THE INTERNATIONAL JOURNAL OF BUSINESS & MANAGEMENT

Does Deviation from Prudential Regulation Leads to Non-Performing Loans? Evidence from Habib Bank and National Bank of Pakistan

Awais Farooq
Regional Coordinator, WMCS, Meezan Bank Ltd., Bahawalpur, Pakistan
Researcher, Islamia University, Bahawalpur, Pakistan
Aziza Naz
Researcher, Islamia University, Bahawalpur, Pakistan
Basit Zaheer
Researcher, Islamia University, Bahawalpur, Pakistan

Abstract:
This study focuses on the deviation from prudential regulation leading to the non-performing loans and to show how these values have been avoided, especially in the Pakistani Banking Industry. This research is descriptive in nature, population incudes HBL and NBP branches of Bahawalpur region. In order to find out the objectives of this study, 30 unstructured Interviews with Credit in- charges, Credit Officers, Loan Officers, and Loan Recovery Officers of National Bank of Pakistan and Habib Bank Ltd. of Bahawalpur region were conducted. 23 Respondents were positively replied while 7 were negatively replied. Some special loan cases from banks file were also added. Research concluded that banks personnel's sometimes deviate from Prudential Regulations at the time of loan issuing, which leads to non-performing loans. Banks need more effective regulations and policies which can secure the bank's profitability.

Keywords: *Financial Institutions, Prudential Regulations, Profitability, Non-Performing Loans (NPLs)*

1. Introduction

Banks providing its services to customers from many years. Banks primary purpose is lending and borrowing. Now banks are also providing wide variety of products and services to its customers due to some factors like ongoing modernization, tough completion among banks, and new market entrants. These banking products and services are both for wholesaler and retail customers. Banking products and services range from traditional to new products and services.

Traditional services of banks include getting financial information, acquiring advances and opening accounts etc. whereas new products and services include electronic bill, customized budgetary "entryways," account collection and business-to-business commercial canter's and trades.

In providing wide variety of products and services, banks face different issues. One of them is non-performing loans. Non-performing loans are those loans which customer fails to pay back. To avoid these banks must do its risk management research before approving a loan. Bank should know about their customer's intention and capacity and whether customer may have the ability to pay back in future or it would fail to pay.

These non-performing loans obstructing banks from profitability, so the state bank of Pakistan is working deliberately to incorporate risk management practices (Haneef, Riaz, Ramzan, Rana, Ishaq, & Karim, 2012). State bank of Pakistan also has devices prudential regulations which banks need to follow at the time of issuing of loans. Prudential regulations are set by regulatory authorities of state bank of Pakistan and are administrative rules and regulations for smooth running of loaning procedure.

Contextual study of banks.

1.1. National Bank Limited

In 1949 National Bank of Pakistan (NBP) established its head office in Karachi, Pakistan. today it has established almost 1409 branches with 1014 ATM networks across the country. It additionally works various offices abroad that include Beijing, Tashkent, Chicago, London and Toronto. National Bank of Pakistan has added an extensive variety of customer items to upgrade business and cater to the diverse sections of society and meet its social obligations.

A few plans have been particularly intended for the low to middle salary segments for the public. It has executed exceptional credit plans like little fund for agribusiness, large Industries and small businesses, Qarz-e-Hasna advances to understudies; independent work plans for unemployed persons, open transport scheme.

1.2. Habib Bank Limited (HBL)

HBL head office was established on the Call of Pakistan`s founding father Muhammad Ali Jinnah by Habib Family in Bombay (now Mumbai) 1941, he knew the importance of financial Institution at that time. in August 1974, HBL moved and established its head office in Karachi, Pakistan and recognized as first commercial bank of Pakistan. This bank was managed and controlled by the Habib family before it was nationalized by the government of Pakistan on 01 January 1974. Today it has flourished its 1700 branches all over the country and almost1900ATMs.

