THE EFFECTIVENESS OF CREDIT RISK MANAGEMENT OF GOVERNMENT AND COMMERCIAL BANKS PERFORMANCES IN NEPAL

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Abstract: The main point of this study was to find how the banks manage the credit risk as it the oldest risk and imposes itself as a great threat to the financial institutions and its performance. This study uses both qualitative and quantitative approach. Quantitative approach studied the credit risk management and the bank performance using financial statements over the seven years ((2006/07)-(2012-13)), while qualitative approach was done through face-to-face interview with seven respondents. The dependent variable for the study was credit risk management with bank performance and the independent variables were capital adequacy, assets quality, management quality, earnings quality, liquidity and operating environment. The study showed that there it has significant relation of capital adequacy and management quality with bank performance. The other variables assets quality, earnings quality and liquidity showed insignificant relation with bank performance. The operating environment was taken as study for qualitative analysis to further help the study and this showed that Nepalese banks needed to improve their service standard continuously and have cautious approach when it comes to credit risk assets. The political instability, slacking economic growth, recession still act as major challenges ahead for the banking sector in Nepal. At last from the study, we can conclude that Nepalese banks are still performing better but still need to increase their speed to introduce themselves in the international financial market.

Key words: Credit risk management, capital adequacy, asset quality, management quality, earnings quality,liquidity

Introduction of the study: Financial sector is the backbone of the economy and banks play a very crucial role in economy. Banks are the financial institutions as they engage in financial activities. Nepalese banking sector is not an exception to this as it is one factor that helps to develop the new economy in the country. Since, the main goal of credit risk management is to maintain credit risk exposure within acceptable parameters so that they can maximize banks risk-adjusted rate of return Basel Committee, (1999). Credit risk management covers both decision making process and the follow-up of credit commitments Jöel Bessis, (1998).Banking sector has always been under various risk but credit risk has been the oldest risk. Growth of banks into regional, national and global institutions has made things harder Golin. J, (2001) which has proven to be affecting Nepal as well.

Research Objectives: The main objective of this study is to have clear and bigger picture of effective credit risk management. The general outlines are as follows:

1. To study the theories, concepts and models used for credit risk and its management in banking.
2. To study the practices of credit risk management in government and commercial banks performance in Nepal.
3. To investigate the determinants of effectiveness of credit risk management of Government and Commercial banks in Nepal.

Literature review

Credit Risk Management: Credit risk management is defined as the process of identifying the risk, measuring it, assessing,

monitoring and controlling the risk Abdelrahim. K, (2013). Credit risk management means maintaining credit risk exposure within acceptable parameters so that they can maximize banks risk-adjusted rate of return Basel Committee, (1999). Effectively managing credit risk is an important factor because it can bring negative consequences to the bank, it can even lead bank to bankruptcy. When banks face certain losses, they have limited capacity to absorb these losses, which becomes more of a reason why banks need to take correct measures for creating effective credit risk management Eveline. N, (2010).

Capital Adequacy: Capital adequacy is referred to the cushion that is used to absorb any shocks that banks may experience as a result of losses of its assets Golin. J, (2001). It is a dynamic concept and also depends on economy of the country. If the country economy is flourishing and its banks management system is doing better than it would require small amount of capital but if it is the opposite situation then the banks would have to increase their capital to protect themselves from the insolvency Adhikary. G. P, (1988). The minimum capital requirement for commercial banks in Nepal is that the total capital fund should not be less than 10 percent of its total risk weighted exposure NRB, (2010).

Assets Quality: Assets Quality refers to the credit quality of the bank's earning assets which also comprises of loan portfolios and off-balance sheet items as well. Banks with good asset quality are the ones that are able to maintain sufficient profits and capital adequacy Golin. J, (2001). Quality of credit here refers to the degree at which the loans are performing. Those loans which has been overdue by one year and above are termed bad loans and the banks in Nepal have to maintain 100 percent provision for these types of non - performing loans NRB, (2010).

Management Quality: Management refers to the competencies of bank's manager. It is about manager's experience, strategic vision, expertise as well as other qualities. It is that segment which involves subjective analysis to measure the efficiency and effectiveness of management Prasada.K and Ravinder. G, (2012). The actions of management is directly related with bank and its employees. Banks performance in the past was not demanding as it is now. This is the era of competition where all the banks should be alert and comply with the changing demand of customers, shareholders, depositors and employees so as to maintain effective balance.

