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MASTER DEGREE THESIS

CREDIT APPRAISAL AND CREDIT RISK MANAGEMENT IN THE NEPALESE BANKING – A CASE STUDY

Ljubljana, September, 2004 **Him B. Gurung**

Author's STATEMENT

I, Him Bahadur Gurung hereby certify to be the author of this Master thesis that was written under the mentorship of dr. Marko Kosak and in compliance with the Act of Authors' and Related Rights – Para. 1, Article 21. I herewith agree this thesis to be published on the website pages of ICPE and the Faculty of Economics.

Ljubljana, date .... Signature ....

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CHAPTER ONE

01. INTRODUCTION

To start this thesis on Credit Appraisal and Credit Risk Management in the Nepalese Banking – A Case Study, I am going to describe banking industry as a producer of financial intermediation services in the economy and its definition in this chapter. I will also highlight the major problems in Nepali Banking system which are to be made corrected.

1.1. Importance of Banks

A bank is a financial institution as it engages it self in the financial activities. It is not a small financial co-operative or a finance company but a large institution with adequate monetary resources which are mobilized to uplift the economic status of the country as well as citizens and in consideration growth of itself. Few definitions of a bank from various experts are as follows:

" The banker's business is to take the debt of other people to offer his own in exchange, and thereby create money."

- Crowther

" Institution for the keeping, lending and exchanging etc. of money."

- Chamber's Twentieth century dictionary

" A bank is an organization whose principle operations are concerned with the accumulation of the temporarily idle money of the general public for the purpose of advancing to other for expenditure."

-Kent

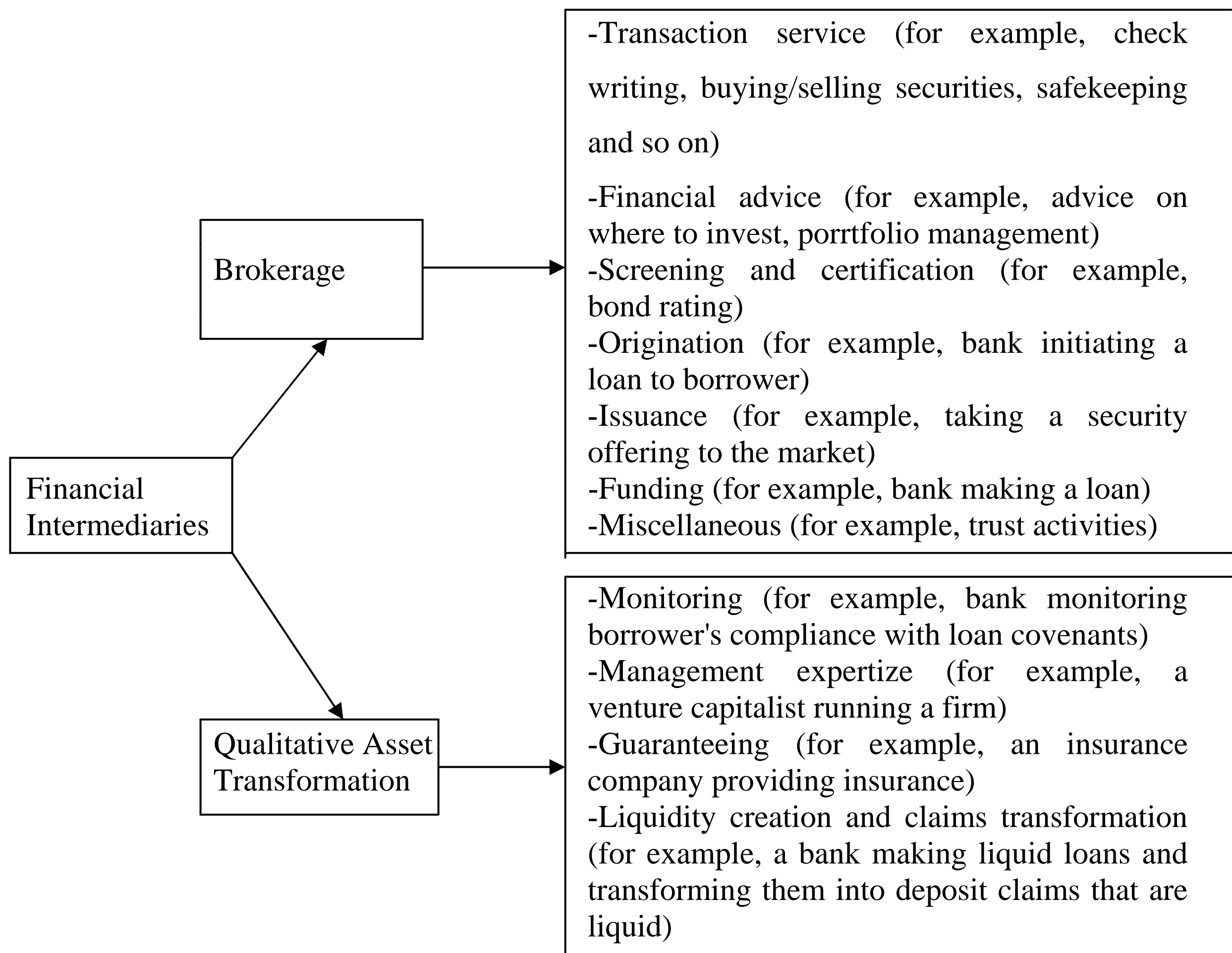
Source: Mandira Dali - Ashwin 2037 B.S. (1980 A.D.), Page 2 .

Banks are the important representatives of financial intermediaries. As the name suggests, **financial intermediaries** are entities that intermediate between providers and users of financial capital. They are typically multi-faceted, and their activities therefore can be understood from a variety of vantage points. Banks are members of an expensive industry that provides a dazzling variety of financial intermediation services. All the financial institutions have in common is the processing of risk and its subtle complement information. Financial Intermediaries produce information for two kinds of applications: (i) to match transactors like a marriage broker would and (ii) to manage risks and transform the nature of claims as when a bank produces credit information to control a borrower's credit risk. Source: Greenbaum, Stuart I. and Thakor, Anjan V., 1995, p. 48 - 49.

Brokerage activities of financial intermediaries involve the bringing together of transactors in financial claims with complementary needs. The broker is usually compensated with a fee for performing this service. The broker's stock-in-trade is information, and its special edge in performing this service derives from special skills in interpreting subtle (that is not, readily observable) signals and also from the reusability of information.

Suppose some individual wishes to borrow for the purpose of purchasing a house. The borrower must find a counterparty willing to hold a mortgage, which is a claim with a number of less desirable attributes. The asset attributes most commonly transformed by financial intermediaries are duration (term to maturity), divisibility (unit size), liquidity, credit risk, and sometimes numeraire (currency identity). But notice that every such asset transformation performed by the financial intermediary requires a mismatch with regard to that attribute on the financial intermediary's balance sheet. Source: Greenbaum, Stuart I. and Thakor, Anjan V., 1995, p. 50 - 53.

Figure 1.1: Services Provided by Financial Intermediaries



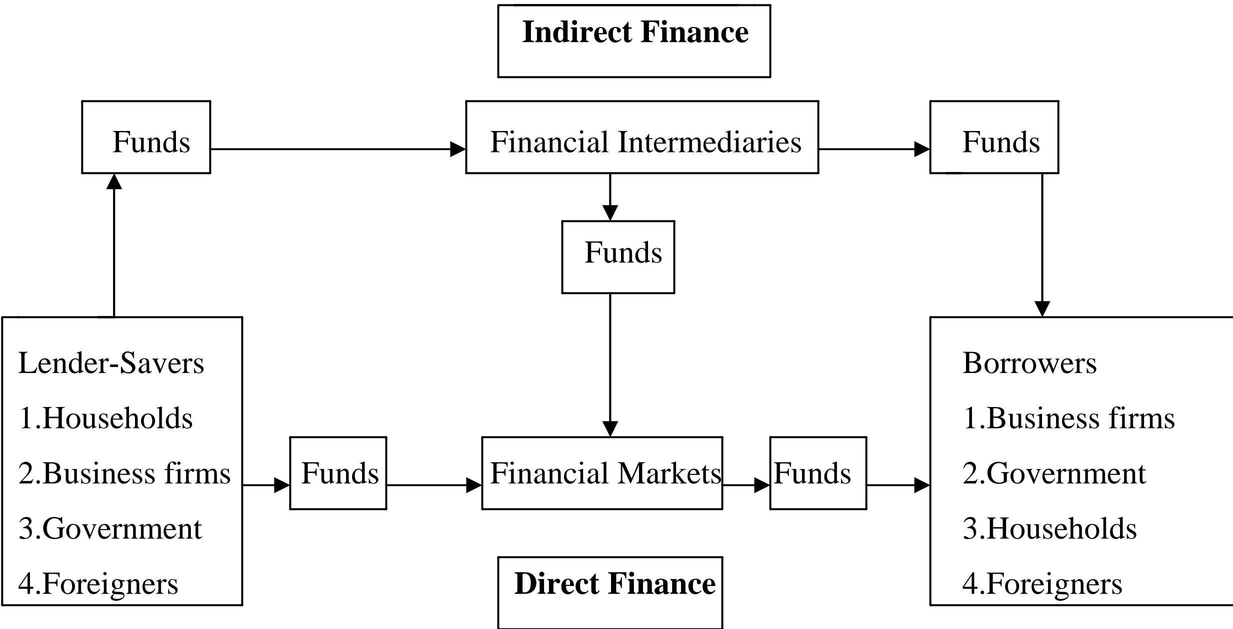
Source: Greenbaum, Stuart I. and Thakor, Anjan V., 1995, p. 55.

The financial system is complex, comprising many different types of financial institutions, including banks, insurance companies, mutual funds, finance companies, and investment banks, all of which are regulated by the government. If you wanted to make a loan to IBM or General Motors, for example, you would not go directly to the president of the company and offer a loan. Instead, you would lend to such companies indirectly through **financial intermediaries,** institutions such as commercial banks, savings and loan associations, mutual savings banks, credit unions, insurance companies, mutual funds, pension funds, and finance companies that borrow funds from people who have saved and in turn make loans to others.

In this time, many of the Nepali citizens have been working abroad and more employment opportunities are available within the country itself, as the result of these facts, the inflow of money is increasing day by day. The citizens of the country are much more aware about the banking activities as they were two decades ago. So, most of them like to keep a large proportion of their financial wealth in banks in the form of checking accounts, savings accounts, or other types of bank deposits. Because banks are the largest **financial intermediaries** in the economy, they deserve careful study. Based on people's interests on financial intermediaries for fulfilling their financial needs, the Central Bank has been continuously permitting the private sector to invest in establishing banking industries.

Financial markets perform the essential economic function of channeling funds from people who have saved surplus funds by spending less than their income to people who have a shortage of funds because they wish to spend more than their income. This function is shown schematically in figure 1.2. The arrows show that funds flow from lender-savers to borrower-spenders via two routes i.e. indirect finance and direct finance (Mishkin, Frederic S. and Eakins, Stanley G., 1998, Second Edition, p. 14).

Figure 1.2: Flows of Funds through the Financial System



Source: Mishkin, Frederic S. and Eakins, Stanley G., 1998, Second Edition, p. 14.

In the upper part of the above figure, the flow of funds from lenders to borrowers is shown within the indirect process which is through the banking system, but in the lower part, it is a direct process that goes through the financial market by selling and buying of financial instruments like government bonds, promissory notes etc.

1.2. Problems in Banking Industry in Nepal

Generally, in my thesis, I am trying to describe the problems of credit activities in banking i.e. in the commercial banks and development banks and other financial institutions in Nepal. The problems which I am going to describe will be related to credit appraisal/analysis and credit risk management in the bank.

Banking industry, a large financial sector in the country and the backbone of strengthening the country's economic situation is going ahead by facing so many problems day by day. During the last 8-9 years, the economic, social and other development activities are facing so many difficulties within the country due to the maoist problem. So, in the banking, the credit appraisal system is not appropriate to some extent based on which the banks provide the different type of credit facilities to the borrowers which are far from using knowledge, skill, capacity etc in smoothly operating the business units and activities.

Basically, the banks in Nepal have been facing the following problems in credit and investment sectors. The provided loan and any investment should be secured for easy recovery not only backed by the fixed collateral securities. Because the money which have been gone out as a loan, is the money deposited in the bank, by the small and big depositors which has to be returned back to the depositors at any time or in a certain period of time. It can be assured by analyzing the borrower's loan request and proposal which is one of the main jobs in the banking.

Banking industry does not have sufficient qualified staffs in credit field. Credit appraisal/analysis regarding the borrower and any business entity have not been done according to the financial norms and internationally accepted standard. It is because of insufficient and lack of knowledgeable and expert staffs in credit sector. So, it is prepared based on the hypothetical norms like they do not know how to process and how to analyze, from which the bank is unable to know the actual condition of the applicant borrower. It

has much more chances of manipulation from the side of credit analyst as well as the borrower.

As the least developed country, everywhere we can find interference. So, in the bank also the credit manager, credit analyst are interfered in most of the cases by the members of top management team and from the board of directors. Therefore, the available few professionals are also unable to put their real observations in the credit analysis report.

There are very few sources of getting the information about the clients like Credit Information Bureau, banks itself and other market sources. There is not any authenticity of the information which is received from different sources. Financial statements have also not given the real picture of the borrowers' financial status even though they are mostly audited by the certified auditors.

Sometimes, documentations, basically the legal documentation can cause the problematic situation. It has not any standard and well known accepted system for preparing the legal documentations between the borrowers and the bank which may create the problematic legal issues in future if there is the conflict arises between the two parties.

In my view, the board of directors and top management in the most of the banks in the country are not thinking about managing of credit risks. After the restoration of multiparty political system in the country in 1990, the Government had opened the door to the private sector to invest in the financial sector. The result, till now, the private sector has been establishing the banks and financial institutions whereas most of the promoters do not have enough banking knowledge. It is the main problem as they do not know what is the problematic situation and what is its solution. Identifying and managing credit risks is the most important factor in the banking. It is the main problem that will be described in my thesis.

The structure of the rest of the thesis is as follows:

In next chapter (chapter 2), I am going to describe the history of Nepalese banking in the first part and the structure of the same as a whole will be described in second part which will make easier to undersatand the reader.

In chapter 3, the government policy on banking system, the structure of government budget and the main aim of recently announced budget that I have incorporated is presented.

The chapter 4 brings a description of recently introduced banking legislation (ordinance).

In chapter 5, I have described the financial system in Nepal like, corporate governance, bank based financing and market based financing. Bank based financing is well established system in the country and market based financing is now still in introducing phase.

In chapter 6, I have described the usual credit appraisal system in the Nepali banking industry using an example. I also, have described the guidance to the staffs and credit policy guides which is one of the key factors of preparing credit appraisals appropriately. I mentioned here, the good lending principles as well as the loan recovery policy.

In chapter 7, I have mentioned the credit control and administration system. To control the credit to mitigate the different types of risks, the banks should maintain risk rating of the borrowers, review and internal control of the borrower is quite necessary which helps to minimize the risk factors.

Chapter 8 is about the management of credit risk. The reader of this thesis will learn about the risk management policy, loan loss provisioning policy, management of non-performing loan portfolio, and review of credit portfolio which are the key factors for credit risk management in my personal view.

In chapter 9, I have mentioned the correcting measures to overcome the aforementioned problems and the thesis concludes in chapter 10 with recommendations and conclusions.

CHAPTER TWO

02. DESCRIPTION OF BANKING SYSTEM IN NEPAL

Nepal's first commercial bank, Nepal Bank Limited (NBL), was established in 1937. The Government owned 51 percent of the share in the bank and controlled its operations to a large extent. NBL headquartered in Kathmandu and has branches in other parts of the country.

There were other government banking institutions. Rastriya Banijya Bank (RBB), a state owned commercial bank, was established in 1966. The Land Reform Savings Corporation was established in 1966 to deal with finance related to land reforms.

There were two other specialized financial institutions. Nepal Industrial Development Corporation (NIDC), a state owned development finance organization headquartered in Kathmandu, was eastablished in 1959 with the assistance of United States to offer financial and technical assistance to private industry. Although the government invested in the corporation, representatives from the private business sector also set on the board of directors. The Co-operative bank, which became the Agricultural Development Bank (ADB/N) in 1967, was the main source of financing for small agribusinesses and co-opratives. Almost 75 percent share of the bank is state owned; 21 percent is owned by Nepal Rastra Bank; and 4 percent by co-operatives and private individuals. The ADB/N also served as the government's implementing agency for small farmers' group development projects assisted by the Asian Development Bank and financed by the United Nations Development Programme. The Ministry of Finance reported in 1990 that the ADB/N, which is vested with the leading role in agriculture loan investement, has granted loans to only 9 percent of the total number of farming families since 1965.

Since the 1960s, both commercial and specialized banks have expanded. More businesses and households had better access to the credit market although the credit market had not expanded.

In the mid-1980s, the foreign commercial banks opened branches in Nepal. Nepal Arab Bank Limited (now, NABIL Bank Ltd.) was co-owned by the Emirates Bank International Limited, Dubai, U.A.E., the Nepalese government and the Nepalese public. Nepal

Indosuez Bank Limited (now, Nepal Investment Bank Ltd.) was jointly owned by French Banque Indosuez, Rastriya Banijya Bank, Nepal, Rastriya Beema Sansthan, Nepal and the Nepalese public. Nepal Grindlays Bank Limited (now, Standard Chartered Bank Nepal Ltd.) was co-owned by a Brithsh firm called ANZ Grindlays Bank, local Nepal Bank Ltd. and the Nepalese public.

Nepal Rastra Bank was established in 1956 as the central bank. Its function is to supervise commercial banks and other financial institutions and to guide the basic monetary policy of the nation. Its major aims are to regulate the issue of paper money; secure countrywide circulation of Nepalese currency and achieve stability in its exchange rates; mobilize capital for economic development and for trade and industry growth; develop the banking system in the country, thereby ensuring the existence of banking facilities; and maintain the economic interests of the general public. It also to oversees foreign exchange rates and foreign exchange reserves.

Prior to the establishment of Nepal Rastra Bank, Kathmandu had little control over its foreign currency holdings. Indian rupees were the prevalent medium of exchange in most parts of the country. Nepalese currency was used mostly in the Kathmandu Valley and sorrounding hill areas. The existence of a dual currency system made it hard for the government to know the status of Indian currency holdings in Nepal. The exchange rates between Indian and Nepalese rupees were determined in the marketplace. Between 1932 and 1955, the value of 100 Indian rupees varied between 71 and 177 Nepalese rupees. The government entered the currency market with a form of fixed exchange rate between the two currencies in 1958. An Act passed in 1960 sought to regulate foreign exchange transactions. Beginning in the 1960s, the government made special efforts to use Nepalese currency inside the country as medium of exchange.

It was only after the signing of the 1960 Trade and Transit Treaty with India that Nepal had full access to foreign currencies other than the Indain rupee. Prior to the Treaty, all foreign exchange earnings went to the Central Bank of India, and all foreign currency needs were provided by the Indian government. After 1960, Nepal had full access to all foreign currency transactions and directly controlled its exports and imports with countries other than India.

As a result of the treaty, the government had to separate Indian currency (convertible currency because of free convertibility) from other currencies (nonconvertible currency because it was directly controlled by Nepal Rastra Bank). In 1991 government statistics still separated trade with India from trade with other countries. Tables showing international reserves listed convertible and nonconvertible foreign exchange reserves separately.

Till 1958 (2015 B.S.[1]), in Nepal, the political system was unstable regularly. From 1951 to 1958, the political condition was completely unstable as in 1951, the ruler for 104 years of the country the undemocratic 'Rana Dynesty' was collapsed by the democratic people revolution and the democratic general election was completed in 1958. That's why the country was disturbed from many side. So, the other sectors of the country were very backward.

In Nepal, there are 17 commercial banks, 4 national level development banks, 5 grameen bikas banks (will be described in chapter two), some financial institutions for long term financing by development nature, around 60 merchant banks and finance companies working in existing financial industry. Some of them are owned by the Government of Nepal (for example: in Nepal Bank Ltd., the government has 51% share and in Rastriya Banijya Bank, the government has 100% share), some of them are joint venture with foreign banks and most of them are established and operating totally by the Nepalese private sector. The problems which will be described in my thesis are the common problems in the whole banking industry.

2.1. Nepal Rastra Bank, the Central Bank

Nepal Rastra Bank (NRB), the central bank of the Kingdom of Nepal, was established in 1956 (2012 B.S.) to discharge the central banking responsibilities along with guiding the development of the embryonic domestic financial sector. Since then, there has been a huge growth in both the number and the activities of the domestic financial institutions.

[1] B.S. (Bikram Sambat) is the official calender year in Nepal. It was introduced by the King Bikramaditya in his era. It is 57 year ahead from the western calender year A.D. So, this 2004 A.D. is 2061 B.S. and the new year starts from the mid April. Every Nepali month ends at the middle of every western month.

To reflect this dynamic environment, the fuctions and objectives of the central bank have been recast by the new NRB Act 2002 (2058 B.S.), the preamble of which lays down the primary functions of the central bank as: to formulate necessary monetory and foriegn exchange policies to maintain the stability in price and consolidate the balance of payments for sustainable development of the economy of the Kingdom of Nepal; to develop a secure, healthy and efficient system of payments; to make appropriate supervision of the banking and financial system in order to maintain its stability and foster its healthy development; and to further enhance the public confidence in the Nepalese entire banking and financial system.

