<u>Dealing with non-performing loans of banks</u>

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A lot of confusion and misunderstanding has been created by several commentators on the issue of non-performing loans (NPLs) of banking system. They take the absolute amount of such loans at the current point of time and compare it with the quantum of such loans in October 1999 and make a hue and cry that the situation has deteriorated because the quantum of NPLs has gone up. Such a simplistic approach creates doubts in the minds of common people about the commitment of the government and the State Bank of Pakistan towards recovery of these loans and distorts the true picture about this important issue.

The aim of this article is to inform the public about the exact magnitude of the problem, the trend over time and the measures the State Bank of Pakistan is taking to tide over this problem.

The State Bank of Pakistan (SBP) is dealing with the NPL issue in a comprehensive manner through (a) improvement in coverage and reporting of NPLs (b) a proactive treatment of the existing stock of NPLs (c) stemming flow of new NPLs and (d) improving the policy and regulatory environment.

It should be realized that the stock of existing NPLs will always grow over time even if all the new loans being granted are fully serviced. This will happen because the declared amount consists of principal and mark up. By its very definition, if the loan is not being serviced and is overdue by 90 days then the unrealized mark up will continue to be added up to the total amount of NPLs. For example, if on October 1999 the principal amount due on a NPL was Rs 1 million and the contracted mark up rate was 20 percent, then this amount will grow to Rs 1.2 million in October 2000, Rs 1.4 million in October 2001 and Rs 1.6 million in October 2002. So it can be seen that if the principal amounts overdue to the banking system in October 1999 were Rs 160 billion and these loans fell in the category of NPLs then three years later they will swell automatically to Rs 256 billion, assuming that the contracted mark up rate was 20 percent per annum. Thus, one can expect that 60 percent increase will take place in the total quantum of NPLs after a three year period, even if every single new loan is performing well. The second complication arises if the NPL is denominated in foreign currency which is the case with 13 percent of all NPLs. These were granted by the foreign branches of NBP, HBL, UBL and Allied Bank. Assume that these loans were granted when the rupee-dollar exchange rate was Rs 46 to $ 1 and suppose the principal amount overdue was $ 1 million. At the time the loan was granted, its value on the books of the bank was Rs 46 million. Today, when the exchange rate is Rs 59, the same NPL will be shown as Rs 59 billion i.e. 28 percent higher than the original value declared in October 1999. This excludes the mark-up overdue which will also move up and if this mark up is included the same NPL will be at least 40 percent higher in value in October 2002 (as the dollar mark up rate has been lower than the rupee mark up rate). Thus it should be seen that without any fault of the bank its aggregate value of NPLs (denominated in foreign currency) has escalated by 40 percent.

(a) Improvement in Coverage and Reporting.

The SBP Inspectors have begun to apply more rigorous standards of classification. In September 2000, the SBP inspectors detected that some of the public sector specialized banks were reporting only default or overdue portion of their non-performing loans instead of total outstanding amount of such loans. This led to an upward revision in the volume of NPLs reported by these banks and resulted in addition of Rs 47 billion of loans classified as non-performing which were not shown as such in the period prior to September 2000. Thus overnight the total volume of declared NPLs rose by Rs 47 billion. The SBP has also revised the valuation method of collaterals underlying the classified loans and brought them in line with international practices. The banks can now take into account only the minimum realizable value of assets mortgaged or pledged for determining the provisions. The realizable value shall be the value that could currently be obtained by selling the mortgaged/pledged assets in a forced/distressed sale condition. The banks have been asked to earmark additional provisions against the revised valuations of collaterals. It can be seen from the above illustrations that the increase in absolute amounts of NPLs cannot be ipso facto attributed to any deterioration in the underlying quality of assets, but has occurred due to the stricter enforcement of regulatory, accounting, valuation and prudential rules.

Despite the above factors i.e. addition of unrealized mark up for three years, currency revaluation due to depreciation of rupee and discovery of undisclosed NPLs, the overall quantum of NPLs by the end of June 2002 amounted to around Rs 259 billion – an increase of only Rs 47 billion in the last three years. This increase is equivalent to just the one time adjustment made in September 2000 to the stock of NPLs due to improvement in the reporting methodology. While the nationalized commercial banks have brought down their non-performing loans, the largest single change has been in the category of specialized banks. Their NPLs have risen from Rs 19.3 billion to Rs 67 billion due to this one time adjustment.

To the banking regulator, it is not the absolute amount, but the ratios of NPLs to total advances which are the relevant indicators of the quality of assets and adequacy of capital of the banks. There are two ratios which ought to be monitored – the gross NPLs/gross advances and net NPLs/net advances. The reason for monitoring these ratios is straight forward and logical. As the banks grant new loans of good quality after careful appraisal and due diligence, these ratios are bound to decline over time and the overall quality of assets of the system will improve. More important, it is non-provisioning of these NPLs which pose a systemic threat to the health of the banking system. The higher is the provisioning, the lower is the systemic risk.

In June 1999, the ratio of gross NPLs/gross advances of the banks and DFIs was 24 percent and is almost the same today. Had this under reported amount of Rs 47 billion been added to the portfolio of banks, particularly ADBP and IDBP, in June 1999 the ratio of gross NPLs / gross advances on comparable basis, would have been 29 percent. On this basis alone it can be seen that the ratio of gross NPLs to gross advances has declined by at least 5 percentage points over last three years.

The more gratifying feature is that the ratio of net NPLs/net advances has declined from 15 percent to 11 percent as the banks and DFIs increased their holding of provisions to Rs 142 billion which covered 56 percent of their classified portfolios of both foreign and domestic loans. The situation will further improve in 2002 as the banks make more provisions against a declining portfolio of NPLs.