Habib bank was privatized in 2004 through which AKFED acquired 51% of its shares 42.5% shares acquired by the govt. and remaining 7.5% shares is offered for general public. Domestic market share of HBL is over 40%. It also continues to lead the commercial banking sector with 55% major share of inward remittance, traders and farmers and loan to small industries. Its mission is to be recognized as the leading financial institution of Pakistan and a dynamic international bank in the emerging markets, providing our customers with the premium set of innovative products and services, and granting superior value to our stakeholders – shareholders, customers and employees.

2. Literature Review

Non-Performing Loans

Business banks are the overwhelming money related organizations in many economies (Rose, 1997). Greuning and Bratanovic (2003), contend that business banks assume a discriminating part to developing economies where most borrowers have no entrance to capital markets. Well working business banks quicken monetary development, while inadequately working business banks are an obstacle to financial advance and exasperate neediness (Barth et.al, 2001; Khan and Senhadji, 2001) cited in Richard (2011).

The primary role of bank is lending and borrowing. In this way banks create their assets (Njanike, 2009). As indicated in the research by Havrilesky and Boorman (1994), Commercial banks interest income pointedly affected by interests on loans. For instance, Reed and Gill (1989) studies show that interest on loans contribute up-to 85% of commercial banks income. A large proportion of banks assets are loans (Saunders and Cornett, 2005). Credit is not a simple undertaking for banks on the grounds that it makes a major issue which is called non performing advances (Chhimpa J, 2002) as referred to in (Upal, 2009). Commercial banks open themselves to the dangers of default from borrowers (Waweru and Kalami, 2009).

In writing about banking literature, the issue of NPLs has been returned to in a few hypothetical and exact studies. A brief survey of the writing brings to the fore bits of knowledge into the determinants of NPL crosswise over nations. A considered perspective is that banks' credit strategy could have critical impact on non-performing loans (Reddy, 2004).

Reddy (2004) curiously inspected different issues relating to terms of credit of Indian banks. In this setting, it was seen that 'the component of force has no bearing on the unlawful action. A default is not by any stretch of the imagination a silly choice. Rather a defaulter considers probabilistic evaluation of different expenses and profits of his choice.

Mohan (2003) conceptualized 'lazy banking' while curiously considering banks' venture portfolio and loaning arrangement. In an investigation of institutional money structure and suggestions for modern development, Mohan (2004) focused on the lending terms of credits, its maturity and interest-terms to business organizations.

Keeton and Morris (1987) shows that primary measure of loan losses by utilizing NPL net of charge offs. Furthermore, variation in economic conditions of that area plus improper execution clarifies the variation recorded by the banks. Commercial banks having more risk appetite experienced greater losses as compared to low risk appetite.

The relation between loan loss rate and internal factors is significantly positive. Internal factors include high investment rates, uncontrolled loaning and funds. Similar to the previous study, Sinkey and Greenwalt (1991) report that unfavourable regional financial condition also explains loan loss-rate of the commercial banks.

Nonperforming loans will increase and if a bank calls in a loan as past due, it may have to write-off existing capital if profits are not a sufficient buffer (Mora, N. & Logan, A., 2012).

In mid-1990s to 2015 Greece spending more than it was collecting from taxes. Greece saw its trade deficits also rise considerably. The Budget deficit and the trade deficit Increase from least 5% of GDP in 1999 to uttermost 15% until year. To cover up those shortfalls and to reduce its debt burden which was considerably raising country borrowed loans form IMF. Lake of Regulations and lawlessness, misleading budget figures, Government deficits, Government debt levels, Greece country fails to pay its debt and default in its credits (Kashyap, 2015).

Bercoff et al (2002) analyze the delicacy of the Argentinean Keeping money framework over the 1993-1996 period; they contend that NPLs are influenced by both bank particular components and macroeconomic elements.

State owned commercial banks of Czech Republic, Hungary and Poland also face the non-performing loans issues. So in case of any hard core plan they world defiantly suffer from liquidity and dissolvability (Matoušek, R. &Sergi, B.S., (2005).

Another study demonstrates that increments in non-performing loans for the most part decrease measured expense effectiveness, decrease in measured expense productivity increments issue credits, and non-performing loans are expanded by diminished bank capital degrees (Lin, T.T. & Lo, I.H., 2006).

