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Credit Risk Management Efficiency and Sustainable Profitability in Commercial Banks of Kathmandu Valley

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ABSTRACT

This paper analyses how the efficiency of credit risk management influences sustainable profitability of commercial banks in Kathmandu Valley, Nepal. The study is based on the risk-return trade-off framework; it specifically examines the potential significant impact of non-performing loans (NPL) and capital adequacy ratio (CAR) on the profitability of the banks in terms of their return on assets (ROA) and return on equity (ROE). The secondary data using a quantitative research design were collected using published annual reports of the selected commercial banks across five years (FY 2076/77 to 2080/81). To test the above hypotheses, Pearson correlation analysis, regression models, and ANOVA tests were used. The empirical findings demonstrate that NPL and ROE have a statistically significant negative correlation ($r = -0.695$, $p = 0.026$), whereas the correlation between NPL and ROA is moderate and negative. Further, NPL is found to explain 35.4% of the change in ROA ($R^2 = 0.354$), which results in the acceptance of H_1. Even though CAR has a positive correlation with profitability, the regression model is not significant ($F = 2.917$, $p = 0.148$), which leads to the rejection of H_2. All in all, the results prove that the quality management of loans is more significant than the capital strength itself in terms of maintaining long-term profitability. The analysis offers evidence on a regional basis that has a significant implication to the management of banks and regulators in Nepal.

KEYWORDS

Bank profitability, Capital adequacy ratio, Credit risk management, Non-performing loans

INTRODUCTION

The commercial banks form the heart of Nepal financial system and a dense combination of economic activity creating more opportunities and vulnerabilities is more visible in Kathmandu Valley than anywhere else in Nepal. Within this type of environment, credit forms the core, and foundation of bank revenue, but also presents them with the most significant financial risk credit risk (Bhattarai, 2017). It can become a strategic resource that makes lending stable and profitable over time when dealt with properly (Poudel, 2018). In inadequately managed situations, it causes balance sheet disbalance, deterioration of capital buffer, and loss of confidence among individuals (Pandey, 2023). The Kathmandu Valley banks should efficiently lend money but have strict risk assessment mechanisms that balance credit books to the regulatory standards, macroeconomic realities and institutional capabilities (Gwachha, 2023). Nonetheless, this is an ideal creature since the financial ecosystem of the Valley has grown faster than its risk management institution maturity (Gurung et al., 2023). The difference between the proposed and the real states has increased during the last decade (Karki & Aryal, 2019). The factors that have contributed to the exposure to credit risk include the rush urbanization, the competition between the commercial banks, as well as the frequent restructuring of the Nepal Rastra Bank regulations, which have placed additional strains on monitoring, and the complex systems of loan recovery (Thakuri, 2024). BPBs even struggle with the increasing levels of non-performing loans, liquidity, and ad hoc risk assessment procedures (Pradhan & Shah, 2019). This imbalance means that profitability is not only fail-safe to financial well-being, but the effectiveness with which

credit risk is controlled defines whether profits will last long or be a temporary phenomenon (Sejuwal, 2023). Nevertheless, current studies on Nepalese banks either consider solitary risk factors or analyze the banking industry of the country in general, disregarding the fact that certain institutions are concentrated in the Kathmandu Valley (Dahal &Dhungana, 2025).

Earlier efforts of trying to comprehend credit risk behaviour in Nepal are not sufficient due to a variety of reasons. Various researches are based on national samples that conceal regional variations in lending relationships, characteristics of borrowers, and market concentration. Others lay focus on conventional determinants that do not examine how well these risks are efficiently managed (Panthee & Acharya, 2025). Furthermore, previous literature addresses the issue of profitability, however, infrequently in relation to sustainable profitability profit trends which are held by solid internal systems as opposed to temporarily affected market dynamics (Chhetri, 2021). Therefore, the literature provides an incomplete picture and the question of whether Kathmandu Valley banks have the efficiency needed to maintain profitability in the long run remains uncertain to the policymakers and practitioners. This body of knowledge gap has both direct and indirect effects (Kandel, 2024). In a direct manner, ineffective risk assessment results in inappropriate credit allocations, accumulation of bad credit and earnings variability. There is no targeted evidence region-specific data, and it constrains the formulation of targeted regulatory interventions based on empiricism (Kalwar and Shrestha, 2024). These reasons are the reason why close research on Kathmandu Valley, an economic center, should be studied, whose activity will greatly affect the banking system of Nepal. The paper aims to determine the effect of credit risk management efficiency to sustainable profitability and financial stability of commercial banks in Kathmandu Valley on general.

