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Non-Performing Assets and Profitability of Joint Venture Banks in Nepal

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Abstract

This study examines the impact of non-performing assets and profitability of commercial banks in Nepal. Out of 27 commercial banks, five joint venture banks have been selected as sample based on descriptive and analytical technique. Secondary data was collected from the annual reports of five selected commercial banks for the period of 2011/12 to 2020/21. Data have been collected and analyzed by using mean, standard deviation, and correlation and regression analysis. The profitability in terms of return on assets (ROA), return on equity (ROE) and profitability are selected as dependent variables. Non-performing assets (NPA), capital adequacy ratio (CAR) and total loan to total deposit ratio (TLTD) are taken as independent variables. The finding indicates that NPA has significant impact on the profitability of Nepalese joint venture banks. The result shows that ROE has been found a positive impact on the NPA, CAR and TLTD. Thus, this study concludes that non-performing assets is an important predictor for the profitability of the bank. Therefore, the success of the bank in term of profitability depends on its non-performing assets.

Keywords: ROE, NPA, ROA, Profitability, Financial Performance

Introduction

NPA stands for “non-performing assets” In the context of banking and financial, an NPA is a loan or advance for which the borrower has stopped making timely payments

of principal or interest, or both. Non-performing assets are considered to be a risk to the lender, as they are less likely to be repaid and many result in a loss for the lender. Non-performing assets can include loans to individuals or business, mortgages, and other types of debt. Banking and other financial institutions are required to set aside funds to cover potential losses from non-performing (Kiran et.al. 2016) assets, which can impact their profitability and overall financial health.

Every commercial bank has long struggled with the reduction of NPAs, and appropriate management of the NPAs is being given high importance. Commercial banks are currently losing their profitability and are fighting for their very existence as a result of several obstacles in the way of managing NPA. The true story of banking reveals that it deals with money lending and money collecting. However, it followed the basic law of demand and supply, whereby people having excess money lent to people who needed it for more productive purposes and were willing to pay a price for this.

According to Nepal Rastra Bank (NRB) Non-Performing Assets is a loan that is overdue for more than three months. Restricted and rescheduled loans and loans not following the criteria policy/ directive of NRB are also included in NPL (Nepali, 2020) on the basis of Nepal Rastra bank's states that NPL are classified as follows:
 Pass: Pass loans are assets that are up to 1 month past due and still considered performing, with a 1% loan loss provision
 Watch list: Loans and advances that is due from 1 to 3 months 5% loan loss provision.
 Sub-standard: Any asset which is past due 3 to 6 months which is 25% loan loss provision.
 Doubtful: Any asset which is past due more than 6 months and less than a year which is 50% loan loss provision.
 Loss: Any asset which is past due 1 year or more that is 100% loan loss provision. As per the Nepal Rastra Bank, loans are categorized as performing and non-performing loans where the non-performing loans are more likely to be converted as non-performing assets. Non-Performing assets not only reduces the overall profit but also the overall operational and administrative cost.

Once the distributed loan is not returned timely by clients and becomes overdue then it is known as NPA for the banks. Reduction of NPA has always been a significant problem for every commercial bank. Due to various hurdles on the management of NPA, commercial banks are now losing their profitability and struggling for their existence. Loans and Advances dominate the assets side of the balance sheet of any bank. Similarly, earning from such loans and advances occupy major space in the income statement of the banks.

A joint venture bank is a financial institution that is owned and operated by two or more separate entities, typically companies or organizations. Joint venture banks are formed as a way for the participating entities to combine their resources and expertise to offer financial services to a specific market or group of customers.

Joint venture banks can take various forms, including partnership, limited liability companies, and other legal structures. The specific structure of a joint venture bank will depend on the needs and goals of the participating entities and the regulator environment in which it operates. Joint venture banks may offer a range of financial services, including deposit accounts, loans, credit card, and investment products. They may also provide specialized financial services tailored to the needs of their target market. Joint venture banks can be an attractive option for companies or organizations that want to enter the banking sector but do not have the resources or expertise to do so on their own. By forming joint venture with another entity, they can share the risk and costs association with starting a bank, as well as pool their resources to offer a wider range of financial services.