The central bank is eminently aware that, for the achievement of the above objectives in the present dynamic environment, sustained progress and continued reform of the financial sector is of utmost importance. Continuously aware of this great responsibility, the central bank is seriously pursuing various policies, strategies and actions, all of which are conveyed in the annual report on monetary policy[2] which provides a comprehensive review and evaluation of the previous monetary policy and justification and the analysis of the following year's monetary policy. The re-engineering of the central bank itself is one of the critical components of the reform agenda. To improve the financial sector legislative framework, some new Acts have already come out and there have been amendments to some existing Acts. Enactments of the draft legislations on banks and financial institutions, secured transactions, insolvency, Assets Management Company and anti-money laundering are expected to be soon materialized, all with goal of strengthening the financial sector through building on its healthy development and improved stability.

These activities convey the commitment of the central bank for addressing the present and future challenges of the financial system more competently. This dynamic and proactive approach to the financial system, especially with its increasing openness and competitive process in the context of growing global financial environment, should ensure a sustained progress and stability of the financial system under NRB's guidance and leadership, for contributing substantially to the sustained development of the economy of Nepal. (Table 2.2 and Annex-I show the continuous growth of economy and banking industry).

[2] describe in Chapter Three

Picture 2.1: The Historical 'Rana Palace' is now the Central Office of the Central Bank

Table 2.1: Recently applied Exchange Rate of Nepalese Currency

Foreign Exchange Rates		
2004-09-10		
	Buy (Rs.))	Sell (Rs.)
US$	74.64	75.25
EURO	91.01	91.75

Source: Nepal Rastra Bank

Table: 2.2 Some Ratios of Commercial Banks as of mid-January, 2000:

Mid-July	1994	1995	1996	1997	1998	1999	2000
A:GDP, DEPOSITS, CREDIT & INVESTMENT:							
Deposit/GDP	26.3	27.9	28.7	29.1	34.6	38.0	46.7
Credit/GDP	13.7	17.7	20.4	20.8	23.1	24.4	30.7
Investment/GDP	7.4	4.4	3.4	3.1	3.7	4.3	5.4
Credit & Investment/GDP	21.2	22.1	23.9	23.9	26.8	28.7	36.1
Time Deposit/GDP	20.4	21.6	22.2	23.4	27.8	31.4	38.9
Current Deposit/GDP	5.8	6.4	6.5	5.7	6.8	6.6	7.9
Credit/Total Deposit	52.3	63.4	71.3	71.5	66.9	64.3	65.7
Investment/Total Deposit	28.3	15.7	12.0	10.5	10.6	11.2	11.5
Credit & Investment/Total Deposit	80.6	79.1	83.3	81.9	77.5	75.5	77.2
Time Deposit/Total Deposit	77.8	77.3	77.4	80.3	80.4	82.5	83.1
Current Deposit/Total Deposit	22.2	22.7	22.6	19.7	19.6	17.5	16.9
Credit to Government Enterprises/Total Credit	2.8	1.8	2.9	2.5	1.8	2.1	2.0
Credit to Private Sector/Total Credit	97.2	98.2	97.1	97.5	98.2	97.9	98.0
Productive Sector/Total Credit	44.9	50.1	53.4	50.7	51.9	52.6	55.7
Priority Sector Credit/Total Credit	7.8	7.2	7.2	8.0	8.6	8.8	8.8
B:LIQUIDITY:							
NRB Balance/Total Deposit	10.8	12.6	9.5	6.9	14.3	11.3	9.0
Vault/Total Deposit	4.6	4.2	4.4	3.5	3.7	3.2	3.0
Total Liquid Fund/Total Deposit	27.1	29.1	26.6	24.2	33.6	31.9	28.2
C:CAPITAL ADEQUACY:							
Capital/Total Deposit	4.9	5.1	5.0	4.6	4.8	4.8	4.4
Capital/Total Credit	9.3	8.0	7.0	6.5	7.2	7.4	6.7
Capital/Total Assets	3.5	3.7	3.5	3.5	3.4	4.2	3.3

Banking and Financial Statistics, Number 36, Mid January 2000, page 2.

The above ratios are related only with commercial banks of the country which represent the relationship with GDP of the country. For example, Deposit/GDP ratio is in growing trend which is increased by 77.57% in comparison between the year 1994 and 2000. Credit/GDP ratio is increased by 124.1% in the same period. Current deposit/Total deposit ratio is in decreasing trend whereas the Time deposit/Total deposit ratio is in increasing trend. It shows that the liquity is surplus in the market and people like to put the money in

the bank for the long period which results in the increament of credit. It can be seen in Annex-I in detail.

2.2. Commercial Banks

The commercial banks are the largest and more effective financial intermediaries not only in Nepal, but mostly all over the world. In this sub-chapter, the development process of commercial banks in Nepal and its role in country's economy is described.

Nepal Bank Limited is still a semi Government bank which has still around 200 branches in operation in the country. It has more than 5,000 employees.

In 1966 (2024 B.S.), Rastriya Banijya Bank was established by the Nepal Government as a second commercial bank in the country. It had a initial core capital of NPR 10 million. It is also the bigger commercial bank in the country which has also more than 200 branches in operations all over the country and more than 5,000 employees.

Till 1984, there were only 5 banking and financial institutions including the central bank in the country. They are Nepal Rastra Bank (NRB), Nepal Bank Limited (NBL), Rastriya Banijya Bank (RBB), Agriculture Development Bank (ADB/N) and Nepal Industrial Development Corporation (NIDC). But the commercial banking activities were done only by NRB, NBL and RBB.

After opening the foriegn investment in financial sector in Nepal, in 1984, the banking industry has taken a new mode of development. Nepal Arab Bank Limited (NABIL) was established in 1984 with the joint venture of Emirates Bank International Limited (EBIL), Dubai, United Arab Emirates with the capital base of NPR 60 million (USD 1 = NPR 13) which was the milestone of banking development in the country. After the establishment of NABIL, Nepal Indosuez Bank Limited (NIBL) and Nepal Grindlays Bank Limited (NGBL) has been established in the country with the joint venture of Banque Indosuez, Paris, France and ANZ Gindlays Bank, United Kingdom respectively. These three bank has started the sophisticated banking business in Nepal which was very traditional till their opening. They entered the modern banking in the Kingdom with computerized and fast customer oriented services. After 1984, the banking system entered into the new era. This time, there are 17 commercial banks in operations.

Table 2.3: Condensed Assets and Liabilities of Commercial Banks

Rs.[3] in Million

Mid-July	2000	2001	2002	2003
Total Deposits	**154531**	**181204**	**183730**	**199954**
Demand Deposits	**20308**	**24629**	**23750**	**25692**
Domestic	16364	20112	19248	20267
Foreign	3944	4517	4502	5424
Saving Deposits	**65704**	**80988**	**83818**	**97154**
Domestic	63365	77602	79984	93259
Foreign	2339	3386	3834	3895
Fixed Deposits	**66516**	**73489**	**74374**	**74609**
Domestic	59774	64178	65060	65021
Foreign	6742	9311	9314	9588
Margin Deposits	2003	2098	1788	2499
Borrowing from NRB	**45**	**6**	**1044**	**948**
Foreign Liabilities			**228**	**141**
Capital & other Liability	**52272**	**64320**	**65933**	**76207**
Assets = Liabilities	**206848**	**245530**	**250935**	**277250**
Liquid Funds	**45161**	**50645**	**46953**	**42531**
Cash in Hand	3507	4117	4909	4122
Balance with NRB	12881	15985	16152	15691
Foreign Currency in Hand	632	666	617	669
Balance Held Abroad	25595	27498	23259	21561
Cash in Transit	2546	2379	2016	488
Loans & Advances	**136185**	**160920**	**173320**	**200336**
Claims on Government	18177	25393	29144	39482
Claims on Non-Fin. Govt.	1801	2216	3069	2897
Claims on Financial Institutions	6883	8010	9692	10637
Claims on Private Sector	107343	123417	130088	146117
Foreign Bills Purchased And Discount	1981	1884	1327	1203
Other Assets	**25502**	**33965**	**30662**	**34383**

Source: Macroeconomic Indicators of Nepal, December, 2003, page 7.

[3] NPR and Rs. are same. The Government offices use 'Rs.' for Nepali Rupees and the private banks use 'NPR' for the same as NPR has internationally recognition.

The above table enables us to identify the assets and liabilities of the total commercial banks and their trends in different consecutive years. For example: the Liquid Fund is increased by 12% in 2001 in comparison to year 2000, but decreased in 2002 by 7% in comparison to year 2001 whereas the Loans and Advances are continuously in increasing trend.

Table 2.4: Sources of Funds of Commercial Banks as of mid-January, 2000:

NPR in million

Sources of Funds	1994 July	1995 July	1996 July	1997 July	1998 July	1999 July	2000 Jan.
Capital Fund	**2544**	**3103**	**3561**	**4461**	**4956**	**6077**	**6109**
-Paid-up Capital	1895	2118	2271	2852	2966	3767	3767
-Statutory Reserve	414	663	885	1091	1272	1594	1740
-Other Reserve	235	322	405	518	718	716	602
Deposits	**52328**	**61193**	**71401**	**81703**	**102598**	**127202**	**138633**
-Current	9794	11629	13246	12820	16310	17710	18222
-Savings	17461	22766	25890	29697	36885	50154	57477
-Fixed	23264	24510	29397	35941	45594	54847	57738
-Call	493	671	685	1235	1767	2166	2659
-Others	1316	1617	2183	2010	2042	2325	2537
Borrowings:	**403**	**603**	**885**	**1629**	**887**	**1179**	**1393**
-NRB	215	424	230	362	381	429	395
-Inter Bank	187	179	655	1267	506	750	998
-Foriegn Bank	1						
Others	**18289**	**19073**	**24875**	**29929**	**36987**	**38000**	**38030**
Total	**73564**	**83972**	**100722**	**117722**	**145428**	**172458**	**184165**

Source: Banking and Financial Statistics, Number 36, Mid January 2000, page 3.

In the above table, the sources of the funds of Commercial banks is detailed. For lending the loan seeker, from where the banks are getting funds which is described here above. For example, the total capital fund is increased by 140.13% in the year 2000 in comparison to year 1994. Also, the bank deposit also increased by 164.93% in the same period of time which is the quite good growth both in capital fund and deposits.

Table 2.5: Uses of Funds of Commercial Banks as of mid-January, 2000:

NPR in million

Uses of Funds	1994 July	1995 July	1996 July	1997 July	1998 July	1999 July	2000 Jan.
Liquid Funds:	**13700**	**17139**	**18206**	**22712**	**33184**	**39093**	**37623**
-Cash in Hand	1860	2038	2446	2837	2889	3310	3282
-Fcy in Hand	459	456	593	628	751	634	731
-Balance with NRB	5453	7429	6495	8757	14103	13913	12017
-Balance with local Banks	346	419	-163	638	409	402	403
-Balance Held Abroad	5153	6455	7804	7023	9180	9452	12671
-Call Deposits	429	342	1031	2829	5852	11382	8519
Investments:	**14822**	**9634**	**8585**	**8569**	**10857**	**14252**	**16003**
-Govornment Security	9097	8333	7777	8213	10591	13222	15678
-Share and Debenture	77	96	127				
-NRB Bond	5648	1205	681	356	266	1030	325
Loans and Advances	**27347**	**38779**	**50891**	**58378**	**68618**	**81759**	**91053**
-Government Enterprise	766	703	1489	1451	1214	1749	1799
-Private Sector	25403	36609	47389	54736	64989	77501	86334
-Foriegn Bills Purchase and & Discount	1178	1467	2013	2191	2415	2509	2920
Interest Accrued	**5234**	**6203**	**7723**	**9074**	**10619**	**12933**	**14286**
-Governement enterprises	514	693	862	545	222	300	458
-Private Sector	4720	5510	6861	8529	10397	12633	13828
Others	**12462**	**12217**	**15316**	**18989**	**22150**	**24421**	**25200**
Total	**73564**	**83972**	**100721**	**117722**	**145428**	**172458**	**184165**

Banking and Financial Statistics, Number 36, Mid January 2000, Page 4.

The above table explains about the uses of the funds of the Commercial banks during the period of 1994 to 2000. In this table, cash in hand, balance with NRB and call deposit are decreased by 0.84%, 13.62% and 25.15% respectively in comparision between the year 1999 and year 2000. But, in the same period balance held abroad, investment on government securities, and loan and advances are increased by 34.06%, 18.57% and 11.37% respectively.

2.3. Growth of Major Commercial Banks

Comparison between the first six months of fiscal year 2002/03 and 2003/04 shows that every commercial bank, except Nepal Bank Ltd. (NBL) and Rastriya Banijya Bank (RBB), has achieved noticeable increase in credit outflow.

Lending is the major source of income of a commercial bank though it involves high risk. In this regard Kumari Bank Ltd. (KBL) seems to have recorded the highest increase of 67.06% . Though the credit-deposit (CD) ratio of Himalayan Bank Ltd. (HBL) is the highest, its credit increment of 26.78% is less than of KBL. In case of NBL and RBB, the credit figure has gone down by 10.41% and 5.99% respectively. It may be because their concentration was only on recovery of the huge NPA. However, it can be pointed out that no matter what its size and circumstances, each bank has to collect the deposit in order to create a lending and to invest in the new ventures. KBL is placed at the top also in regard with the significant increment of 80.34% in deposit collection as compared to that of the same period of the previous year. All of the rest of the banks have made noticeable increment in deposit collection except RBB in which case it has gone down by 0.62%.

A decrease in CD ratio (the percentage of the deposit mobilization over the credit) signifies the presence of high liquidity and comparatively lower fund mobilization and vice versa. High liquidity and idle funds will result in lower profits. Among the commercial banks analyzed here, HBL has the highest growth of 18.47% in CD ratio as compared with that of the previous year. Similarly, NABIL, Everest Bank Ltd (EBL), Nepal SBI Bank Ltd. (SBI) have recorded growth rates of 6.28%, 11.83% and 7.45% respectively in their CD ratio. However, this ratio of other commercial banks has declined, largely due to the external factors to the banks.

As per the Central Bank's directives, all commercial banks have to maintain loan loss provision according to the size of over due loans. Nepal Credit and Commerce Bank Ltd. (NCCB) was able to decrease its loan loss provision by 27.63% as compared to the previous year indicating a good recovery of interest as well as principal. In case of Nepal Investment Bank Ltd. (NIB), the growth in loan loss provision (which in fact decreased by 6.73%) was much less than the growth of the total credit (which increased by 53%). Similarly, NBL and HBL were able to maintain a healthy composition of loan loss provision (decreased by 9.49% and 0%) and credit (increased by 3.7% and 26.78%), again signifying good results from their loan recovery efforts. In case of remaining banks, the situation is not satisfactoy as the growth of loan loss provision is higher than the growth of credit.

Table 2.6a: Financial of Commercial Banks (mid-January 2004) NPR in million

Particulars	NIC	NABIL	EBL	RBB	Machha-puchhre	NBB	SBI	HBL
Paid-up Capital	499.96	492.00	455.00	1,172.00	550.00	359.92	425.16	429.00
General Reserve	21.06	652.00	64.46	68.00	3.06	201.11	136.18	287.00
Provision for Loan Loss	177.96	440.00	159.28	14,955.00	39.01	941.64	327.12	745.00
Other Reserve	2.67	141.00	14.59	225.00	-	41.25	27.46	22.00
Retained Earnings	47.66	30.00	40.85	(23,882.00)	(45.53)	9.64	3.41	120.00
Total Deposit	4,327.34	13,997.00	7,430.80	39,758.00	2,026.32	11,034.06	5,832.77	21,799.00
Total Credit	2,836.48	8,500.00	5,777.22	25,187.00	1,682.04	9,771.16	4,992.98	12,596.00
Total Investment	1,940.15	5,935.00	2,427.77	5,887.00	548.70	2,071.63	1,146.44	10,313.00
Cash & Bank Balance	271.22	1,320.00	734.26	4,675.00	332.43	789.03	908.01	1,022.00
Other Assets	167.44	1,149.00	496.58	29,828.00	121.53	1368.50	172.66	1,253.00
Other Liabilities	138.64	826.00	1,097.81	33,281.00	86.85	1165.61	398.15	1,381.00
Total Income	193.45	696.00	376.55	1,228.00	112.21	563.44	248.84	794.00
Total Expenditure	127.62	293.00	222.47	1,226.00	79.91	388.25	179.00	(393.00)
Operating Profit	65.83	403.00	154.08	2.00	32.30	175.19	69.84	401.00

Source: New Business Age, August, 2004, page 25.

As per the Government policy and the Central Bank's directives, all commercial banks have to increase their paid-up capital to Rs. 1 billion (for national level operation) and Rs.250 million (for regional level operation) by the fiscal year 2066/67 B.S. But while the Central Bank wants that target to be met with paid-up capital, Nepal Bankers Association is insisting that it should be allowed to be met with the summation of paid-up capital and reserves. In this regard, NIB has increased its capital to Rs.295 million by issuing the bonus shares out of the profit of the fiscal year 2001/02. Similarly, HBL, NBB, EBL and SBI have increased their paid-up capital by 10%, 0.75%, 13.94% and 0.04% respectively as compared to the previous year.

The national and international events, political and economic instability and lack of long-term plan while venturing into new projects have also laid the obstacles before the growth of Nepalese banks. In such a situation the stability and the safety of the banks is the matter of prime concern. A bank's stabilty depends on the reserves it maintains. In this regard, Laxmi Bank Ltd. (LBL) reserve growth by 23.53% is very high. But due to the short peroid of its operations in the fiscal year 2002/03, this figure is not practical to compare

with other banks. Leaving aside LBL, NABIL's reserve growth is very good i.e. 1400% on retained earning and 67.86% on other reserves. Similarly, all other banks have except NCCB and KBL made noticeable increment in it.

NIB has the highest growth in total income of 77.11%. However, if one compares the interest income, KBL appears at the top with the growth of 80.52%. NCCB has the highest income from the other sources. Similarly, HBL, Bank of Kathmandu Ltd. (BoK), EBL, SBI, Nepal Industrial and Commercial Bank Ltd. (NIC), NCCB, and RBB have the growth of 15.74%, 14.72%, 24.92%, 1.70%, 21.10%, 11% and 25.82% respectively as compared to the previous year. However, the total income of NABIL, Nepal Bangladesh Bank Ltd. (NBB), LBL and NBL has declined by 0.41%, 2.66%, 5.67%, and 26.53% respectively.

Table 2.6b: Financial of Commercial Banks (mid-January 2004) NPR in million

Particulars	NIB	LBL	BoK	KBL	Siddhartha	SCBN	NBL	Lumbini	NCCB
Paid-up Capital	295.30	545.57	463.58	350.00	350.00	340.00	380.00	350.00	490.00
General Reserve	268.70	0.21	51.42	3.00	-	680.00	557.00	18.90	13.44
Prov. for Loan Loss	177.66	12.77	344.75	49.00	13.60	310.00	10,161.00	315.91	403.83
Other Reserve	46.14	0.56	55.28	1.00	-	134.00	119.00	1.85	-
Retained Earnings	96.04	(3.95)	8.86	7.00	(1.28)	453.00	(11,705.00)	(215.10)	-424.61
Deposit	9,278.00	1,099.37	7,334.14	3,367.00	1,005.83	19,902.00	35,727.00	3,356.01	5,191.88
Credit	7,069.00	1,276.79	5,694.69	2,830.00	1,119.19	6,047.00	17,486.00	3,041.13	3,863.73
Investment	2,586.14	217.12	2,298.83	634.00	134.19	13,946.00	13,146.00	405.10	928.64
Cash/Bank Balance	799.36	109.49	651.50	211.00	93.12	2.197.00	4,314.00	354.68	519.86
Other Assets	1,083.28	126.50	434.83	252.00	53.20	793.00	15,687.00	244.50	862.47
Other Liabilities	1,075.94	66.33	821.82	122.00	17.88	1,164.00	15,886.00	446.62	434.12
Total Income	409.13	60.30	342.60	150.00	54.59	737.00	954.00	156.19	261.18
Total Expenditure	266.34	46.24	209.29	105.00	33.61	(374.00)	965.00	127.68	190.47
Operating Profit	142.79	14.06	133.31	45.00	20.98	363.00	(10.00)	45.25	70.71

Source: New Business Age, August, 2004, page 26.

On the expenditure side, Standard Chartered Bank Nepal Ltd. (SCBN), NABIL, HBL, SBI, NBL, and RBB were able to record decrease of 7.2%, 12.8%, 3.44%, 6.12%, 35.75%, and 18.54% respectively. All other commercial banks have increased their expenditure. In case of NIB, however the total income growth is the highest, but also the expenditure of this bank is the highest.

The major yardstick to measure the status of bank (and this is the shareholders' prime concern) is the profitability of the bank – the spread between what the bank has earned and expended). In this regard, KBL has made the significant growth of 181.25% in profit as compared to the previous year. Similarly, SCBN, NABIL,HBL, BoK, EBL, NIB, SBI, NIC, and NCCB have the growth percentage of 7.72%, 6.33%, 43.73%, 29.83%, 61.8%, 62.76%, 29.26%, 37.89% and 4.03% respectively. On the other hand NBB, Lumbini Bank Ltd. (Lumbini), NBL and RBB have negative growth of profit by 21.76%, 61.09%, 97.22% and 100.38% respectively as compared to the previous year.

