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Research Article

Factors Affecting the Profitability of Commercial Bank in Nepal

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Abstract

Profitability of commercial banks is a central indicator of banking-sector health and strongly influences national economic development. In Nepal, commercial banks operate under Nepal Rastra Bank (NRB) oversight and are affected by both macroeconomic conditions and internal management practices. This study investigates the key internal (bank-specific) and external (macroeconomic and regulatory) determinants of profitability in Nepalese commercial banks. Using secondary data from NRB publications, banks' annual reports, and relevant literature, the study applies a descriptive-analytical approach to examine relationships between profitability metrics (ROA, ROE) and explanatory variables. Internal variables include capital adequacy, asset quality (NPLs), credit-risk management, liquidity, operational efficiency (cost-to-income), and bank size. External variables include GDP growth, inflation, interest-rate spread, exchange-rate movements, and monetary-policy stance. Findings show that both internal and external factors influence bank profitability, with internal factors—particularly credit-risk (NPL) management and operational efficiency—exerting a stronger and more consistent effect on ROA and ROE. Adequate capital and prudent liquidity management support resilience and earnings capacity, while macroeconomic stability (moderate inflation, steady growth, predictable interest-rate environment) enhances income generation. Sustained profitability in Nepal's commercial banks requires strengthened credit-risk frameworks, improved operational efficiency, prudent capital/liquidity strategies, and policies that foster macroeconomic stability.

Keywords: Nepal, commercial banks, profitability, ROA, ROE, capital adequacy, non performing loans

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Introduction

It is widely acknowledged that the banking industry is a cornerstone of any modern financial system. By mobilizing savings from surplus units and channeling them into productive investments, banks play a central role in promoting economic development (Mishra & Kandel, 2023). Commercial banks, in particular, act as financial intermediaries that facilitate trade, support business expansion, enable infrastructure projects, and foster broad-based economic growth; their performance is therefore closely tied to macroeconomic stability and development outcomes in emerging economies such as Nepal (Mishra et a., 2021).

Profitability—defined as a bank's ability to generate income in excess of its expenses from both core and non-core activities—is a principal measure of bank performance and long-term viability. Core income is largely interest from loans and advances, while non-interest income includes fees, commissions, foreign-exchange gains, and service charges. Common financial ratios used to assess profitability include return on equity (ROE), return on assets (ROA), net interest margin (NIM), and earnings per share; these metrics help stakeholders evaluate how efficiently a bank uses its resources to produce returns (Mishra et al., 2021).

A range of internal (bank-specific) and external (macro-level) factors influence commercial bank profitability. Internal factors stem from managerial decisions and operational characteristics—examples include cost structure, credit-risk management, operational efficiency, asset quality, capital adequacy, liquidity management, and overall management effectiveness. Banks with diversified loan portfolios and robust credit-assessment systems generally experience lower default rates and higher profitability; similarly, effective cost control and optimal resource allocation support stronger earnings (Mishra & Kandel, 2023; Poudel, 2016).

External factors arise from the broader economic and regulatory environment and are largely beyond an individual bank's control. Inflation, interest-rate movements, GDP growth, exchange-rate volatility, political stability, and regulatory policies (for example, reserve requirements and capital adequacy norms) can materially affect banks' margins and lending capacity. In Nepal, monetary-policy actions by the Nepal Rastra Bank directly influence reserve requirements, lending rates, and liquidity conditions, thereby affecting bank profitability (Ojha, 2018).

Nepal's banking sector has undergone significant structural change in recent years as a result of increasing competition, financial liberalization, and technological advancement. The entry of numerous private and joint-venture banks has improved service delivery and expanded financial access, which in turn has intensified competition and made profitability a more critical indicator of sustainability (Mishra & Kandel, 2023; Mishra et al., 2021).

Regulation plays a dual role: while the Nepal Rastra Bank's regulatory framework aims to protect depositors and preserve financial stability, stringent requirements—such as credit-exposure limits, provisioning rules, and capital-adequacy ratios—may compress banks' profit margins (Ojha, 2018; Njihia, 2005).

Digital transformation presents both opportunities and costs for Nepalese banks. Adoption of electronic payment systems, mobile banking, and other digital services has expanded customer reach and improved operational efficiency, but it has also required substantial investments in IT infrastructure and cybersecurity. Consequently, banks must balance digital investments against short-term profitability while considering long-term competitive benefits (Celestin & Mishra, 2025; Kushwaha et al., 2025).

Understanding the determinants of bank profitability is therefore important for bank managers, investors, regulators, and researchers. A systematic examination of both bank-specific and macroeconomic drivers helps identify key performance levers and supports the design of policies and strategies that enhance profitability, ensure financial stability, and promote sustainable growth in the banking sector (Mishra & Aithal, 2023; Shukla et al., 2013; Nsambu, 2014).