In filling this gap, the current study is theoretically framed by the risk-return trade-off concept that stipulates that profitability in financial institutions is inherently determined by their capacity to ensure that the exposure to risk is balanced with the generation of returns. A credit risk issue in the banking sector is one of the main determinants of this trade-off because the high exposure to non-performing loans can negatively affect the quality of the assets, the capital bases, and the sustainability of earnings. On the other hand, sufficient capitalization improves resilience of a bank amid sudden losses, confidence of depositors and investors and long-term profitability (Thakuri, 2024). This theoretical related approach offers a consistent basis on which the research on the efficiency of credit risk management can be compared in the context of sustainable profitability in commercial banks in Kathmandu Valley. In this context, capital adequacy and asset quality are essentials that directly indicate exposure to credit risk, and the return on assets and return on equity measures earnings performance. The study equates theoretical expectations to measurable financial results by operationalizing capital adequacy ratio (CAR) and non-performing loans (NPL) as important indicators of credit risk management efficiency, and profitability through ROA and ROE (Dahal & Dhungana).

In line with this, the following hypotheses are stated to explore the effect of credit risk management efficiency on the profitability of Kathmandu Valley commercial banks:

H_1: Non-performing loans (NPL) have a statistically significant negative effect on bank profitability.

H_2: Capital adequacy ratio (CAR) has a statistically significant positive effect on bank profitability.

These hypotheses give a systematic foundation to the quantitative analysis carried out in this research and allow a methodical evaluation of the effectiveness of credit risk management contracts in ensuring sustainable profitability in the most concentrated financial center of Nepal.

METHODOLOGY

The research design used in this study was a quantitative type of research design that enabled systematic investigation of the indicators of credit risk management efficiency and sustainable profitability in commercial banks in Kathmandu Valley which are measurable. Quantitative design was specifically appropriate since the study was to examine the objective financial variables, determine statistical links, and test the theoretical hypotheses based on the literature on financial intermediaries and risk management (Saunders & Allen, 2023). The research was carried out in Kathmandu Valley banking environment, which is the most concentrated financial center of Nepal and the lasting five years of 2076/77 BS to 2080/81 BS were considered to represent current trends, changed regulative policies and the changing credit conditions.

Secondary data were derived from presentation of published annual reports of commercial banks, publications of commercial banks and such deliberations on financial disclosures presented publicly in line with the requirement of regulations. These sources offered continuous and dependable readings of credit risks measurements like bad loans and ratio of capital adequacy and various liquidity ratios, measures of profitability, including return on assets, return on equity and net interest margin. The secondary data saved time used on responding bias and standardization of all samples used in the research. The analysis of the data was performed with the help of the Smart PLS software to measure the descriptive patterns and approximate scatter plot, which evaluated the impact of the efficiency of credit risk management on sustainable profitability. This paper explores the effectiveness of the commercial banks within Kathmandu Valley in managing credit risk and the effectiveness in the context of sustainable profitability. Using some of the indicators like ROA and ROE, the study examines whether better practices.