However, the growth rate of Machhapuchhre Bank Ltd. (Machhapuchhre), LBL, and Siddhartha Bank Ltd. (Siddhartha) seems quite high due to the fact that they have just come to operations. (Sources: New Business Age, monthly business megazine and Bulletins and Periodicals, published in different times by the Central Bank).

2.4. Development Banks

After restoration of democracy in 1990 (2046 B.S.), the economic policy is liberalized much more than before. So, the enterpreneours from the private sector were emphasized to invest in the financial sector. As the result, the enterpreneours from small scale industries were interested to open a Small Sacle Industrial development bank. The Government has made a policy and the central bank has introduced the Development Bank Act 1997 (2053 B.S.) to establish the development banks as a new banking system in the country. Before that, Agriculture Development Bank (ADB/N) and Nepal Industrial Development Corporation (NIDC) were in the country as a development bank with separate Acts. After 1997 (2053 B.S.), there are 18 development banks in the country including regional level development banks.

Table 2.7: Main Indicators of Non-Bank Financial Institutions (NBFIs)

Mid-July	1995	1996	1997	1998	1999	2000	2001	2002
Total Nos. of NBFIs	**34**	**77**	**96**	**113**	**122**	**107**	**114**	**135**
-Finance Companies	20	34	41	43	45	46	48	54
-Development Banks[4]	2	2	2	2	6	8	9	11
-Rural and Micro Finance Dev. Banks	4	5	5	5	6	8	8	11
-Saving and Credit Cooperative Societis	8	13	19	29	35	35	34	34
-Financial Intermediary FINGOs	-	23	29	34	30	10	15	25
Total Deposits in Million	**707**	**1887**	**4029**	**6756**	**8906**	**11040**	**17428**	**40115**
Total Loans and Advances in Million	**828**	**2138**	**4171**	**6258**	**8366**	**10671**	**24780**	**42312**
Total Investmant in Million	**312**	**353**	**1047**	**2237**	**1720**	**1521**	**2110**	**5266**
Deposits Growth in %	255	167	114	68	32	24	58	130
Loans/Advances Growth in %	251	158	95	50	34	28	132	71
Investments Growth in %	170	13	197	114	-23	-12	39	150

Source: Non-bank financial Statistics, Number 5, Mid July 2002, Page 1.

[4] The introduction of development bank is lesser than a decade in the country. So, the central bank has included it in non-bank financial institution group. Basically, the development banking concept developed in Nepal was only after 1997, otherwise there were only commercial banks in the country for banking transactions. However, there were two development banks by nature before 1997. They are Agriculture Development Bank and Nepal Industrial Development Corporation.

Non-bank financial institutions in number and according to their activities like deposits and credit are in increasing trend. In number it is increased by 19.47% in comparison between the year 1998 and year 2002 (within 5 years), total deposits, and loans and advances also increased by 493.76% and 576.13% respectively within the same period of time. Therefore, it shows that there is a big market for banking business which is not covered by the commercial banks.

Table 2.8: Some Ratios of Non-Bank Financial Institutions (NBFIs)*

Ratios in percentage

Mid July	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**
Deposit/GDP	0.3	0.8	1.4	2.2	2.6	2.9	4.3	9.4
Credit/GDP	0.4	0.9	1.5	2.1	2.4	2.8	6.1	9.9
Investment/GDP	0.1	0.1	0.4	0.7	0.5	0.4	0.5	1.2
Credit & Investment/GDP	0.5	1.0	1.9	2.8	2.9	3.2	6.6	11.1
Credit/Deposit	117.1	113.3	103.5	92.6	93.9	96.7	142.2	105.5
Investment/Deposit	44.0	18.7	26.0	33.1	19.3	13.8	12.1	13.1
Capital Fund/Deposit	54.2	35.3	27.1	19.4	17.9	14.4	19.3	15.0
Capital Fund/Credit	46.3	31.1	26.2	17.4	19.0	14.9	13.6	14.0
Capital Fund/Total Assets	25.6	22.2	17.7	10.9	12.2	9.9	15.0	10.0

*NBFIs = Development Banks, Finance Companies, Rural and Microfinance Development Banks, Savings and Credit Cooperative Societies and Financial Intermediary Non-Governmental Organizations.

Source: Non-bank financial Statistics, Number 5, Mid July 2002, Page 2.

Ratios of non-bank financial institutions are highly increased in relation to GDP. For example, deposit/GDP ratio and credit/GDP ratio are increased by 2.2 to 9.4 and by 2.1 to 9.9 respectively during the period of 5 years i.e. 1998 to 2002. However, the effect is only 1/3 or less in GDP in comparison to the ratios of commercial banks as mentioned in table 2.2.

2.5. Grameen Bikas Banks

In Nepal, after the restoration of multiparty democratic system and the liberalization of the country's economy, 5 Grameen Bikas Banks were established by the Government which aim to strengthen and to boost up the economic condition of the people who live in the villages, basically the women. In the countryside, most of the women are not involved in financial activities till now. But, after the establishing these type of banks, they are encouraged to involve in such activities and successful also in majority. To some extent, they are successful also, because, except the Government, the equity holders or promoters of the banks are the joint venture banks which have the major role to introduce the modern banking in the country. The establishment of this type of banks is because of the successful implementation/result of Grameen Bank in Bangladesh.

Grameen Success as a Bank in Reaching the Poor in Bangladesh:

In 1993, with 1,039 branches covering almost half of Bangladesh's villages, the bank served more than 1.8 million borrowers and disbursed US$ 169 million. By 1993, cummulative member savings totaled over US$ 218 million. Almost 94 percent of the bank's members are poor women, accounting for nearly 70 percent of savings mobilized, and receiving over 80 percent of the total loan disbursed. Its loan recovery rate has been consistently over 90 percent compared with rate from 25 to 50 percent for other financial institutions in Bangladesh. The Grameen model is being replicated in more than 30 countries and the World Bank has provided a grant of US$ 2 million for its replicable in low-income countries.

(Poverty Reduction Strategy: The Grameen Bank Experience. http://www.gdrc.org/icm/grameenbank.html)

Table 2.9: Comparative Progress Report of Five Grameen Bikas Banks:

NPR in Thousand **Mid July 2002**

	Purban-Chal	**Madhya-manchal**	**Paschi-manchal**	**Madhya-Paschi-mancal**	**Sudoor-Paschi-manchal**	**Total**
No. of Centers	1363	1112	1086	538	583	**4682**
No. of Groups	10860	7062	7791	3754	3355	**32822**
No. of Members	51697	35105	39694	18770	18694	**163960**
No. of borrowers	47728	33992	39604	16281	11944	**149549**
General loan Disbursed	2733296	854534	1362084	537095	581975	**6068984**
General loan Repaid	2396088	651252	1109957	452815	483661	**5093773**
General loan Outstanding	337208	203282	252127	84280	98314	**975211**
Other loan Disbursed	267137	63885	172462	138187	101748	**743419**
Other loan Repaid	192894	52928	95164	99233	92516	**532735**
Other loan Outstanding	74243	10957	77298	38954	9232	**210684**
VDC[5] covered	259	247	262	102	80	**950**
District[6] covered	8	12	13	4	5	**42**
Current year's profit	(2131)	(7236)	3462	(4997)		**(16588)**
Accumulated profit/loss	(2131)	(7236)	3462	(4997)		**(76790)**

Source: Non-bank financial Statistics, Number 5, Mid July 2002, Page 34.

[5] VDC – Village Development Committee. In Nepal, there are 3,911 VDCs and 58 Municipalities as a local political body formed through election. The working area of all the Grameen Bikas Banks are the VDCs.

[6] In Nepal, there are 75 districts and 14 zones. Till mid July 2002, Grameen Bikas banks covered 42 districts for operating banking activities.

2.6. Merchant Banks and Finance Companies

The development of Merchant Banking and Finance Companies has also taken place after the restoration of democracy in 1990 (2046 B.S.). Before that, the activity of Merchant Banking and Finance companies were almost nil, although the Finance Company Act 2042 was already introduced by the Government and the Central Bank in 1985 (2042 B.S.). Now, till May 2003 (Baishakh 2060 B.S.), there are 56 merchant banks and finance companies all togather in operation.

2.7. Competition in Banking Industry in the Future

Nepali financial sector, especially the banking sector, has undergone drastic changes within the past two decade. The opening up of the financial market to foreign joint venture banks in the mid-80s, ending the monopoly of the two state-owned banks (one fully and other partially), namely, Rastriya Banijya Bank and Nepal Bank Limited., is a notable step after which a number of private and foreign affiliated joint venture banks emerged. Though the two state-owned banks still continue to hold over 50 percent share in total domestic banking transactions, yet they are challenged by the more innovative and efficient private banks. Presently, there are seventeen commercial banks including RBB and NBL and eighteen development banks, among which fifteen are regional ones in operation.

One of the most important achievements as a result of the growth in the number of commercial and development banks in the post liberalization period is in the area of domestic savings. Quantitative growth of the banking sector has positively contributed in raising domestic banking savings, which crossed the 152 billion mark in mid-August, 2000. In addition, deposit-GDP ratio (we can see it in different tables shown in sub-chapter, 2.1, table 2.2, and Chapter 2.4, table 2.8 because the Central Bank does not publish their reports in single condensed table), one of the major economic parameters widely employed to analyze the efficiancy of the banking system, as substantiated by empirical data, also rose from 0.128 before reforms to 0.199 after the reforms. This would directly make more funds available for investment.

Given that efficiency of the financial sector is the backbone of the economy, the edvent of joint venture commercial banks has contributed much to this direction. The opening of the financial sector in 1992 for free entry of commercial banks has added more to the

efficiency (appropriately use of funds) of funds flow into the economy, which surely would not have been possible had the government maintained a conservative and inward looking policy restricting free competition.

A laudable contribution by the banking sector growth, and the resulting competition, in the past one decade is the diversion of banking sector resources to the industrial sector. Post liberalization era competition has forced commercial banks to broaden their lending portfolio that has resulted in the expansion of loan extension from the trading sector to the industrial sector. This is particularly important due to the fact that Nepalese trading sector is dominated by transit trade. Empirical data shows that lending to the industrial sector has increased significantly from 15 percent of the total loan portfolio in the pre-liberalization era to about 35 percent presently.

In addition, competing joint venture commercial banks have played a crucial role in modernizing, though only to an extent, the banking system. The recent introduction of 24-hour banking service facilities in 2000 throught the installation of Automatic Teller Machines (ATMs) by some banks and initiation of innovative schemes for granting credit facilities to consumers is a notable achievement. However, the fact that only a few banks have really followed suit, and the usual rush of customers seen in almost all banks for withdrawing their accounts during times of festivals, only puts a question mark on the correlation between quantitative growth of the banking sector and the quality of services, and hence casts doubt over the existence of so called stiff competition in the banking sector.

Most bank officials on their part, however, claim of tight market situations and maintain that the banking sector is already saturated with an excess number of commercial banks. They assert that banks are presently operating at minimal margin (spread rate between deposit and lending, for example: banks accept deposits at 6% p.a. and lending at 8.5% p.a. which is shown in annex-II) and are of the view that if lending continues under the present circumtances, commercial banks would be in a precarious position within the next five years.

Says one professional banker, "About 60-70 percent of the total deposits of banks are interest bearing. due to the lack of investment avenues, banks are tempted to invest without

proper credit appraisal and on personal guarantee, whose negative side-effects would show colours only after four or five years." Source: Business Age, Volume 2, No. 12, November, 2000.

Though the quality of services offered to all beneficiaries and the contribution of the banking sector to the economy as a whole has seen a quantum leap after the advent of the private banks, thereby opening up larger avenues for all investors, depositors as well as enterpreneurs, there still exist ample rooms for improvement. And, despite all alluring developments, it would be but naive to paint a rosy picture of the banking sector.

Firstly, there still exist anomalies in the banking sector in spite of the claim of stiff competition. The rate of interest offered by banks to depositors still varies widely from bank to bank. For example, Standard Chartered Bank, previously known as Grindlays Bank, one of the most successful joint venture banks, offers only 2.5 percent interest on savings deposit, while Nepal Bangladesh Bank, another joint venture, offers 5 percent for the same category of deposit. But the lending rate on long-run and short-run are similar of all banks. This only suggests independence of the operation from bank to bank directly contradicting the principles of competition.

Another issue needing special mention is the system of making interest payment by the banks. Most banks still make interest payment on the minimum monthly balance of a depositor's account, wherein it is credited only at the end of 6th month. This indicates lack of competition in the banking sector, which otherwise would have been forced to shift from making interest payment on a monthly minimum balance basis to calculating the payments on the daily balance.

Moreover, private commercial banks have mushroomed only in the urban areas where banking transaction in large volumes is possible. The rural and sub-urban areas mostly remain unattended to, and which is likely to prevail till competition takes its full rein in the urban sector.

For an investor, commercial banks themselveshave grown as the most lucrative sector for investment. Investors' confidence into the banking sector is easily exemplified by the over subscription of shares of the banks and financial institutions in more than five folds.

Moreover, continued high performance by the stocks of commercial banks, reflected in the charts of Nepal Stock Exchange (NEPSE), where banks dominate 90 percent of the total share transaction, is another reason luring investors to invest readily into the banking sector.

As a whole, increasing credit flow to both trading and industrial sector and channelling domestic savings into capital investments, towards which the contribution of the banking sector cannot be questioned, will ultimately bolstar the country's rate of economic growth. In addition, the sector has actually done more than just providing mere safety to small investors' capital. Yet, the sector will become prudent and successful only when the banking sector 'interest rate' will draw the interests of both depositors and creditors.

I have described about the banking history and its structure in Nepal in this chapter in detail. In next chapter, I am writing about the government policy on banking and its budgetary operations which also be the right information for the readers about the Nepalese economic policy.

CHAPTER THREE

03. GOVERNMENT ECONOMIC POLICY

In this chapter, the banking policy of the Nepalese government is prepared on the basis of an article written by Nara Bahadur Thapa, who is the deputy director in the Central Bank and published in a daily newspaper “The Kathmandu Post’.

3.1. Government Policy on Banking Sector

Every country has their own policy of economic development and growth of the country. Banking and Financial Institutions are the best means of economic development of the country. They collect the funds from the small depositors/investors to the big depositors/investors for further institutional investment which can help definitely to the economic growth of the individual and the nation as well. So, every government has their economic policy to strengthen the financial sector which includes the banking industry in the country.

Nepal Rastra Bank (NRB), in accordance with the provision made in the NRB Act 2002, brought out the annual monetary policy and programme for the fiscal year 2002/03 on July 16, 2002. Ever since the announcement of the policy, it has drawn wide attention.

Bankers and business community have expressed their happiness over the cut in cash reserve requirement (CRR), withdrawal of interest spread as well as NRB's representation from the board of banks and financial institutions. Likewise, provision of additional refinancing facility to commercial banks against their sick[7] industry loans has also been appreciated. Similarly, the policy of allowing development banks to mobilize saving deposits up to 20 percent of their financial resources, new provision of fund for long-term loans to priority sectors, waiver of penalty up to 25 percent of the shortfall on the priority sector lending requirement and measures aimed at strengthening the supervisory functions of the NRB are also well received, particularly by the concerned quarters.

However, others have argued that there is nothing new in the policy and as such it will have no positive impact on the economy. The policy pronouncement of facilitating the economic growth with the provision of adequate amount of liquidity has also been the subject of criticism in some quarters. So has been the indicative target set for inflation. These criticisms emanate from the rigid theoretical propositions in some cases. As this is the maiden annualpolicy announcement, some room exists for further improvement. In this light, it must be stated that the comments and criticisms on the policy should be valued in the sense that these can be taken as an important guidance for the next policy formulation.

A careful analysis of the policy document reveals that it has focused on three areas: (i) core policy objectives, (ii) financial sector stability and (iii) rural credit. The NRB Act 2002 and the present economic and financial situation have dictated the policy focus on these three areas.

As regards the core policy objectives, the policy document clearly states that the primary objectives of the monetary policy are to achieve domestic price stability and to maintain

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[7] It is basically non-performing loans, but in Nepal, due to the unavoidable political scenario of the country, the industries are not doing well. Like tourism industry which was one of the best investment sectors in the past, but due to the MAOIST problem in the country, whole tourism sector is totally damaged. So, the tourism sector is introduced as sick business sector by the Government and the Central Bank as well.

the external sector stability. Judging the present and the likely future price development, the indicative inflation target set for the fiscal year 2002/2003 is about 4 percent. This has been the bone of contention for some economists. The argument is that in a small and open economy such as Nepal, the monetary policy is ill equipped to control domestic inflation. On top of it, it is also contended that in a fixed exchange rate regime like in Nepal, inflation is generally imported. These arguments are theoretically valid. While formulating monetary policy and setting a target for domestic inflation, Nepal Rastra Bank (NRB) cannot ignore this. It appears that NRB has taken likely price development in India into consideration for making inflation forecast at about 4 percent for the fiscal year 2002/03. Although some regions of India have faced droughts, it is unlikely to push up foodgrain prices as India is currently maintaining bufferstocks in foodgrgain (agricultural products) of about 80 million tons. On the other hand, although inflation target setting is debatable, it will obviously set a benchmark for price expectation in the economy.

Against this backdrop, it is also important to seek the meaning of the monetary policy target for inflation especially in a developing country like Nepal. Four point are needed to spell out the money-price relationship in Nepal. First, in the short run, structural factors such as weather conditions, administered prices and the behaviour of Indian prices do influence the price movement in Nepal. Second, the domestic price level consists of prices of both traded goods and non-traded goods. It can be argued that in the case of traded goods prices, monetary policy will have little influence in a country such as Nepal. However, it cannot be true for the nontradables. It is important to take note that in Nepal's consumer price index, the weight of non-tradable is as high as 31 percent. Obviously, the monetary policy will have an impact on overall price level to the extent of nontradable influencing the overall price level. Third, even in inflation targeting countries, core inflation rather than headline inflation is taken for target setting. The main reason for doing so is that structural factors are beyond the control of monetary authorities, and hence monetary policy is not held responsible for structural factors induced inflation even in developed countries. Fourth, long run inflation is a monetary phenomenon. This means that a sustained rise in prices will not occur unless a significant increase in money supply persists. In the light of these facts and assuming structural factors remaining unchanged, indicative inflation target setting implies that domestic inflation would not be allowed to go beyond the target of 4 percent due to the sole reason of increased money supply.

The current monetary policy 2004/2005 stance is the external sector stability, which refers to securing a surplus in the balance of payments and maintaining an adequate level of international reserves. It is argued that the current accommodative monetary policy stance will jeopardise this objective especially because of a deficit in the balance of payments observed during the last fiscal year. Two point can be made in this regard. First, despite the deficit in the balance of payments, international reserves have remained sufficiently adequate in terms of import cover. On top of it, it can also be argued that there should be a productive use of such reserves. Piling up of idle international reserves may prove costly for the economy in the long run. Anyway, there would not be any harm if reserves were used productively to induce economic growth and an adequate amount of reserves exists in terms of import cover. Second, the present deficit in the balance of payments has not been due to the increased domestic absorption. Hence, accommodative monetary policy is not responsible for a deficit in the balance of payments. A number of policy measures have been initiated to augment and conserve the international reserves, especially the convertible reserves. A review of items allowed against dollar imports from India, extension of period for usance credit, new provision of loans for those who seek foreign employment and monetary incentives for money transfer agencies to bring remittance into the banking channel are some of the measures introduced to augment convertible reserves. Foreign inflow from donor community is also likely to augment our reserves.

3.2. Government Budget:

Government Budget shows the economic activities of the country. Most of the country's economic activities are related to banking sector as they are transacted through the banking system. It explains the trend of budget and sources and uses of funds (see Table 3.1).

In Nepal, Bikram Sambat (B.S.) is the official calender year which is started in the mid April every year. But the Fiscal Year is started from the 1st day of fourth month i.e. from mid July. Before starting of the new Fiscal Year, the Government's Budget is announced in the regular session of Parliament by the Finance Minister. I will try to give some financial data from the whole Budget of a few years which give the sign of economic development of the country, basically, financial sector development. It will help to analize about the Government Policy.

The Government budget has always a huge deficit which is fulfilled by the source of external and internal loans and grants. Due to this reason, the Government is in financial crisis regularly. They use their big amount of income to repay the loans and its interest every year not in development activities within the country. It is one of the major factors that frustated the people against the Government which may be the cause of the maoist problem.

Table 3.1: Government Budgetary Operations

Rs. in Million

	1999/00	2000/01	2001/02	2002/03
Total Expenditure	**66273**	**79835**	**80072**	**84572**
Revenue Expenditure	34523	42769	48590	56556
Development Expenditure	31750	37066	31482	28016
Sources of Financing	**48606**	**55647**	**57131**	**63622**
Revenue	42894	48893	50446	55250
Foreign Grants	5712	6754	6685	8372
Bilateral	4171	2185	4588	6342
Multilateral	1541	4569	2097	2030
Revenue surplus	**8371**	**6124**	**1856**	**-1306**
Surplus (+) Deficit (-)	**-17667**	**-24188**	**-22941**	**-20950**
Source of Deficit Financing	**17667**	**24188**	**22941**	**20950**
Foreign Loans	11812	12044	7699	8950
Bilateral	758	587	87	100
Multilateral	11054	11457	7612	8850
Domestic Borrowings	5500	7000	8000	12000
Banking System	3300	0	0	0
Non-Banking system	2200	0	0	0
Change in Cash Balance (- surplus)	**355**	**5144**	**7242**	**0**

Source: Macroeconomic Indicators of Nepal, December, 2003, Page 5.