Literature Survey

NPA can be described as bad debt, however the banking industry also includes loans and advances that are performing poorly and are at risk of becoming bad debt. NPA negatively affects financial institutions. Because the anticipated return cannot be achieved, the investment loses all of its value on the one hand, and because of the provisions needed for risk reduction, the profitability suffers as a direct result. In this case, the bank's very survival may be in doubt. Therefore, interest and principal must be paid back on time and without any problems. Given the significant amount of non-performing loans held by public sector banks, the Indian government and Reserve Bank of India have the regulatory power to take swift action to maintain public trust in the stability of commercial banks (Vasudevan, 2018)

According to (Herrero 2017), a larger ratio of loans to assets should boost bank profitability as long as interest rates on loans are liberalized and the bank uses markup pricing, notwithstanding the operating expenses of maintaining a large portfolio of loans. Due to the fact that a bank's income is produced from loans from which interest is collected, credit risk appears to have the greatest influence on the profitability of the bank among the several forms of risk that banks are exposed to.

The highlighted a critical issue in Nepal's banking system: a significant level of Non-Performing Assets (NPA), where borrowers were not repaying loans on time, affecting banks' profitability. To investigate this, a study analyzed how non-performing loans impacted bank profits (Return on Assets) and their profitability compared to investments (Return on Equity). The study also considered factors like loan loss provisions, capital, and bank size. Data were collected from sources like bank and government reports spanning 2010 to 2017, covering three government-owned and ten private banks. Mathematical models were employed to assess the impact of non-performing loans on Nepal's bank profits (Gnawali, 2018).

Impacts of credit risk management on the profitability of rural and community banks in Ghana were examined for the years 2006 to 2010. The non-performing loan ratio and capital adequacy ratio were used by the authors as measures of managing credit risk, and ROA and ROE were used as indications of bank profitability. According to the study's findings, non-performing loans and bank profitability have a substantial positive association, which means that despite widespread loan default, non-performing loans are growing proportionately to profitability. The authors reported that banks pass the burden of loan default to other customers with increased interest rates as the cause of inefficient credit risk management practices among Ghana's rural and community banks. The community banks were lucrative as a result of this strategy. Due to the fact that nonperforming loans theoretically lower bank profitability, this nonetheless demonstrates that Ghana's rural and community banks lack good and effective credit risk management practices. To put an end to this behavior, the authors strongly advise the Bank of Ghana to improve its controls over the rural banking sector (Afriyie & Akotey, 2012).

For the years 2006 to 2009, secondary data from the fiscal statements and annual reports of 10 Nigerian banks were examined to determine the link between risk management practices and banking's overall performances in Nigeria. Given that the data used in this analysis is cross-sectional units recorded across time, the authors have employed the panel data estimation approach. As independent variables, the authors used the cost of poor and doubtful loans, non-performing loans, liquidity, equity-total asset ratio, equity-loan ratio, and debt-equity ratio. In contrast, the dependent variables used are return on asset (ROA) and return on equity (ROE). The results of this study indicate that there is an inverse link between the cost of bad and doubtful loans and banks'

financial performance, but a positive and substantial association between banks' financial performance and their capital assets ratio. The writers came to the conclusion that there is a considerable connection between risk management and bank performance. To improve banks' financial performance, the authors advise that the identified credit risk indicators cost of bad and dubious loans, debt-to-equity ratio, and managed fund be properly managed (Alidade et al., 2014).

Research on "A Study on Non-Performing Assets of Commercial Banks with References to SCBNL, RBB, Everest bank, NB bank and NBBL" has been done. His research's primary goal is to ascertain the ratio of non-performing loans and the level of NPA in total assets, total deposits, and total lending in the selected commercial bank, as well as the relationship between loan loss provisions in the commercial bank and the impact of non-performing assets on the performance of commercial banks. Inadequate credit policies, political pressure to lend, a lack of oversight and monitoring, a downturn in the economy, and an overvaluation of collateral, in his opinion, are the main reasons NPAs develop. A lot of effort has been put out in recent years by banks in the public and private sectors such as the NBBL, EBL, and SCBNL sectors, to prevent their loans and advances from turning into non-performing assets. Public banks should create a suitable loan loss strategy and endeavor to quickly recover their loans and interest payments in order to lower their NPA. His investigation shows that, in addition to lowering bank profitability, a significant degree on non-performing assets has an effect on the organization's financial and operational health. The NPA will be the key factor in any future bank closures if it is not soon brought under control. The capacity of the banking system to create money by employing the available corporate assets is also measured by ROA, which is a key indicator of bank profitability. (Zahara & Abderaman, 2017)

