

PEMERIKSA

NONPERFORMING LOANS IN BANKING AND FINANCIAL
SECTOR

BY

CHANG NING NING
(EGA 99005)

SUBMITTED TO THE FACULTY OF ECONOMICS AND
ADMINISTRATION, UNIVERSITY OF MALAYA, IN PARTIAL
FULFILMENT OF THE REQUIREMENT FOR THE DEGREE OF
MASTER OF ECONOMICS

OCTOBER 2000

Perpustakaan Universiti Malaya



A510947863

ACKNOWLEDGEMENTS

I would like to express my sincere appreciation to my supervisor, Professor Dr. Lee Hock Lock, for his patience, intellectual guidance, invaluable advice, and constructive comments in the development and completion of this research paper. His constant encouragement that drove me through this research is very much appreciated.

I feel a deep sense of gratitude to all my friends who have helped me in more than one way. I wish to extend my heartfelt appreciation to them for their moral support, inspiration and companionship throughout my entire study.

Last but not least, I am deeply indebted to my parents and my siblings for their undying love, care, concern, understanding, and unwavering support throughout the duration of the course. Without them, I would not have made this far. This piece of work is especially dedicated to them.

ABSTRACT

It is crucially important to understand the connection between banking sector fragility and the nonperforming loans (NPLs) problem. The problem of mounting NPLs gained much prominence during the recession that hit particularly all countries over the world in 1980s. It is again become prominent following the financial crisis that recently hit the Asian countries.

This study examines various factors contributing to the NPL problem, where some endogenous as well as exogenous factors are identified. Poor management and poor lending policies, fraud and embezzlement, moral hazard incentives, heavy government intervention and weaknesses in prudential regulation and supervision are among the factors highlighted in this paper.

The consequences of NPLs have been identified at individual bank level and at banking system level. The NPLs are financial tapeworms: when they are greater than anticipated, they eat up capital. They reduced banks' profitability and finally caused banking sector distress.

Finding the right policies and strategies for dealing with the NPLs problem can be an arduous task. As the NPL problems in the emerging economies have multiple causes, there is therefore no single solution. However, a resolution of the NPLs problem requires effective institutions to drive bank restructuring efforts, an effective legal system for loan recovery and also the political will to make many tough decisions. Resolving NPLs problem is crucial to restore investors' confidence and help revive the economy onto a sustainable growth path.

TABLE OF CONTENTS

CONTENTS	PAGE
Acknowledgements	i
Abstract	ii
Table of Contents	iii
List of Tables	vi
List of Charts	vi
Chapter 1: Introduction	
1.1 Overview	1
1.2 Research Objective	5
1.3 Significance of the Study	6
1.4 Scope of the Study	6
1.5 Research Methodology	6
1.6 Literature Review	7
1.7 Organization of the Study	12
Chapter 2: The Nonperforming Loan Problem: What Empirical Studies Reveal	
2.1 Identifying Nonperforming Loans (NPLs)	14
2.1.1 Definition of NPLs	14
2.1.2 Loan Classification and NPLs	17
2.2 What Do Nonperforming Loans Indicate	
2.2.1 Relationship between Bank Efficiency and NPLs	22
2.2.2 Relationship between Skills and Policies and Severity of NPLs	24
2.2.3 The Usefulness of Substandard Loan Ratio	27
2.2.4 NPLs as a Key Indicator of the Magnitude of Banks' Difficulties	29
2.2.5 NPLs as an Indicator of Asset Quality	30
2.3 Factors Contributing to Nonperforming Loans	
(a) Endogenous Factors	
2.3.1 Poor Management and Poor Lending Policies	31
2.3.2 Skimping on Resources: Expense Reduction	35
2.3.3 Weaknesses in Risk Management by Lenders	36
2.3.4 Fraud and Embezzlement	38
2.3.5 Relationship between Loan Growth and Loan Quality	38
2.3.6 Relationship between Loan Growth and Loan Losses	40
2.3.7 Moral Hazard Incentives	43
2.3.8 "Evergreening"	45
2.3.9 Lack of Diversification on Loan Portfolio	46