A different research finds either implementation of beneficiaries is effected by banking projects in coming years? Results shows that in short run loans are of no use for beneficiary countries as they are in longer run. They uplift the export performance of that country (Agostino, M. &Trivieri, F., 2014).

Studies in different nations demonstrate that the greater part of bank disappointments have been created by Non-performing advances (Brownbridge, 1998). Ahmad (2002), in examining the Malaysian money regulations, reported a huge relationship between credit danger and monetary emergencies and inferred that credit danger had effectively begun to develop before the onset of the 1997 Asian budgetary emergency, and got to be more genuine as non performing advances expanded. Li (2003) and Fofack (2005) additionally discovered this relationship to be noteworthy. There is confirmation that the level of non -performing credits in the US began to increment significantly in mid-2006 in all divisions before the breakdown of the sub-prime home loan showcase in August 2007 (Greenidge and Grosvenor, 2010) referred to in (Joseph, Edson, Manuere, Clifford, & Michael, 2012).

The banks are in the matter of danger taking and there are events when financial shocks or business cycles or continuous changes in government strategies do turn some of their advantages harsh. Until and unless there is no individual thought process of the investors or any political weight, the write-off of hopeless credits and cleaning up of their monetary records is the ordinary practice of the banks everywhere throughout the world.

Pakistani banks have likewise made a move, in the same way as different banks, to write-off advances and waive off charges on the premise of straight forward criteria and rules. The main special case is that willful defaulters are berated and made to pay their liabilities. Legitimate move was made against them and their cases were alluded to National Accountability Bureau (NAB). Anyhow there are true blue agents and individual borrowers who have been casualties of circumstances, for example, business down turn, flighty government strategies of tariff and taxes, sharp changes in regulatory environment and in addition business misjudgments, and so forth. They may not be in a position to keep making installments as per the first contractual assertions under the changed circumstances. Both sides –the banks and borrowers –are in an ideal situation in the event that they make opportune move to rebuild the credits and transform them into a performing contract. In doing as such, the banks may need to waive-off i.e. write-off some gathered charges and/or take a halfway rebate on the outstanding. The upside, on the other hand, is that the nature of rebuilt resource gets overhauled. The borrower will then be in a position to work the unit and produce income to administration liabilities. (Haneef, Riaz, Ramzan, Rana, Ishaq, & Karim, 2012)

The SBP has permitted the Top managerial staff of Banks to waive-off credits in the misfortune class in a straightforward, non-biased and uniform way as per decently characterized policies. The banks are obliged to reveal the detail of the borrower and peoples who have been permitted to write-off of above Rs. 0.5 million in their yearly financial statements (Haneef, Riaz, Ramzan, Rana, Ishaq, & Karim, 2012).

A number of housing loan companies, banks and securities houses failed over the period, while others were bailed out or nationalized. The poor condition of a large number of borrowers along with a deflationary macroeconomic environment, low margins charged on loans (and a lack of revenue diversification to offset these), losses incurred on investments in Southeast Asia in the late 1990s, high labour costs and low levels of investment in new process technologies all explain the poor profits of Japanese banks relative to their European and US counterparts (Liu, H. & Wilson, J.O.S., 2010).

(Lu et al., 2005) in his study utilizes a board information set of open posting organizations in China exactly to investigate the relationship between banks' loaning conduct and non-performing loans. In results it demonstrates that state-owned enterprises (Soes) got a larger number of loans than different firms, different things being equivalent, and Soes with high default dangers were capable to obtain more than the generally safe Soes and non-Soes. This proposes that Chinese banks had a systemic loaning inclination for Soes, especially those with high default dangers, amid the period under examination.

The profit commitment for loan/advances is given by the distinction between the premium paid by the client and the premium rate that the bank could gain in the capital business. The profit commitment is a horrible measure as it doesn't contain overhead expenses from the bank (Berlemann et al., 2014). In cases where the bank gains a commission on an agreement, the commission is added to the profit measure.

2.1. Problem Statement

State bank of Pakistan has devised some prudential regulations for the smoothrunning of loan processes but still banks are facing non-performing loans which is a serious cause of concern.