The increment in expenditure is 27.61% in between fiscal year 1999/2000 and 2002/2003 during the period of 4 years whereas in income there is an increased rate of 30.89% during the same period of time which is the positive sign of budget. But, grants and loans are in increasing trend every year.

3.3. Government Budget 2061/62 B.S. (2004/05 A.D.) "Peace Budget"

Finance Minister announced a "Peace Budget" (as he called it) on July 16, 2004 for the fiscal year that began on the same date. To prove his point, he cited that he has made some significant increases in allocations for the social sectors like education and health and local development. He allocated Rs. 10 million each for 40 districts most affected by the insurgency and which are also the most backward. Similarly, a total of Rs. 300 million is allocated for some supplementary activities to help the economies of these areas. And he hoped that as these will address some of the basic factors that are helping the Maoist insurgency, it will be easier now to help stem the insurgency if the funds allocated in those headings will be utilised as intended.

Table 3.2: Government Budget '2004 & Macro Economic Targets

Targets	Status of FY 2003-04	Target for 2004-05
Economic Growth Rate	3.6%	4.5%
Agriculture Sector Growth Rate	3.7%	3.7%
Non-agriculture Sector Growth Rate	3.3%	4.6%
Inflation	4.0%	4.0%-4.5%
Govt Revenue to GDP		13%
Internal borrowing to GDP		1.7%

Source: T.R. Upadhyaya, New Business Age, August, 2004, Page 20.

However, the Finance Minister has also tried to send a message to the rebels that the government is not lagging behind in beefing up the security forces. Though the allocation on the defense heading is less than the revised estimates for the fiscal year just completed (Rs. 8005 million against the last year's revised estimate of Rs. 8386 million), it is reported and confirmed by the officials concerned of the government that there are some additional allocations made for security forces. The allocation for the home ministry (which includes the police forces) has remained almost the same as in the last year. There is an allocation of Rs. 1050 million made for the purpose of holding elections for the House of Representatives. A larger amount (Rs. 1060 million) was allocated last year for this purpose. But as the elections could not be held, the saving thus made was handed over to the security forces. The same is likely to happen also this year if the elections cannot be held. And this is more likely scenario as the developments so far indicate that elections are

not possible to start by mid-April 2005, the starting date fixed by the king some months ago.

The other initiatives announced for restoration of peace are the proposal to set up a Peace Secretariat (Rs. 20 million allocated for this), immediate relief to the insurgency affected people (Rs. 50 million) and reconstruction of the war damaged infrastructure at the district head quarters (Rs. 600 million).

Government Budget and Business

If peace is restored, or even not allowed to worsen from the present level, that would in itself be enough reason for the business sector to rejoice. However, the budget speech in fact promises more than that.

Among the positive points about the budget cited by the business community are the waiver of the export taxes and fees on three items (copper wire, zinc oxide and marble) and reduction in case of this tax on the others. But they also complain that such facility was not offered for the vegetable ghee, an item which can be exported at a huge quantity and in which India (its virtually only market abroad) has been posing different hurdles making it difficult to export there.

Also positive for the business sector is the arrangement to reduce the requirement of the bank guarantee for bonded warehouse facility for export-oriented units to import raw material (from earlier one year to now six months). However, the business community is still complaining that other more important suggestions in this regard were turned a deaf ear to.

Similarly, the budget has simplified the VAT administration with the provision of issuing advance order. With this, in case of some confusion about certain provision, the business can ask the tax administrator for advance order specifying, for example, whether the item attracts VAT or not.

In agriculture business, the provisions welcomed by the business sector are those related with the subsidy on electricity charges for cold storages, capital subsidy on the shallow tube wells in the Terai and expansion of the interest subsidy on tea cultivation to 12 districts. However, there is no specific new arrangement announced regarding how the

administration of the subsidy regime is to be carried out to avoid earlier malaise of this facility not reaching the intended beneficiaries.

The budget has also promised to amend the labour laws, though there is no hint about how they are being changed. However, it has promised a more flexible labour law for the Special Economic Zones and to work together with the trade union and the employers union to develop the new statute.

In another promise, the budget speech has announced a plan to set up a fund to support the small and micro industrial enterprises to compete in the new international economic order in view of the recent joining of Nepal to World Trade Organisation (WTO). It also promises a separate law to govern the small and cottage industries.

Another provision of the budget that facilitates the business of the small industries, particularly those in the handicraft, is the promise to start the system for refunding the VAT to the foreign tourists who carry with them some VATable Nepali products. Such return is to be made at the Tribhuvan International Airport while the tourist is departing after completing the Nepal tour.

The budget has also exempted VAT on tourist transport making it at par with the other passenger transport.

It has also promised for an arrangement for quality control on the raw material imported for carpets and Pashmina. Similarly, there is a promise for developing domestic capacity of international standard for certification of the testing laboratories.

Lackings

However, the business community was saddened to not find any big projects announced in the budget that would boost investment and cause some significant multiplier effect. The increase in the budget allocation for the ministries of Water Resources and Works and Physical Planning is not that significant. Last year, the government could add only 24 Km of roads by spending about Rs. 2000 million.

The business community was saddened also because the budget has remained silent on the question whether the customs duty will be higher on goods imported from non-WTO member country.

Though the budget speech talks of helping the sick industrial units, it has not spelled out how this is going to be any better now than in the previous years when similar promises were left unfulfilled.

One significant complaint is about the promise to conduct a study on the proposal of the private sector to make the import duty on raw material lower than that for the finished goods from the same raw material. Though this complaint was there for the last several years, the government is still lingering with this, as the budget speech indicates.

Similarly, the budget has no allocation made for the Export Processing Zone proposed near the Birganj 'dry port' made operational recently. There is no mention of the Craft Village project planned in the last year's budget speech.

Other provisions directly related to the business sector

1. Promise for a separate law on Public Sector Procurement

2. No deposit required for request for administrative review of orders on income tax and Value Added Tax (VAT).

3. Business involved in petroleum exploration and mining to be allowed to adjust the previous losses for first 12 years.

4. Repair and maintenance expenses of the aircraft to be treated as expense for income tax purpose.

5. Import duty reduced from 40% to 35% on a number of items.

6. Government offices allowed to procure goods and service above Rs. 5,000 only from firms registered under VAT.

Monetary Policy

Immediately after the budget announcement, the Nepal Rastra Bank (NRB) announced a new monetary policy dubbed "relaxed monetary policy" reducing the compulsory reserve ratio (the percentage of total deposits of the commercial banks that they are required to deposit with NRB) from 6% to 5%. This is expected to release some Rs. 2000 million as liquidity in the banking sector. However, the repo lending facility is cancelled. The policy

allows Nepalis going abroad to get US$ 1000 in foreign exchange instead of only $ 500 so far.

Other Highlights of Monetary Policy 2004

- To be incorporated in the monetary indicators, informing about the foreign deposits in Nepali banking system.
- Commercial banks allowed till the end of 2005-06 to increase their capital adequacy ratio to 12%.
- Credit Information Company to be set up replacing the Credit Information Bureau.
- Commercial banks allowed to develop their own e-payment system.

In this chapter, the government policy on banking industry have been explained and in chapter four I will be describing about newly introduced banking legislation with the comments.

CHAPTER FOUR

04. NEW BANKING LEGISLATION

In this chapter, I have put the personal view on newly introduced banking legislation by the government and the central bank. It may be the suggestions for the time to time amendment of the legislation which will be necessary in the futrue.

4.1. Ordinance on Banking:

An ordinance relating to bank and financial institution has been promulgated that has come into force effective April 4, 2004 (Chaira, 2060 B.S.), after a lobour pain of almost two years. Though this Ordinance may be considered one of the achievements of financial sector reform programme, it is debatable if such an important law having far flung effect on the financial sector should be implemented by an Ordinance that survives only six months. As the installation of new parliament (that alone has the power to enact permanent law) is nowhere in sight, the financial sector must go through the uncertainty in foreseeable future.

The Ordinance is popularly called an Umbrella Act as is repeals and replaces all existing Acts relating to Commercial Banks, NIDC, ADB/N, Development Banks and Finance Companies and brings all such institutions under the purview of a single Act. The Ordinance is comprehensive and prescribes in detail the provisions for licensing, incorporation, governance, and merger and dissolution procedures for banks and financial institions (FIs). This is a significant improvement over the existing Acts but apprehension is expressed about the discretionary power that the Ordinance has vested on Nepal Rastra Bank (NRB).

The Ordinance is divided into 12 chapters and contains altogether 93 sections. the first chapter defines the various terms used in the Ordinance but has conspicuously omitted to define 'security' and 'collateral' among some other important terms. These words have been frequently used in relation to lending activity but in the absence of universally acceptable definaition the ongoing anomalies owing to the ambiguity are expected to continue though it has been clarified that the financial institutions henceforth can lend against personal or corporate guarantees.

Second chapter specifies the procedures for establishing a bank or financial institution and has brought transparency in licensing procedure. The authority has to either issue the license within 120 days of application or notify the reason of refusal within the said period. Further, a foreign bank's presence in Nepal either through a joint venture or branch banking is legally mandated. This provision will probably meet the long outstanding demand of the donors and conforms to Nepal's entry to World Trade Organization (WTO).

Buying back of its own share by a financial institution, a unique provision, is legislated by this Ordinance and that could be considered progressive. But it has failed to explain the objective of such provision and at the same time appears to be too restrictive to implement. The Ordinance has failed to prescribe conditions for enhancing the stake of joint venture partner, fresh issue of shares to strategic partner, issue under Employees Stock Option Plan and preferential issue that is vital from the investor's perspective.

Chapter 3 deals with the constitution of Board of Directors and appointment of Chief Executive Officer (CEO). Henceforth, in addition to directors appointed by the shareholders' meeting, the FIs must have one independent director in its Board appointed

from amongst the names in the roster maintained by NRB. Also the academic qualification of remaining directors has been prescribed that requires the 2/3rd of all directors must possess required academic qualification and experience but is has failed to describe procedures that could ensure that people of requisite qualification are elected by the general meeting. Similarly, academic qualification for a position of CEO is also prescribed and his/her tenure is limited to four years. But the intention for limiting the tenure of such paid executive remains unexplained. It might prevent young and dynamic person from taking this leadership position. Further, the authority and responsibility specified are not commensurate to the position of a CEO. As vesting of executive authority on CEO is not guaranteed by the law, it may be played down at the hands of unscrupulous directors and might be inconsistent with the principle of divesting management from investor to professional managers.

Chapter 4 places restriction on using bank of FI's name or carrying out financial transactions by institutions other than those licensed by NRB as per the Ordinance. Chapter 5 deals with capital adequacy, reserves and provisioning for NPAs. But the more it has tried to be transparent, the more it has vested discretionary powers with NRB. To protect the interest of depositors, the prime concern of legislatures in drafting the law should be continued maintenance of adequate capital and such an important matter should not be left to the discretion of NRB. The lesson should be learnt from the past experiences where NRB's leniency sent two largest banks technically bankrupt. In this regard, it may be pertinent to remind why the Basel Committee recommendation on capital adequacy (that is universally acceptable) is not being made mandatory in Nepal. Further, mandatory obligation on the part of the promoters is not created to meet the capital gap within specified time. Such an obligation is vital for protecting the depositor's interest. As has been the case with the two largest banks (i.e. Nepal Bank Ltd. and Rastriya Banijya Bank) and a few other private sector banks in Nepal, continued flouting with NPAs has eaten away not only their equity but the depositor's money as well.

Chapter 6 prescribes the financial transactions the banks and FIs are empowered to undertake. It has attempted to include all types of traditional financial transactions hitherto undertaken by a bank or FI but has failed to visualize the requirement of a modern banking like debt securitization, swap and hedge transactions and dealing in other financial

derivatives. The finance company will be benefited with this Ordinance as they are now authorized to accept interest free deposit.

Regulatory, inspection and supervision responsibility with regard to FIs continue to remain with NRB. The new provision has enlarged the scope of NRB's regulatory role. Banks set up with foreign shareholding will now be required to submit to NRB the inspection reports prepared by their headquarters. Severe penalty including suspension of Board or taking over the management of FIs has been prescribed if the result of NRB inspection indicates non-compliance with its directives or if the FIs are found to be quality of engaging in activities that are detrimental to the interest of the shareholders or the depositors.

The deregulated interest rate regime appears to be drifting away as the Ordinance has empowered NRB to intervene in rate fixation but it does not specify the conditions that would oblige NRB to do so. Looking at the current rate of interest offered on deposit by FIs, that has gone below the inflation rate, NRB intervention could bring relief to thousands of small depositors, especially old, disabled and pensioners whose lifetime saving is at stake.

Loan disbursement and its recovery procedures are covered under chapter 8 that re-establishes the NRB's authority to regulate lending and minimize the chances of loan going to an unscrupulous borrower or diversion of the funds. The Ordinance has specifically provided for the compulsory registration of all charges on assets pledged as collateral but the agency responsible for such registration (other than real estate) is not identified. The authority of FIs in loan recovery has been extended and it may now reach to other assets of the borrower in case the security for loan falls short or becomes inadequate. The hitherto requirement of disposal of non-banking assets within seven years has been done away with. It may result in accumulation of significant unproductive assets in FIs balance sheet. The role of loan recovery Tribunal has been undermined and no role is envisaged for Asset Management Company that is in the offing.

The role of the auditor of FIs has been extended and it goes beyond the scope of expertize of accounting profession. Auditors shall require, among others, to certify whether FIs have acted (or failed to act) to protect the interest of depositors or investors and whether the

business of FIs has been conducted satisfactorily. Basis of such opinion is not outlined and, accordingly, it will serve no purpose other than becoming a ritual.

Chapter 10 deals with merger that permits an FI to merge with another FI only. This is a new provision but does not prescribe the circumstances when such merger will be permitted. The missing part on merger is the safeguard of interest of minority shareholders. It does not entitle shareholders opposed to the merger to ask for compulsory acquisition of their stake by the management group. Similarly, no provision has been made for acquisition that is vital for promoting foreign investment.

Chapter 11 prescribes penalty for various offences that could be both civil and criminal. Chapter 12 has laid down procedures for voluntary winding up of FIs, arbitration and miscellaneous administrative and operational procedures. The client confidentiality is guaranted but with so many restrictive sub-clauses it is doubtful if the objective would ever be met. Similarly, depositor's right is clearly protected by reiterating that there would be no other claiment on deposit kept with FIs other than the depositor himself or his nominee but certain other provision could interfere with such right. The state may intefere in one or other pretext defeating the intention of law and lessening the confidence in the banking system.

For the first time, the law has taken cognisance of international terrorism and NRB is empowered to suspend operation of account related to organization or individual associated with such activity. But it has omitted any anti-money laundering provision. Probably, a separate Act is being envisaged to deal with such transaction.

In conclusion, it could be said that the Ordinance is comprehensive and deals with significant aspect of operation of FIs. However, attempts should be made to limit NRB's discretionary power by framing transparent, prudent and unambiguous policies and regulations. Further work would be necessary to integrate the country's financial sector with international financial market and effort should be directed to encourege adoption of international best practices like International Financial Reporting Standards (IFRS), International Standards on Auditing (ISA), Basel Committee Recommendation etc.

In the next chapter, I am describing about the financing system in Nepal.

CHAPTER FIVE

05. IMPORTANCE OF BANK BASED VERSUS MARKET BASED FINANCING IN NEPALESE FINANCIAL SYSTEM

5.1. Corporate Governance

Liberalization and the volatility of financial markets, increased competition, and diversification expose banks to new risks and challenges, requiring the continuous innovation of ways to manage business and its associated risks in order to remain competitive. The responsibility for maintenance of the banking system and markets is being re-defined, in one country after another, as a partnership among a number of key players who manage various dimentions of financial risks. This approach reconfirms that the quality of bank management, and especially the risk management process, are the key concerns in ensuring the safety and stability of both individual banks and the banking system as a whole.

This considers the partnership approach and the emerging framework for corporate governance and risk management, as well as the identification and allocation of tasks as part of the risk management process.

The working of the risk management partnership can be summarized as follows:

i. **Bank regulators and supervisors:** Bank regulators and supervisors cannot prevent bank failures. Their primary role is to act as facilitators in the process of risk management and to enhance and monitor the statutory framework in which risk management is undertaken. By creating a sound enabling environment they have a crucial role in influencing the other key players.

ii. **Shareholders:** They are in a position to appoint the people in charge of the corporate governance process and should be carefully screened to ensure that they do not intend to use the bank solely to finance their own or their associates' enterprise.

Ultimate responsibility for the way in which a bank's business is conducted lies with the **Board of Directors**. The Board has to set the strategic direction, appoint management, establish operational policy and most importantly, take responsibility for ensuring the soundness of a bank.

iii. **Executive management:** The executive management of a bank has to be 'fit and proper', meaning not only that managers subscribe to standard of ethical behavior, but also that they have the competence and experience necessary to run the bank. The management is responsible for the implementation of the board's policies through its running of the bank on a day to day basis. It is vital that it has intimate knowledge of the final risks that are being managed.

iv. **Audit committee and internal auditors:** They should be regarded as an extension of the board's risk management policy function. The auditors have to perform an independent appraisal of a bank's compliance with its internal control systems, accounting practices and information systems. Although audit committees play a valuable role in assisting managemant in identifying and addressing risk areas. The prime responsibility for risk management cannot be abdicated to them, but rather should be integrated into all levels of management.

v. **External auditors:** They have come to play an important evaluative role in the risk based financial information process. Since bank supervisors neither can nor should repeat the work done by external auditors. Proper liaison mechanisms are necessary between these two parties, particularly on a trilateral basis that includes bank management. The audit approach should be risk oriented rather than based on a traditional balance sheet and income statement audit. Over reliance on external auditors would weaken the partnership, especially if it leads to a weakening of the management and supervisory roles.

vi. **Public/consumers:** They are as market participants have to accept responsibility for their own investment decisions. In order to do so, they require transparent disclosure of financial information and informed financial analyses. The public can be assisted in its role as risk manager if the definition of public is widened to include the financial media, financial analysts such as stockbrokers and rating

agencies. The small or unsophisticated depositor would normally need more protection than simply transparent disclosures.

Table 5.1: Partnership in Corporate Governance of Banks

Corporate Governance	Financial & Other Risk Management Area						
	Balance Sheet Structure	Income Statement Structure	Solvency Risk and Capital Adequacy	Credit Risk	Liquidity Risk	Inrerest Rate Risk	Market Risk
Key Players & Resposibilities	Accountability (dimension of risk for which responsible)						
Systemic:							
Legal and Regulatory Authorities	Set regulatory framework including risk exposure limits & other risk management parameters to optimize risk management						
Supervisory Authorities	Monitor financial viability & effectiveness of risk management in compliance of regulations						
Institutional:							
Shareholders	Appoint fit and proper board, management and auditor						
Board of Directors	Set risk management & other policies as responsible entity						
Executive Management	Create system to implement board policy, risk management in day to day operations						
Audit Committee/ Internal Audut	Test compliance with board policies						
External Audit	Express opinion and evaluate risk management policies						
Public/Consumer							
Investors/Depositors	Take & understand responsibility for own decisions						
Rating Agency & Media	Inform the public and emphasize downside risk						
Analysts	Analyzed risk based information and advise clients						

Source: Greuning, Hennie van and Bratanovic, Sonja Brajovic, 2000, p. 6.

5.2. Bank Based Financing

Nepalese financial sector is based on bank based financing. After establishing of Nepal Bank Limited in 1937, the banking system is started in Nepal. It is not a long peroid. This industry is still in learning process. Actually, the development of banking has been taken after the establishment of NABIL Bank in 1984. It has introduced a different types of banking system in the country. It is around two decade only which is very short period of development of any system. For development of the banking system, Government's policy palys a vital role. Due to the political system in the country, the development of banking and other financial sectors are backward. After the restoration of multiparty democratic system in 1990, the sector has developed to some extent which is an ongoing process. As data provided by Nepal Rastra Bank through its Bulletins, the total credit (loans/advances) of the commercial banks only in 2003 was NPR 200 Billion (Macroeconomic Indicators of Nepal, December, 2003, Nepal Rastra Bank, Statistic Division).

5.3. Market Based Financing:

In Nepal, the market based financial system is not actually developed. Banks and Financial Institutions are involved in all the financial activities basically in the urban areas. Most of villages do not have access to the banking. They fulfill their financial needs from the rich people of the village. Anyway, now the share/stock market has been continuously growing up in its way.

Government Budget and Stock Market

The annual budget for the fiscal year 2004/2005 has overlooked the importance of development in Nepali capital market. It again talked about increasing the efficiency of the stock market as was stated in the previous year's budget. But no new program has been introduced to increase the efficiency of an old-aged open out cry and paper based system.

