Nepalese Commercial Banks: Performance, Non-performing Loans and Corporate Governance

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Declaration

I, Ravi Prakash Sharma Poudel, declare that to the best of my knowledge and belief this thesis entitled “Nepalese Commercial Banks: Performance, Non-performing Loans and Corporate Governance” does not incorporate without acknowledgement any material previously submitted for a degree or diploma in any institution for higher education. This thesis also does not contain any material previously published or written by another person except where due reference is made in the text, or contain any defamatory material.

Signature
Date: 13 February 2014
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Abbreviations

BAFIA = Bank and Financial Institution Act
CEO = Chief Executive Officer
DRT = Debt Recovery Tribunal
FE = Fixed Effects
FEDAN = Foreign Exchange Dealers Association of Nepal
GDP = Gross Domestic Product
GMM = General Method of Moment
NEPSE = Nepal Stock Exchange Limited
NGOs = Non-government Organizations
NPL = Non-performing Loan
NPR = Nepalese Rupee
NRB = Nepal Rastra Bank
OLS = Ordinary Least Square
RE = Random Effect
ROA = Return on Assets
SE = Securities Exchange
SEBON = Securities Board of Nepal
SEC = Securities Exchange Centre
VIF = Variation Inflation Factor
Abstract

The purpose of this study is to examine the macro-economic, bank specific and corporate governance determinants of non-performing loans in Nepalese banking. In addition to this, the next objective of the study is to analyze the influence of corporate governance on bank performance in Nepal. The study is to investigate the above objectives in order to improve the means by which commercial banks in Nepal manage their non-performing loans and performance. This will provide guidance for the regulatory bodies in safeguarding the stability and integrity of the Nepalese financial system.

The theoretical basis for this study is based on financial intermediation theory, diversification theory and agency theory. Literature in relation to macro-economic, bank specific and governance determinants of non-performing loans and the influence of corporate governance on bank performance reported mixed results. The conceptual framework underpinning this study describes how the macro-economic, bank specific and corporate governance factors influence non-performing loans in Nepalese banks and also how the corporate governance influences bank performance in Nepal. In this framework, macro-economic variables were gross domestic product, inflation, money supply, foreign exchange, share price indices and market interest rate. Bank specific variables were lagged non-performing, loan growth, loan loss provision, earnings, capital, bank size, branch growth, bank size and interest rate spread. In the case of the conceptual framework of corporate governance, the study includes board size, board independence, board diligence, audit committee size, audit committee independence, audit committee diligence, foreign ownership, and institutional ownership and CEO remuneration as corporate governance variables. The study explored the relationship of these variables with non-performing loans and bank performance. Non-performing loans were calculated by the ratio of non-performing loans to total loans, whereas bank performance was assessed by the return on assets and Tobin’s Q.

This is the first study conducted in Nepal on the influence of macro-economic, bank specific and corporate governance on bank non-performing loans and the influence of corporate governance on bank performance during a period of high volatility in the environment due to the adverse economic and political conditions. As a result, this study makes a significant contribution to the body of knowledge on determinants of non-performing loans and the
influence of corporate governance on bank performance in developing economies like Nepal, and how these factors impact on bank non-performing loans and performance.

A sample of 29 banks was selected from the 31 banks operating in Nepal in 2011. Data were obtained from annual reports of individual banks, World Bank database and various related publications of the central bank of Nepal. The study covers data from 2001-2011 to examine the macro-economic and bank specific determinants of non-performing loan, whereas data from 2005-2011 is used to examine the influence of corporate governance on bank non-performing loans and performance. The selection of data and period was determined by the availability of data. The STATA software is used for analysis.

This study used the Ordinary Least Square (OLS), Fixed Effect (FE), Random Effect (RE) and Generalized Method of Moment (GMM) regression to examine the relationship between dependent and independent variables. On the base of a preliminary tests, this study used OLS, RE and GMM to check the relationship of macro-economic, bank specific and corporate governance on bank non-performing loan, whereas OLS and FE regression are used to check the influence of corporate governance on bank performance. OLS and GMM are used to compare the result with RE and FE.

The results of the study show that among the macro-economic variables used, the gross domestic product growth, inflation, exchange rates and the market interest rate have a significant influence on bank non-performing loan, whereas non-performing loans with lag, loan growth, loan loss provision, bank size, and earnings are found as bank specific determinants of non-performing loan. The results show that of the corporate governance variables, board independence, audit committee size, audit committee independence and institutional ownership have a significant influence on non-performing loan. The study found that only board characteristics, namely board size, independence and diligence, have a significant influence on bank performance.

In conclusion, this study implies that the management of Nepalese banks should pay attention to the significant macro-economic, bank specific and corporate governance factors which are shown to influence non-performing loans and bank performance.
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