2.2. Objective of the Study

The objective of this study was to investigate that the deviation from prudential regulation leads to the non-performing loans and causes of non-performing loans also is there any effect on banks profitability.

2.3. Research Questions

These research questions can help the researcher to achieve the desired result.

- Does the deviation from prudential regulation leads to the non-performing loans?
- What are the causes of non-performing loans?

2.4. Significance of the study

This study describes the importance of prudential regulations for ensuring banking profitability and factors that influence the repayment of loan in the commercial banking sector and also focus on the association of prudential regulation and bank profitability through Non Performing loans.

It’s further supportive of assist the Banking Sector to develop and reframe their policies in terms of regulations. Recommended suggestion can help commercial banks for the improvement of their loan performance.

2.5. Data Collection

The type of data collection was primary in nature. Primary data was acquired by taking unstructured interviews from relevant peoples who are bank employees of National banks and Habib Banks Branches from Bahawalpur and take some cases for study.

2.6. Hypothetical Framework

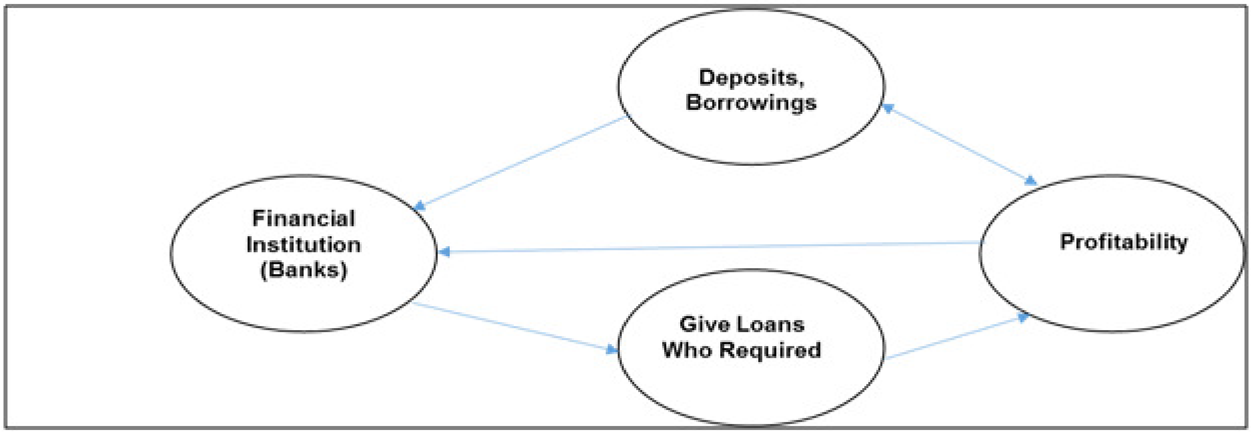

Figure 1: It shows that how banking system works. Banks accept deposit and lend money for interest. Bank charge interest on loans and pay interest on deposit. The difference between deposit interest and loan interest becomes bank's profit

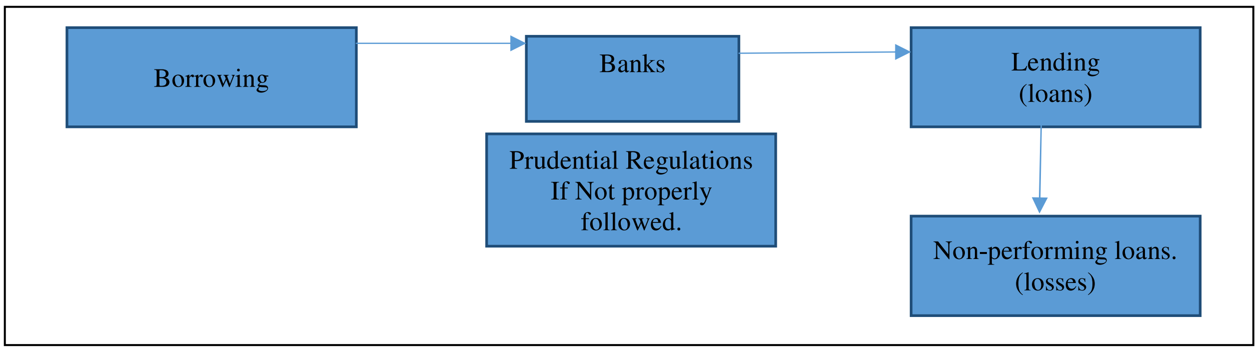

Figure 2: Banks primary purpose is lending and borrowing. In doing so sometimes banks didn't properly follow Prudential regulations, which are set by State bank of Pakistan and in result face non-performing loans