RESULTS

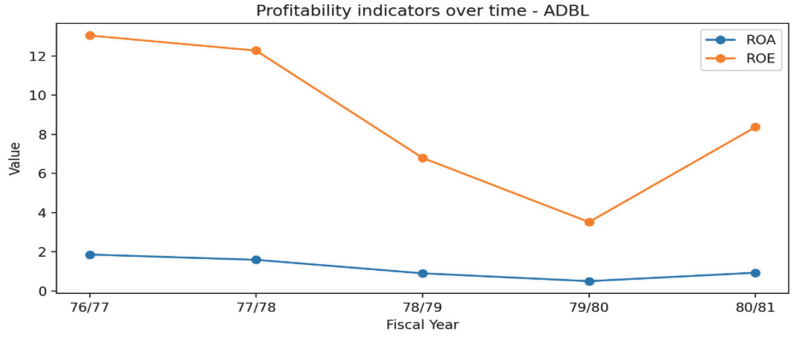
The results section presents the empirical findings derived from the analysis. It was begun with descriptive statistics summarizing the performance of credit risk indicators among Kathmandu Valley commercial banks. The section shows the outcomes of credit risk management efficiency assessments, followed by the presentation of profitability results for the sampled banks. Regression or panel data analysis findings have been reported to demonstrate how credit risk management efficiency influences sustainable profitability. Key patterns and significant results are highlighted clearly.

Table 1: Bank summary by mean indicators

Bank	CAR	NPL	ROA	ROE
ADBL	15.76	2.7	1.156	8.804
EBL	12.67	0.392	1.242	12.442
Global IME	12.816	0.768	1.308	12.494
NBL	15.01	2.706	1.034	7.074
NIMB	14.10	3.262	1.194	8.93
NMB	13.984	2.51	1.144	10.688
Nabil	12.742	2.256	1.42	12.192
PRABHU	12.272	3.322	0.51	6.042
RBB	12.68	3.49	1.09	11.42
SCBL	16.944	1.062	1.866	15.714

(Source: Authors Compilation from annual financial reports, 2025)

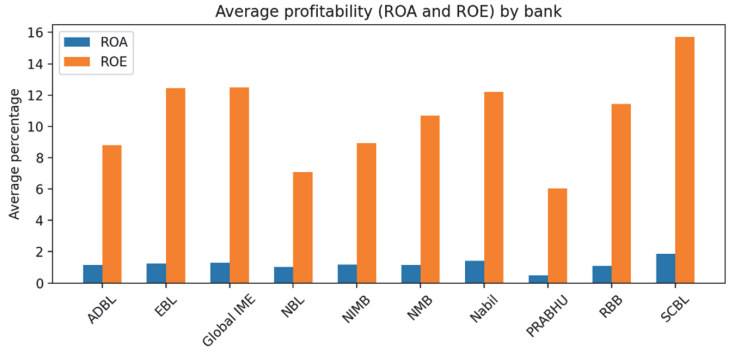
Table 1, the average value of the main financial indicators of each of the available years will be provided, including; Capital Adequacy Ratio (CAR), Non-Performing Loans (NPL), Return on Assets (ROA), and Return on Equity (ROE). The table presented below summarizes these metrics in single averages in order to have a succinct but useful comparison of each bank in terms of their usual risk position and profitability performance. The banks that have high CAR and liquidity exhibit greater buffers to risk whereas those with the lower ratios of NPLs have high credit quality. On the same note, ROA and ROE indicate efficiency in profits at large. These averages combine to enable you to scan the bank in terms of managing risk and creating returns within a small amount of time.



(Source: Authors Compilation from annual financial reports, 2025)

Figure 1: Profitability trend plot for an example bank

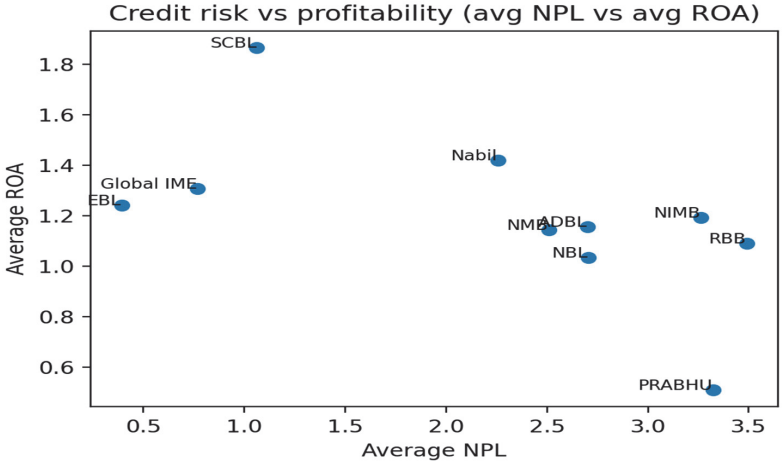
Figure 1 shows that ADBL which is the first bank in the data and plotting its profitability indicators between the fiscal years 76/77 and 80/81. The figure shows ROA and ROE over time. The horizontal scale is the fiscal years whereas, the lines indicate the way ADBL changes its profitability every year. Using the way these lines go up and down, it is easy to know whether the financial performance of the bank is strong or not. The latter visual trend gains relevance later in the comparison of results of profitability and risk factors, including NPL and CAR, in the regression or correlation analysis.