The promise of the government to list the government bond in the stock exchange for the easy access to the general public has not yet been fulfilled. This will not help to fulfill the ambitious objectives of the tenth plan to increase the dealing amount to Rs. 12 billion and market capitalization to 15% of GDP.

Table 5.2: Secondary Market Activities **Rs. in million**

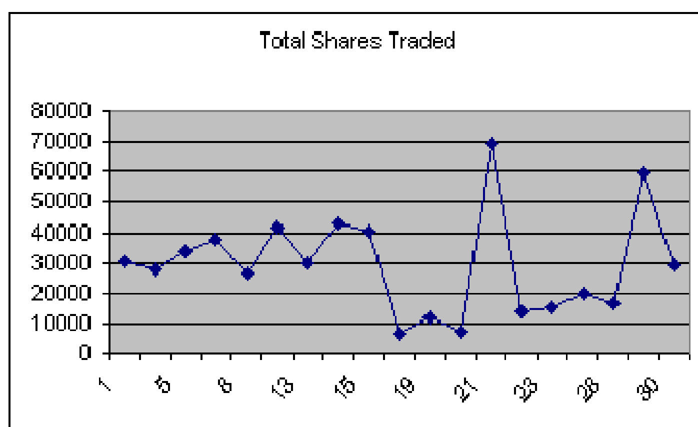
	First Eight Months		Change over
	2003-04	2002-03	previous period
Transaction Amount (Rs.)	377.3	376.2	0.3%
Market Capitalization (Rs.)	38045.6	34503.3	10.27%
Number of Shares Traded (M)	1.6	1.4	14.29%
Number of Transaction	37709	33538	12.44%
Listed Companies	113	100	13%

Source: Bhattarai, Rabindra, New Business Age, August 2004, p.15.

Annual budgets are important strategies for meeting the long-term objectives of periodic plans. But the annual budget 2004/05 lacks the appropriate strategies for meeting the objectives of 10th five-year plan. Moreover, the budget could not go for expansion of centralized stock exchange into regional stock exchange, implementation of electronic trading system as well as the electronic transfer of ownership though these programs are mentioned in the tenth plan.

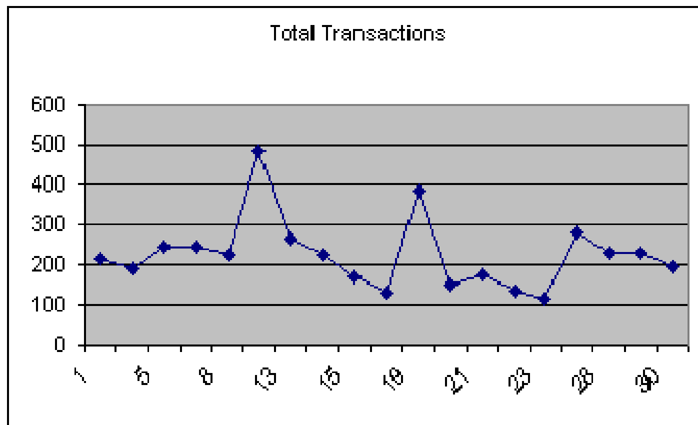
Little initiation could be a great step towards the achievement of the tenth plan objectives because the overall statistics of Nepali stock markets for the first eight months of the fiscal year 2003-04 show an increasing trend over the same period in the previous fiscal year 2002-03. This momentum needs to be maintained by proper policy support.

Figure 5.1: Total Shares Traded



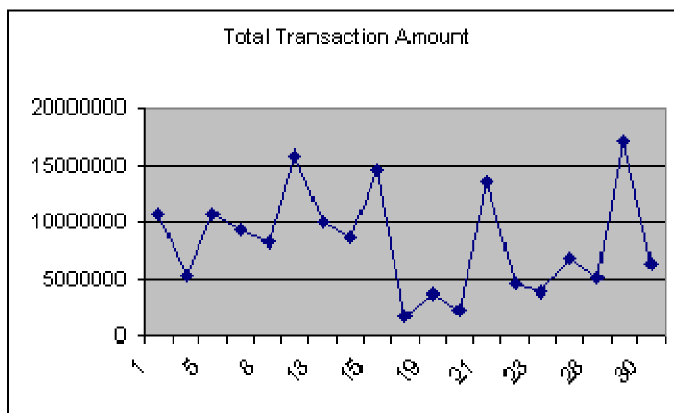
Source: Bhattarai, Rabindra, New Business Age, August 2004, p.16.

Figure 5.2: Total Transactions



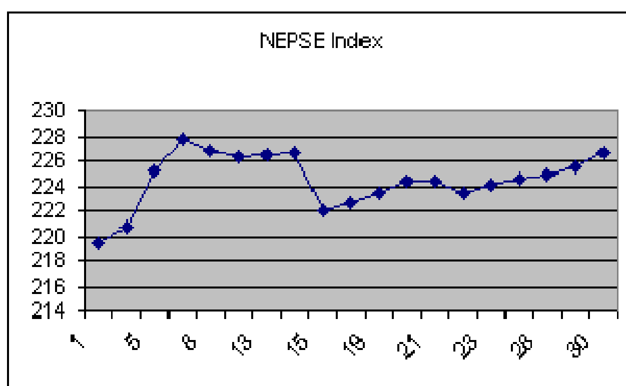
Source: Bhattarai, Rabindra, New Business Age, August 2004, p.16.

Figure 5.3: Total Transaction Amount



Source: Bhattarai, Rabindra, New Business Age, August 2004, p.16.

Figure 5.4: NEPSE Index



Source: Bhattarai, Rabindra, New Business Age, August 2004, p.16.

These statistics show that the size of Nepali Capital Market is increasing day by day. The increase in volume of shares traded, no of transactions, transaction amount all indicate the increasing participation of investors in the secondary market. To increase this participation even more, the government had to bring new strategies. Moreover, the issuance of new shares in the market is also increasing day by day and government owned big companies are going public. Listing of these scrips will definitely increase the volume of transaction as well as overall activities.

If the initiatives necessary for developing the efficiency in the market are not taken very soon, neither the government will achieve its objectives nor the stock exchange be able to avoid imminent disaster.

NEPSE Index

The NEPSE index during the month of July remained less volatile as compared to the previous month. The bullish trend of the index during second half of the June continued to July 6 reaching 227.83 and turned bearish when maoist murdered a DSP and Ward President in the capital on July 7. The bearish turn continued as it again fell by 4.57 points on July 15 and reached to 222.04 when the director of Nepal Electricity Corporation was killed in the capital on July 14. The index then turned bearish upto July 21 and fell by 1 point on July 22. This fall could not continue but turned bullish during the end of the month.

The movement of NEPSE seems to be highly affected by the political incidents and the similarity in the movement can be observed during the months of June and July. The index in the beginning of the both months is bullish and turned bearish in the middle of these months and again turned bullish during the last part of the months.

During the months of July, 560257 shares were traded. The trading volume picked on July 21 with 69129 shares due to the bulk shares transaction of Laxmi Bank Ltd. On that day 55540 shares of the bank were transacted. Lowest number of shares were transacted on July 16 with 6796 shares. Laxmi Bank Ltd. remained dominant in the market on the basis of aggregate volume of transactions for the month.

The number of transactions during the month seems consistent as compared to the volume of transaction. The transactions peaked on July 9 and the lowest was on July 23. Total

number of 4282 transactions were made during the month. During the month, the transaction amount aggregated to Rs. 158.22 million and highest transaction was made on July 29 with the amount of Rs. 17.10 million. Similarly, the aggregate market capitalization during the months reached to Rs. 696555.78 million.

In chapter six, I am giving an example (in annexture) of credit appraisal in a Nepali bank and principle procedure for good lending. Also I am providing some financial datas of few Nepali banks with the comments.

CHAPTER SIX

06. THE USUAL CREDIT APPRAISAL PRACTICES

In every bank, they have their investment policy. Within the policy, they have a strong guidelines for the staffs working in credit/investment division. To guide such staffs for maintaining descipline, the management issues an internal directives called 'Ten Commandments'.

6.1. The Ten commandments of Credit Policy Guide

For the smooth and system running of an organization and to make honest the employees in the organization, there are a good non-law rules within the system which are strictly followed by the credit personnels as known Ten Commandments:

1. You shall place a high priority on the quality of bank's credit exposure. New relationship must meet bank's credit criteria and existing portfolio should be under continuing review to improve risk positions. Bank's preference is for regularing amortizing and self liquidating loans geared to a borrower's ability to repay.

2. You shall constantly be mindful of bank's urgent need for earnings from bank's existing and new credit exposures. Every profit opportunity should be explored and negotiation skills fully employed. Innovative employment of the bank's resources to increase return on assets must be encouraged.

3. You shall be constantly alert for profitable new business opportunities that increase the size of bank's customer base. You must not under any circumtances rest on bank's existing base of customers nor direct all bank's efforts on their behalf. Growth through enlargement of bank's base is far more attractive in the long run. In our search for new customers, the stress should be on desirable ongoing relationships rather than on marginal performers.

4. Risk dispersion is basic to sound credit principles and policies. You should be careful about large and undue concentrations of credit by industry, 'one obligor' or any risk factors bearing on a group of borrowers. However, bank must not diversify itself into an unwanted or unnecessary prblem just for the sake of diversification.

5. You shall constantly be aware of the expense burden in bank's credit operation. Is there a less costly means of accomplishing the bank's mission ? What can be done to improve the cost efficiency of bank's credit operation ? Increase in customer base must be weighed against cost in terms of expense, time and service.

6. Lending desisions must consciously focus on optimizing the use of the bank's capital funds. The benefits so gained must be quantifiable, adequate and lasting, both for the bank and the borrower.

7. You shall use every effort to reduce and contain the size of bank's criticized loan portfolio. This is time killer and the very root of bank's losses.

8. Credit 'quality' is heavily impact by the structure of the credit. The risks of trouble along the line are increased materially as bank erodes basic protections which are designed th enable a timely and comfortable payback within the borrower's ability.

9. You shall endeavour to improve both the bank's external and internal communications to limit unnecessary time and effort amongst the bank's customers and associates. Clear, concise and summary type communication should be emphasized and utilized where necessary.

10. You shall endeavour to make a contribution to all matters that involve your approval, concurrence or other action. On the other hand, you shall not lend your name marely to see it in print. You shall avoid alltemptations which can jeopardize or compromize the bank's risk assets.

6.2. Guidelines

Every bank and financial institution has a guidelines or a credit policy guide for appropriate use of credit system within the organization. The policy is prepared by the individual bank and financial institution based on the country's financial policy and the central bank's directives. After preparation of the policy the approval from the central bank should be taken.

All the credit facilities from such banks and financial institutions have been providing on the basis of the above said policy. But the system of individual bank and financial institution is different. A credit policy guide of one bank focuses on one factor then another bank's credit policy guide focuses on the another factor. Principally, it should not have much more deviation between the organizations, which is the major issue in credit systems in Nepalese banking. If it has more deviation between the banks then the standard of credit system and appraisal, risk measurement, monitaring and controlling is also a vast different.

6.3. An Example of a Credit Appraisal in a Nepalese Bank

In this section, I am trying to give an example of a credit appraisal prepared by the Nepalese bank and/or a financial institution in Nepal. I will not give the exact name of the bank or financial institution and the name of the borrowers, but try to give the exact appraisal system which have been used in most of the Nepalese banks/financial institution. I will analyze where the bank or financial institutions are focusing in preparing their credit appraisal on borrowers (Annex.-III).

Comparison of Financial Data Between Some Nepali Banks:

I have taken some financial statements of the Nepalese banks for some illustrations and observations for comments. Here, I would like to compare the financial statements of four different banks operating in the country. They are two big semi-government and government banks (Nepal Bank Limited and Rastriya Banijya Bank) and two joint venture private banks (NABIL Bank Limited and Standard Chartered Bank Nepal Limited).

The two government banks are the problematic ones but still in operations which are now under the financial sector reform programmes assisted by World Bank and International Monetary Fund (IMF) to the government.

Table 6.1: Nepal Bank Limited.
Balance Sheet

NPR in million (mid July)

Capital and Liabilities	**2001**	**2002**	**Assets and Properties**	**2001**	**2002**
Share Capital	380	380	Cash in Hand	1783	1665
Reserve & Funds	(6735)	(9934)	Bank Balances	4484	4962
Borrowings	211	213	Money at Call	1650	1544
Deposits	35619	34265	Investments	6776	7151
Bills Payables	88	120	Loans,Advances & Bills Purchased	11919	8638
Other Liabilities	12029	14349	Fixed Assets	147	140
			Other Assets	14833	15293
	41592	**39393**		**41592**	**39393**

Source: Financials of Nepal Bank Ltd, 2001 and 2002.

Table 6.2: Nepal Bank Limited.

Profit & Loss Account

NPR in million (mid July)

Expenses	**2001**	**2002**	**Incomes**	**2001**	**2002**
Interest Expenses	1835	1713	Interest Income	2383	1527
Staff Expenses	871	1228	Commission and Discount	234	241
Office Overhead Expenses	159	159			
Exchange Loss			Exchange Gain	134	184
Non-operating Expenses			Non-operating Income	121	125
Bad Debt Written off			Other Income	8	66
Provision for Loan Loss	2193	2114			
Provision for Staff Bonus					
Provision for Income Tax					
Net Profit			Net Loss	2178	3071
	5058	**5214**		**5058**	**5214**

Source: Financials of Nepal Bank Ltd, 2001 and 2002

Table 6.3: Rastriya Banijya Bank

Balance Sheet

NPR in million (mid July)

Capital and Liabilities	**2002**	**2003**	**Assets and Properties**	**2002**	**2003**
Share Capital	1172	1172	Cash Balance	850	1019
Reserve Funds	(18624)	(23564)	Bank Balance	3676	2717
Borrowings	156	162	Money at Call and Short Notice		740
Deposits	38993	39402	Investments	4159	4623
Bills Payables	20	16	Loans, Advances & Bills Purchase	13690	11679
Other Liabilities	23252	25567	Fixed Assets	403	479
			Other Assets	22191	21498
	44969	**42755**		**44969**	**42755**

Source: Financials of Rastriya Banijya Bank, 2002 and 2003.

Table 6.4: Rastriya Banijya Bank

Profit & Loss Account

NPR in million (mid July)

Expenses	**2002**	**2003**	**Incomes**	**2002**	**2003**
Interest Expenses	2347	2108	Interest Income	1745	2051
Employee Expenses	759	3249	Commision and Discount	215	211
Office Expenses	243	245			
Exchange Loss			Exchange Gain	78	3
Non-operating Expenses			Non-operating Income	7	7
Bad Debt Written off			Other Income	78	84
Provision for Loan Loss	5842	1594			
Provision for Staff Bonus					
Provision for Income Tax					
Net Profit			Net Loss	7068	4840
	9191	**7196**		**9191**	**7196**

Source: Financials of Rastriya Banijya Bank, 2002 and 2003.

As shown in table 6.1, 6.2, 6.3 and 6.4 are the balance sheets and profit and loss account statements of Nepal Bank Ltd. and Rastriya Banijya Bank, the semi government and government banks respectively. They are in heavy loss since the long time back. Their Non-Performing Asset (NPA) is almost more than 25% but now in decreasing trend. Five years before it was around 40-50%. Their total loss is still 26.14 and 20.1 times larger than their equity capital respectively. It is felt that the situation is due to the poor management and political interference. So, the central bank decided to give the management to the foreign banks which has been under working terms since the last two years. The loan loss provision of Nepal Bank Ltd. has increased from 18.4% to 24.47% of the total loan outstanding in the year 2001 to 2002 whereas Rastriya Banijya Bank has decreaed it from 42.67% to 13.65% of the total loan outstanding in the year 2003 to 2003. The result of 2003 of Nepal Bank Ltd. is yet to publish. The net loss of Nepal Bank Ltd is still increasing by 41% from year 2001 to 2002 whereas Rastriya Banijya Bank has noticeably decreased its total loss by 31.52% from the year 2002 to 2003. As recently announced by

the central bank's Governor, that the situation is little bit better but not satisfactory. However, the working term is extended for next one year, because it is going ahead to the right direction. The funding is provided by the World Bank as loan to the nation.

Table 6.5: NABIL Bank Ltd.

Balance Sheet

NPR in million (mid July)

Capital and Liabilities	**2001**	**2002**	**Assets and Properties**	**2001**	**2002**
Share Capital	492	492	Cash in Hand	208	318
Reserve & Funds	571	655	Bank Balnace	604	734
Borrowings		417	Money at Call and Short Notice	523	31
Deposits	15839	15506	Investments	7704	8199
Bills Payable	70	68	Loans, Advances & Bills Purchased	7733	7438
Other Liabilities	799	491	Fixed Assets	249	238
			Other Assets	750	671
	17771	**17629**		**17771**	**17629**

Source: Financials of Nabil Bank, 2001 and 2002.

Table 6.6: NABIL Bank Ltd.

Profit & Loss Account

NPR in million (mid July)

Expenses	**2001**	**2002**	**Incomes**	**2001**	**2002**
Interest Expenses	578	462	Interest Income	1267	1120
Staff Expenses	147	145	Commissions and Discounts	97	114
Office Expenses	123	137			
Exchange Loss			Exchange Gain	159	154
Non-operating Expenses			Non-operating Income	2	
Bad Debt Written off			Other Income	15	251
Provision for Loan Loss	166	442			
Provision for Staff Bonus	53	44			
Provision for Tax	182	138			
Net Profit	291	271	Net Loss		
	1540	**1639**		**1540**	**1639**

Source: Financials of Nabil Bank, 2001 and 2002.

Table 6.7: Standard Chartered Bank Nepal Ltd. (SCBN)

Balance Sheet

NPR in million (mid July)

Capital and Liabilities	**2001**	**2002**	**Assets and properties**	**2001**	**2002**
Share Capital	339	339	Cash Balance	188	258
Reserve & Funds	773	896	Bank Balance	773	567
Borrowings	1667	685	Money at Call & Short Notice	2612	2062
Deposits	15430	15836	Investment	9559	9276
Bills Payables	35	51	Loans, Advance & Bills Purchased	5407	5364
Other Liabilities	839	636	Fixed Assets	122	101
			Other Assets	422	815
	19083	**18443**		**19083**	**18443**

Source: Financials of SCBN, 2001 and 2002.

Table 6.8: Standard Chartered Bank Nepal Ltd. (SCBN)

Profit & Loss Account

NPR in million (mid July)

Expenses	**2001**	**2002**	**Incomes**	**2001**	**2002**
Interest Expenses	474	300	Interest Income	1227	1014
Staff Expenses	102	127	Commission and Discounts	187	163
Office Expenses	225	191			
Exchange Loss			Exchange Gain	215	228
Non-operating Expenses		18	Non-operating Profit		
Bad Debt Written off	1	1	Other Income	33	42
Provision for Loan Loss	100	75			
Provision for Staff Bonus	86	72			
Provision for Tax	243	184			
Net profit	431	479	Net Loss		
	1662	**1447**		**1662**	**1447**

Source: Financials of SCBN, 2001 and 2002.

Table 6.5, 6.6, 6.7 and 6.8 are the balance sheets and profit and loss accounts statements of two successful joint venture banks in the country. All the figures of both banks show their managerial capacity which is the example for others. In the mean time, the loan loss provisions of NABIL Bank Ltd and Standard Chartered Bank Nepal Ltd. have 5.94% and 1.40% respectively of their total loan portfolio in the year 2002. They were 2.14% and 1.84% respectively in the year 2001. Due to the increment of loan loss provision, the net profit of NABIL Bank Ltd. has been affected which is decreased by 6.87% in the year 2002 in comparison to year 2001.

It advises the efficiency of the private sector and joint venture banks and the inefficiency of government owned banks.

6.4. Principles of Good Lending

There are a few general principles of good lending which every banker follows when appraising an advance proposal. Source: Bedi, H.L.and Hardikar, V.K., 1968, Eighth Edition, p. 25.

i. Safety: 'Safety first' is the most important principle of good lending. When a banker lends, he must feel certain that the advance is safe; that is, the money will definitely come back. For example, if the borrower invests the money in an unproductive or speculative venture, or if the borrower himself is dishonest, the advance would be in jeopardy. Similarly, if the borrower suffers losses in his business due to his incompetence, the recovery of the money may become difficult. The banker ensures that the money advanced by him goes to the right type of borrower and is utilized in such a way that it will not only be safe at the time of lending but will remain so throughout, and after serving a useful purpose in the trade or industry where it is employed, is repaid with interest.

ii. Liquidity: It is not enough that the money will come back; it is also necessary that it must come back on demand or in accordance with agreed terms of re-payment. The borrower must be in a position to repay within a reasonable time after a demand for repayment is made. This can be possible only if the money is employed by the borrower for short-term requirements and not locked up in acquiring fixed assets, or in schemes which take a long time to pay their way. The source of repayment must also be definite. The reason why bankers attach as much importance to 'liquidity' as to 'safety' of their funds, is that a bulk of their deposits is repayable on demand or at short notice.

iii. Purpose: The purpose should be productive so that the money not only remains safe but also provide a definite source of repayment. The banker must closely scrutinize the purpose for which the money is required, and ensure, as far as he can, that the money borrowed for a particular purpose is applied by the borrower accordingly.

iv. Profitability: Equally important is the principle of 'profitability' in bank advances. Like other commercial institutions, banks must make profit. They have to pay interest on deposits received by them. They have to incur expenses on

establishment, rent, stationery, salary, etc. They have to make provision for depreciation of their fixed assets, and also for any possible bad or doubtful debts. After meeting all these items of expenditure which enter the running cost of banks, a reasonable profit must be made; otherwise, it will not be possible to carry anything to the reserve of pay dividend to the shareholders. It is after considering all these factors that a bank decides upon its lending rate.

v. **Collateral/Security:** It has been the practice of banks not to lend as far as possible except against security. Security can be considered as an insurance. Security may be generally classified as personal and tangible, as well as primary and collateral. The banker carefully scrutinizes all the different aspects of an advance before granting it. At the same time, he provides for an unexpected change in circumstances which may affect the safety and liquidity of the advance.

vi. **Spread:** Another important principle of good lending is the diversification of advances. An element of risk is always present in every advance, however secure it might appear to be. In fact, the entire banking business is one of taking calculated risks and a successful banker is an expert in assessing such risks. He is keen on spreading the risks involved in lending, over a large number of borrowers, over a large number of industries and areas, and over different type of securities.

vii. **National interest:** Even when an advance satisfies all the aforesaid principles, it may still not be suitable. The advance may run counter to national interest. In the changing concept of banking. factors such as purpose of the advance, viability of the proposal and national interest are assuming a greater importance than security, small borrowers, and export-oriented industries.