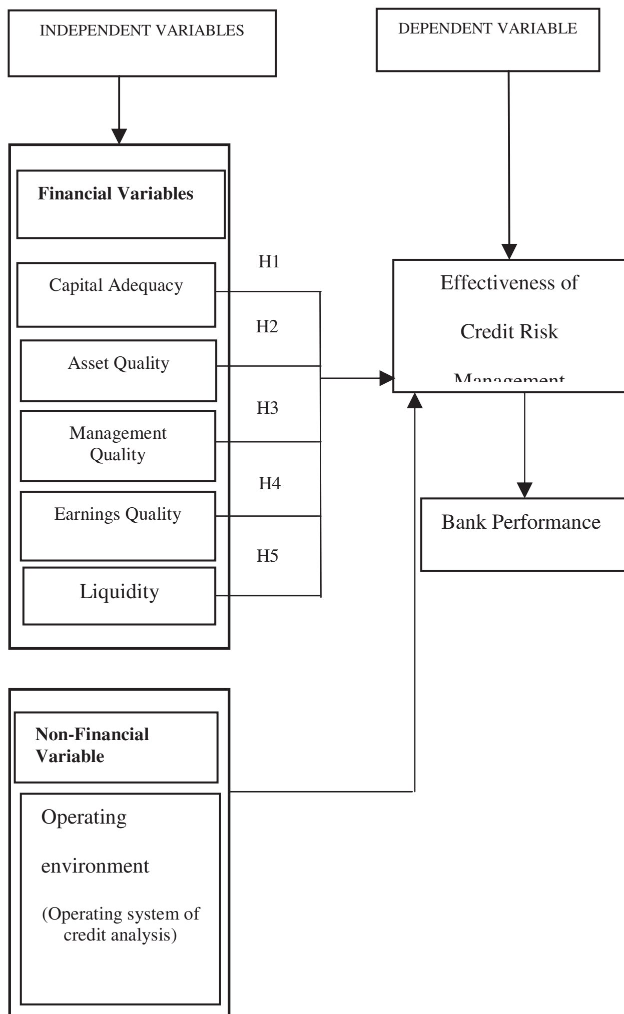
Earnings Quality: Earnings refer to profitability of bank and explain its sustainability and growth in earnings in future. A bank with strong earning capacity and profitability can always keep itself out of trouble and continue to invest and grow in the business Golin. J, (2001). Profit is the lifeblood of all financial institutions. Thus, it is very important for banks to generate profit so as to sustain and create its credit worthiness. High risk means high return and it is necessary for banks to have high profit but they should also check where they are investing.

Liquidity: Liquidity refers to the ability of banks to access liquid asset. Banks have to take proper care to hedge the liquidity risk but at the same time they should invest which can generate higher return. Thus, a lack of sufficient liquidity can cause bank failures Golin. J, (2001). Commercial banks in Nepal have to maintain five percent of total deposit liab ility. If they do not maintain these they are subject to be penalized NRB, (2010).

Operating Environment: The operating environment comprises of macro and micro economies, central bank supervisory roles guidelines and policy, market condition such as change in technologies, political changes. These are related to the internal as

well as external changes in the bank. Mekasha. G, (2011), banks will be more effective if the structure and processes of the banks match their environment. The information flow should be proper as the internal pattern of the bank depends on the relation, authority and communication. Ineffective credit risk management were mainly caused because of incompetence of board and senior management, lack of adequate guidelines on credit risk and too much concentration on speculative activities Njanike. K, (2009).

Conceptual Framework



Research Methodology: The research taken for this study is descriptive research. To achieve the aims and objectives of the study, it applied mixed-method research design in which both qualitative and quantitative study were used to get the actual result.

The number of banks studied were five and these banks were selected on the basis of capital which should be more than 2,500 million rupees and should have been in Nepalese banking sector for more than five years. For quantitative, the study used accounting information in financial statement for the fiscal years 2006/7 to 2012/13 and for qualitative, the study used face to face interview to contribute more to the topic.

The data collected from the annual financial statement of the five commercial banks,

which included government and commercial bank. The data collected was analyzed using Pearson Correlation Coefficient and Multiple Regression Analysis for quantitative part and ten-step content analysis Beverly Hancock, (1998) for qualitative part.

Empirical Findings and Analysis: This section of the study has been done to understand credit risk management and its effect on banks performance in various parts of the world. This section was divided into quantitative and qualitative analysis. Quantitative analysis used Pearson Correlation and regression analysis to understand the effectiveness of credit risk management on each bank while qualitative analysis used in-depth study which was done from information taken from interview. The researcher used questionnaire to investigate for the in depth understanding of credit risk management in bank performance.