(Source: Authors Compilation from annual financial reports, 2025)

Figure 2: Average profitability by bank (ROA & ROE)

The two bars in Figure 2 were the representations of each bank average Return on Assets (ROA) and the other average Return on Equity (ROE). This graphical comparison makes you immediately find out which banks are overall more profitable. The chart also indicates the efficiency of each bank in terms of the use of its shareholders equity as compared to the total assets of the bank since ROE is usually greater than ROA. By looking at the height of these bars against other banks, it is easy to tell how well these institutions perform regularly and the differences in the way they are organized to make profit.



(Source: Authors Compilation from annual financial reports, 2025)
Figure 3: Credit risk vs profitability (avg NPL vs avg ROA)

The Figure 3 presents the correlation existent amid the average Non-Performing Loan (NPL) ratio, and average Return on Assets (ROA) value of chosen commercial banks. The average NPL of SCBL is 1.1 which is low with the highest ROA of approximately 1.9 which shows that it is very profitable but does not have any aggressive credit risk. EBL and Global IME have low NPLs (0.4–0.7), and moderate returns of 1.2 & 1.3%. Nabil Bank demonstrates a moderate NPL of about 2.2% and ROA of around 1.4 and therefore the overall performance is balanced. NMB and ADBL are close to 2.5% NPL and ROA of 1.1-1.15%. NBL has a marginally greater NPL at approximately 2.7% and ROA at close to 1.0%. NIMB and RBB have high NPLs (3.1-3.5) and ROA of 1.1-1.2. PRABHU is ranked the least and NPL is estimated to be 3.3% and ROA is just 0.5 which indicates their credit risk is more and less profitability.

Pearson's Correlation

Table 2: Pearson's Correlation Matrix of Credit Risk Indicators and Profitability Variables

			Pearson's r	P
CAR	-	Liquidity ratio	0.218	.639
CAR	-	NPL	-0.055	.906
CAR	-	ROA	0.607	.148
CAR	-	ROE	0.407	.365
Liquidity ratio	-	NPL	-0.560	.191

			Pearson's r	P
Liquidity ratio	-	ROA	0.149	.750
Liquidity ratio	-	ROE	0.221	.634
NPL	-	ROA	-0.595	.070
NPL	-	ROE	-0.695	.026
ROA	-	ROE	0.881	< .001

(Source: Author, 2025)

Table 2 shows that bank profitability is negatively associated with non-performing loans (NPL) and that the inverse relationship between NPL and ROE has a statistically significant value (r = -0.695, p =. 026) which implies the inverse correlation. NPL is also moderately negative related with ROA, but the correlation is quite marginal. Capital adequacy ratio (CAR) correlates positively with both ROA and ROE but the significance is not sufficiently determined in this sample.

This results support H_1. Pearson's correlation analysis shows a significant negative relationship between NPL and ROE ($r = -0.695$, $p = 0.026$), while the association with ROA is moderately negative.

Liquidity ratio indicates ineffective and unproductive associations with profitability indicators. The consistency between the measures of profitability is confirmed by a strong positive and significant correlation between ROA and ROE ($r = 0.881$, $p < .001$). All in all, the results indicate credit risk to be the most critical variable that impacts on bank profitability.