6.5. Recovery of Advances

In whatever form bank advances are granted, they are repayable on demand or at the expiry of some fixed period. Like, Bills of Exchange discounted are payable on maturity. Overdrafts and Cash Credit are legally repayable on demand, although the bank seldom exercises the right except in circumstances mentioned below. Loans are repayable on the expiry of the periods for which they are granted. In case the loan is repayable in

installments and default occurs in the payment of any installment, the entire loan usually becomes immediately recoverable at the option of the bank.

Recalling of Advances:

Banks conduct a regular scrutiny of all advances and ensure that timely action is taken in each case either for the continuance of the facility on the existing terms, or with such modifications as may be considered necessary, or for the recovery of the amount if it is decided not to continue the facility. Advances are usually recalled under the following circumstances:

i. Death of the borrower or the guarantor.
ii. Insolvency of the borrower or the guarantor, orliquidation of the borrowing company.
iii. Dissolution of the partnership.
iv. Failure to renew the documents sufficiently before the expiry of the period of limitation. The bank cannot afford to wait till the last day when the period of limitation expires.
v. Want of satisfactory turnover, or deterioration of the security.
vi. Failure to adhere to the terms and conditions of the sanction in spite of the bank's repeated requests.
vii. Deterioration of the financial position of the party. If it comes to the notice of the bank that the party has committed a fraud or has heavily speculated, it will be an adverse factor and the bank may consider recalling the advance.
viii. Failure to maintain adequate margin in spite of requests to the borrower.
ix. Change in the bank's policy regarding certain types of advances. The bank may at any time decide to restrict advances against certain commodities because of their overproduction or the fear of an expected slump.
x. The Central Bank, sometimes directs banks to withdraw or restrict advances against certain commodities in short supply. In that case the particular accounts will have to be partially or wholly marked for adjustment, as may be necessary or advisable.
xi. There may also be other reasons for withdrawing the facility i.e. the law and order situation at a certain place is such that it may be risky to continue the advance there.

In the cases stated above, the bank endeavours to recover the advance by making a formal demand, and thereafter, if necessary, by putting pressure on the borrower or his/her legal representative, as the case may be, with a threat of legal action. If there is guarantor, he is also called upon to adjust the account or have it adjusted by the principal. The party may come round and make a proposal for repayment, may be by installment and request for a time to implement it. He may agree to offer additional security or a respectable guarantor of means. The banker should carefully scrutinize the proposal and if he considers that the debt could be recovered without resorting to litigation, he may agree. Much will, however, depend on the honesty of purpose of the borrower and his financial position at that time. If he is already heading towards insolvency, any indulgence shown to him may further complecate matters for the bank. If the threat of litigation does not have the desired effect, the bank may consider filing a suit. It must, however, be known that legal proceedings entile a good deal of delay and expense and the results in the long run may not generally be satisfactory.

CHAPTER SEVEN

07. CREDIT CONTROL AND ADMINISTRATION

7.1. Risk Rating

A risk rating is a number based on a sliding scale for one (best) to ten (worst) and PAYDEX (Annex-IV) which reflects the bank's assessment of a degree of risk to the bank existing in a given credit exposure. By using PAYDEX Score key, the bank measures the payment performance of the borrower. For example, if the borrower pays his/her obligation in advance then his/her PAYDEX score can be measured as 90-100 or if the borrower pays his/her obligation after 90 days and by 180 days then his/her PAYDEX score is measured as 30. The credit exposure normally measured in terms of a risk rating is that of a borrower (borrower risk rating), a single credit facility (facility risk rating), or that of an overall credit relationship (obligor risk rating). To serve bank's objective of being on top of bank's portfolio quality, risk rating is intended to be adjusted on an on-going basis to reflect the current risks associated with a particular borrower.

a. Borrower risk rating

The borrower risk rating represents an evaluation of the borrower on an unsecured basis, however if the bank would only lend a particular borrower on a secured basis, the degree and nature of such protection should be factored into the borroer risk rating. Addionally, to determine the appropriate borrower risk rating in each case, it is necessary to define the business characteristics of the borrower in question. The appendix defines the each risk rating.

b. Facility risk rating

A facility risk rating is a risk rating applicable to a single credit facility. Facility risk rating for non-criticized credit facility run from 1-7, while facility risk ratings for criticized credit facilties are graded from 7 (special mention)-9 (sub-standard) and to 10 (doubtful or loss). An example of a facility risk rating of 1 would be a loan fully cash collateralized by cash denominated in the same currency and safe kept by the lending unit extending the credit, whereas a faciltiy risk rating of 2 would be for a loan fully cash collateralized in the same currency, but the collateral is lodged in another location than where the loan is booked.

A risk rating is a number based on a sliding scale from 1 (best) to 10 (worst) which reflects the bank's assessment of the degree of risk to the bank existing in a given credit exposure. Risk rating will be adjusted an on going basis to reflect the current risks associated with a particular facility. In determination of facility risk rating, it is useful to factor risks into the one associated with a borrower and those associated with collateral and other factors such as type of business, economic environment, etc.

c. Description of risk rating categories

i. Exceptional: Exceptional degree of stability, substance and diversity. Strong fundamental balance sheet with continuous significant cash flow demonstrated throughout the business or industry cycle. Both size and market position give obligor unquestioned access to financial markets. Obligation in this category would typically be rated AAA by the major rating agencies.

ii. Excellent: High degree of stability, substance and diversity. The balance sheet and operations are slightly more prone to diversity within the business or industry cycle.

Ready access to financial markets. An AA rating would be typical of obligors in this category.

iii. **Strong:** Strong market and financial position with history of successful performance, but more susceptible to economic and market changes. Stability, substance and diversity are still characteristics, but some exceptions may exist. Has access to financial market conditions. An A/A- rating would be typically of this category.

iv. **Good:** Comfortable asset coverage and cash flow protection, but may be susceptible to cyclicle changes. More concentration of business risk, by product or market, may be present. May have limit access to financial markets. An A-/B+ rating would be typical of this obligor.

v. **Satisfactory:** Assets and cash flow protection are reasonably sound. Risk elements exist and more likely to be reflected in volatility of earnings and overall performance. Alternative financing is available, but may be limited to private or institutional sources. A BBB rating could be used for this category.

vi. **Adequate:** Acceptable asset protection and cash flow provide reasonable prospect of orderly payout. Nevertheless, risk elements are sufficiently pronounced to make future performance and the ability to attract alternative financing uncertain. Alternative financing may be difficult to source. Financial strength is at a level generally considered to be minimally acceptable for a new customer.

vii. **Marginal:** Unfavourable industry or company specific risk factors represent a concern. Operating performance and financial strength may be marginal, and it is unlikely that the obligor can attract alternative sources of financing. Considering all weaknesses and mitigating factors, there is an expectation that conditions will improve and the risk rating will be upgraded.

viii. **Special mention:** Potential and emerging weaknesses create unacceptable business risk. Concern center on the potential for a continuation of unfavourable economic, market or borrower's specific conditions or trends, which may effect future debt

service capacity. Defects in loan documentation, collateral control and financial information may also be a factor. Weaknesses are not pronounced and do not represent an imminent or serious threat to orderly repayment or asset protection. Nevertheless, greater than normal management attention is warranted to ensure a continuance of cash flow and asset value protection. Must posses potential for improvement and upgrading.

ix. **Substandard:** Loans are inadequately protected by the current sound worth and paying capacity of the obligor or by any collateral pledged. Loans so classified must have a well defined weakness or weaknesses that may jeopardize the liquidation of the debt. They are characterized by the possibility that the bank will sustain some loss (of principal and/or interest) if the deficiencies are not corrected.

x. **Doubtful:** Loans have all the weaknesses inherent in those classified as substandard with the added characteristic that existing facts, conditions and values make collection or liquidation in full improbable. The extent of the probable loss cannot be quantified at this time. Although the possibility of loss is significant, there may be certain important and reasonably specific pending factors include merger, acquisition, liquidation procedures, capital injection, additional collateral, new financing sources, and/or additional guarantors. All loans in this category must be in non-accrual.

xi. **Loss:** Represents loans or portions of loans which are determined to be uncollectible. While there may be some long-term salvage of recovery potential. Prospects are not sufficiently assured to support continuance as a bankable asset.

7.2. Internal Review

During any period of time, the credit officer/manager is in receipt of the financial statement of the borrower(s) and in the event a material adverse condition has been determined, and for the timely recognition of problem loan. The credit officer/manager should immediately classify the loan and justify the risk rating change accordingly. It is the purpose of the internal review.

a. Monthly review:

A credit meeting should be conducted on a monthly basis during which time the credit/loan officer would have the opportunity to openly discuss with the panel (bank management that includes General Manager, Deputy General Manager-Credit and Credit Manager) the risk rating change for borrower(s) whose financial condition, debt servicing capacity and collateral and/or other factors which would have a negative impact on the loan/relationship.

b. Quarterly review:

A quarterly review of the entire loan portfolio is mandated. Again the panel consisting of the General Manager, Deputy General Manager and Credit Manager togather with the other credit/loan officers would participate in an open quorum to evaluate every loan/relationship and assign a risk rating associated with each relationship.

During the quarterly review, a 'criticized asset report' for each adversely graded relationship must be completed with a well-defined action plan and target dates incorporated to ensure that the borrower(s) comply with the bank's intentions to cure the problem. Once the portfolio review has been completed and the assignment of a risk rating for each relationship has been finalized, and based on the input, the loan loss reserve would be calculated accordingly for the next financial quarter end as per the NRB directive.

c. Annual review:

The purpose of an annual review is to analize each obligor's recent financial performance, to determine the appropriateness of its existing credit facilities, and to discuss the recommended Credit Exposure Strategy (CES) and Obligor Risk Rating (ORR) including any changes thereto. Each credit/loan officer must perform an annual review of their relationship and must make a determination of CES for each account.

A CES is a reflection of the bank's attitude towards doing business over the foreseeable future with a borrower, based on the outlook for the obligor's principal business, the bank's exposure to that industry, the obligor's financial condition and the bank's assessment of management's performance. Each borrower should be assigned a CES as part of the annual review process. The categories, CONTINUE, EXTEND, CURTAIL and OUT will be the standard term used for all relationships.

The amendment on CES is to be reported to the higher management.

In addition, the annual review should involve the determination of client's past performance and the anlysis od the latest financial statements.

d. Subject areas for review:

The following areas are to be considered in the loan review process:

- Loan repayment records
- Uses of borrowed funds
- Financial statements
- Collateral
- Borrower's business
- Trend of industry
- Loan concentrations
- Document review
- Compliance with the terms and conditions as per contract
- Compliance with the bank's loan policy
- Compliance with laws and regulations

7.3. Problem Loans Management

a. problem loans:

Criticized facilities[8] as classified in sub-chapter 7.1.c should be recognized by all lending personnel as those that present the greatest risk of future loss and as such should be given special attention in all aspects of bank's credit process.

The responsibility for identifying and self-criticizing problem facilities rests with credit/loan officers. Under no circumtances should the fact that a loan is criticized be revealed to the borrower or any outside party, including other creditors. Information must be kept current and special attention must be given to all proposed changes in terms of

[8] An internal format or report of loan categorization

conditions. It is the responsibility of credit control officers to constantly strive to improve the bank's position to lessen the chance of worsening conditions leading to a possible loss.

Criticized facilities are categorized into the following four levels of criticism (the last three of which are described as 'classified'):

- Special mation (risk rating 08)
- Substandard (risk rating 09)
- Doubtful (risk rating 10)
- Loss (risk rating 10)

The documents and collateral of any facility subject to criticism must be carefully reviewed at the time of criticism, and at least on an annual basis thereafter.

The policy of the bank is to discontinue accrual of interest income on loans where it is determined that reasonable doubt exists with respect to the timely collectibility of such interest and/or principal. Such loan should be risk rated 09 at a minimum. It is the responsibility of the credit officer to make this determination promptly and to place on non-accrual status loans falling into this category.

The loan is placed on non-accrual if either:

- the loan is maintained on a cash basis because of deterioration in the financial position of the borrower, or
- payment in full of principal or interest on the loan is not expected, or
- payment in full of interest or principal on the loan is past due 90 days or more, or
- the loan is whole or in part is classified as doubtful.

When any loan or portion thereof, is deemed to be uncollectible, it should be immediately recommended for charge-off (to be approved by board of directors). Quarterly reviews of charge-off recommendations will be made on or about the end of each quarter. Under no circumstances should the fact that all or any portion of a loan that has been charged-off be revealed to a borrower, nor should the borrower be informed that the loan is on a non-accrual basis.

The following procedures have been designed to monitor problem loans:

- Each credit/loan officer would be proveded a copy of the monthly past due report. Upon receipt of the report, he/she would immediately determine the cause for the past due payment by contacting the borrower(s) and establish a definitive time frame for the borrower to cure the delinquency.
- A 'problem loan checklist' must be completed to determine the cause and the corrective action plan to cure the problem. The deadline to cure the problem should be noted on the 'loan management checklist' as a follow up to ensure that the borrower(s) meet the target dates. A copy of the 'problem loan checklist' and the 'loan management checklist' are to be forwarded to the Credit Manager for control purpose.
- Each credit/loan officer will be responsible to complete the 'classified/criticized asset report' for all adversely graded loans (09 or worse) on a quarterly basis.

The 'classified/criticized asset report' should identify the weaknesses and implement an action plan and contingency plan with specific target dates to cure the problem.

The following are the signs of potential problem:

- Missing payment
- Request for loan renewal
- Adverse financial trend
- Depreciation of collateral value
- Appearance of other creditors and credit inqueries
- Illness or death of the borrower
- Damages of business from fire or natural disaster
- Industry trend facing downward
- etc.

b. Workout arrangement:

There a number of arrangements that the bank can bring into use. The choice of a particular arrangement or a combination of them depends on the nature of each problem loan.

- Restructuirng by reducing monthly payment, extending maturity, give some grace period, etc
- Request additional collateral
- Obtaining guarantees
- Advance additional funds that borrower may need more working capital to keep his business operational
- Encourage the borrower to increase capital
- Provide financial advisory such as how to manage inventories and account receivables more effectively and how to raise funds in financial market, etc
- Management control that the bank may send its team to participate in the management of the borrower's business
- Merger with other business entity may help improved the situation.

c. Liquidation:

Liquidation must be sought immediately in case where it is obvious that the borrower is unwilling to repay the loan or when dishonesty or fraud has been detected. The deteriorating financial conditions of the borrower to the point of hopelessness may warrant liquidation action. Liquidation action includes legal actions.

d. Accounting procedure for problem loans:

i. Past due loans (no credit approval is required)

When the loan has been past due for 90 days and more:

Debit - Past due loans

Credit - Loans

ii. Non-accruals (no credit approval is required)

When the loan is placed on non-accruals, the interest being accrued upt to this date will reversed against interest received for current period (the criteria for placing loans on non-accrual basis is stipulated in the bank's credit policy guide):

Debit - Interest received – loans

Credit - Interest receivables – loans

iii. Reserved for possible loan losses (credit approval from the board of directors is required):

iv. Liquidation (credit approval is required)

When the loan is placed on liquidation process:

Debit - Liquidation loans

Credit - Past due loans or

Credit - Loans (in case where the loan is not past due but circumstances warrant liquidating action)

v. Charge-off (credit approval from the board of directors is required)

Debit - Allowances for loan losses

Credit - Past due loans or

Credit - Liquidation loans

vi. Loan-loss recovery

Debit - Cash

Credit - Allowance for loan losses.

7.4. Internal Control

a. General internal control guidelines:

There should be the clear assignment of responsibilities for carrying out each activity. The approval authority must be delegated in writing.

There should be at least two persons involved in the processing of each activity. No transaction should ever be processed by only one person from the beginning to the end.

To prevent possible irregularities, the separation of responsibility for the following activities are desirable (the application of this guideline is flexible, depending on the branch organizational structure and the availability of its human resources):

- Loan analysis
- Loan processing and administration
- Appraisal of collateral
- Loan approval
- Loan collection

- Loan review

Loan review function must be performed regularly and independently. It is desirable that a person(s) conducting loan review should not be involved in loanextention process.

Periodic conformation of loan balance by customer is necessary.

Perodic rotation of works among employees to prevent the cover up or irregularities.

Periodic report to the manager and the head office.

b. Reporting:

i. Report to the General Manager and Deputy General Manager-Credit:

Monthly:

Loan Outstanding:

- by borrowers
- by facilities
- by interest rate
- by maturity
- by currency

Quarterly:

Loan review that inclides:

- past due loans
- problem loans and follow ups
- loan risk ratings (upgrading and downgrading)
- loan liquidation, charge off and recovery

Report on new accounts and account closing

Half yearly:

- loan risk rating of entire portfolio.

ii. Report to the higher management (board):

Monthly:	Report from
- bad debt and bad debt recovery report	Account Dept.
- loan summary	Account Dept.
Quarterly:	
- past due loan	Credit Dept.
- classified assets	Credit Dept.
- Problem loan watch list	Credit Dept.
Half yearly:	
- report of advances (businesswise)	Credit Dept.
- Report of advances (maturitywise)	Credit Dept.
- past due & non-accrual loans	Credit Dept.
- Credit report/charge off loans	Credit Dept.

CHAPTER EIGHT

08. RISK MANAGEMENT

8.1. Credit Risk Management Policy

Notwithstanding structural changes that have taken place in business line of the banks, the core business – gatering deposits and extending credit – still represents the heart of banking. Nevertheless,disintermediation halted this core business, as both deposits and loans have lost to competing instruments, such as Certificate of Deposits, commercial Papers, Bonds, Mutual Funds etc. In addition, by separating the origination of credit from its funding and securitization presents banks with the opportunity to remove credit, liquidity and interest rate risks embadded in their balance sheets.

Credit risk is the most common cause of bank failures, causing virtually all regulatory environments to prescribe minimum standards for credit risk management. The basis of sound credit risk management is the identification of the existing and potential risks inherent in lending activities. Specific credit risk management measures typically include three kind of policies like reduce credit risk, asset classification, and loss provisioning.

Yes, of course, liquidity risk has also the almost same degree of bank failures. Liquidity risk management lies at the heart of confidence in the banking system. The importance of liquidity trascends the individual institution, since a liquidity shortfall at a single institution can have system-wide repercussions. Banks transform the term of their liabilities to have different maturities on the asset side of the balance sheet. At the same time, banks must be able to meet their commitments (such as deposits) at the point at which they come due. The contractual inflow and outflow of funds will not necessarily be reflected in actual plans and may vary in different times. A bank may therefore, experience liquidity mismatches, making its liquidity policies and liquidity risk management in its business strategy.

The assessment of a credit risk management function should consider loans and all other extensions of credit (on and off balance sheet) to ensure that the following factors are considered: Source: Greuning, Hennie van and Bratanovic, Sonja Brajovic, 2000, p. 142.

- the level, distribution and severity of classified assets,
- the level and composition of nonaccruing, nonperformaing, renegotiated, rolled over, and redused rate assets,
- the adequacy of valuation reserves,
- management's ability to administer and collect problem assets,
- undue concentrations of credit,
- the adequacy and effectiveness of, and adherence to, lending policies and credit administration procedures,
- the adequacy and effectiveness of a bank's process for identifying and monitoring initial and changing levels of risk, or risk associated with approved credit exposure.

8.2. Credit Portfolio Management

The portfolio risk in turn comprises intrinsic risk and concentration risk. While intrinsic risk is inhaerent in certian type of lending like credit card etc., the prtfolio risk refers to risk exposure due to disproportionate concentration of loans to specific industries, sectors, regions or types. Lenders also take on interest rate and liquidity risks. The symptoms of liquidity crisis in any bank can be traced to excessive credit risk, manifested in heavy loan losses.

The credit risk of a bank's portfolio depends on two sets of factors – external and internal. The external factors are the state of the economy, natural calamities, nationwide strike, Government's policy, business cycles, sector/industry recession etc. The banks can, however, influence the adverse effects of these factors on their performance (earnings, NPA and loan losses) through safe and sound lending policies and attitude towards risk taking (diversified credit portfolio, careful credit analysis, loan syndication, consortium, etc.).