3. Methodology

To investigate the deviation from prudential regulation leads to the non-performing loans, its effect on the banks profitability and causes of non-performing loans, a descriptive case study was employed by selecting two banks HBL and NBP (Pk) on convenience basis and primary data were collected by 30 unstructured interviews with credit in-charges, Loan Officers, Credit Officers, Loan Recovery Officers.

3.1. Data Analysis and Results

Data has been collected from National and Habib Bank of Bahawalpur Region to analyze the Divergence from Prudential regulations and bank policies can lead toward the losses.

While examining the data several factors came in notice some are official and some non-official. Brief discussion on it is a sensitive issue also banks and officer's names we can't be exposed in this research.

3.2. Interviews

To Examine the reasons of Non-Performing Loans, we did interviews with Credit in charges, Credit Officers, Loan Officers, and Loan Recovery Officers about the factors that lead the Performing loans into Non-Performing loans.

Some important PR`s questions which are required to check during the loan process and disbursal time. During the data analysis, reviewing NPL`s cases and through interview with the loan officer from different National Banks and Habib bank branches it seems that these PRs are properly followed in loan issuing and disbursement time but sometime these were ignored.

We find these questions from the Prudential Regulations of State Bank issued for the Banks in its website.

1. Is the borrower checked properly, his Character, Capacity, Capital, Collateral, and Conditions that are made for loan offering?
2. Were all the fees/plantae's and other charges were disclosed completely to the borrower?
3. ECIB and DATA Check reports of borrower were taken from the CIB and DATA Check companies whom the Banks are member?
4. Documentation of borrower was physically verified by the Loan officer?
5. Are Banks maintaining its MIS daily/Weekly/Monthly/Sami annually/Annually bases to check the borrower loan performance and if divergence necessary actions were taken by the Banks?

These are the important questions, which are answered as YES in loan Process and Documentation but in actual they are not properly followed at all. Loan officer never bother to check borrower's 5C's. Fees, charges and Plantae's were never disclosed to borrower properly. Sometime loan officers just issue the loans to ineligible's customer for the sake of achieving their targets. Loan officers in this context fulfill the documentation which is not clean. Banks ignore such things just to achieve their targets.
In some cases, all PRs and bank polices were followed but still banks are facing loan losses, which shows that existing prudential regulations and bank polices are in-sufficient to secure banks profitability.
ECIB and DATA reports are taken but through special recommendation of banks managers it was ignored. Loan officer never visit the borrower`s provided collateral and verified the documentations because of manager's recommendations and personal references. MIS were not properly followed by the Recovery officer and also not informed to those borrowers before the due payment date. We also find in many cases that some borrower does not know about their installment deductions dates.
We moreover include some special cases in this research to understand the complete phenomena. These interviews and cases complete the objectives of our research which is to analyze deviation from prudential regulation leading to non-performing loans.
To investigate that the deviation from prudential regulation leads to the non-performing loans we added here some special cases which are presented to understand the reasons of banks losses, which could be avoided by proper implementation of policies.

3.2.1. Borrower 1

Borrower 1 took loan from the Bank against his salary on 12/23/2010. While due to transfer from one city to another, he shifted his salary account without getting clearance certificate from the bank. According to rules and regulation person and his organization should take a proper clearance certificate from bank to change salary account. Loan recover officer inquire it and found that the clearance certificate found in accounts branch of particular organization. On this behalf organization allow to shift his salary.