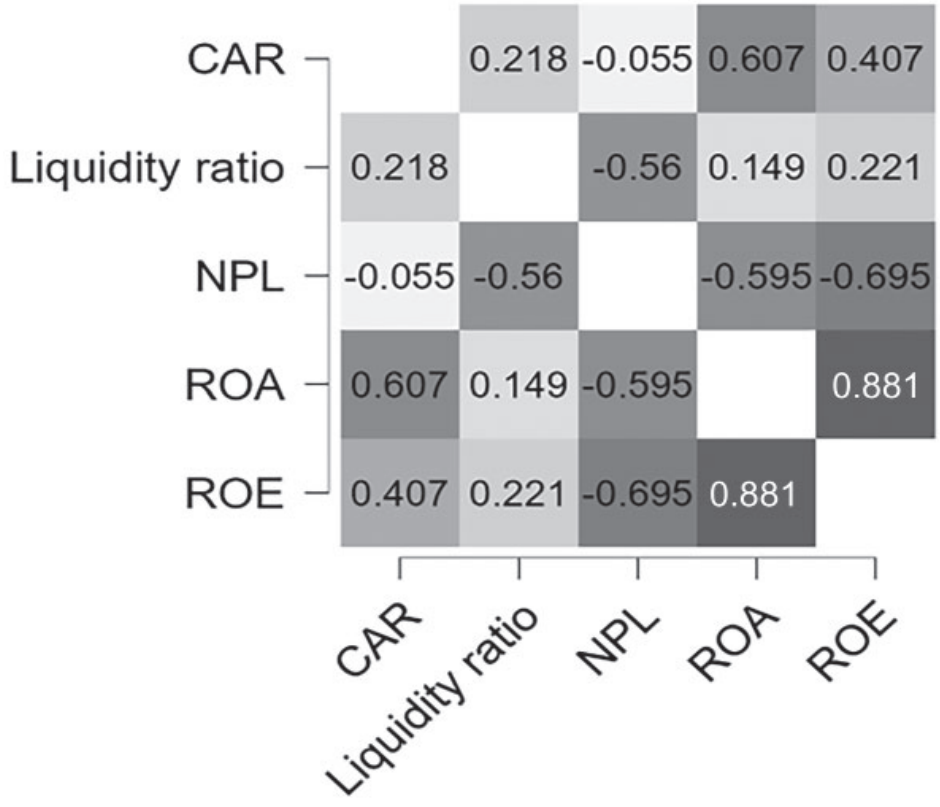


Figure 4: Pearson's Correlation Heatmap of Capital Adequacy, Liquidity, Credit Risk, and Profitability Variables

(Source: Author, 2025)

Figure 4 gives a visual summary of the bond or degree of relationship between the capital adequacy and liquidity on the one hand and credit risk or profitability indicator on the other hand. The most significant trend is the close positive relationship between ROA and ROE (r = 0.881) with which there is a high level of consistency between the two profitability ratios. The non-performing loans (NPL) have moderate to strong negative relationship with both ROA (r = -0.595) and ROE (r = -0.695) which indicates that the greater the credit risk, the lower the profitability, especially the returns of shareholders.

Capital adequacy ratio (CAR) has moderate positive relationship with profitability particularly between capital adequacy ratio (CAR) and ROA (r = 0.607) and ROE (r = 0.407), indicating that better capitalized banks are more profitably operated, though not as high as the relationship between NPL and the capital adequacy ratio (CAR). The liquidity ratio shows no significant correlations with profitability, however, negative correlation with NPL is noticeable (r = -.560), which means that higher liquidity statuses are also associated with the quality of assets. In general, the heatmap supports the idea that the credit risk (NPL) is the strongest variable, which influences the profitability of the bank, with the capital adequacy and liquidity having the supporting roles.

