

CHAPTER 1: INTRODUCTION

1.1 OVERVIEW

Financial institutions, particularly banks, play a critical role in the development of the economy of a country. They perform the role of intermediary between the savers of funds and their users in an economy. Through their lending operations, they are able to create money and provide finance for agriculture, commerce, industry and other purposes. They exert vast influence on the course of economic development of a country.

The economic and financial life of a country depends on banks in three important respects: (a) Banks occupy a central place in the payments mechanism for households, government and business; (b) They accept deposits, which are widely regarded as “money”, which are expected to be repaid in full, either on demand or at their due term; and which constitute part of society’s financial assets; (c) Banks in market economies play a major role in the allocation of financial resources, intermediating between depositors of surplus funds and would-be borrowers, on the basis of active judgements as to the latter’s ability to repay. This is in marked contrast to practice under conditions of central planning, where banks would typically act merely as passive conduits for the distribution of funds, without the necessity to make credit decisions (Ware 1996: 5).

Banks are financial intermediaries whose liabilities are mainly short-term deposits and whose assets are usually long-term loans to businesses and customers. When the

value of their assets falls short of the value of their liabilities, banks are insolvent (Demirguc-Kunt and Detragiade 1994: 84). The value of a bank's assets may drop because borrowers become unable or unwilling to service their loans, where credit risk is involved. This will result in the rising of nonperforming loans (NPLs), which is a common problem facing the financial regulators. NPLs, although a normal expected part of banking, jeopardize a bank's well being when they are greater than anticipated (Yeats 1991). Virtually, all banks sustain problem loans; the key is to minimize the loss.

Since the early 1980s, systemic banking sector problems have emerged repeatedly over the world. The need to understand the connection between banking sector fragility and the NPL problem is all the more urgent. The problem of mounting NPLs gained much prominence during the recession that hit particularly all countries all over the world during the 1980s. Assets turned sour during the period of unfavorable economic conditions. The year 1985, particularly, pointed a significant slowdown in the world economy after a strong economic recovery in 1984. The economy of the United States, which had led the upswing in the world economy, began to show signs of slowdown even as early as late 1984. Against such international scenario, the developing countries as a whole recorded a slower growth in 1985 and 1986.

The NPL problem is again highlighted following the financial crisis that recently hit the Asian economies. Between June 1997 and January 1998, a financial crisis swept like a brush fire through the "tiger economies" of South-East Asia. Over the previous

decade, the East Asian states of Thailand, Malaysia, Singapore, Indonesia, Hong Kong, and South Korea had registered some of the most impressive economic growth rates in the world. Their economies had expanded by 6% to 9% per annum compounded, as measured by Gross Domestic Product. This Asian miracle, however, appeared to come to an abrupt end in late 1997 when in one country after another, local stock markets and currency markets imploded. When the dust started to settle in January 1998, the stock markets in many of these states had lost over 70% of their value; their currencies had depreciated against the US dollar by a similar amount (Hill 1998). Financial and corporate sector weaknesses play a major role in the Asian crisis in 1997. These weaknesses increased the exposure of financial institutions to a variety of threats, one of which included declines in assets value caused by the NPLs.

At the level of individual banks, the rising trend of NPLs reduced the banks' profitability, as the provision for loan losses increased. Another adverse consequence of NPLs is that it lowered bank capital because banks were forced to increase their loan loss reserves when NPLs grew. Cost efficiency of banks may decline when extra expenses associated with the NPLs are created. On the other hand, there are several adverse consequences at the level of banking system. Rapid increase in NPLs may cause fragility in banking system and bank failures due to contagion and deposit run and excessive credit risk.

Bank lending involves a great deal of credit or default risk due to the possibility of non-repayment of interest and principal. It is vital for banks to minimize this form of risk in order to realize profits. Although bankers aim only to make good loans, mistakes are sometimes made in the process of lending which materialize in the form of problem loans or NPLs. It is inherent that we define problem loans in terms of default risk. The survival of a bank with regard to liquidity and profitability is adversely affected by problem loans. One of the major reasons for bank failures in the United States, which have occurred over the past two decades, can be attributed to such loans. In fact, they have also caused major bank collapses in the Asia-Pacific region. Problem loans breed loan losses which sap the financial strength of a bank (Shamsudin 1987: 47).

