

2.2 Significance of the Study

Lending is the major functions of every commercial bank's but it is difficult task to disburse it. Good lending policy of the bank has positive impact on economic development of the country and vice versa. This study will also help the management of the bank to analyze the effectiveness of its loan management and policies of the bank in comparison to competitors. The study will also be equally significant to the central bank to formulate the new credit policy, as there are certain loopholes as a result of which the non-performing assets has been regarded as the main problem of the commercial banks in these days. This study no doubt will have importance to various groups of people but in particular it is directed to certain group of people which are:

a) Importance to shareholders.
b) Importance to management team of the bank.
c) Importance to financial institution and stock exchange.
d) Importance to government bodies and policy makers.
e) Importance to researcher.
f) Importance to institute.
g) Importance to outside parties: investors, customers, competitors, stockbrokers, dealers and market makers.

2.3 Limitations of the Study

The research study has some limitations. The main limitations of the study are as follows:

a) This study is concerned with loan management of only two banks namely; Nepal Bank Ltd. (State-owned Bank) and Everest Bank Ltd (Private Bank).
b) The period of the study is limited from fiscal year 2014/15 to 2018/19 A.D.
c) The study is basically based on secondary data collected from annual financial report of sample banks.
d) Only selected financial and statistical tools and techniques are used for the analysis.

2.4 Organization of the Study

The whole study is divided into five different chapters. They are:

Chapter - I: Introduction

It includes general background of the study, brief profile of sample banks, statement of the problem, objective of the study, significance of the study, limitations of the study and organization of the study.

Chapter - II: Review of Literature

This chapter presents conceptual framework, review of related literature like books, dissertation, articles, brochure, booklets, journals, report and magazines etc. Research gap also includes in this chapter.

Chapter - III: Research Methodology

This chapter deals with research methodology to be adopted for the study to satisfy the objectives of the study. It consists of research design, sample and population, sources of data, data collection procedure, methods and tools of data analysis.

Chapter - IV: Presentation and Analysis of Data

This chapter is most important and plays vital role in this study. This chapter deals with presentation, analysis and interpretation of data as required by the objectives stated in this study. These collected data have been analyzed and interpreted by the help of various statistical and financial tools and techniques. It also includes major findings of the study.

Chapter - V: Summary, Conclusion and Recommendations

This chapter is the general idea of the study and it represents all the opinions of the research as far as possible. Summary, conclusions and recommendations are mentioned in the last chapter of the study.

References, Appendices and Research proposal is presented at the end of this research study as per the topic included in each chapter.

CHAPTER III

RESEARCH METHODOLOGY

Research methodology is formal, systematic and intensive process of carrying on a scientific analysis. It is a method of solving the scientific problem which consists of problem identification, hypothesis formulation, observation, analysis and conclusion. Methodology is the research method used to examine the objectives. Research methodology is a way to systematically solve the research problem. It describes the method, process, tool and techniques which are used in data analysis and preparation of the report. It is the careful investigation especially through the search for new fact in any branch for knowledge the appropriate research methodology. Following methodology has been used to achieve the objectives of the study.

3.1 Research Design

Research design is the specification of method and procedures for acquiring the information needed. It deals with what information is to be collected from which sources and by what procedures. If research design is good, it ensures that the information obtained is relevant to the research questions and collected by objective and economic procedures. To achieve the specific objective of the study, descriptive and analytical research has been carried out in terms of Loan Management of Nepal Bank Ltd. and Everest Bank Ltd.

3.2 Population and Sample

The population refers to the industries of the same nature and its services and product in general. Thus, 27 commercial banks operating in Nepal constitute the population of the data and the bank under study constitutes the sample for the study. Among them only two banks namely; Nepal Bank Ltd. and Everest Bank Ltd. are selected as the sample bank to carry out the study.

3.3 Nature and Sources of Data

The study will be mainly based on the secondary data. The necessary secondary data and information has been collected from the annual reports of the individual bank, Nepal Rastra Bank BFIs statistics, and audited balance sheet of respective bank, published journal and Books. The sources of data has been collected from the annual report of selected commercial banks, final account of banks.

