Chapter 2

Concept, Classification and Treatment
of Non-Performing Loans

2.1 The concept of Non-Performing Loans (NPLs)

A term that is used in many loan classification regimes is "non-performing loans" (NPLs) and is sometimes referred to as bad loans or problem loans. A non-performing loan requires that payments of both interest and principal be past due, and that either event should trigger classification of the loan as non-performing (Svartsman, 2003). It is a loan on which contractual obligations for example interest or amortization payments are not being met (Long, 1990), or debt instruments whose obligors are unable to discharge their liabilities as they become due (Woo, 2000). A problem loan could also be one in which the original loan repayment terms have been altered because the loan could not be paid in accordance with the bank's requirements and needed restructuring or when collateral margin is depleted to the point where the bank's risk increases substantially (Clarke & Johnston, 1995),.

The failure of some borrowers to service loans is common, even healthy banks expect to have some non-performing loans (Long, 1990); the key is to minimize the loss (Clarke & Jonhston, 1995).

2.2 Classification and treatment of Non Performing Loans

The term "non-performing loans" is subject to many differences among countries, as to how many days a payment should be in arrears before past due status is triggered. The criterion that seems to be getting acceptance is the past due status of the credit usually 90 days or more (Laurin & Majnoni, 2003). Many researches suggest that provisions should be made if it is likely that the bank fails to collect the amounts due. Provisioning approach by IAS implies that a loan categorized as NPL should be classified at a minimum as a "substandard loan".

Most of the countries have adopted the standard requirements of provisioning - 20 percent of the outstanding balance in respect of 'substandard' category of assets; 50 percent in respect of 'doubtful' category; and 100 percent in respect of 'loss' category (Subrahmanyam, 2003). Many countries require banks facing a rise in non-performing loans to increase their loan loss provisioning. According to Bernanke & Lown (1991) as cited by Woo (2000), when provisions are substantial this can result in a reduction in bank capital, which in turn can limit the ability of banks to make new loans. Subrahmanyam (2003), Laurin & Majnoni (2003) and Pecchioli (1987) expressed that if provisions are tax deductible, banks have an incentive to overstate their loss provisions and to smooth profits over time in order to reduce the amount of tax liability. According to Mishkin (2000), general provisions are generally not intended to reflect the loan quality

13

problems of the loan portfolio but rather aimed at cushioning against future events. For banks with good current performance and expected poor future performance, managers will save income for the future by reducing current income through loan loss provision, and vice versa (Kanagaretnam, Lobo & Mathieu,2003).

There are varied opinions on whether non-performing loans is a good indicator of the health of a bank. According to Meeker & Gray (1987), non-performing asset information can be a useful aid in analyzing the asset quality of banks, particularly when the information is timely. Athukorala (2001) claimed that the measure is backward looking and, in a context of rapid credit growth, any such historical summary measure is likely to be an inadequate indicator of future performance and creditors always have the option of arranging credit rollover through their banks. According to Caprio & Honohan (1999) as cited by Mitchell (2001), bank supervisors do not have the inside information or the resources to challenge the banks' assessment of its loans on a case-by-case basis and even with the best accounting systems, it is difficult to prevent a bank from concealing a non-performing loan simply by making a new loan cover the repayment; a practice known as 'evergreening'. The comparability of NPLs over time may be affected by changes that individual banks make to their definition of the term. Poor classification approaches and provisioning practices have led to solvency

ratios giving a false sense of security, as noted with apparently 'adequately' capitalized financial systems failed in the 1990s (Athukorala,2001). Usually in the face of trouble, banks tend to give themselves the benefit of the doubt, thus making the indicators even more dubious in the context of a crisis (Mishkin, 1997; as cited by Athukorala, 2001). Long (1990) explained that, "The financial statements of banks in developing countries are often misleading and insolvency is not apparent in their accounts because they may have engaged in "cosmetic mismanagement" like capitalizing unpaid interest to raise profits or rescheduling loans by classifying bad loans as good and in so doing avoid making provisions. Bank supervisors should be able to make appropriate provisions for loan losses, to write off uncollectible assets, and to suspend interest on non-performing loans". When a loan is recognized as nonperforming, interest accrual should be reversed or fully provided by crediting it to the "interest-in suspense" account so as to avoid overstating of income (Svartsman, 2003; Subrahmanyam, 2003).

2.3 Conclusion

The way a loan is classified or provisioned can give different indicators of the asset quality in the banks. In the next chapter, the NPL situation in the banking institutions of Malaysia would be reviewed.