The rising of NPLs is therefore forcing banks to choose writing them off or selling them at a discount. Removing NPLs from the banks' balance sheets and transferring them to a separate loan recovery agency is an effective way of addressing the banks' solvency problem. The survey done by Dziobek and Pazarbasioglu (1997) on 24 countries, where the systemic bank restructuring has taken place, showed that most substantial and moderate progress countries made use of this technique. Removing the NPLs immediately improves the banks' balance sheets and it helps the banks to focus their attention on their core business. From South Korea to Indonesia, government regulators and bank advisers are in the process of setting up asset management companies (AMCs) as vehicles to acquire problem loans and disposing them to a separate vehicle. Banks could then resume lending to cash-strapped clients,

restore investors' confidence and help revive the economy (Dziobek and Pazarbasioglu 1997; De Ramor 1998).

Other ways of dealing with NPL problem includes prudent credit risk and country risk management; loan guarantees provided by the government to cover the risk the borrower would be unable to repay the loan; prudential regulation and supervision which include capital adequacy and provisioning of loan loss reserves and public disclosure; Adequate bankruptcy law is equally important to resolve the NPL problem besides restructuring the NPLs by merger and acquisition or other banking restructuring agencies.

1.2 RESEARCH OBJECTIVES

This study will attempt to examine the management of NPLs by selected countries.

The major objectives of the study are as follows:

- To examine the causes of NPLs, their prevention and measures to minimize them.
- To study the differences or variations in the approaches adopted by different countries, namely Malaysia, Indonesia and South Korea, to manage the NPLs. The analysis will include the period during the recession in 1980s, and the period of financial crisis, which began in 1997. The study will also look at the condition of post-crisis situation.
- To explore financial sector restructuring of the selected countries hit by the financial crisis in 1997, which includes the setting up of asset management

companies to manage low quality assets of financial institutions. Although the process is still ongoing, the implication can be seen in many aspects.

1.3 SIGNIFICANCE OF THE STUDY

What is to be done with the mounting of NPLs is a common problem facing financial regulators. This study hopes to provide insights into the policies and strategies adopted by different selected countries to deal with NPLs. It is hoped that this study will contribute to future strategy decisions to manage the NPLs.

1.4 SCOPE OF THE STUDY

This study will cover the banking system in some selected Asian countries, namely Malaysia, Indonesia and South Korea. The analysis covers a period from the economic slowdown in 1980s to the present. The coverage of financial institutions in the countries will include commercial banks, merchant banks and finance companies and other financial institutions. As commercial banks constitute the most important of their institutions in these countries, greater emphasis is given to them on the study.

1.5 RESEARCH METHODOLOGY

The materials obtained for this research are mainly from secondary sources. This include publications like various banks' annual reports (Federal Reserve Banks in the United States; Bank Negara Malaysia; Bank of Indonesia; Bank of Korea; Bank of Thailand, etc), bankers' journals (The Journal of Banking and Finance, Journal of Money, Credit and Banking, Journal of Commercial Bank Lending, Journal of

Finance and Development, etc), economic reviews (of Federal Reserve Banks of Cleveland, Dallas, San Francisco, Boston, Philadelphia; New England Economic Review, etc), business magazines, economic magazines, the International Monetary Fund (IMF) Working Papers; periodicals; text books; newspapers and compact disks.

One of the most important sources of data and information for this study is obtained via the Internet. The up-to-date information gathered include selected articles, press conferences, and electronic-journals published in homepages of the IMF, World Bank, Bank of International Settlements (BIS), the Central Bank of Malaysia (Bank Negara Malaysia or BNM), Oxford Development Studies, Institute For International Economic (IIE), University of Malaya (UM), National University of Singapore (NUS) and so on. Data from the various sources will be analyzed using tables and charts gathered.

1.6 LITERATURE REVIEW

Various works on NPLs have been carried out over time. A number of countries have been selected to include in this literature review. The United States constitutes a large part of this literature review, followed by the South-East Asian countries and some Eastern European Countries.