3.4 Method of Data Analysis

To make the study more specific and reliable, the researcher uses two types of tool for analysis:

I. Financial Tools &
II. Association Credit Exposure with Loan Loss Provisioning and Profitability

3.4.1 Financial Tools

As this study is related to financial performance analysis financial tools are more useful. They help to identify the financial strength and weakness of the firm. In spite of various financial tools available the research has primarily stressed on ratio analysis assuming it the most suitable tools.

Lawrence (1990) describes a ratio is simply a number expressed in terms of other number and it expressed the quantitative relation between any two variables.
Moreover, it is used as a technique to quantify the relationship between two sets of financial data taken from either profit and loss account or balance sheet. It provides information related to strength and weaknesses of financial data in relation to others. However, the researcher has employed his utmost effort to use as many ratios as possible to reach the point of true financial position of the banks. This study includes activity ratios, credit efficiency ratios and profitability ratios.

a. Activity/Efficiency Ratios

Activity ratios are also known as assets management ratios. These ratios look at the amount of various types of assets and attempt to determine if they are too high or tool with regard to current operating levels. Mostly, activity ratio is used to evaluate managerial efficiency and proper utilization of asset. The Activity/Efficiency Ratios are as follows:

i. Loans and advance to Total Deposit Ratio

The main sources of bank's lending depend on its deposit. This ratio is calculated to find out how successfully the banks are utilizing their deposits on loans and advances for profit generating activities. Greater ratio indicates the better utilization of total deposits.

$$\text{Loans and advance to Total Deposit Ratio} = \frac{\text{Loan and advance}}{\text{Total Deposit}} \times 100$$

ii. Loans and Advances to Total Assets Ratio

Loans & advances is the major part of total assets for the bank. This ratio indicates the volume of loans & advances out of the total Assets. A high degree of the ratio indicates that the bank has been able to mobilize its fund through lending function. However lending always carries a certain risk of default. Therefore a high ratio represents low liquidity and low ratio represents low productivity with high degree for safety in terms of liquidity.

$$\text{Loan and Advance to Total assets Ratio} = \frac{\text{Loans and Advances}}{\text{Total Assets Ratio}} \times 100$$

iii. Loan Loss Provision to Loan and Advances Ratio

The provision for loan loss reflects the increasing probability of non-performing loan. Increase in loan loss provision decreases its profit and result to decrease in dividends. But its positive impact is to strengthen the financial conditions of banks by controlling the credit risk and reduced the risks related to deposits. The low ratio indicates the good quality of assets in total volume of loan &advances. High ratio indicates more risky assets in total volume of loan & advances.

$$\text{Loan Loss provision to Loan and advance Ratio} = \frac{\text{Loan Loss Provision}}{\text{Loan and Advances}} \times 100$$

iv. Non-Performing Loans to Loan and Advances Ratio

NRB has directed all the commercial banks to create loan loss provision against the doubtful and bad debts. This ratio helps in minimizing the non-performing loans and helps to control the credit.

$$\text{NPL to Loan and advance Ratio} = \frac{\text{Non-performing Loans}}{\text{Loan and advances}} \times 100$$

v. Loan Loss Provision to Non-Performing Loan Ratio

Loan loss provision is the compulsion factor in lending practices and Non-performing Loan is the evil factor in banks. If they are high then they will decrease the amount of profit to the bank's target to receive. This ratio measures the portion of provisioned loan with non-performing Loan.

$$\text{LLP to Non-performing Loan Ratio} = \frac{\text{Loan Loss Provision}}{\text{Non - performing Loan}} \times 100$$

b. Profitability Ratios

Profitability ratio is one of the main indicators to analyzing the financial performance of a firm. It is calculated to measure the earning performance and operational efficiency of the bank. A bank should be able to produce adequate profit on each rupee of investment. If investments do not generate sufficient profits, it would be very difficult for the bank to cover operating expenses and interest expenses. The profitability of the bank should also be evaluated in term of its investment in assets and in term of capital contributed by creditors. If the bank is unable to earn satisfactory return of investment, its survival is threatened.