Variables	**HBL**	**N/SBI**	**NIBL**	**NBL**	**ADBL**
Capital Adequacy	1.686	1.653	-11.418	-9.994	-0.177
Assets Quality	8.535	-4.150	6.945	-26.087	-1.023
Management Quality	-345.164	-511.211	-746.584	-3591.074	213.182
Earnings Quality	20.835	25.186	28.510	136.188	5.234
Liquidity	-5.756	-0.784	-2.159	29.089	0.132
Adj. R^2	0.86	0.979	0.921	0.971	0.996
Signif.	0.592	0.242	0.459	0.287	0.110

The whole study done on each bank with regression analysis shows that capital adequacy has negative and insignificant effect on effectiveness of credit risk management on the performance of bank. This study implies that when more capital are allocated for the safety of banks; it affects the performance of Nepalese banks. The asset quality had negative and insignificant effect except for Himalayan Bank (HB) which showed positive effect but is still insignificant. Management Quality shows negative and insignificant but strongly in a position to affect the three private banks whereas for government bank shows positive effect but it is still insignificant. Earning quality shows the positive but insignificant effect on all the banks that were taken under study. The last determinant, liquidity shows negative and insignificant effect on the private banks but shows positive effect on government banks.

The respondents included for the in-depth survey were seven, from different banks. Most of the respondents shared the same thoughts but with different words. The banks that were studied took credit risk management as an important factor for continuous sustainability of the bank. Integration of policies and strategies were taken seriously because the banks do not want themselves in a serious situation. Banks provide loans to their customers, the factors related to providing loan were discussed in this study. The determinants included collateral, capacity of the person to

repay the loan, character, condition of the customer and capital are always considered when providing loan. These are not the only determinants but were taken to be the most important when assessing for loans.

This study showed the importance of guidelines for banks in Nepal. The reliability factor, quick response to certain situations and the actions taken were considered more important. The circulation of the guidelines to every bank within the time frame. This would help banks as well as individual in the country to minimize the damages if there are any. Challenges are the part of life. Thus, banks are not an exception to it. The challenges faced by government and commercial banks such as: economic condition, political condition, inadequate information. The most important point in this study was with unavailability of proper information and the lack of source to get proper information. This study showed the part where there were places for improvement. Nepalese banking sector has more potentiality to grow in the future and some of them are discussed with this study. One of the most important part was the availability of external rating agencies, which would be more beneficial to the banks.

Hypotheses

Variables	Correlation	Significant
Capital Adequacy	-0.388	0.024
Assets Quality	-0.216	0.220
Management Quality	-0.537	0.001
Earnings Quality	-0.104	0.559
Liquidity	-0.252	0.151

Hypotheses testing was done using Pearson Correlation Coefficient which tested the relationship between independent and dependent variables. The testing showed that there is negative but significant relationship between capital adequacy and management quality but negative and insignificant relationship between assets quality, earnings quality and liquidity.

The study further found that 61.3 percent change in ROE can be predicted for the CAMEL components. The F-test also shows significant relationship between the dependent and independent variable. Thus, CAMEL rating system can be used as credit risk management indicator when determining the bank performance of government and commercial banks.

The study on each bank using regression showed the dependent and independent variables with 61.3 percent prediction level. Thus, this shows that prediction can be done with these variables when it comes to bank performance using credit risk management. The study showed that increased credit risk management showed increase in bank performance.

Conclusions: The aim of the study is to learn how effectively banks manage the credit risk and its result in the bank performance in government and commercial banks. The effect the banks have to face the when there are any challenges. It is important to note that the sample size though satisfactory may not be enough to give a proper result to all the commercial and government banks of Nepal. The first objective was to study theories, concept and models to understand credit risk management in banking sector. The first objective was cleared with the use of CAMELS model. The study found that there is little impact between the CAMEL components taken as determinants and the credit risk management in the performance of each bank. Banks chosen for the study all had different strategies and policies to handle credit risk, the performance of bank will also vary according to that. The second objective was to study the practices of credit risk management in government and commercial bank performance in Nepal. The study showed that Nepalese banking sector is still at its early stage, it is doing better but there are more places for improvement.

The last objective was to investigate the determinants that is related to effectiveness of credit risk management. The determinants that banks chooses was relevant to the study as it uses the five Cs when assessing the customer to provide loan. Besides these there were other factors that banks followed including the guidelines provided by bank. The determinants not only include one side but also included economy. Nepal has been suffering from lack of constitution and some of these factors are seen affecting the economy as well. Therefore, commercial banks need to improve their service standard continuously and have cautious approach when it comes to credit risk assets. The political instability, slacking economic growth, recession still act as major challenges ahead. At last from the study, we can conclude that Nepalese banks are still performing better but still need to increase their speed to introduce themselves in the international financial market.

Limitations:During the study there were certain limitations the researcher had to face with. One of them was the unavailability of financial data and thus had to exclude one bank from the study. The second one was the reluctance of respondents to give interviews.

Recommendations for Future Research: This study could be further developed by including the BASEL III act, even though simplified version is used for Nepalese financial market. It can be used to compare between the two phases to understand the difference between before and after phase when BASEL III was applied. This study can also include more independent variables and also increase the samplesize.

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