First of all, the NPL was identified by the definition of NPLs. Behren (1985a) introduced a more general definition of problem loan. Their definition of NPL is the loan in which there is a major breakdown in the repayment agreement resulting in an

undue delay in collection. Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo (1999), on the other hand, have given another simple definition on NPLs. They defined NPLs as those loans whose estimated value is below their original book or contractual value.

Clark and Johnoton (1995) introduced problem loan as one where repayment is in jeopardy, especially if the expected or anticipated source of repayment is no longer sufficiently available to repay the debt.

Some other literatures defined NPLs by introducing the specification of the period of default allows for loans before they are treated as NPLs. The works on this were done by Walter (1991), Keeton and Moris (1987), Peek and Rosengren (1999) and Huh and Kim (1994).

In the same vein, the literatures on loan classification and NPLs are reviewed. Walter (1991) classified loans into four categories: good loans, loans past due or otherwise in doubt, written-down loans, and charge-off loans. Meeker and Gary (1987) identified four categories of NPLs in their study: Loans past due 30 to 89 days and still accruing, loans past due 90 days and still accruing, nonaccrual loans and renegotiated loans. Many studies have been done by other authors to classify NPLs into three categories: substandard loan, doubtful loan, and loss or bad loans. The definitions of the three categories are taken from the work of Spong (1983), Bank

Negara Malaysia (1987), and Federal Deposit Insurance Corporation's (FDIC) Manual of Examination Policies (1975).

The survey further looks at the indications of NPLs. Berger and DeYoung (1996) suggested that cost efficiency might be an important indicator of future problem loans and problem banks. They examined the intersection between the problem loan literature and the bank efficiency literature. The ~~Granger~~-causality techniques were used to test hypothesis regarding the relationship among loan quality cost efficiency and bank capital. They referred to these hypotheses with the mnemonic "bad luck", "bad management", "skimping" and "moral hazard". Jordon (1998) tested empirically to determine whether a "skills" hypothesis or a "policies" hypothesis better explains differences in the severity of loan problem.

The survey then explores what indications of NPLs mean. The usefulness of substandard loan ratio (SLR) are identified by Benston and Marlin (1974). Gonzalez-Hermosillo (1999) found that NPLs may be a key indicator of the magnitude of banks' difficulties. Meeker and Gary (1987), on the other hand, found NPLs as an indicator of asset quality.

Factors contributing to NPL were examined. Many works touched on the factors contributing to the NPL problem. The factors can be either endogenous or exogenous. Jordon (1998), Keeton and Morris (1987), Berger and DeYoung (1997), and de Juan (1991) shared the similar view that the NPL is endogenous to the extent

that the nonperformance is from bad bank management or poor lending policies. Clair (1992) and Berger and DeYoung (1997) found that skimping on the resources might contribute to higher NPLs rate.

Behren (1985a), Clair (1992) and de Juan (1991) explored why fraud and embezzlement may be one of the significant factors contributing to higher probability of NPLs rate.

SEACEN (1983) and Harrington (1987) pointed out that when the credit risk and country risk is high, debtors will be unwilling or unable to pay their debt and this will give rise to the NPLs.

Many analyses drew the conclusion that there was a relationship between rapid growth of lending activity and deterioration of loan quality. The analysis done by Clair (1992) and Stevenson (1994) are a few of the analyses identified. Keeton (1999) examined the relationship between loan growth and loan losses.

Akerlof and Romer (1996), Krugman (1999), Demirgüç-Kunt and Detragiache (1998), Hardy (1996), Kane (1989) and Gonzalez-Hermosillo (1999) shared the same opinion that moral hazard incentives may cause an increasing trend in the NPLs. One of their reasons given is that banks with relatively low capital respond to moral hazard incentives by increasing the riskiness of their loan portfolios, which results in higher NPLs on average in the future.

that the nonperformance is from bad bank management or poor lending policies. Clair (1992) and Berger and DeYoung (1997) found that skimping on the resources might contribute to higher NPLs rate.