Financial institution non-performing loans (NPL) are viewed as a major issue in the context of Nepal over the recent years. The purpose of this paper is to analyze the effects of macroeconomic factors (Gross domestic product, inflation, and actual exchange rate) as well as bank-specific factors (size, modify in loan, actual lending interest rate and share of loans to total assets assets) here on non-performing loan of Nepal's commercial banks. Primary sources were not used much in the study. 227 observations from the period 2002–2012 were made while collecting data for 26 commercial banks. According to the study, macroeconomic factors like the effective real exchange rate have a negative significant

effect on non-performing loans. In this study, the effect of rate of GDP growth has been found to be negligible. Non-performing loans are benefited significantly by an inflation rate that is one year behind. According to earlier studies' findings, banks that charge comparatively high real rates of interest have more non-performing loans. The ownership dummy has a positive coefficient and is significant at the one percent level, indicating that the non-performing loan ratio would be higher if the bank was owned by the government than it would be if it were privately owned. Additionally, since the loan change coefficient in the past and present years has a negative coefficient and is significant at the one percent level, so much borrowing in the prior years and current year decrease the non-performing loan (Bhattarai, 2015).

This study asserts that, despite the operational costs of managing a sizable loan portfolio, profitability should rise if interest rates on loans are modernized and the bank uses markup pricing. Given that a bank's revenue is derived from loans under which interest is paid, credit risk appears to have the greatest impact on the bank's profitability among the various risks it faces. Loans classified as NPA fall into three categories: substandard, doubtful, and loss, per NRB directives. According to the circular, an NPA is a form of credit for which interest has not been paid for 2 quarters. The circulars state that the loans are divided into four groups based on their fragility and reliance on collateral securities, along with the provisioning rate (García-Herrero et al., 2009).

The amount of NPA in the banking sector in Nepal is very serious. It is a well-known truth that banks and other financial institutions in Nepal have been struggling with the issue of growing non-performing assets as well as the issue of becoming unmanageable day by day. This study investigates how non-performing loans affect the financial success the Nepalese commercial banks. Asset return and equity return are regarded as dependent variables (Ibrahim & Thangavelu, 2014). As independent factors, non-performing loans, loan loss provisions, capital adequacy ratios, loan loss provisions to total loan ratios, total loans to total deposit ratios, and company size are chosen. This research is based on secondary data that was gathered from several issues of the Banking and Financial Data, the Nepal Rastra Bank's Bank Supervision Report, and bank annual reports. The study includes the years 2010 to 2017 and includes 24 to 80 observations for three government banks and ten non-government banks, respectively. The significance and effect the non-performing loans on the profitability of Nepalese commercial banks were examined using regression models (Gnawali, 2018).

Problem Definition

Commercial banks in Nepal have been facing several problems like lack of smooth functioning of economy, different policies and guidelines of NRB, political instability, security problem, poor information system, over liquidity caused by lack of good lending opportunities, increasing non-performing assets etc. In the present context where Nepalese banks are facing the problem of increasing NPAs, more amounts have to be allocated for loan loss provision. As earlier mentioned, the provision amount is taken out by deducting from the profit of the bank; the bank's profit might come down.

Increasing NPA has now become the major issue for every commercial bank. Every bank now has put the NPA management under the top priority and is functioning to reduce the major part of it from the assets side of their balance sheet. The main objective of the study is to analyze the recent trend of the net profit of selected commercial banks in Nepal. In addition, the impact of NPA, CAR, and TLTD on bank ROA and ROE will be examined.

Research methodology

A descriptive research design was used for the study. The study concentrated on secondary information collection from five joint venture banks in Nepal. The main sources of this information were the annual reports of these sample banks, Nepal Rastra Bank's report on bank supervision, and the report on bank supervision. The time period of data analysis was from 2011 to 2020. Using a capital-based methodology, a sample of five joint venture banks was chosen randomly from among the 27 commercial banks. This group of financial institutions includes Himalayan Bank Limited, NMB Bank Limited, Nabil Bank Limited, NSBI Bank Limited, and EBL. Statistical methods including mean, standard deviation, CV, correlation, and regression analysis using SPSS were used to analyze the data. Non-Performing Assets (NPAs), the total deposit to total loan ratio (TDTL), and the capital adequacy ratio (CAR) were the independent variables, while Return on Assets (ROA) and Return on Equity (ROE) were the dependent variables.