Regression Analysis and ANOVA Test

Table 3: Regression Model Summary Predicting ROA from Non-Performing Loans

Model	R	R^2	Adjusted R^2	RMSE
M_0	0.000	0.000	0.000	0.338
M_1	0.595	0.354	0.273	0.288

(Source: Author, 2025)

As seen in Table 3, Model M_1 that incorporates non-performing loans (NPL) as the predictor implies a significant percentage of variability in bank profitability as represented by Return on Assets (ROA). The coefficient of 0.595 indicates that there is a moderate relationship between the overall NPL and ROA. The value of R^2 is 0.354, which suggests that on average 35.4% of the change in ROA can be attributed to influence of varying NPL which means that the credit risk is a significant factor in determination of asset-based profitability. Adjusted R^2 of 0.273 is still found to mean that nearly 27.3% of the variance in ROA can be explained upon by NPL, and this proves that the model is explanatory as well.

In addition, the RMSE value in the null model (M_0) stands at 0.338 whereas; on adding NPL, the value of the same rises to 0.288 in Model M_1). On the whole, the findings indicate that NPL inclusion can substantially improve the explanatory capacity of the model in terms of ROA, which supports the use of credit risk to determine the profitability in the operations of the banks. Regression analysis further indicates that NPL explains 35.4% of the variation in ROA (R^2 = 0.354), confirming that higher credit risk adversely affects bank profitability. Hence, H_1 is accepted.

Table 4: Model Summary for Regression Analysis of Capital Adequacy Ratio (CAR) on Return on Assets (ROA)

Model	R	R^2	Adjusted R^2	RMSE
M_0	0.000	0.000	0.000	0.404
M_1	0.607	0.368	0.242	0.351

(Source: Author, 2025)

Table 4 indicates that Model M_1, which contains capital adequacy ratio (CAR), gives a significant contribution to the explanation of the bank profitability (as indicated by Return on Assets (ROA)) when compared to the null model. The positive relationship between CAR and ROA is moderate with a value of 0.607. The value of R^2 is 0.368 indicating that 36.8% of the change in ROA is provided by variations in capital adequacy and emphasizing the significance of the capitalization process in increasing the asset-based profitability. Upon the consideration of the model complexity, the adjusted R^2 of 0.242 represents that about 24.2% of the variation in the ROA should be attributed to CAR and this indicates that it has an explanatory value.

Moreover, the RMSE decreases between 0.404 in Model M_0 to 0.351 in Model M_1 that reflects better predictive performance of the model with CAR. Comprehensively, the outcomes suggest that capital adequacy endows a positive effect on the profits of the operation of banks, and it proves the importance of the presence of capital buffers in maintaining efficient asset utilization.

Table 5: ANOVA Results for the Regression Model Predicting Return on Assets (ROA) from Capital Adequacy Ratio (CAR)

Model		Sum of Squares	df	Mean Square	F	p
M_1	Regression	0.360	1	0.360	2.917	.148
	Residual	0.618	5	0.124		
	Total	0.978	6			

(Source: Author, 2025)

As seen in Table 5, results of ANOVA test the significance of the entire Model M 1, as it tests the impact of the capital adequacy ratio (CAR) on Return on Assets (ROA). The regression model describes a fraction of the variability in the ROA, and the regression sum of squares of 0.360 is of a sum of squares of 0.978. The results of the model are the F-test is 2.917 and its degrees of freedom is 1 and 5, and the p-value is 0.148.

The p-value is more than 5%, hence, this model is not statistically significant; that means that there is no statistically significant mean of CAR on ROA in this sample. Though the direction of its relationship is that an increase in capital adequacy can be related to better asset-based profitability, the proof is not strong enough to make a definite conclusion. The implication of this finding is that, although capital adequacy can contribute CSR to bank stability, its immediate effect on ROA can be affected by other issues like the quality of assets, management effectiveness or market environment. The findings do not provide sufficient statistical support for H_2. Although CAR is positively related to ROA and ROE, the regression model is not statistically significant ($F = 2.917$, $p = 0.148$). Thus, despite its positive direction, the effect of CAR on profitability cannot be confirmed at the 5% significance level, and H_2 is rejected. Overall, the results indicate that loan quality (NPL) is a more critical determinant of sustainable profitability than capital adequacy among commercial banks in Kathmandu Valley.

