Credit Risk Management of Kumari Bank Ltd. Nepal

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Abstract:

Banks are always faced with different types of risks that may have a potentially negative effect on their business. Risk-taking is an inherent element of banking and, indeed, profits are in part the reward for successful risk taking in business. On the other hand, excessive and poorly managed risk can lead to losses and thus endanger the safety of a bank’s depositors. Risks are considered warranted when they are understandable, measurable, controllable and within a bank’s capacity to readily withstand adverse results. Sound risk management systems enable managers of banks to take risks knowingly, reduce risks where appropriate and strive to prepare for a future, which by its nature cannot be predicted.

Financial institutions are subject to a number of risks such as Credit risk, Market risk management, Foreign exchange risk, Operational risk, and Liquidity risk. Although credit risk has always been of primary concern to these institutions, its importance became paramount during the recent financial crisis. The crisis exposed the shortcomings of existing risk management systems, and several firms saw significant losses resulting from failure of their counterparties to deliver on contracts. Firms may also be worried about a second recession, which makes credit risk a top priority.

Keywords: Bank, Credit risk, Nepal.

I. INTRODUCTION

A bank is a financial institution licensed to receive deposits and make loans. The history of banking in Nepal in the form of money lending can traced back in the reigning in period of Gunakama Dev, “The King of Kathmandu” (Nepal Bank Limited, Nepal Bank Limited Patrika, 2037:31). The first bank in Nepal was established in 1937 A.D. (1994 B.S.) as Nepal Bank Limited under Nepal Bank Act to provide modern and organized facilities.

Kumari Bank Limited, came into existence as the fifteenth commercial bank of Nepal by starting its banking operations from Chaitra 21, 2057 B.S. (April 03, 2001) with an objective of providing competitive and modern banking services in the Nepalese financial market. The bank has paid up capital of Rs. 1,485,000,000 of which 70% is contributed from promoters and remaining from public. Nepal has opened its door to foreign commercial bank to operate in the kingdom of Nepal, consequently, KBL bank Ltd. was establishing as a private sector commercial bank. KBL establish in 2056 B.S. with the objective of provide complete bank. Its office is in Kathmandu Putlisadak. KBL is also a joint venture bank but it joint venture with Nepalese people when it establish, its authorized capital was 1000 million its share has been divided proportionally on the basis of ownership. The shareholding pattern is as follows:

- Promoters - 70%
- General Public - 30%

In very short period the bank has introduced itself as one of the fastest growing commercial bank of the country. Recently, KBL have capital more than the level of directions of NRB (Nepal Rastra bank), NRB directed every commercial bank put maximum 11% capital, this is the KBL transferred remain amount at capital reserved a/c. Similarly KBL increases their profit each year but increase profit at decreasing rate. KBL is steady growing its size strategic alliance with ICICI bank, which facilitates their customers to remit money in India through ICICI bank branches and their correspondent banks in India.
It provides latest technology based services like ATM Debit Card, Visa electronic card, E-pay and SMS banking etc. This bank has introduced internet banking. It has globally connected through various prominent banks in foreign. The bank services across the globe include remittance draft arrangement, foreign trade, guarantee etc.

II. RISK MANAGEMENT

Being a financial institution, risk management is an integral part of Kumari Bank Limited (KBL). With the continuing increase in the scale as well as complexity of the banking business and the rapid growth in the volume of financial-related transactions, risk management has become essential. Moreover the current financial crisis, which brewed due to financial institutions high exposure to risky assets, and the collapse of venerable financial institutions due to their inability to manage risky assets have further emphasized the need for prudent and effective risk management. The management team of KBL manages the overall risk profile, aiming for a good balance between risk and return.

The risk management system ensures that the bank takes well-calculated business risks while safeguarding the bank’s capital, its financial resources and profitability. The bank’s primary business activity is commercial banking where substantial risk comprises of credit risk. To a lesser extent, commercial banking activities also expose the bank to market risk arising from reprising, maturity and currency mismatches of assets and liabilities. These mismatches give rise to interest rate risk, liquidity risk, and foreign exchange risk. Risk management in the bank includes risk identification, measurement and assessment, and its objective is to minimize negative effects that risks can have on the financial result and capital of a bank. Risk management strategies include the transfer of risk, avoidance of risk, reduction of the negative effect of the risk and acceptance of the consequences of a particular risk. The design of a risk management system depends among other things, on its size, capital structure, complexity of functions, technical expertise, and quality of Management Information system (MIS) and is structured to address both banking as well as non banking risks to maximize shareholders’ value.