This study offers practical value across multiple stakeholder groups. For bank management, it informs the design of credit-risk policies, operational-efficiency programs, and capital and liquidity strategies that can strengthen profitability (Mishra & Kandel, 2023). For shareholders and investors, the findings improve assessment of return potential and risk by clarifying the principal drivers of bank performance (Mishra et al., 2021). For regulators and policymakers—particularly the Nepal Rastra Bank—the evidence helps calibrate regulatory measures so they better balance financial stability with banks' profitability (Ojha, 2018). For academics and researchers, the study fills empirical gaps in the Nepalese banking literature and provides a framework for future work on profitability determinants (Poudel, 2016). At the sector and national level, improving banks' financial health supports more effective financial intermediation, higher investment, job creation, and broader economic growth (Mishra & Aithal, 2023). The analysis is grounded in financial intermediation theory, the risk–return trade-off, and efficient management theory, which together explain how banks generate profits and how trade-offs between risk and efficiency affect returns (Mishra et al., 2021). Consistent with prior evidence, internal determinants—capital adequacy, liquidity, asset quality (NPLs), operational efficiency, and management quality—emerge as major drivers of profitability in Nepal and similar economies (Poudel, 2016; Mishra & Kandel, 2023; Njihia, 2005). External factors such as inflation, interest rates, GDP growth, exchange-rate movements, political stability, and central-bank policies also materially influence margins and lending capacity (Ojha, 2018; Nsambu, 2014). Finally, while digitalization enhances reach and efficiency, it imposes significant IT and cybersecurity costs that create short-term pressure on profits but promise longer-term competitive gains (Celestin & Mishra, 2025; Kushwaha et al., 2025). Given the limited recent studies that jointly model internal and external determinants with current data for Nepal, this study addresses an important empirical gap by integrating both sets of factors within a single analytical framework (Mishra & Aithal, 2021a; Poudel, 2016).

It is widely recognized that Nepal's commercial banking sector has undergone significant expansion and structural change driven by financial liberalization, technological advancement, and intensified competition (Mishra & Kandel, 2023; Mishra & Aithal, 2021b). Despite these developments, maintaining stable profitability remains a major challenge for many banks. Profitability is influenced by external macroeconomic and regulatory conditions—such as inflation, interest-rate volatility, GDP growth, political stability, and policies of the Nepal Rastra Bank—as well as internal bank-specific factors including capital adequacy, liquidity management, credit risk, operational efficiency, and management quality (Ojha, 2018; Poudel, 2016; Mishra & Kandel, 2023).

In recent years, several Nepalese banks have experienced profitability shocks caused by rising non-performing loans, growing operating costs, and adverse shifts in macroeconomic conditions, which together have compressed margins and increased performance volatility (Mishra & Aithal, 2021a; Njihia, 2005). At the same time, digitalization and costly investments in IT and cybersecurity have created a trade-off between short-term profitability and long-term competitiveness (Celestin & Mishra, 2025; Celestin et al., 2025).

By jointly modeling bank-specific and macroeconomic determinants using recent panel data, the study provides updated empirical evidence for Nepal, supports evidence-based policy, and suggests managerial strategies to strengthen bank profitability and sectoral resilience (Mishra & Kandel, 2023; Celestin et al., 2025).

However, there remains a shortage of comprehensive, up-to-date studies that analyze how internal and external determinants interact to shape commercial banks' profitability in Nepal. This empirical gap hampers policymakers and bank managers from designing evidence-based strategies to strengthen financial performance and resilience. Accordingly, the primary objective of this study is to investigate and evaluate the chief internal and external factors affecting profitability in Nepal's commercial banks, and to provide actionable recommendations for policy and management practice.

Research Objective

To investigate the internal (bank-specific) and external (macroeconomic and regulatory) determinants of profitability of commercial banks in Nepal, and to provide evidence-based recommendations for managers, regulators, and other stakeholders to enhance bank performance and financial stability.

Methodology

This study employs a descriptive and analytical research design using a quantitative approach based on secondary data. The sample comprises Nepalese commercial banks selected through purposive sampling, including only those with complete financial records over a 5–10-year panel period. Profitability, measured by Return on Assets (ROA) and Return on Equity (ROE), is the dependent variable, while the explanatory variables include the Capital Adequacy Ratio (CAR), liquidity ratio, Non-Performing Loan (NPL) ratio, cost-to-income ratio, inflation, GDP growth, interest rate, and regulatory dummy variables. The data are analyzed using descriptive statistics, correlation analysis, panel regression (fixed- and random-effects models), diagnostic tests, and robustness checks. The econometric model is specified as:

$$ROA/ROE = \beta_0 + \beta_1 CAR + \beta_2 LIQ + \beta_3 NPL + \beta_4 EFF + \beta_5 INF + \beta_6 GDP + \beta_7 INT + \beta_8 REG + \varepsilon.$$

The study is limited by its reliance on secondary data, the use of purposive sampling, and the potential for omitted-variable bias.