DISCUSSION

The research revealed that the credit risk profile and profitability of commercial banks of Kathmandu Valley were evidently different, which explains the difference in efficiency in dealing with credit exposures. Banks that were better in advanced credit risk management (as reflected in lower NPLs and larger capital buffers) posted larger ROA and ROE. Other banks like SCBL, EBL, and Global IME were relatively low on non- performing loans, and very profitable, which is an indication that their loan screening, monitoring, and recovery processes were well in place. On the other hand, banks that reported greater NPLs, such as PRABHU and RBB, were less profitable, and credit risk dysfunctional approaches had a direct negative effect on sustainable profits (Shrestha, 2022). The trends analysis of ADBL also supported such trends by indicating that the variation in profitability over the years was similar to the fluctuation in credit quality and capital adequacy (Goet, 2022). The scatterplot of the average NPL and ROA supported the inverse relationship among credit risk, and profitability which is supported by the existing financial intermediation theory. In general, the findings suggested that robust credit risk models, based on a timely surveillance, a judicious lending, and a good capital planning, played an important role in profitable sustainability (Sigdel & Deswal, 2024). These results indicated significant implications in the Nepalese banks which were in the Kathmandu Valley operating in the competitive level where cutting the credit risks had been critical in long term financial strength and stability (Shrestha & Niraula, 2021).

The findings suggest that the most crucial factor that defines the profitability of banks in Kathmandu Valley is credit risk, which is represented by non-performing loans (NPL). The high negative correlation between NPL and ROE, and moderate negative correlation between NPL and ROA indicate that the more impaired loans there are, the less significant the interest income, the higher the provision costs, and the lower the overall financial performance. This conclusion is in agreement with earlier empirical studies that poor asset quality is a major factor in lowering bank profitability and performance (Karki & Aryal, 2019; Dahal & Dhungana, 2025).

Despite the positive relationship between the capital adequacy ratio (CAR) and the indicators of profitability, its impact is not significant in the regression model. This means that the greater the capitalization, the more resilient and stable it becomes, but it does not necessarily ensure greater short-term profitability. Earlier studies have found similar mixed or weak impacts of capital adequacy on profitability, especially where the earnings performance is dominated by asset quality and other operating factors (Balami & Chalise, 2023). Liquidity ratio does not have any meaningful correlation with profitability but it has negative correlation with NPL meaning high liquidity could support quality of assets but not directly improve returns. Lastly, the high positive correlation between ROA and ROE validates the internal consistency of profitability measures, which is widely found in banking research (Kalwar & Shrestha, 2024).

CONCLUSION

This paper concludes that credit risk management efficiency is a decisive variable that will define sustainable profitability between commercial banks in Kathmandu Valley, and profitability alone without proper management of risks will not ensure financial health in the long term. Using Pearson correlation analysis, the empirical evidence reveals that non-performing loans (NPL) correlate with profitability, shows that the inverse relationship between NPL and ROE is statistically significant and therefore proves that increasing credit risk directly reduces shareholder returns. This close positive correlation between ROA and ROE also confirms the uniformity of the profitability measures in this research. The results of the

regression analysis support this conclusion by demonstrating that NPL can explain a significant percentage of the variation in ROA, which means that asset quality is an influential factor in sustainable earnings. The profitability of banks that had less efficient credit monitoring systems and suffered more loan defaults was always lower, which underscores the negative influence of inefficient credit risk management. Conversely, despite the positive correlation between the capital adequacy ratio (CAR) and the profitability, the ANOVA outcomes show that the relationship is not found to be statistically significant in the sampled period. This indicates that even though the capital buffers increase resilience and stability, they do not guarantee increased profitability alone unless the quality of assets is taken into consideration. Results in hypothesis testing prove these observations: the hypothesis asserting the relationship between NPL and profitability is approved, and the positive hypothesis about the relationship between CAR and profitability is disapproved at the 5% level. Generally, the research confirms that quality management of loans is more decisive in making Kathmandu Valley commercial banks sustainable in profitability than capital strength itself. Ensuring credit appraisal, continuous monitoring of loans, and proactive management of NPL is thus not only necessary in terms of improving profitability over the long term, but also in creating systemic stability and safeguarding the interests of stakeholders in the development of the new financial regime in Nepal.

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