Behren (1985a), Clair (1992) and de Juan (1991) explored why fraud and embezzlement may be one of the significant factors contributing to higher probability of NPLs rate.

SEACEN (1983) and Harrington (1987) pointed out that when the credit risk and country risk is high, debtors will be unwilling or unable to pay their debt and this will give rise to the NPLs.

Many analyses drew the conclusion that there was a relationship between rapid growth of lending activity and deterioration of loan quality. The analysis done by Clair (1992) and Stevenson (1994) are a few of the analyses identified. Keeton (1999) examined the relationship between loan growth and loan losses.

Akerlof and Romer (1996), Krugman (1999), Demirgüç-Kunt and Detragiache (1998), Hardy (1996), Kane (1989) and Gonzalez-Hermosillo (1999) shared the same opinion that moral hazard incentives may cause an increasing trend in the NPLs. One of their reasons given is that banks with relatively low capital respond to moral hazard incentives by increasing the riskiness of their loan portfolios, which results in higher NPLs on average in the future.

Lack of diversification on loan portfolio is also a contributing factor of NPL problem. Pantalone and Platt (1997) and Harrington (1987) shared the similar view that inadequate bank capital is a vital factor that cause NPLs.

According to Rennhack (2000), the ratio of NPLs to total loans is manipulated by weak banks through “evergreening” of loans, which convert overdue loan principal and interest payments into new loans. de Juan (1991) backs his view.

As for exogenous factors, the bursting of speculative bubbles often results in an economic downturn. They will cause deterioration in loan portfolio of all banks and cause NPLs to rise. Shiller (1998) and Jomo (1998) have their explanation on this. Huh and Kim (1994) found that heavy government intervention can cause bad loans rate to increase.

Keeton and Morris (1987), on the other hand, discovered that local economic condition, such as closing of major plant or bad weather may add to the variation in loan loss rate.

It is equally important to note that the weakness in prudential regulation and supervision may increase the probability of loan loss. Lindgren, Balino, Enoch, Gulde, Quintyn, and Teo (1999) brought up this point. Lack of bankruptcy law can further exacerbate the NPL problem. Borish, Long, and Noel (1995) had their explanation on it.

This review also explores some works done by various authors, which touched on the consequences of NPLs. At the level of individual bank, Clair and Gunther (1987) undertook a study on NPLs and bank profitability. They found that NPLs may reduce banks' profitability. Syron (1991) reported that as NPLs grew, banks were forced to increase their loan loss reserves, resulting in lower capital. Dzuibek and Pazarbasioglu (1997) and Yeats (1991) supported Syron's (1991) view.

At the level of banking system as a whole, the NPLs may contribute to the fragility in banking system and eventually bank failure. The evidences are given by Gonzalez-Hermosillo (1997). Contagion may occur when the NPL rate is high. This may cause deposit or bank run which may eventually cause the banking system to fail. Temzelides (1997) had his view on this.

1.7 ORGANIZATION OF THE STUDY

This report will consist of five chapters

Chapter 1:

Chapter 1 first provides an overview of the NPL problem. It also furnishes the scope and objectives of the study, significance of the study, research methodology, a literature review on NPLs, and the organization of the study.

Chapter 2:

Chapter 2 presents what the empirical studies revealed on NPL problem. First it identifies NPLs which includes the discussion about the concept and definitions of

NPLs, and the various ways of the loan classifications and classifications of NPLs. It also looks at the indicators of NPLs. It then reviews the various factors contributing to NPLs from the evidence of various hypotheses and tests. This survey then provides an insight into the consequences of NPLs.

Chapter 3:

Chapter 3 gives an overview of a series of measures to deal with NPLs, including the establishment of special agencies to acquire NPLs, institutional reform, and bank restructuring process.

Chapter 4:

Chapter 4 explores the techniques used by selected countries to manage the NPLs. The selected countries are Malaysia, Indonesia and South Korea. It covers the techniques to deal with NPLs. A brief discussion on the prospect of the special vehicles will be introduced to complete the picture.

Chapter 5:

Chapter 5 will touch on some concluding observations.