## 3.0 <u>Research Subject</u>

### 3.1 Why SME Bank?

The decision to conduct a research on SME Bank because of its primary role and mandate to assist and provide financing and service advisory to all qualified SMEs in the country. The issue of non-performing loans (NPLs) has created greater issues to SME Bank. Although the rate of NPLs showed a decreased, still there is tendency of these NPLs rate to increase. This key issue is interested to analyse and study as SME Bank should have counter measures based on strategic management perspective to overcome NPLs issues.

The study will concentrate on the current process flow of the SME Bank's **Rehabilitation Department on the Non Performing Loans (NPLs).** Non Performing Loans, or NPL, are loans that are no longer contribute income to the respective bank that owns them. It would become nonperforming when borrowers default payments. Usually loans which have been default for three consecutive months are classified as NPLs; however, the exact classification can vary from institution to institution. Generally, a smaller NPL ratio indicates smaller losses for the bank, while a larger (or increasing) NPL ratio means larger losses for the bank due to provision exercise and also to writes off bad loans. Due to this, Banks seldom reports their NPLs ratios over their total loans as to maintain their performance on outstanding loans. Access to financing is an important aspect in the business operations of SMEs. Various channels had been introduced in providing financing and widen the avenues of financing to SMEs. A wide range of financing available for SMEs, according to their various stages of life cycle such as start-ups, business expansion and rehabilitation (NSDC, 2007).

This research aims to analyse the operations of the rehabilitation department and the subsequent parameters that affect its profitability and efficiency relating to the NPLs. Consequently, it will propose an improved and streamlined system. Specifically, the study aims to look at the loan restructuring, rescheduling and negotiated settlement procedure as well as the bankruptcy issuance to vision a way to generate profit from the errant loans. Most of the SME businesses are perceived as high risk and low margin borrowers. Therefore, the growth of SME's are usually stunted due to lack of loans from the private commercial sector. SME Bank provides an avenue for these high risk businesses to obtain a loan for their business. Furthermore, the bank also encourages new SMEs by providing loan for startup businesses. Despite the benevolence of SME Bank, the cash is not emanating from a bottomless pit. To ensure continuous support for the SMEs, the Bank will need to review its procedures constantly.

## 3.2 SME Bank Definition on Non Performing Loans (NPLs)

The research will only concentrate and focus on how the rehabilitation department manages the Non Performing Loans (NPLs) using the current process flow. Non Performing Loan is a term used essentially for accounts which have payments that are more than 6 months overdue or outstanding. Under the Bank Negara ***Guidelines on Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts (BNM/GP3),*** in general, a loan is classified as non-performing when the principal or interest is due and unpaid for six months or more from the first day of default. In this case, the credit facilities such as term loans, revolving credit, leasing loans, hire-purchase loans and other loans shall be classified as non-performing, when principal or interest is due and unpaid for six months or more from the first day of default.

However, the new ruling set by Bank Negara Malaysia with effective on 1st January 2010, supersedes the ***Guidelines on Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts (BNM/GP3)*** on the definition of Non Performing Loans (NPLs). The new ***Classification and Impairment Provision for Loans and Financing under the FRS 139 (Financial Reporting Standard 139)*** classify the loans/financing as impaired:-

- **Where the principal or interest/profit or both is past due for more than 90 days or 3 months. In the case of revolving facilities (e.g. overdraft facilities), the facility shall be classified as impaired where the outstanding amount has remained in excess of the approved limit for a period of more than 90 days or 3 months; or**
- **Where the amount is past due or the outstanding amount has been in excess of the approved limit for 90 days or 3 months or less, the loan/financing exhibits weaknesses8 that render a classification appropriate according to the banking institution's credit risk grading framework.**

*(FRS 139, Classification and Impairment Provision for Loans and Financing)*

Impaired loans/financing will be known as Non Performing Loans in this paper and for rescheduled and restructured activities of the impaired account shall be classified as NPLs. Non Performing Loans are essentially from the branches' portfolios. Once the accounts are classified as NPLs, they will be transferred to Rehabilitation Department for further action. In the Rehabilitation Department, the officer in charge will study the account and determine whether the account can be recovered or it was deemed to foreclosure. Before arriving at this final decision, there are multiple interrelated process flows and decision making paths that need to be followed.

The portfolios of accounts can be effectively categorize the client's accounts into 4 sections as below as refers to ***Guideline On Classification Of Impaired Loans / Financing And Provisioning For Bad And Doubtful Debts under The Classification of Non-Performing Loans and Provision for Substandard, Bad and Doubtful Debts (BNM/GP3)***.

SME Bank is allowed to formulate own system in classifying impaired loans, however, this is subject to a minimum requirement to comply with the categories of classification as follows:-

- Active accounts / clients is refer as current
- Delinquent account is referring to account which has more than 1 to 3 months outstanding.
- **Non Performing Loans (NPL)** is referring to accounts which have more than 3 months outstanding. NPL refers to three categories:-

    i. **Bad:** Credit facilities which are deemed uncollectible and worthless, on the basis of relevant circumstances.

    ii. **Doubtful:** Credit facilities where collection in full is improbable and there is a high risk of ultimate default.

iii. **Sub-standard:** Credit facilities which involve more than a normal risk of loss due to certain adverse factors. These factors include delays in debt servicing, unfavorable financial condition, insufficient security or other factors which have some doubts on the repayment capacity of the borrower. However the account/loan is still not considered as doubtful or bad.

- Special Asset is refers as account to be closed.

Definition of the loan classification under the **Institut Bank Bank Malaysia (IBBM)** as follows: - ·

- **Current** is when the payment (principal plus interest) is always prompt and up-to date, this loan account is considered as current.
- **Special mentioned** is loan which always delayed by one or two months. Although the borrower has the ability to make payment but he/she is reluctant to pay.
- **Substandard** is refers to loans that have been poorly designed or approved unwisely. However, these loans yet to turn into doubtful loans.
- **Doubtful** is when the loans show possibility of non-recovery.
- **Loss** refers to loans that are confirmed non-recoverable. (bad loans)

Many factors have been identified as major determinants of loan defaults; time of disbursement, supervision and profitability of enterprises which benefited from small holder loan scheme in contributed to the repayment ability and consequently high default rates (Okorie, 1986). For financial institutions, the critical factors contributes to the default rate are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans.  High loan defaults could not be confirmed by the study as SMEs were asked to indicate the status of their loans in order to determine the level of default in loans repayment. Based on the responses and in line with acceptable banking practices, the loans were classified into Performing loans and non performing loans (Obamuyi, 2007).