(b)	Exogenous Factors	
2.3.10	Heavy Government Intervention and Tight Government Control Of the Banking Sector	48
2.3.11	The Bursting of Speculative Bubbles and Economic Downturn	50
2.3.12	Adverse Consequences of Financial Liberalization	52
2.3.13	Local Economic Conditions	53
2.3.14	Weaknesses in Prudential and Supervision	54
2.4	Consequences of Nonperforming Loans	
(a)	At Level of Individual Banks	
2.4.1	Reduced Banks' Profitability	57
2.4.2	Lower Bank Capital and Banking System Distress	58
(b)	At Level of Banking System	
2.4.3	Contagion, Deposit Run, and Banking System Distress	
2.4.4	Banking Crises	60
2.4.5	Systemic Banking Failure and Corporate Insolvency	61
Chapter 3: Resolving Nonperforming Loan Problem		
3.1	Prudent Credit Risk and Country Risk Management	65
3.2	Loan Guarantee	69
3.3	Monitoring and Scanning the Borrowers	70
3.4	Factors to Consider for Lending During Hard Times	71
3.5	Prudential Regulations and Supervision	72
3.5.1	The Role and Scope of Banking Supervision	73
3.5.2	Loan Classification	75
3.5.3	Public Disclosure	78
3.5.4	Capital Adequacy and Provisioning	78
3.5.5	Reserve for Loan Loss	82
3.5.6	Adequacy Bankruptcy Law	82
3.6	Restructuring the Nonperforming Loans	
3.6.1	The Role of Central Bank in Banking Restructuring	84
3.6.2	Bank Restructuring Agencies	86
3.6.3	Separation of the Management of NPLs from the Original Bank	88
(a)	Sharing the Recovery of NPLs	88
(b)	Setting Up Asset Management Companies	88
3.6.4	Merger and Purchase and Assumption (P&A) Arrangement	90
3.6.5	Speed of Disposing NPLs	92

Chapter 4: Nonperforming Loans in Malaysia, Indonesia and South Korea	94
4.1 Malaysia	
4.1.1 Overview	95
4.1.2 Factors Contributing to the NPL Problem under 1985/86 Economic Recession	97
4.1.3 Resolution of the NPL Problem under 1985/86 Economic Recession	98
4.1.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis	102
4.1.5 Resolution of the NPL Problem: Mid-1997 Financial Crisis	105
4.1.6 Vulnerabilities of the Malaysian Model in Resolving the NPL Problem	116
4.1.7 Conclusion	117
4.2 Indonesia	
4.2.1 Overview	118
4.2.2 Factors Contributing to the NPL Problem: 1983-1994	119
4.2.3 Resolution of the NPL Problem: 1983-1994	120
4.2.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis	122
4.2.5 Resolution of the NPL Problem: Mid-1997 Financial Crisis	123
4.2.6 Vulnerabilities of the Indonesian Model in Resolving the NPL Problem	126
4.2.7 Conclusion	127
4.3 South Korea	
4.3.1 Overview	127
4.3.2 Factors Contributing to the NPL Problem: 1979-1994	128
4.3.3 Resolution of the NPL Problem: 1979-1994	130
4.3.4 Factors Contributing to the NPL Problem: Mid-1997 Financial Crisis	131
4.3.5 Resolution of the NPL Problem: Mid-1997 Financial Crisis	132
4.3.6 Vulnerabilities of the South Korean Model in Resolving the NPL Problem	136
4.3.7 Conclusion	136
Chapter 5: Some Concluding Observations	137
Bibliography	140
Appendices:	
Appendix A	149
Appendix B	152
Appendix C	155

LIST OF TABLES

Table		Page
3.1	Indicators on Accounting and Prudential Standards	76
3.2	Time Period for Overdue Criteria for Interest Suspension and Loan Classification	77
3.3	Comparison of Key Indicators and Policy Reactions in Four Asian Countries	87
4.1	Malaysia: Outstanding Loan Provisions and NPLs of the Banking System	96
4.2	Malaysia: Banking Risk	103
4.3	Malaysia: Loan Classification and Provisioning 1999	106
4.4	Malaysia: Corporate Debt Restructuring Committee	108
4.5	Malaysia: Capital and Net Nonperforming Loans Ratio of the Banking System	112
4.6	Malaysia: 10 Anchor Banks For Merger Program	115
4.7	South Korea: Share of NPLs and Bank Profitability of Seven National Commercial Banks in South Korea	129
4.8	South Korea: Disposition of Sales of KAMCO's Assets	133
4.9	South Korea: Schedule for KAMCO's Purchase of NPLs	134

LIST OF CHARTS

Chart		Page
4.1	Malaysia: Overview of Institutional Framework	107
4.2	Asset Management—Loan vs. Asset	111