Managerial philosophy, loan policy – high propensity to assume risk or granting of loans with high probability of default, loan volume – high ratio of loan to total assets, loan mix, lax procedures and unsound prevention strategies and unexperienced credit officers are the internal factors influencing credit risk.

Bank supervisors place considerable importance for formal policies laid down by the board of directors and diligently implemented by management. This emphasis is most critical with regard to the bank's lending function which stipulates that a bank must adopt a sound system for managing credit risk. A lending policy should contain an outline of the scope and allocation of bank's credit facilities and manner in which a credit portfolio is managed, i.e. how loans are originated, serviced, supervised and collected. A good lending policy is not overly restrictive, but allows for the presentation of loans to the board that officers believe are worthy of consideration but which do not fall within the parameters of written guidelines. Flexibility must exist to allow for fast reaction and early adaptation to changing conditions in a banks earning assets mix and market environment.

Consideration that form the basis for sound lending policies include the following:

i. **Limit on total outstanding loans:** A limit on the total loan portfolio is usually expressed relative to deposits, capital or total assets. In setting such a limit, factors such as credit demand, the volatility of deposits and credit risks should be considered.

ii. **Geographic limits:** This limits are usually a dilemma. If a bank lacks understanding of its diverse markets and does not have quality management, geographic diversification may become a reason for bad loan problems. On the

other hand, the imposition of strict geographical limits can also create problems, particularly in the case of regions with narrow economies. In any case, a bank's business market should be clearly delineated and commensurate with its market knowledge, managerial and staff experience. Bank's officers should be fully aware of specific geographical limitations for lending purposes, an aspect that is particularly relevant for new banks.

iii. **Credit concentrations:** A lending policy should stimulate portfolio diversification and strike a balance between maximum yield and minimum risk. Concentration limits usually refer to the maximum permitted exposure to a single client, connected group and sector of economic activities. This is especially important for small, regionally oriented or specialized banks. A lending policy should also require that all concentrations be reviewed and reported on a frequent basis.

iv. **Distribution by category:** Limitations based on aggregate percentage of total loans in commercial, real estate, consumer or other credit categories are common. Policies related to such limitations should allow for deviations that are approved by the board.

v. **Types of loans:** A lending policy should specify the types of loans and other credit instruments that the bank intends to offer to clients and should provide guidelines for specific loans. Decisions about types of credit instruments should be based on the expertise of lending officers, the deposit structure of the bank and anticipated credit demand. Types of credit that have resulted in an abnormal loss should be controlled by senior management or avoided completely.

vi. **Maturities:** A lending policy should establish the maximum maturity for each type of credit and loans should be granted with a realistic repayment schedule. Maturity scheduling should be determined in relation to the anticipated source of repayment, the purpose of the loan and the useful life of the collateral.

vii. **Loan pricing:** Rates of various loan types must be sufficient to cover the costs of funds, loan supervision, administration (including general overhead) and probable losses. At the same time, they should provide the reasonable margin of profit. Rates

should be periodically reviewed and adjusted to reflect changes in costs or competitive factors. Rate differentials may be deliberately maintained either to encourage some types of borrowers to seek credit elsewhere or to attract a specific type of borrower. Guidelines for other relevant procedures, such as the determination of fees on commitments or penalty interest rates are also an element of pricing policy.

viii. **Lending authority:** Lending authority is often determined by the size of the bank. In smaller banks, it is typically centralized. In order to avoid delays in the lending process, larger banks tend to decentralize according to geographical area, lending products and types of customer. A lending policy should establish limits for all lending officers. If policies are clearly established and enforced, individual limitations may be somewhat higher than would normally be expected, depending on the officer's experience and tenure with tha bank. Lending limits could also be based on group authority which would allow a committee to approve larger loans. Reporting procedures and the frequency of committee meetings should be specified.

ix. **Appraisal process:** A lending policy should outline where the responsibility for appraisala lies and should define formal, standard appraisal procedures, including reference to reappraisals of renewals or extensions. Acceptable types and limits on the amount of appraisal should be outlined for each type of credit facility. Circumtances requiring appraisals by qualified independent appraisers should also be described. The ratio of the amount of the loan to the appraised value of both the project and collateral, as well as the method of valuation and differences among various types of lending instruments should be detailed. A lending policy should also contain a schedule of downpayment requirements, where applicable.

x. **Maximum ratio of loan amount to the market value of pledged securities:** A lending policy should set forth margin requirements for all types of securities that are accepted as collateral. Margin requirements should be related to the marketability of securities. A lending policy should also assign responsibility and establish a timetable for periodic pricing of collateral.

xi. **Recognition:** A bank should recognize a loan, whether original or purchased, in its balance sheet. This should occur as soon as the bank becomes the party to the contractual provisions that apply to the loan. A bank should initially carry the loan at cost.

xii. **Impairment:** A bank should identify and recognize the impairment of a loan or a collectively assessed group of loans. This should be done whenever it is neither probable nor assured that a bank will be able to collect the amounts due according to the contractual teerms of a loan agreement. Impairment can be recognized by reducing the carrying amount of the loan to its estimated realizable value through an allowances or charge-off, or by attributing charges to an income statement during the period in which the impairment occurs.

xiii. **Collections:** A lending policy should define deliquent obligations of all types and specify the appropriate reports to be submitted to the board. These reoprts should include sufficient detail to allow for the determination of the risk factor, loss potential and alternative courses of action. The policy should require a follow-up collection procedure that is systematic and progressively stronger. Guidelines should be established to ensure that all accounts are presented to and reviewed by the board.

xiv. **Financial informations:** The safe extension of credit depends on complete and accurate information regarding every detail of the borrower's credit standing. A possible exception to this rule is the case in which a loan was originally approved with readily marketable collateral to be used as the source of repayment. A lending policy should define the financial statement requirements for business and individuals at various borrowing levels and should include appropriate guidelines for audited, non-audited, interim, cash flow and other statements. It should include external credit checks required at the time of periodic updates. If the loan maturity is longer than one year, the policy should require that the bank's officers prepare financial projections with the horizon equivalent to the loan maturity, to ensure that the loan can be repaid from cash flow. The assumptions for the projections should be clearly outlined. All requirements should be defined in such a manner that any negative credit data would clearly violate the bank's lending policy.

Finally, a lending policy should be supplemented with other written guidelines for specific departments of the bank. Written policies and procedures that are approved and enforced in various departments should be referenced in a bank's general lending policy. The absence of written policies, guidelines and procedures is a major dificiency and a sign that a board of directors is not properly executing its fiduciary responsibilities.

Credit Risk Evaluation:

All extensions of credit must be supported by a complete analysis of the proposed credit. A comprehensive and accurate appraisal of risk in every credit exposure of the bank is mandatory. No credit proposal can be put up for approval unless there has been a complete written analysis.

Objectives:

The objectives of having written documentation of an analytical nature to credit extensions are:

- to ensure a thorough analysis of all new borrowers.
- to ensure a periodic (at least, once a year) critical review of ongoing borrowing relationships including all aspects of the credit risk, overall profitability to the bank and marketing potential.
- to ensure proper and clos evaluation of facility increases and/or significant modifications in existing credit arrangements.
- to facilitate and systemize the credit approval process by providing permanent signed record of approval together with the basis for the decision made.

Steps in Analysis:

The credit analyst should follow at least the following five distinct and logical steps to arrive at conclusions and make appropriate recommendations with regard to a proposed credit: Source: Credit Policy Guide, NABIL Bank Ltd., p. 41.

i. Historical Analysis:

The purpose of the historical analysis is to evaluate the past performance of the management of the borrowing entity. The analyst determines the major risk factors and evaluates how these risks have been mitigated in the past. It identifies the factors in the borrower's present condition and the past performance which foreshadow difficulties, or indicate likelihood of success, in the ability to repay the requested facility at a future time. The two major tools for historical analysis are financial analysis and business risk analysis. The financial analysis is the quantitative toll and the business risk analysis is the qualitative.

ii. Forecast:

Having analyzed management's past performance, the nature of the risks involved and how these were mitigated, the analyst should proceed to make a reasonable forecast of the probable future performance of the entity, whether through cash generated in the future operations or conversion of assets. The findings of the financial and business risk analysis will form the basis of forecaast in light of the relevant business environment at present and during the foreseeable future. While forecasting, the analyst should highlight to what extent the inherent risks involved in the proposed lending situation are mitigated and indicates how the unmitigated risks can be covered.

iii. Pricing:

Every credit facility generates some income for the bank in the form of interest earned and other fees. The funds the bank lends are generally deposited by the depositors or borrowed from other financial institutions. They, therefore have a cost. The analyst must determine the Return on Investment (ROI) of a facility to see if it meets the normal standards.

iv. Protection Against Loss:

The analyst must then consider the bank's position in a distress situation. Liquidation analysis would be carried out to ascertain the bank's ability to recover the outstandings. If liquidation analysis indicates insufficient cover, the analyst may recommend increase in or additional collateral.

v. Debt Structure and Control:

The analysis process should conclude with an assessment of the borrower's creditworthyness. If the analyst feels that the proposed facility may be extended, he/she

should give a proposal for structuring the facility, given the borrower's assets and/or projected cash flow, so that it gives the bank adequate protection against loss and control of the relationship.

8.3. Loan Loss Provisioning Policy

Classification of assets can provide a basis for determining and adequate level of provisions for possible loan losses. In determining an adequate reserve, credit history, collateral and all other significant factors that affect the collectibility of the loan portfolio should be considered. These include the quality of credit policies and procedures, prior loss experiences, loan growth, quality and depth of management in the lending area, loan collection and recovery practices, changes in national and local economic and business conditions, and general economic trends. The asset value assessments should be performed systematically, consistently over time, and in conformity with objective criteria. They have to be supported by adequate documentation.

A loan loss provisioning policy ranges from mandated to discretionary, depending on the banking system. The loan loss provisioning is treated as business expenses for tax purposes. The tax considerations should not, however, influence prudent risk management policies.

In many countries, in particular those with fragile economies, regulators have established mandatory levels of provisions that are related to asset classification. The mandatory level of provision is normally determined by certian statistics. In countries, where the legal framework for debt recovery is highly developed like USA, have demonstrated approximately 10% of sub-standard assets eventually deteriorate into loss. And, it is approximately 50% of doubtful and 100% of loss classification. In developing countries, where the legal frameworks and traditions for debt collection is less effective, provisions in the range of 20-25% of substandard assets. In Nepal, it is 25% for substandard assets, 50% for doubtful and 100% for loss assets. Sources: Nepal Rastra Bank, Directive to the banks, 2002; and Hennie van Greuning, Sonja Brajovic Bratanovic, 1999, Page 155.

There are basically two approaches for dealing with loss assets. First is to retain loss assets on the books until all remedies for collection have been exhausted. In such case, the level of loss reserve may appear unusually large. The second is that all loss assets be promptly

written off against the reserve, i.e. removed from the books. These type of assets are considered to benon-bankable but not necessarily non-recoverable. By immediately writing off of loss assets, the level of the reserve will appear smaller in relation to the outstanding loan portfolio. An analyst must clearly understand whether the bank is aggressively writing off its losses or is simply providing for them.

The level of necessary loan loss provisions necessarily include the degree of subjectivity. Management discretion, however, should occur in accordance with established policies and procedures. The following aspects have to be included in analysis of adequacy of the overall allowance for losses:

- A survey of the bank's existing provisioning policy and the methodology used to carry it out. In particular the value attributed to collateral and its legal/operational enforceability have to be considered.
- An overview of risk grading (asset classification) procedures and the review process including the time allotted for review.
- Any current factors that are likely to cause losses associated with a bank's portfolio and that differ from the historical experience of loss. These may include changes in a bank's economic and business conditions or in its clients, external factors, or alterations of bank procedures since the last review.
- A trend analysis over a longer period of time, which serves to highlight any increases in overdue loans and the impact of such increases.
- An opinion of the adequacy of the current policy and, on the basis of the loans reviewed, extrapolation of additional provisions necessary to bring the bank's total loan-loss provisions to a level in line with International Accounting Standard (IAS).

8.4. Non-performaing Loan Portfolio

Non-performaing assets are those not generating income. Loans are normally considered to be non-performaing when principal or interest on them is due and left unpaid 90 days or more (this period may vary by jurisdiction). It is an international stardard. The introduction of asset classification that entails provisioning requirements is costly to the banking sector. The delinquency period for non-performing assets is therefore typically introduced at 180 days and then tightened to 90 days after a period of time.

The non-performing loan portfolio is an indication of the quality of the total portfolio and ultimately of a bank's lending decisions. Another such indicator is the bank's collection ratio.

Table 8.1: Loan Porfolio Statistics

Credit Risk	Period 1	Period 2	Period 3	Period 4	Current Period	Remarks
Overdue loan percentage of total loans						
Bad debt percentage of total loans						
Value of loan loss provision percentage of total loans						
Loans to private sector as percentage of total loans						
Loans to individuals as percentage of total loans						
Loans to public sector as percentage of total loans						
20 largest borrowers as percentage of total loans						
20 largest borrowers as percentage of total off-balance-sheet items						
20 largest borrowers as percentage of net interest income						
20 largest borrowers as percentage of total assets						
20 largest borrowers as percentage of qualifying capital						

Source: Greuning, Hennie van and Bratanovic, Sonja Brajovic, 2000, p. 138 and reporting forms of different Nepalese Banks.

When assessed within the context of non-performing loans, the aggregate level of provisions indicates the capacity of a bank to effectively accommodate credit risk. The analysis of a non-performing loan portfolio should cover a number of aspects, like:

- Aging of past due loans, including principal and interest, by more than 30, 90, 180 and 360 days. These classifications can be broken down by type of customer and

branch of economic activity to determine overall trends and whether or not all customers are affected equally.

- Reasons for the deterioration of the loan portfolio quality, which can help identify possible measures that can be undertaken by the bank to reverse a given trend.
- A list of non-performing loans, including all relevant details should be assessed on a case to case basis to determine if the situation is reversible, exactly that can be done to improve repayment capacity, and whether or not work out and collection plans have been used.
- Provision level should be considered to determine the bank's capacity to withstand loan defaults.
- The impact of profit and loss account should be considered to determine exactly how the bank would be affected by the deterioration of asset quality.

There are so many reasons that can explain deteriorating loan portfolio quality. It is unavoidable that banks make mistakes in judgement. However, for most failed banks, the real problems are systematic in nature and rooted in the bank's credit culture. There are a number of reasons that can explain deteriorating loan portfolio quality. The following kinds of problems that indicate distortion in a bank's credit culture.

i. **Self-dealing:** An over extension of credit to directors and large shareholders, or to their interests, while compromizing sound credit principles under process from interested parties. Self dealing has been the key issue in a significant number of problem situations.

ii. **Compromize of credit principles:** Arises when loans that have undue risk or are rare extended under unsatisfactory terms are granted with full knowledge of the violation of sound credit principles. The reasons for the compromize typically include self-dealing, anxiety over income, competitive pressures in the bank's key markets, or personal conflicts of interest.

iii. **Anxiety over income:** A situation in which concern over earnings outweighs the soundness of lending decisions, underscored by the hope that risk will not materialize or lead to loans with unsatisfactory repayment terms. This is a relatively

frequent problem since a loan portfolio is usually a bank's key revenue producing asset.

iv. **Incomplete credit information:** Complete credit information is the only reasonably accurate method of determining a borrower's financial capacity. The existense of such information as a basis for extending credit should be made clear in the bank's credit files and should include adequate financial statements. The purpose of borrowing, the intended plan and source of repayment, progress and supervision reports, inspections, and minutes of loan conferences should also be specified.

v. **Complacency:** This is a frequent cause of bad loan decisions. Complacency is typically manifested in a lack of adequate supervision of old, familiar borrowers, dependence on oral information rather than reliable and complete financial data, and an optimistic interpretation of known credit weaknesses because of survival in distressed situations in the past. In addition, banks may ignore warning signs regarding the borrower, economy, region, industry or other relevant factors or fail to enforce repayment agreements like by failing to initiate prompt legal action.

vi. **Lack of supervision:** Ineffective survision invariably results in a lack of knowledge about the borrower's affairs over the lifetime of the loan. Consequently, initially sound loans may develop problems and losses because of a lack of effective supervision.

vii. **Technical incompetence:** This inclides a lack of technical ability among credit officers to analyze financial statements and obtain and evaluate pertinent credit information.

viii. **Poor selection of risks:** It involves the following:

- The extension of loans with initially sound financial risk to a level beyond the reasonable payment capacity of the borrower. This is a frequent problem in unstable economies with volatile interest rates.

- Loans to establish businesses in situation where the bank financed share of required capital is large relative to the equity investment of the owners. Loans for real estate transactions with narrow equity ownership also fall into this category.
- Loans based on the expectation of successful completion of a business transaction rather than on the borrower's creditworthyness, and loans made for the speculative purchase of securities or goods.
- Loans to companies operating in economically distressed areas or industries.
- Loans made because of benefits such as the control of large balances on deposit in a bank rather than on sound net worth or collateral.
- Loans predicated on collateral of problematic liquidation value or collateral loans that lack adequate security margins.

The presence of above mentioned problems are in Nepalese banking system. But, however, point ii, iv, vi, and viii are the most prominent problems in the Nepalese banking system.

Solution: Non Performing Loans

Non Performing Loans (NPLs) remain an acute headache for every national regulator because the problem is tough to be sorted out. The government's role looks to be unavoidable to stop the surging NPLs. However, there are two sides of the coin; its intervention could either end up with bad loan reduction or finish up with no achievement at all with persisting flow component (flow component means new lending to state owned enterprises made by banks to reduce its impaired loan ratio). To manage NPLs, it is necessary to assess two main methods normally undertaken by governments (debt cancellation and debt transfer to Asset Management Companies) to deal with NPLs.

Debt cancellation

Obviously, the wrong decisions make enterprises unable to repay their principal or even interest with the government indirectly "making its own goal". The consequence here is the lending institutions are left out with huge burden of bad debts to deal with. This can reduce the loan loss provision and balance sheet, and profit and loss account statement of the bank may have shown the good picture but not reality. For example, the exception of Bulgaria, none of the transition economies (eastern European economy) have cancelled any of the inherited debt. The most frequent explanation for the absence of this policy has been its

creation of a credibility problem: if the government is willing to cancel debt once, then the state enterprises and banks may believe that the government will be willing to do the same in the future as well. Interestingly, in Nepal also, there are two big state owned commercial banks, however, still they are not in the process of debt cancellation whereas most of their big clients are also governmental enterprises. On the banks though, debt cancellation means their asset side gets a deficit and thus, they must be provided with some kind of financial assistance by the government.

Asset Management Company

In the recently announced government budget, there is a provision of establishing an Asset Management Company (AMC). Setting up Asset Management Company (AMC) has been employed to tackle the bad debt problem in the commercial banking system or in the other financial systems. The main aim of AMC are either expediting corporate restructuring or disposing of assets acquired/transferred to the government or to the private sector.

There are two methods used to balance the asset/liability of parent banks, or to put it in another way, to get the resulting hole on the bank's balance sheet filled.

- To reduce the liability side, the parent banks transfer some lending from the central bank to the AMC. This method take both bad assets (NPLs) and liabilities (Central Bank lending) and hence the bank downsizes.
- To increase the asset side, the parent banks buy some bonds issued by AMC.

The transfer of NPLs from parent banks to AMC involves an exchange at the face value of the loans; thus, the parent banks get compensated fully for all transferred loans. The desirability of transferring debt to an AMC has been the subject of considerable policy discussions and also has been cited by many economists as an element of best practice in the response to the surge of NPLs. However, some researches conducted on the issue of efficiency of AMC show that it can be effectively used only for narrowly defined purposes of resolving insolvent and highly distressed financial institutions and selling off their assets.

The AMC may have the bad performance like the above mentioned government owned Nepali banks, NBL and RBB. There are at least three reasons for bad performance of AMC.

First, the AMC will be under control of the government authorities such as Ministry of Finance, Central Bank or special committee who will be in charge of dealing with NPLs. With the overlapping directions from government and "behind the curtain" problems (corruption), the AMC can not take their own and the right decisions. Second, transferring bad debt from parent banks to AMC does not mean that all information is transferred. Parent banks with long standing records of borrowers can easily find out the potential trouble borrowers and therefore take actions accordingly. This advantage of parent banks cannot be transferred to AMC. Moreover, the relationship also fosters collusive behavior and inhibits competition. Third, the size of the capital market in Nepal is still small, there will be very less investors to invest on NPLs.

After going through the literature of the experiences of other countries, some of the recommendation we deem necessary to put up here for Nepal , which is also suffering from the growing trend of NPLs, are as follows:

- To reduce the loss of information problem, not only old bad loans should be transferred to the AMC, as has been the current practice, but all of the borrower's banking business should be transferred to the AMC so that AMC could get adequate information. This will evade the problem associated with asymmetric information.
- To encourage the collection of revenues and to punish nonperformance and corruption, a penalty-incentive scheme must be designed.
- To broaden and deepen the capital market, the government should allow foreign investors enter to the market and such policies would enhance the performance among AMC themselves due to competition.