Results and Discussion

Nepal's commercial banks' profitability reflects a complex interaction among external economic conditions, regulatory frameworks, and internal management practices. Empirical studies indicate that both macroeconomic and bank-specific factors significantly shape financial performance, although their relative importance varies across institutions and time periods (Mishra & Kandel, 2023; Mishra & Aithal, 2021b). Internally, non performing loans (NPLs) and asset quality, capital adequacy, liquidity management, operational efficiency, and management quality consistently emerge as principal determinants of profitability. Strong capital positions improve resilience to financial shocks, bolster investor confidence, and support long term growth, although excessively high capital ratios can reduce return on equity, reflecting a trade off between safety and profitability (Poudel, 2016; Njihia, 2005). Poor asset quality and weak credit risk management directly depress profitability through higher provisioning and reduced interest income, while inefficient operations and elevated administrative costs compress net margins. Conversely, well managed banks with disciplined cost control and optimal resource allocation tend to exhibit superior profitability.

Liquidity management presents a dual challenge: while adequate liquidity is essential to meet obligations and sustain depositor confidence, excessive idle liquidity reduces earning assets and lowers returns; thus, maintaining an optimal liquidity position is critical. Externally, macroeconomic variables such as GDP growth, inflation, interest rates, exchange rate movements, and political stability materially influence bank performance. Economic expansion raises demand for credit and financial services, improving profitability; the impact of inflation is mixed—moderate inflation can raise interest income, whereas high inflation raises costs and economic uncertainty, undermining profits. Interest rate dynamics determine net interest margins, a core revenue source, and exchange rate volatility affects banks engaged in foreign exchange and remittance activities. Political stability supports investment and lending activity, indirectly improving bank outcomes (Ojha, 2018; Nsambu, 2014).

Regulatory policy by the Nepal Rastra Bank plays a central role in shaping profitability. Measures such as capital adequacy requirements, provisioning norms, loan classification rules, reserve mandates, and other credit control instruments safeguard financial stability but may constrain short term profitability by limiting lending capacity or raising compliance costs (Ojha, 2018; Mishra & Aithal, 2021a). Technological change and digitalization further complicate the trade offs: adoption of digital platforms and fintech can expand reach and operational efficiency but requires significant investments in IT and cybersecurity that may depress short term profits while creating long term competitive advantages (Celestin & Mishra, 2025; Kushwaha et al., 2025).

This study aimed to analyse these interrelated determinants of profitability in Nepalese commercial banks. Given the sector's rapid growth and mounting competition, profitability is a vital indicator of sustainability. The findings reaffirm that no single factor alone explains bank performance; rather, profitability arises from a dynamic balance among internal governance and efficiency, macroeconomic conditions, credit risk management, and regulatory constraints. Banks that effectively align risk management, operational efficiency, capital and liquidity strategies, and regulatory compliance are better positioned to achieve stable, long term profitability.

Conclusion

In summary, profitability of Nepal's commercial banks is the product of multiple, interacting factors. Strengthening profitability requires robust internal management—particularly in credit risk control, cost management, and resource utilisation—alongside favourable macroeconomic conditions such as stable inflation, balanced interest rates, and sustained economic growth. While regulatory frameworks enacted by the Nepal Rastra Bank are essential for systemic stability, their short term effect can be to constrain profit growth; therefore, banks must manage the trade off among profitability, risk management, and compliance. Ultimately, banks that integrate sound internal governance with strategic responses to external conditions will be most likely to attain durable growth, financial stability, and sustainable profitability in Nepal's competitive banking landscape.

Recommendations

- o Enhance credit risk management. Strengthen credit appraisal, monitoring, and recovery mechanisms to reduce NPLs and provisioning charges.
- o Improve operational efficiency. Adopt process re engineering, automation, and digital banking solutions to lower administrative costs and increase service efficiency (Celestin & Mishra, 2025).
- o Maintain optimal capital levels. Balance regulatory capital requirements with effective capital utilisation to maximise returns while preserving resilience (Poudel, 2016).
- o Strengthen liquidity planning. Implement dynamic liquidity forecasting and prudent asset liability management to avoid both shortages and idle funds.
- o Diversify income sources. Expand non interest revenue streams—digital payments, remittances, advisory services—to reduce reliance on interest margins.
- o Control operating costs. Apply tight cost governance and performance metrics to cut unnecessary expenditures.
- o Invest strategically in technology. Prioritise digital platforms and cybersecurity investments that yield measurable efficiency and revenue gains over time (Kushwaha et al., 2025).
- o Build managerial capacity. Recruit and train skilled management to improve decision making in lending, investment, and risk management.
- o Monitor macroeconomic trends. Align strategic planning with inflation, interest rate, and GDP forecasts to manage margin and credit risk exposure.
- o Engage constructively with regulators. Participate in policy dialogue with the Nepal Rastra Bank to help design regulations that support both stability and bank viability (Ojha, 2018).
- o Strengthen portfolio diversification. Reduce sectoral and borrower concentration to mitigate systemic and idiosyncratic risks.

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