Chapter 3

Non-Performing Loans in the Banking Institutions of Malaysia

3.1 Non-Performing Loans before the East Asian Crisis

Clarke and Johnston (1995) explained that one of the reasons for the rise in NPLs is that borrowers may be hurt by an economic downturn or a market decline, which could play havoc in its business and also lower market asset values and the subsequent collateral values necessary to recoup the loan. Asian financial systems worked well as long as economies grew fast and steadily while problems like mounting bad loans, overextended property markets and some scandals arose when economies slowed and faltered (Frankel 1998). It can be made significantly worse by microeconomic structural problems like corruption, nepotism (Tzong, 2001), corporate governance problems like inside lending (Frankel, 1998), and principally procedural breakdowns within their own system such as poorly defined or excessively lenient credit policies and procedures (Clarke & Johnston, 1995).

The high NPL ratio is not unique in Malaysia's recent history. As a result of the recession in the mid-1980s, NPLs reached as high as 30 percent of loans in 1988, before declining to below 4 percent in 1997 (Kochhar et.al, 1999). Since the mid 80s, there was excessive concentration of credit to the volatile sectors of the economy in Malaysia, in particular the property sector and the stock market. According to Bank Negara in the book "The Central Bank and the financial system in Malaysia-A decade of change", eventhough banks had been cautioned time and again of the destabilizing effects of a downturn in these cyclical sectors, the lure of quick profits and illusion of never ending increase in prices and the ability to escape before the downturn sets in had blinded the banks.

3.2 Criticisms on the loan classification and prudential practices

In the 90s, prior to the East Asian Crisis in 1997, again banks were lending a lot to the property sector and stock market although speculative bubbles in those sectors were common knowledge. Though sharing many characteristics with its regional neighbors like rapid loan growth and significant credit exposures to the property and stock market, Malaysia has avoided the effects of full scale financial sector crisis that have affected Indonesia, South Korea and Thailand (Kochhar, et. al, 1999).

According to Bank Negara, despite the rapid expansion in total loans in 1996, banking institutions were able to increase their general provisions for non-performing loans well in excess of the minimum requirement and the levels recorded in previous years due to strong profit growth (BNM, 1996). However, some researchers claimed that the non-performing loans did not foreshadow weakness in the banking system, and indeed indicated growing strength (Kochhar et.al,1998) because non-performing loans "tend to be lagging indicators of true asset quality and tend to underestimate the extent of problems, especially in periods of high growth, and when loan classification standards and safeguards against such practices as "evergreening" are weak.

3.3 Non-Performing Loans during the East Asian Crisis

The contagion effect of the currency crisis in Thailand that triggered in mid 1997 caused a sharp downturn in Malaysia's economy. This significantly affected the credit quality, profitability, and capital adequacy among all financial institutions (Kochhar et. al, 1999). According to Sivalingam in his paper "The Banking Crisis in Malaysia" presented at the Asia Pacific Finance Association Conference in 1999, eventhough property prices had fallen steeply compared to the fall of stock prices, the NEAC was concerned about a slump in property prices and its effects on the ability of property developers to repay their loans and how this would affect the sustainability of the banking system.

As a result of the stock market crash, firms and individuals were facing difficulty to service their payments and as most of the loans to the property sector had been collaterized with property, stocks and shares that were valued at over inflated prices (Athukorala, 2001), asset deflation had caused the value of the collaterals to fall and so banks were required to ask more collateral for loans (Sivalingam, 1999).

Prudential regulations for non-performing loans were strengthened by tightening the classification period from six months to three months from year 1998 onwards (BNM, 1997). In addition, The Malaysian government simultaneously pursued an IMF-advocated type of policy of by raising interest rates and progressively tightening liquidity to protect the ringgit. Domestic monetary policies must respond to these pressures, especially when a country is attempting to manage or peg its exchange rate, but to do this monetary authorities must be able to raise interest rates temporarily (Frankel, 1998), to avoid overly damaging the health of the corporate and banking sectors (Kochhar et. al.,1998) and cause a higher fraction of non-performing loans (Kunt & Detragiache, 1998).

Some have argued that if the classification of non-performing loans was based on interest not paid for six months instead of three months, the non-performing loans ratio to total loans would be lower. According to Bank Negara, the tightening of the NPL classification period at times when uncertainties were rising coupled with higher interest rates led to a sharp decline in bank lending as many banks were over focusing on managing the rising NPLs as well as erosion in their capital. As a result, the earlier tightening of the classification of NPLs was relaxed to six months and interest rates were gradually reduced. Standard and Poor indicated that if the interest rates had not been cut sharply in the last six months, the NPLs could have risen to above 30 percent of total loans if computed on a three month basis (Kochhar et. al, 1999).

3.4 Conclusion

The NPLs of the banking institutions in Malaysia had risen after the East Asian crisis as a result of decline in asset and stock prices. The next two chapters review the use of asset management companies as a solution to the NPL problem.