Results and Discussion

Descriptive Statistics

Table 1 shows the overall features of the components used to show the key findings of an inquiry. They provide clear explanations of the case and the overall measurements. The measurements show a combined outcome concerning the informational high points for several variables. The average estimates are NPA, net profit in billions, ROE, ROA, CAR, and TDTL, which each display the average position. Furthermore, the proportions of absolute and relative inconstancy are represented by the standard deviation (SD) and coefficient of variation (CV). In this aspect, the CAR has shown more consistency (CV = 0.11) whereas the NPA has shown greater volatility (CV = 0.56).

Table 1

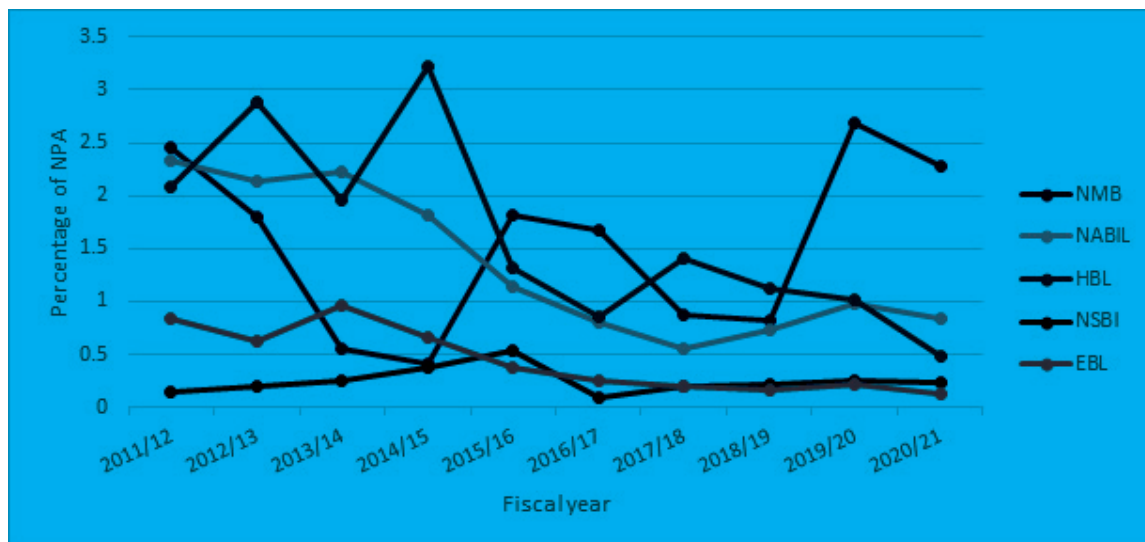
Banks' Presents the Descriptive Statistics of Selected Variables

| | NPA | NP billion | ROE | ROA | CAR | TDTL |
|------|------|------------|-------|------|-------|-------|
| Mean | 1.04 | 1.78 | 18.52 | 1.78 | 12.81 | 79.42 |
| SD | 0.57 | 0.79 | 4.91 | 0.43 | 1.38 | 9.21 |
| CV | 0.56 | 0.48 | 0.26 | 0.25 | 0.11 | 0.12 |
| N | 50 | 50 | 50 | 50 | 50 | 50 |

Non-performing assets

Non-performing assets (NPAs) are assets that do not generate a profit for the bank. They are becoming a serious issue in the banking business since they lower the organization's earnings. Non-performing assets (NPAs) are a big issue in Nepalese banking. Because Nepal's banking system is still in its early stages, non-performing assets are getting more difficult to eliminate owing to a variety of variables such as lax lending policies, economic considerations, and so on. The table below provides the specifics of selected banks' non-performing assets over the previous 10 years.

Figure 1



Non-Performing Assets

Source: Annual report of sample banks.

In Fig.1, the non-performing assets of selected commercial banks tend to be fluctuating as we can see dissimilar trend in the non-performing assets over a selected period of study.