3.2.2. Borrower 2

Borrower 2 was a Govt. Employee. He took loan from bank for the period of 04/30/2011 to 04/25/2016. His outstanding balance is Rs. 150,162.95 and his current due payment is Rs. 32,669.72. His monthly installment is Rs.5, 987.00. Bank is unable to get any recovery from this person because he left his organization and switched off his all contacts. Bank Loan Recovery Officer said he tried to contact with his References and ask them about borrower but still get no positive response from past 218 days.

3.2.3. Borrower 3

Borrower 3 took loan from bank for the period of 12/28/2012 to 12/20/2015. Loan Recovery officer said on the inquiry of bank from borrower`s organization and colleagues, he found that borrower was injured due to accident and his condition was serious. According to Loan Recovery Officer, this loan was Insured and recovered in case of accident or accidental death by the Insurance Companies. This case was moved for the Insurance Claim and still in the process in Head office.

3.2.4. Borrower 4

Borrower 4 was also a Govt. employee and took a loan from the bank for three years of Installment's period (10/04/2013 to 10/01/2016). Bank did not recover anything in this case because the borrower was murdered by Gun Shot in Petrol pump. This case was sent to Head Office for Claim but declined because the death was not natural. Special recommendation in this case was made, but still insurance company did not claim due to their policy. Giving favour to the borrower's widow this case was specially put into NPL and made Write-off permanently.

3.2.5. Borrower 5

Borrower 5 was also a Govt. employee and took a loan from the bank for three years of Installment's period (11/28/2014 to 10/01/2017). Bank did not recover anything from last 173 days. On the inquiry of Loan Recovery Officer from organization and its employees, it comes to know that borrower was working with the Organization on the six-month renewal contract basis while borrowers showed him as a permanent employee of the organization. Borrowers provide the permanent proof letter to the bank to avail loan. Loan officer did not verify borrower documents properly and also did not do the physical verification. Borrower sold his house and shifted to another city. Bank Recovery Officer is trying to reach borrower, but his loan was moving toward NPL`s.

4. Conclusion

Research conclude that Banks consciously and unconsciously deviate from prudential regulations. The primary role of bank is lending and borrowing. In this way banks create their assets (Njanike, 2009). Havrilesky and Boorman (1994) in his research, Commercial banks interest income pointedly affected by interests on loans. In Reed and Gill (1989) studies showed that interest on loans contribute up-to 85% of commercial banks income. A large proportion of banks assets are loans (Saunders and Cornett, 2005). Credit is not a simple undertaking for banks on the grounds that it makes a major issue which is called non performing advances (Chhimpa J, 2002) as referred to in (Upal, 2009). Deviation from enforcement of prudential regulations leads to the failure of economy & financial institutions. Failure means lack of generating profits (Fernández et al., 2013). In this research to investigate the phenomena that the deviation from prudential regulation leads to the non-performing loans some case studies were added here which presents the researcher to understand the reasons of banks losses, which could be avoided by proper implementation of policies.
In generally this research emphasized on examining the consequence of prudential regulation and its impact on the decreasing profitability, measuring the effect of prudential regulation on the profitability of commercial banking sector, identify these factors impacting the profitability of banking sector and measuring the involvement of identified factors in the prudential regulation. Results

conclude that there is divergence from prudential regulations and existing prudential regulations are not much effective enough to make sure the profitability. Banks need more effective regulations and policies which can secure the bank's profitability. It is also concluding that banking policies should effectively and efficiently enforce without any discriminations. There should be standardize goals/policy which can easily achieved by the banking sales staff, they take no risk to deviate from these regulations.

4.1. Limitations of the Study

Limitations of the study are:

- The most important constrain was time.
- Data has been collected only from commercial banks (National Banks and Habib Banks only).
- Data has only been collected from a limited region (i.e. Bahawalpur).
- Small sample size of population has been selected.
- Other intervening and contribution factors have not been tried to investigate.

4.2. Suggestions for Future Study

Future study can undertake the factors which are left by this study unexplored. Future study can be done as follow:

- Data of government banks, microfinance banks and foreign banks also can be studied.
- Other contribution factors and intervening factors can also be taken under phenomenon of study.

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