1. Operational Risk Management

The term Operational Risk Management (ORM) is defined as a continual cyclic process which includes risk assessment, risk decision making, and implementation of risk controls, which results in acceptance, mitigation, or avoidance of risk. ORM is the oversight of operational risk, including the risk of loss resulting from inadequate or failed internal processes and systems; human factors; or external events. However, applying an explicit regulatory capital charge against operational risk is a relatively new and evolving idea requires banks to hold capital against the risk of unexpected loss that could arise from the failure of operational systems.

The most important types of operational risk involve breakdowns in internal controls and corporate governance. Such breakdowns can lead to financial losses through error, fraud, or failure to perform in a timely manner or cause the interests of the bank to be compromised in some other way. Other aspects of operational risk include major failure of information technology systems or events such as major fires or other disasters. The failure to properly manage operational risk can result in a misstatement of an institution’s risk/return profile and expose the institution to significant losses. Gross income, used in the Basic Indicator Approach is only a proxy for the scale of operational risk exposure of a bank and can in some cases underestimate the need for capital. Therefore KBL has developed a framework for managing operational risk and evaluating the adequacy of capital covering the bank’s appetite and tolerance for operational risk, as specified through the policies for managing this risk, including the extent and manner in which operational risk is transferred outside the bank. It also includes policies outlining the bank’s approach to identifying, assessing, monitoring and controlling/mitigating the risk.

2. Credit Risk Management

Credit risk is the major risk that banks are exposed to during the normal course of lending and credit underwriting. Within Base I & II, There are two approaches for credit risk measurement: The standardized approach and the internal ratings based (IRB) approach. Due to various inherent constraints within the Nepalese banking system, the standardized approach in its simplified form, Simplified Standardized Approach (SSA), has been prescribed in the initial phase. Credit risk is the probability that a Bank’s borrower or counter party will
fail to meet its payment obligations in accordance with the terms of the credit. This includes non-repayment of capital or interest within the agreed time frame, at the agreed rate of interest and in the agreed currency. The goal of credit risk management is to maximize a bank’s risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. The effective management of credit risk is a critical component of a comprehensive approach to risk management and essential to the long-term success of any banking organization.

For most banks, loans are the largest and most obvious source of credit risk; however, other sources of credit risk exist throughout the activities of a bank, including in the banking book and the trading book, and both on and off the balance sheet. Banks increasingly face credit risk in various financial instruments other than loans, including acceptances, inter banking transactions, trade financing, foreign exchange transactions, and in the extension of commitments and guarantees and the settlement of transactions. KBL has developed methodologies to assess the credit risk involved in exposures to individual borrowers or counterparties as well as at the portfolio level. The credit review assessment of capital adequacy, at a minimum, covers risk rating systems, portfolio analysis, large exposures and risk concentrations. Internal risk ratings are an important tool in monitoring credit risk and supporting the identification and measurement of risk from all credit exposures and are integrated into our overall analysis of credit risk and capital adequacy.

3. Market Risk Management

Market risk is defined as the risk of losses in on balance sheet and off-balance sheet positions arising from adverse movements in market prices. The major constituents of market risks are:

a) The risks pertaining to interest rate related instruments
b) Foreign exchange risk (including gold positions) throughout the bank, and
c) The risks pertaining to investment in equities and commodities.

Market risk is also the uncertainty in the future value of the bank’s on-balance sheet and off-balance sheet financial items resulting from interest rates, foreign currency, equity, and commodity risks. The Asset liability Management Committee (ALCO) serves as the primary oversight and decision making body that provides strategic directions for the bank’s management of market risk. The key elements in the market risk measures. The prescribed approach for the computation of capital charge for market risk is very simple and thus may not be directly aligned with the magnitude of risk. Likewise, the approach only incorporates risks arising out of adverse movements in exchange rates while ignoring other forms of risks like interest rate risk and equity risks. KBL has taken measures to address these various forms of risk and at the same time perform stress tests to evaluate the adequacy of capital using internal models for the measurement of market risk.

4. Foreign Exchange Risk Management

Foreign Exchange is a risk factor that is often overlooked by small and medium sized enterprises that wish to enter, grow and succeed in the global market place with exchange rate movements which affect the profit of the bank. Because of bank’s exposure to foreign currency, foreign exchange risk management is a fundamental component in market risk management of the bank. The frequency and direction of rate changes, the extent of the foreign currency exposure and the ability of counterparties to honour their obligations to the Bank are significant factors in foreign exchange risk management. This risk is managed by setting predetermined limits on open foreign positions, the monitoring of the open positions against these limits and the setting and monitoring of our spotless mechanism. In order to manage the foreign exchange risk and protect the bank’s financial position, the bank may follow the following procedures:

1. Establish and implement sound and prudent foreign exchange risk management policies.
2. Develop and implement appropriate and effective foreign exchange risk management and control procedures.