(b) Proactive treatment of the stock of NPLs.

The State Bank is still not satisfied with this declining trend of these NPLs, as the spread between the deposit and lending rates is still high due to this drag. It has adopted a multi-pronged approach to resolve this issue. First, it has put pressure on the banks and DFIs to accelerate recovery. During the past three years, an amount of more than Rs 40 billion or 20 % of 1999 outstanding stock of NPLs has been recovered in cash. Second, it has decided to distinguish between willful defaulters and circumstantial defaulters. The cases of willful defaulters have been referred to NAB for action under the NAB Ordinance. NAB has helped in recovering (including rescheduling) Rs 17.5 billion so far from these defaulters. Third, the Committee on Revival of Sick Units (CRSU) has been authorized to restructure the NPLs and revive the underlying sick units which are found to be financially and economically viable. Fourth, the Government has created an asset resolution framework in the form of Corporate and Industrial Restructuring Corporation (CIRC). This corporation acquires the bad loans from nationalized banks at a discount and auctions them publicly thus taking away the assets from the existing owners and repaying the proceeds to the banks. Fifth, as there are aged loans which can hardly be recovered due to passage of time and the diminution in their value, the SBP has developed general guidelines for the use of bank boards of Directors to write-off these loans particularly to help small and medium borrowers. Finally, 80 percent of these non-performing loans are concentrated in seven public owned banks and DFIs. NDFC has been merged with NBP. UBL has been privatized and HBL is in the process of privatization. IDBP and ADBP are being restructured and NBP shares are being floated. As this link between political loans and the public-owned banks will be severed the probability of huge accretion of bad loans in the future will be minimized.

The banks are in the business of risk taking and there are occasions when exogenous shocks or business cycles or frequent changes in government policies do turn some of their assets sour. Until and unless there is no personal motive of the bankers or any political pressure, the write off of loans and cleaning up of their balance sheets is the normal practice of the banks all over the world and Pakistani banks should not hesitate to take appropriate action on the basis of transparent criteria and policy guidelines. The Board of Directors and the regulators should exercise oversight and make sure that the decisions taken by the bank management conform to the approved criteria and guidelines. Only willful defaulters should be taken to task and made to repay their full liabilities. Legal action should be taken against them and their cases referred to NAB.

(c) Stemming flow of new NPLs.

The banking sector reforms implemented since 1997 have improved the quality of assets. The flow of NPLs has been significantly contained. The ratio of NPLs to total loans disbursed since 1997 has remained around 5 percent – much lower than international norms. This will ensure that the future ratios of NPLs will look much better than the historical or current ratios.

It has also been observed that theNPLs and their ratios to advances are much lower in case of domestic private banks and foreign banks. As the nationalized commercial banks (NCBs) and DFIs are privatized or liquidated or merged the incidence of new non performing loans will be reduced significantly.

There has been a perceptible change in the credit culture of the NCBs who now pay increasing attention to more rigorous credit appraisal, proper credit documentation, monitoring and follow up. Their management have also developed mechanisms for better risk management and discontinued lending on political considerations.

This new Credit Culture, of course, has some negative repercussions as credit officers have become more risk averse in recommending new loans and the potential borrowers have become more cautious in contracting new loans. Decline in private sector credit can be partially attributed to this risk aversion among the bank credit staff. The SBP is trying to mitigate this by asking the banks to diversify their portfolios and open up new lines of business – consumer financing, mortgage financing, SME lending, microfinance, agriculture credit and thus manage the aggregate risks better. This diversification and risk management strategy should help meet the broad credit demand of the various segments of the economy but also stem flow of non performing loans.

(d) Policy and regulatory environment.

The State Bank's policies and regulatory environment have also been revamped to resolve this problem. Interest rates have declined significantly and low interest rates should help the borrowers in repaying their stuck up loans. Information on exposure to various individual companies and groups will now be available to the banks on-line to help them in making informed decisions on credit extension.

The protracted and cumbersome legal processes and prolonged litigation for execution of decrees have been a major stumbling block in the recovery of loans. An important recent development has been the enactment of a new recovery law in 2001 which enables the banks to repossess the collaterals without recourse to litigation. A new bankruptcy law is also in offing which will permit orderly resolution of debtor obligations under distress.

The SBP has also strengthened its supervisory capacity by shifting to risk-based supervision and by assessing the strengths and weaknesses of internal controls, systems and risk management mechanisms within the financial institutions. The supervisors make a more prudent evaluation of the provisioning requirements and take corrective actions to enable the financial institutions to set aside the right amounts of provisions.

The introduction of market based instruments, swap desks, development of a yield curve, allowing the banks to raise second tier capital through subordinated debt and matching their asset and liability maturities are some of the additional steps which have been taken by the SBP to facilitate the banks to manage their risks in a more prudent manner.

To sum up, while significant progress has been made in dealing with the old stock of non-performing loans of the banks and DFIs, SBP is still not satisfied with the existing situation. The good news is that the proportion of NPLs among the new loans approved since 1997 is shrinking while a combination of policies aimed at cash recoveries, rescheduling, restructuring, sale of assets to third parties, execution of legal decrees, write off of aged and irrecoverable loans are being pursued to reduce the quantum of old stock. For a variety of reasons – legal, accounting, valuation, prudential and regulatory – the stock may continue to show an upward rise as mark-up is added over time to overdue principal, exchange rate revaluations are effected and more rigorous standards are applied by the SBP in classifying and reporting these loans. This rise should, therefore, be seen in the correct and overall perspective, as explained in this article.