8.5. Credit Portfolio Quality Review

A loan portfolio reflects a bank's market position and demand, its business and risk strategy and its credit extension capabilities. When feasible, the loan portfolio review should normally include a random sampling of loans so that approximately 70% of the total loan amount and 30% of the number of loans covered. It should also consider at least 75% of the total loan amount and 50% of the number of all foreign currency loans and of all loans with maturities greater than one year. Additionally, a detailed credit portfolio

review should include the following: Source: Greuning, Hennie van and Bratanovic, Sonja Brajovic 2000, p. 132.

- all loans to borrowers with aggregate exposure larger than 5% of the bank's capital
- all loans to shareholders and connected parties
- all loans for which the interest or repayment terms have been rescheduled or otherwise altered since the granting of the loan
- all loans for which cash payment of interest and/or principal is more than 30 days past due, including those for which interest has been capitalized or rolled over
- all loans classified as substandard, doubtful, or loss.

In each of these cases, a loan review should consider documentation in the borrower's file and involve a discussion of the borrower's business, near-term prospects and credit history with the responsible credit officer. For each of the loans reviewed, a summary file should be made showing the following:

- borrower's name and line of business
- use of proceeds
- date of credit granted
- loan maturity date, amount, currency, and pricing
- principal source of repayment
- the nature and value of collateral/security
- total outstanding liabilities, including loan principal and interest due and all other real and contingent liabilities, in cases where the bank is absorbing the credit risk
- delinquency or non-performance, if any
- description of monitoring activities undertaken for the loan
- financial information including current financial statements and other pertinent information
- specific provisions that are required and available

When the total amount due exceeds 5% of a bank's capital, the analysis should also consider the borrower's business plans for the future and the potential consequences for debt service capacity and principal repayment.

Interbank deposits is also the most important categary of assets for which a bank obsorbs the credit risk.It may account for a significant percentage of a bank's balance sheet, particularly in countries that lack convertibility but allow their citizens and economic agentss to maintain foreign currency deposits.

Interbank deposits can be treated just like any other credit risk exposures from the point of view of a credit risk management.

The transactions that incur credit exposure like off-balance sheet commitments should also be reviewed. The adequacy of credit risk analysis procedures should be made as an assessment and the supervision and administration of off-balance-sheet credit instruments, such as letter of credits and guarantees. An off-balance-sheet portfolio review should be carried out with the same principles and in a manner similar to a loan portfolio review.

A good picture of a bank's business profile and business priorities can usually be provided by an analysis of the aggregate loan portfolio and its characteristics as well as the type of credit risk that the bank is ready to take. The analysis should include the below mentioned points:

- a summary of the major loan types, including details of the number of customers, average maturity, and the average interest rate earned
- distribution of the loan portfolio, including various perspectives on the number of loans and total amounts, for example, according to currency, short-term (less thanone year) and long-term (more than one year) maturities, industrial and/or other pertinent economic sectors, state owned and private borrowers, and corporate and retail lending
- loans with government or other guarantees
- loans by risk classification
- non-performing loans

For a comprehensive assessment of the portfolio of characteristics of the aggregate loan portfolio, an analyst can use various tools including to whom, what and for how long the bank has lent. This profiles highlights the target customer segments that pose an acceptable

risk to a bank. The figure also traces the shift of target customer profiles from public sector enterprises toward the private sector.

A bank can lend out its various products in response to market demand. Changes in a bank's target customers apparently affect the distribution of its lending products. Changes in maturity structure may be influenced by shifts in customers and lending products, as well as by a bank's risk factors and macroeconomic trends.

CHAPTER NINE

09. CORRECTIVE MEASURES

For the effective and sound operations of Nepalese banking system now onwards, the following banking related authorities have to play the vital role as mentioned below for further strengthening the banking industry in future:

9.1. Supervision from the Central Bank

Every banking system in every country has at least one regulatory and supervisory authority. But, the specific responsibility of each authority are different in different countries. It is usually a consequence of traditions and of the legal and economic environment of a particular country. Sometimes, regulatory and supervisory authorities are politically motivated. In most of the countries, the regulatory and supervisory authority for the banking sector is assigned to the central bank. The responsibilities of such an entity usually include the following:

- issuance and withdrawal of banking licenses on an exclusive basis
- issuance and enforcement of prudential regulations and standards
- the authority to prescribe and obtain periodic reports i.e. establish prudential reporting as a precondition for off-site surveillance and to perform on-site inspections
- assessment of fines and penalties and the initiation of emergency actions, including cease and desist orders, management removal and suspension orders and the imposition of conservatorship
- closure and/or liquidation of banks

A supervisory authority have to have appropriate enforcement power and an adequate degree of autonomy in order to be effective.

A New Philosophy of Bank Supervision:

The Reserve Bank of New Zealand provides a leading example of a regulatory environment that reflects the new philosophy of banking supervision. In the words of its Governor:

For effective banking supervision, the Base Committee on Bank Supervision has identified certain pre-conditions and set certain standards. If more than one supervisory authority exists, they must operate within a consistent and coordinated framework in order to avoid regulatory and supervisory arbitrage, where distictions between banking business and other deposit taking entities are not clear. Supervisory authority should have adequate resources including the staffing, funding and technology needed to meet established objectives, provided on terms that do not undermine the autonomy, integrity and independence of the supervisory agencies.

'A further concern we have with on-site examination or the off-site collection of detailed private information on banks, at least in the New Zealand context, is the risk that these approaches can blur the lines of responsibility for the management of banks. If the banking supervisor has responsibility for regular on-site examinations, it presumably follows that the supervisor also have responsibility for encouraging or requiring to bank to modify its risk positions or make other adjustments to its balance sheet where the supervisor has concerns in relation to the bank's risk profile. This has the potential to erode the incentives for the directors and management of banks to take ultimate responsibility for the management of banking risks, effectively passing some of this responsibility to the banking supervisor. It also has the potential to create public perceptions that the responsibility for the banking risks is effectively shared between a bank's directors and the banking supervisors. In turn, this makes it very difficult indeed for a government to eschew responsibility for recuing a bank in difficult .... I acknowledge that any system of banking supervision creates a risk for the taxpayer in the event that a bank gets into difficulty. However, in order to minimize these risks, the Reserve Bank of New Zealand

prefers to keep the spotlight clearly focused on the directors and management of a bank, rather than risk a further blurring of their accountability.'

D.T. Brash, Reserve Bank of New Zealand, 1997

Source: Greuning,Hennie van and Bratanovic, Sonja Brajovic 2000, p. 36.

9.2. Organizational Structure

A bank has to properly organize its set-up for an efficient handling of its business, particularly the lending operations. The traditional security oriented approach is giving away to the scientific purpose oriented and need based approach in suitable cases. A proper organizational set-up in a banking institution from the top level at which important financial and policy decisions are taken, down to the level at which these decisions are implemented is, therefore, of vital importance.

Board of Directors
Chairman
Executive/Managing Director
General Manager
Joint/Deputy/Assistant General Managers
Zonal/Regional Managers
Branch Managers
Other Officers

Table 9.1: Powers of Senior Officers to Sanction Advances to Any One Party:

Type of Advances	Chairman	Executive/ Managing Director	General Manager	Joint/Dy/ Asst.Gen. Managers	Reginal/ Branch Mangers
Cash Credit/Overdraft					
Export/Import Credit					
Other Working Capital Loan					
Long-Term Project Loan					
Hire Purchase Loan					
Bills Purchase and Discount					
Letter of Credit Facility Limit					
Bank Guarantee Limit					

9.3. Internal Supervisory Committee:

As per the banking law, the board of directors is the ultimate responsible body of every bank. It is answerable to depositors and shareholders for the safeguarding of their interest through the lawful, informed, efficient, and able administration of the institution. The members of the board delegate the day to day management of bank business to officers and employees, but cannot abdicate responsibility for the consequences of unsound or imprudent policies and practices concerning lending, investing, protecting against internal fraud or any other banking activities.

The role of the Board:

The bank's board of directors is ultimately responsible for the conduct of the bank's affairs. The board controls the bank's direction and determines how the bank will go about its business. The board hires management and establishes the policies under which it will operate. The board may delegate day to day operations to management, but remains accountable for making sure that these operations are carried out in compliance with applicable laws and regulations and are consistent with safe and sound banking practices. The board monitors the bank's operations and makes sure its management can meet the challenges presented as the bank grows, its operations become more complex and its goals change.

Responsibilities of the Board:

A bank's board of directors should be strong, independent and actively involved in its affairs. The bank directors and the executive management both must adhere to high ethical standards and be fit and proper to serve. However, the bank's directors will not be necessarily experts on banking, they should have the skills, knowledge and experience to enable them to perform their duties effectively.

The most important responsibility of the board is to ensure that the management team has the necessary skills, knowledge, experience and sense of judgement to manage the bank's affairs in a sound and responsible manner.

Table 9.2: Board of Directors/Supervisory Board:

Name	Representative of general shareholders	Representative of Promoters	Qualifications	Experience	Responsi-bilities

Responsibilities: administration, corporate banking, international division, domestic treasury, retail banking, internal control, finance and accounting, credit and marketing, bank operations systems, information systems, branch management.

Responsibility of Management:

The soundness financial performance of a banking system depends on the board of directors and on the senior management team. The nature of a bank's risk profile and the adequacy of the systems for identifying, monitoring and managing the profile reflect the quality of both the management team and the directors' oversight of the bank.

The board and management need to support each other as each has its own distinct role and responsibilities to fulfill. The Chief Executive Office (CEO) and management team members should run the bank's day to day activities in compliance with board policies, laws, regulations and should be supported by sound system of internal control.

For managing the risk, the management's responsibilities are:

- Develop and recommend strategic plan and risk management policies for board approval
- Implement strategic plans and policies after approval by the board
- Ensure development of mannuals of policies, procedures and standard for the bank's key functions and risks

- Ensure the implementation of controls that enforce adherence to establish risk limits
- Ensure immediate reporting of non-compliance to management
- Ensure that the internal auditors review and assess the adequacy of controls and compliance with limits and procedures
- Develop and implement management reporting systems that adequately reflect business risks.

The importance of Bank Management:

It is important to recognize that bank stockholders suffer losses on their investments, and senior bank management is almost always replaced, regardless of the resolution technique used.

(Kelley, E.W., 1991; Greuning, Hennie van, Bratanovic, Sonja Brajovic, 2000, p. 46)

Table 9.3: Executive Management/Management Board:

Name	Qualifications	Experience	Responsibilities

Responsibilities: administration, corporate banking, international division, domestic treasury, retail banking, internal control, finance and accounting, credit and marketing, bank operations systems, information systems, branch management.

9.4. Internal and External Auditors

Responsibilities of Internal Auditors:

The function of internal audit is an integral part of the audit committee's overall responsibilities as the audit committee is headed by one of the members of board of directors. The duties of internal auditors are to review annual finanacial statements prior to

their submission to the board of directors and to ensure the appropriate accounting policies and practices are used in the development of financial statements. It also considers compliance with regulatory and legislative requirements, identify all significant discrepencies and disclosure problems.

Internal Auditors, therefore have a very important contribution to make in the risk management process. The monitoring the institution's financial risk profile and review of management procedures are the risk management responsibilities.

Role of External Auditors:

External Auditor's primary objectives are to enable to express an opinion on whether the bank's financial statements fairly reflect its financial condition and to state the results of the bank's operations for a given period.

External Auditors have traditionally looked for fraud and mismanagement in the lending function. External Auditors, as an integral part of the risk-management partnership, have a specific role to fulfill.

CHAPTER TEN

10. CONCLUSIONS:

Credit Appraisal and Credit Risk Management in the Nepalese Banking - A Case Study is the title of this thesis. The banking industry in Nepal is still behind from the point of view of appropriate preparation of credit appraisal and managing credit risk. It is one of the reasons of the increasing trend of non-performing assets. The main problems are described in the introduction part of this thesis.

On the basis of my own observations gained through practical experience and on the basis of the consultation of the relevant literature, the under-noted points are recommended for implementation to make streamline the credit appraisal and credit risk management system in the banks in Nepal:

i. Credit Analyst should be qualified and knowledgeable in preparing credit appraisal note and in managing credit risk.

ii. Credit Analyst should be independent in every bank and financial institution to put their observations regarding the borrower and business in credit appraisal note.

iii. Credit Analyst should be always as described in Ten Commandments in chapter 6 sub-chapter 6.1.

iv. Top management team/approval authority should be aware about credit risk.

v. The Central Bank has to monitor and control the banks and financial institutions with the same degree to all on the basis of country's economic situation and government policy on the banking.

vi. Inspection of Inspection Department of Central Bank should not be only the duty of inspecting and presenting the report/observation to the management, but action oriented.

vii. Auditors, basically, the Chartered Accountants should also be controlled by the authority as they are the main manipulator of financial condition of every entity.

vii. Government should create the investment opportunities for the banks as they have huge surplus liquidity since the long time back.

viii. Legal documentations between the banks/financial institutions and borrowers should be uniformity within the banking industry, as in Nepal, there are so many type of documents have been used in same sector. It is not the practical matter.

ix. Legal Advisor of the bank should have the practical experience in company law and banking law of the country.

The major cause of serious banking problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other circumstances that can lead to a deterioration in the credit standing of a bank's counterparties.

Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credit. Banks should also consider the relationships between credit risk and other risks like liquidity risk, operational risk, market risk, foreign exchange risk. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization. For most banks, loans are the largest and most obvious source of credit risk. However, other sources of credit risk exist throughout the activities of a bank like acceptances, interbank transactions, trade financing foreign exchange transactions.

As set out by the Basel Committee, the areas of sound practices on credit risk management are: (i) establishing an appropriate credit risk environment (ii) operating under a sound credit granting process (iii) maintaining an appropriate credit administration, measurement and monitoring process and (iv) ensuring adequate controls over credit risk. Although, specific credit risk management practices may differ among banks depending upon the nature and complexity of their credit activities. A comprehensive credit risk management program addresses the above four areas. This practices should also be applied in conjunction with sound practices related to the assessment of asset quality, the adequacy of provisions and reserves and the disclosure of credit risk. (Basel Committee Publication No. 54, July, 1999).

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Annex-I

Major Indicators of Banks as of Mid January 2000

	Unit	1994 July	1995 July	1996 July	1997 July	1998 July	1999 July	2000 Jan
Gross Domestic Products	Rs. in Million	199272	219175	248913	280513	296547	334723	296547
Number of Bank Branches	In Unit	438	444	469	484	493	511	513
Population per Bank Branches	Rs. in Thousand	42.2	41.6	39.4	38.1	37.4	36.1	36
Total Deposits:	Rs. in Million	52328	61194	71401	81703	102598	127202	138634
-Current		9794	11630	13246	12820	16310	17710	18222
-Savings		17461	22766	25890	29697	36885	50154	57478
-Fixed		23263	24510	29397	35941	45594	54847	57768
-Others		1810	2288	2868	3245	3809	4491	5196
Total Credit	Rs. in Million	27347	38779	50891	58378	68618	81759	91053
Total Investment	Rs. in Million	14822	9634	8585	8569	10857	14252	16003
Total Produc. Sector Credit	Rs. in Million	12282	19424	27167	29616	35644	43005	50697
Total Priority Sector Credit	Rs. in Million	2130	2797	3683	4676	5893	7183	8030
Credit to Govt. Enterprises	Rs. in Million	766	703	1489	1451	1214	1749	1799
Average Deposit/ Branch	Rs. in Million	120	138	152	169	208	249	270
Per Capita Deposits	Rs. in Unit	2834	3315	3867	4425	5557	6890	7509
Average Credit Per Branch	Rs. in Million	62	87	109	121	139	160	178
Per Capita Credit	Rs. in Unit	1481	2101	2757	3162	3717	4429	4932
Deposit Growth	In Percentage	19.5	16.9	16.7	14.4	25.6	24.0	7.2
Credit Growth	In Percentage	42.1	41.8	31.2	14.7	17.5	19.2	3.7
Investment Growth	In Percentage	9.0	-35	-10.9	-0.2	26.7	31.3	15.3
Time Deposit Growth	In Percentage	19.4	16.1	16.9	18.7	25.7	27.3	6.5
Produc. Sector Credit Growth	In Percentage	21.3	58.2	39.9	9.0	20.4	20.6	5.3
Paid up Capital & Reserve Fund	Rs. in Million	2544	3103	3561	4461	4956	6077	6109

Source: Banking and Financial Statistics, Number 36, Mid January 2000, page 1.

All the data taken at the middle of the month of English calender, because the Nepali months (B.S. as an official calender) are ended at the middle of every English month.

The datas show that changes in rate of incresing and decresing which enable us to understand the trend of banking industry in Nepal. For example: deposit and credit amounts are continuously increasing trend.

Annex-II

Structure of Interest Rates. **Percentage Per Annum**

The trend of interest rate is continuously decreasing in every year in both the deposits and lending. Due to the maoist problem, the major problem in the country for investment and huge legal incoming remittances from the abroad, the liquidity surplus is high in the financial market. So, the banks are pressurized to decrease their interest rates.

Mid-July	2000	2001	2002	2003
Nepal Rastra Bank				
Bank Rate	7.5	7.5	5.5	5.5
Refinance Rate	6.5	6.5-7.5	2.0-4.5	2.0-4.5
Government Securities				
Treasury Bills* 91 days	5.3	4.94	3.78	2.98
N. Saving Certificate	8.5-13.25	8.5-13.25	8.5-13.25	7.0-13.0
Development Bonds	3.0-10.5	3.0-10.5	3.0-8.0	3.0-8.0
Interbank Rate	4.16	4.50	4.22	3.62
Commercial Banks Rates				
Deposits				
Savings Deposits	4.0-6.5	3.0-6.5	2.5-6.25	2.5-6.0
Time Deposits:				
1 month	-	-	2.0-4.5	-
3 months	4.0-6.0	2.5-6.0	2.5-5.5	2.0-5.0
6 months	5.0-6.75	3.5-8.75	2.5-6.0	2.5-6.0
1 year	6.0-7.75	4.5-7.75	3.5-7.0	3.0-7.0
2 years and above	5.75-8.5	4.25-8.5	3.25-8.0	3.25-7.5
Lending Rates				
Industry	10.5-15.5	7.0-15.0	7.0-14.0	8.5-14.0
Agriculture	12.0-14.5	12.5-14.5	12.0-14.0	4.0-14.5
Export Bills	7.5-15.0	7.0-16.0	6.5-12.0	4.0-12.5
Commercial Loans	9.0-16.5	7.0-16.0	7.0-16.0	7.5-16.0
Overdraft	10.0-18.0	10.0-18.0	11.0-17.0	7.0-17.0
Cash Reserve Ratio-CRR				
With NRB **	7.0	7.0	6.0	6.0
Cash in Vault	3.0	3.0	3.0	2.0
* Weighted Average Discout Rate ** Average				

Source: Macroeconomic Indicators of Nepal, December, 2003, page 5.

Annex-III

1. ABC Bank Ltd. (a joint venture bank), Kathmandu, Nepal.

Part 1

a. Name of the bank or branch
b. Date of completion of preparation
c. Name of the borrower(s) and registered address and constitution and address
d. Borrower's obligor or loan account number
e. Date of sanction and expiry/next review date
f. Main contact person and contact address with telephone no.

Part 2

a. Credit facility for the unit and total group limit
b. Type of credit facility and amount in each facility
c. Pricing (interest rates and commission rates)
d. Margin rate (in cash or in fixed collateral)
e. Personal and/or corpaorate guarantees
f. Detail of collateral securities
g. Detail of security documents
h. Repayment schedule
i. List of required legal documentations

Part 3

a. Background of the promoters with their involvement of business activities and networth
b. Details of facilities provided for the other group units
c. Details of facilities of group units enjoying from other banks or financial institutions
d. Estimated income from the unit during the next year with calculation

Part 4

a. Details of the company and promoters with registration date and capital.

b. Management team with their backgroud (academic qualification and experience) and second line management.

c. Examination of credibility of the promoters

d. Project/company detail with projected investment from equity and debt.

e. Type of required debt.

f. Deatil calculation of investment from promoters and from the banks and/or financial institutions.

g. Appraisal with justification of requested type of debt with calculation, individually.

Part 5

a. Supply risk analysis from the supplier (raw materials and finished goods).

b. Demand risk analysis from the market (finished goods).

c. Production risk analysis with machinery, human resources and available of other utilities.

d. Collection risk analysis as the goods are sold in credit.

e. Future relationship analysis with the borrower.

Part 6

a. Strengths of the company, products, promoters, financials, management, market etc.

b. Weaknesses of the company, products, promoters, financials, management, market etc.

Part 7

a. Recommendation of the proposal with summarized justification.

Part 8

a. Financial analysis with sales, profit margin.

b. Ratio analysis.

c. Cash flow analysis.

d. Sensitivity analysis.

Part 9

a. Family chart with business involvement.

b. Detail networth of the borrower

Annex-IV

PAYDEX Score:

Payment summary highlights a company's payment performance as reported to the concerned banks.

PAYDEX Score gives branches an instant overview of how a borrower pay its obligations and help branches dertermine how quickly they are like to pay.

The following key to help to determine the meaning of score:

Paydex	Payments
100	Anticipate/Advance
90	Rebate/Advance
80	Prompt
70	Slow to 15 days
60	Slow to 30 days
50	Slow to 60 days
40	Slow to 90 days
30	Slow to 180 days
20	Slow to 265 days
Under	Poor