Table 2

Relationship of Analysis of Variables (N=50)

| | ROA | ROE | NP | NPA | CAR | TLTD |
|------|--------|--------|--------|--------|-------|------|
| ROA | 1 | | | | | |
| ROE | 0.680 | 1 | | | | |
| NP | 0.437 | -0.031 | 1 | | | |
| NPA | 0.072 | 0.157 | -0.092 | 1 | | |
| CAR | -0.221 | -0.525 | 0.241 | -0.302 | 1 | |
| TLTD | -0.020 | -0.426 | 0.351 | 0.042 | 0.512 | 1 |

Correlation is significant at the 0.01 level (2-tailed).Correlation is significant at the 0.05

level (2-tailed). The correlations between the various variables are shown. The association between ROA and NPA and NP is positive, as the table demonstrates. Positive relationships exist between NPA and TDTL, respectively.

The correlation between NPA and net profit is seen to be negative. It is usual looking to the effect of the NPA. Due to the increment in total lending the ROE, ROA and Net Profit of the selected commercial bank is increased when there is increase in NPA. So the effect of NPA is not seen in a way in which it would be. Due to the increment in total lending that is simultaneously increasing the total profit. This increment in the total profit is making the effect of the NPA unnoticeable on ROE, ROA and NPA.

Table 3

Impact of the Effect of CAR, NPA and TDTL on ROA

| Variables | Coefficients | Standard Error | t Stat | P-value |
|---|--------------|----------------|---------|---------|
| Intercept | 2.5295 | 0.7533 | 3.3577 | 0.0015 |
| NPA | -0.0144 | 0.0981 | -0.1473 | 0.8834 |
| CAR | -0.1016 | 0.0618 | -1.6427 | 0.1072 |
| TDTL | 0.0071 | 0.0092 | 0.7709 | 0.4446 |
| <i>R₂ = 0.0614; Adjusted R₂ = 0.0046; F-stat = 0.9926; F-sig = 0.4047; E = 0.5394; Number = 50</i> | | | | |

Table 3 presents the regression consequence of the impact of CAR, NPA, and TDTL on one of the intermediaries of profitability, ROA. The consequences of R_2 and adjusted R_2 speaks to the level of the changeability of dependent variable can be clarified by the autonomous variable. These outcomes express the general informative intensity of the regression model. The estimation of R_2 and adjusted R_2 are 0.0614 and 0.0046 individually. This demonstrates most extreme 6.14% of the variety in the earning per share can be clarified by the variety in the logical variable. Based on these outcomes, it can't be guaranteed as solid generally logical intensity of the regression model is reasonable and factually fitted. The size of the coefficient for autonomous variable gives the size of the

impact on subordinate variable. The sign on the coefficient provides the direction of the impact.

ANOVA (analysis of variance) is used to report quantities related to the overall explanatory power and significance of the regression model. Since p-value is greater than 0.05 (critical level of significance) it is concluded that there is insignificant relationship between ROA with NPA, CAR and TLTD F- value of 0.9928, with a corresponding p-value of 0.4047, which means that the overall fitness of the model is not well justified.

The P value for F statistics in the model represent that the model is fairly fitted since it is less than 0.01. Thus the overall explanatory power of the regression model is fair and statistically fitted the result indicate that the coefficient of NPA is positive and statistically insignificant (P-value = 0.883). The result revealed that NPA has a positive and significant impact on bank profitability. Further the result indicates that, the effect of CAR is positive an insignificant (P-value 0.10725). The result revealed that CAR ratio has a positive and significant impact on bank profitability.

F- Value of 6.911, with a corresponding p-value of 0.000615, which means that the overall fitness of the model is well justified. The result indicate that the coefficient of NPA is positive and statistically insignificant (P-value = 0.7221). The result revealed that NPA has a positive and significant impact on bank profitability. Further the result indicates that, the effect of CAR is significant (P-value =0.0135). The P value for F statistics in the model represent that the model is fairly fitted since it is less than 0.05. The result revealed that CAR ratio has a positive and significant impact on bank profitability.