5. Liquidity Risk management

Liquidity is crucial to the ongoing viability of any financial institution. The capital positions can have a telling effect on institution’s ability to obtain liquidity, especially in a crisis. KBL has adequate systems for measuring, monitoring and controlling liquidity risk. The objective of liquidity management is to ensure that
bank has sufficient funds to meet its contractual and regulatory financial obligations at all times. Liquidity risk is the probability of loss arising from a situation where:

a. There will not be enough cash/or cash equivalents to meet the needs of depositors and borrowers.
b. Sale of illiquid assets will yield less than their fair value or
c. Illiquid assets will not be sold at the desired time due to lack of buyers.

Liquidity risk relates to the ability of the Bank to maintain sufficient liquid assets at reasonable cost to meet its financial obligations as and when they fall due. Liquidity risk arises from situations in which a party interested in trading an asset cannot do it because nobody in the market wants to trade that asset. Liquidity risk becomes particularly important to parties who are about to hold or currently hold an asset, since it affects their ability to trade.

The bank’s liquidity policy is to ensure that all contractual commitments can be met by readily available sources of funding. In addition, liquid assets are maintained in relation to cash flows to provide further sources of funding in the event of a crisis. The bank also has excellent access to financial markets to ensure the availability of funds. The bank has established an adequate system for monitoring and reporting risk exposures and assessing how the bank’s changing risk profile affects the need for capital. The bank’s senior management or board of directors receives on a regular basis reports on the bank’s risk profile and capital needs.

**Data presentation and analysis**

The systematic arrangement of classified data and information finally takes a shape of analysis and interpretation. The major importance of data analysis is as:-

1. Data analysis makes the complex presentation of detain simplified versions.
2. Data analysis is very much important in identifying the content and units of classification.
3. Data analysis is important in facilitating comparison between different variables.
4. Data analysis establishes numerical relationship between different variables.
5. Data analysis establishes representativeness and more authenticity in pronunciations.

**III. RATIO ANALYSIS**

Ratio Analysis enables the business owner/manager to spot trends in a business and to compare its performance and condition with the average performance of similar businesses in the same industry.

**A. Liquidity Ratios**

These ratios indicate the ease of turning assets into cash. Liquidity refers to the ability of a firm to meet its short term or current obligations. So liquidity ratios are used to measure the ability of a firm to meet its short term obligations. In the worst case, inadequate Liquidity can lead to the liquidity insolvency of the institution. To find out the ability of the bank, to meet their short term obligations which are likely to mature in the short period, the following ratios are developed under the liquidity ratios to identify the liquidity position.

**i) Current Ratio**

![Current Assets and Current Liabilities of KBL (Rs. In millions)](chart)

Fig.1: Current Assets and Current Liabilities of KBL (Rs. In millions)
ii) Cash and Bank Balance to Total Deposit Ratio

![Fig.2: Cash & Bank Balance and Total Deposit of KBL (Rs. In millions)](image)

**B. Activity/ Efficiency Ratios**

It is also known as turnover or efficiency ratio or assets management ratio. It measures how efficiency the firm employs the assets. Turnover means, how many numbers of times the assets flow through a firm's operations and into sales (Kulkarni: 1994:26). Greater rate of turnover or conversion indicated more efficiency of a firm in managing and utilizing its assets, being other things equal. Various ratios are examined under this heading.

i) Loans and Advance to Total Deposit Ratio

![Fig.3: Loans and Advance to Total Deposit Ratio of KBL (Rs. In millions)](image)

ii) Loan, Advance and Investment to Total Deposit Ratio

![Fig.4: Loan, Advance and Investment to Total Deposit Ratio of KBL (Rs. In millions)](image)
iii) Performing Assets (Loan) to Non-performing Assets Ratio

![Graph: Performing Assets (Loan) to Non-performing Assets Ratio of KBL (Rs. In millions)](image)

Fig.5: Performing Assets (Loan) to Non-performing Assets Ratio of KBL (Rs. In millions)

iv) Non-Performing Assets to Total Assets Ratio

![Graph: Non-Performing Assets to Total Assets Ratio of KBL (Rs. In millions)](image)

Fig.6: Non-Performing Assets to Total Assets Ratio of KBL (Rs. In millions)

v) Loan Loss Provision to Total Loan and Advances Ratio

![Graph: Loan Loss Provision to Total Loan and Advances Ratio of KBL (Rs. In millions)](image)

Fig.7: Loan Loss Provision to Total Loan and Advances Ratio of KBL (Rs. In millions)
vi) Non-performing Assets to Total Loan & Advances Ratio

![Fig.8: Non-performing Assets to Total Loan & Advances Ratio of KBL (Rs. In millions)](image_url)

vii) Provision for Pass Loan to Total Pass Loan Ratio

![Fig.9: Provision for Pass Loan to Total Pass Loan Ratio of KBL (Rs. In millions)](image_url)