Under this category the researcher has calculated the following ratios to obtain the stated objectives of the study.

i. Net Profit to loans and Advances Ratio

This ratio indicates the proportion of the return over total loans and advances. It describes how efficiently the bank has employed its resources in the form of loans and advances of the bank.

$$\text{Net profit to Loan and Advances Ratio} = \frac{\text{Net profit}}{\text{Loan and Advance}} \times 100$$

3.4.2 Association Credit Exposure with Loan Loss Provisioning and Profitability

The statistical tool is essential to measure the relationship of two or more variable. It is the mathematical technique used to facilitate the analysis and interpretation of the performances of the organizations. It also helps to present the data, show the relation and deviations or differences of variables of organizations. In this research study some statistical tools are used for the analysis of the data more accurately, which are given below.

a) Arithmetic Mean

The arithmetic mean or simple mean of set of observations in the sum of all the observation divided by the number of observations. It is the best value, which Represent to the whole group means is the arithmetic average of a variable. Arithmetic mean of a series is given by:

$$\text{Mean } (\bar{X}) = \frac{\Sigma x}{n}$$

Where,

$\bar{X}$= Sum of the variables 'x'

N = No. of Observation

b) Standard Deviation

The standard deviation is the absolute measure of dispersion in which the drawback present in other measure of dispersion as it satisfied most of the requisites of a good measure of dispersion. Standard deviation is defined as the positive square root of the mean as square of the deviation takes from the arithmetic mean. It indicates the ranges and size of deviance from the middle or mean. It measures the absolute dispersion. Higher the standard deviation Higher will be the variability and vice versa. Dispersion measures the variation of the data from the central value. In other words, it helps to analyze the quality of data regarding its variability. It is calculate as:

Standard Deviation (S.D.) = $\sqrt{\frac{\Sigma(X - \bar{X})^2}{n}}$

c) Coefficient of Variation (C.V)

Standard deviation is the absolute measure of dispersion. The relative measure of dispersing based on the standard deviation is known as the measurement of coefficient of standard deviation. The percentage of measure of co-efficient of so is called co- efficient of variation. Less C.V. is the more uniformity and consistency and vice versa. Only standard deviation is not appropriate to compare two pairs of variables but also CV is capable to compare two variables independently in terms of their variability. It is calculated as under:

Coefficient of Variation (C.V.) = $\frac{S.D.}{\bar{X}} \times 100$

d) Correlation Coefficient (r)

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

Correlation Coefficient (r) = $\frac{n\Sigma xy - \Sigma x\Sigma y}{\sqrt{n\Sigma x^2 - (\Sigma x)^2}\sqrt{n\Sigma y^2 - (\Sigma y)^2}}$

e) t- Statistics

For this study, t-test for significance of an observed and sample correlation coefficient is used. Set up Hypothesis

Null hypothesis (H_0); $\rho = 0$ i.e. There is no correlation between the considered variables.

Alternative Hypothesis (H_1); $\rho \neq 0$ i.e. There is significant correlation between the considered variables.

Test statistic under H_0;

$$t = \frac{r}{\sqrt{1 - r^2}} \times \sqrt{n - 2}$$

Where,

r = Sample correlation between two variables

r^2 = Coefficient Determination

n = No of Pair of observations

Level of significance: Level of significance $\propto$ = 5%

Critical Value: Tabulated or critical value of t at $\propto$ % level of significance for (n - 2) degree of freedom obtain from ‘t’ tables.

Decision: If calculated ‘t’ is less than or equal to tabulated value of ‘t’ it falls in the accepted region and the null hypothesis is accepted and if calculated ‘t’ is greater than tabulated ‘t’ null hypothesis is rejected.

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