Table 4

Analysis of Regression of ROE with NPA, CAR, and TLTD

| Variables | Coefficients | Standard Error | t Stat | P-value |
|-----------|--------------|----------------|---------|---------|
| Intercept | 47.2632 | 6.9282 | 6.8218 | 1.6907 |
| NPA | 0.3228 | 0.9025 | 0.3577 | 0.7221 |
| CAR | -1.4619 | 0.5691 | -2.5687 | 0.0135 |
| TDTL | -0.1302 | 0.0849 | -1.5341 | 0.1318 |

R₂. 0.3107; Adjusted R₂. 0.2657; F-stat. 6.9116; F-sig. 0.00062; E. 4.9609; Number. 50

The regression result of the effect of non-performing assets, capital adequacy ratio

and total loan to total deposit ratio on return on equity. The value of R square indicates the 31.07% of the variance in the dependent variables that the independent variables explain by the model.

On the basis of NPA, CAR and TLTD with respect to ROE which have already tested by ANOVA gave significance result. There are five sample banks NBM, NABIL, HBL, NSBI and EBL which are taken to obtain results. Out of them, only NPA, CAR and TLTD with ROE have significant. This result is consistent with (Soyemi et al., 2014, Kiran & Jones, 2016). The result of the study is contradictory with (Gnawali, 2018)

The methodology, descriptive and analytical research methodology has been adopted, which is similar to (Bhattarai, 2015, Kurawa & Garba, 2014). But, previous researcher used generalized Methodology (García-Herrero et al., 2009). The highest and lowest net profit trend analysis of selected commercial banks is NABIL Bank and NMB. The profit is in fluctuation trend. The impact of NPA, CAR and TLTD ratio with respect to ROA and net profit has positive but insignificant relation. Similarly the impact of NPA, CAR and TLTD with net ROE has significant whereas (Gnawali A, 2018), NPA, CAR and TLTD with ROA has significance and with ROE has insignificant.

Current study is a supplement to an overcome the weakness and limitation of previous studies, so this study will be fruitful to those interested scholars, students, stakeholders, civil society, businessman and government academically as well as for policy prospective. Therefore this study is to the concern bank as well as different persons: such as shareholders, investors, policymakers, stockbrokers, state of government etc.

Conclusion:

Looking at the profitability trend, the highest and lowest of selected sample banks are NABIL and NMB. The non-performing assets (NPA) of all the banks have been able to reduce but HBL has been unable to do so. The study's main finding is that non-performing loan, capital adequacy ratio and total loan to total deposit have no effect on return on asset. The impact of NPA, CAR, and TLTD on return on equity is significant. Similarly, when comparing net profit to NPA, CAR, and TLTD, the result is minimal.

From the above, we can conclude that one of the key causes of Nepalese commercial banks' rising nonperforming assets (NPA) is a lack of appropriate financial analysis of the borrower by the banks. As a result, before granting a loan to a borrower, a

thorough financial investigation should be carried out. Those banks with a high level of nonperforming assets (NPA) should take all required steps to recover their bad loans as soon as feasible. In the event that the borrower is unsure about repaying the loan, the bank should sell the collateral and reclaim the principle and interest.

Future Scope:

There are a number of important topics that should be addressed in future study. The researcher also argues that a more comprehensive study with a bigger and more representative sample is necessary in order to provide a more generalized picture of work activities in the Nepalese setting. Further research might be conducted with a larger sample of banks, as this study only looked at five Nepalese commercial banks. It has the potential to provide new insight into the issue at hand. Last but not least, the Nepalese environment is anticipated to become more globally competitive in the next years. As a result, it would be interesting to broaden the survey to include a longitudinal survey of nonperforming assets change, which would capture changes in strategy adoption and considerable effect on bank performance over time.

The following suggestions are recommended to BFIs and for further research:

For the BFIs: The NPA of Himalayan bank is comparatively higher than other selected commercial banks so it is highly recommended to sanction loans by more care. The capital adequacy ratio of HBL has low, so it is recommend increasing the investment.

The total loan to total deposit ratio i.e. (80% to 90%) is not fulfilled by NSBI, NABIL and EBL. So they are recommending has increasing. Bank should maintain the adequate level of non-performing assets to insure the better performance. Non-performing assets not only decrease the interest income, it also makes the part of total assets ideal. In addition to non-performing assets, additional factors such as total lending, interest rate, operational profit, national economic conditions, and other external factors all have a role in determining bank profitability. As a result, banks must pay close attention to these aspects.

Nepal Rastra Bank's provisions define the amount of provisioning to be made

for non-performing assets, i.e. these provisions reduce earnings. So, not only the volume of non-performing assets, but also the profitability, is determined by the central bank's provisioning requirements.

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