C. Profitability Ratios

A company should earn profit to survive and to grow over a long period of time. It is the difference between revenues and expenses over a period of time. It shows the overall efficiency of the business concern. The following ratios are calculated under the profitability ratios:

i) Interest Income to Loan and Advances and Investment Ratio

![Fig.10: Interest Income to Loan and Advances and Investment Ratio of KBL (In millions)](image_url)
ii) Interest Expenses to Total Expenses Ratio

![Graph](image1)

Fig.11: Interest Expenses to Total Expenses Ratio of KBL (Rs. In millions)

iii) Interest Expenses to Interest Income Ratio

![Graph](image2)

Fig.12: Interest Expenses to Interest Income Ratio of KBL (Rs. In millions)

iv) Return of Equity Ratio

![Graph](image3)

Fig.13: Return of Equity Ratio of KBL (Rs. In millions)
v) Return on Total Assets Ratio

![Net Profit after Tax](#) vs [Total Assets](#)

**Fig.14: Return on Total Assets Ratio of KBL (Rs. In millions)**

vi) Return on Net Loan and Advance

![Net Profit after Tax](#) vs [Net Loan and advance](#)

**Fig.15: Return on Net Loan and Advance (Rs. In millions)**

vii) Earnings per Share

![Number of Shares](#) vs [Earning per shares](#)

**Fig.16: Earning per Share of KBL (Rs. In millions)**
Major Finding of the study

1. At the time of financial reengineering process of Kumari Bank Limited, new policy of lending focuses on cash flow lending by passing out collateral based lending.

2. The credit information Bureau was established in 1989 A.D. Nepal Rastra Bank started to control the financial institution with strengthening the supervision and monitoring system.

3. Liquidity position of Kumari Bank Limited seems strong. It is obvious that in the present situation of the country, investment potential is not favourable, so the liquidity is sufficient in the bank.

4. Under the structure adjustment programmed, of the IMF, the financial sector was further liberalized in 1987. The focus of Nepal Rastra Bank was placed on indirect monetary control.

5. Most of the banks of Nepal now days are focusing on consumer lending. Kumari Bank Limited is also falls on the same category. This is because of load shading. Industrial development in Nepal is not good due to load shading at this time. So it has directly affected the lending policy of commercial banks.

6. Kumari Bank Limited has invested money in growing credit and advances but the recovery process of the bank is slow. Efficiency in the management is not satisfactory.

7. Most of the credit customers of Kumari Bank Limited are satisfied with the banks. Customers said that the main strength of Kumari Bank Limited is its lending interest rate. In the comparison of other banks, the lending rate of Kumari Bank Limited is found low. Due to which customers are interested to borrow loan from Kumari Bank Limited.

8. The non performing assets with respect to total assets of Kumari Bank Limited are found with standard volume i.e. 0.009 or 0.09%. As per Nepal Rastra Bank direction, all the commercial bank to have non-performing assets not to exceed 10% of total assets.

9. Kumari Bank Limited operated as fully fledged commercial bank. The bank is providing services to clients such as credit and advances, consortium finance, working capital credit, term credit, demand credit, trade finance, hire purchase credit, letter of credit, bills purchase, bank guarantee and others.

10. The bank is fully computerization with new technology. All branches of Kumari Bank have been already computerized and rest new upcoming branches are in the process of computerization. The bank has already started Web Remit, Any Branch Banking etc. and is preparing for the installation of Automatic Teller Machine.

11. By analyzing the market demand and trend. Kumari Bank Limited has brought retail banking facilities like Home Loan, Margin Lending whose market performance at present seems satisfactory.

12. For effective credit management and customer's service, Kumari Bank Limited has been making great effort for the development and empowerment of employees by conducting various training related to credit management and customer services so that they could provide the best services to the customers as well as credit risk could be reduce.

IV. CONCLUSION

Most of banks have been operating smoothly and have been successfully in becoming the pillars of economic system of the country. These banks are acting as financial intermediaries. Based on the analysis and the finding of the study, the following conclusions can be drawn. So that KBL is minimizing its credit risk.

- The bank’s financial performance seems to be pretty sound in maintaining financial status.
- The research finding suggested that credit risk position of KBL is experiencing with fluctuation from time to time.
- The bank has been able to some extent maintain the CRR as per NRB’s directive.
- High risk loans such as loans to hotels, agriculture sector, against personal guarantee, stocks and receivables are avoided by the bank.
- Deposit plays vital role in strengthening the schemes of deposit introduced by KBL are encouraging and have successes in capitalizing customer attention in order to increase the bank’s deposit base.
- Collateral is considered a secondary source of repayment in the event of loan default so that it reduced the risk to the bank and incentive for the borrower to repay the loan.
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