BANK MANAGEMENT

NON-PERFORMING LOANS

BCOM III

What is a Non-Performing Loan?

A non-performing loan (NPL) is a loan in which the borrower is in default and has not paid the agreed principal and interest repayments for a specified period.

Usually, banks classify loans as non-performing loans when the repayments of principal and interest are due for more than 90 days or depending on the terms of the loan agreement.

As soon as a loan is classified as an NPL, it means that the likelihood of receiving repayments are significantly lower.

According to the International Monetary Fund (IMF)

A loan can become non-performing in the following ways:

1. Loan installments of principal and interest are at least 90 days due, and the lender no longer believes the borrowers will honor their debt obligations.

2. Ninety (90) days' worth of interest payments are capitalized, refinanced, or delayed due to changes in the loan agreement.

3. Payments of principal and interest are less than 90 days overdue, and there are reasons to doubt that the borrower will not pay the outstanding loan in full.

Classification of Non-Performing Loans

The Financial Institutions (Credit Classification and Provision) Regulations 2005 (FICCP Regulations) require SFIs to report to BOU on a quarterly basis on non-performing credit facilities.

They are also required to classify loans into Normal Risk (Pass), Watch (Special Mention), Substandard, Doubtful and Loss categories according to specified criteria.

SFIs then have to make special provisioning for the non-performing loans i.e. the Substandard, Doubtful and Loss categories. Provisioning means that the SFIs have to set aside capital to cover the losses from those non-performing loans.

Credit facilities can be classified into the following five categories:

1	2	3	4	5
Normal Risk (Pass)	Watch (Special Mention)	Substandard	Doubtful	Loss

Classification Categories (1 of 2)

(a) Normal Risk (Pass)

Credit facility with fixed repayment which is up-to-date in payments; and an overdraft or credit facility without fixed repayment which is operating within the approved limit; with unexpired credit line; with interest charges covered by deposits.

(b) Watch (Special Mention)

When the principal or interest is due and unpaid for one month to less than ninety days; the interest charges for thirty days to less than ninety days have been capitalized, refinanced or rolled-over; or for an overdraft or credit facility without fixed repayment dates; when the approved limit has been exceeded for thirty days to less than ninety days.

Classification Categories (2 of 2)

(c) Substandard

Which principal or interest remain unpaid or where credit line is exceeded or expired, for ninety days to less than one hundred and eighty days.

(d) Doubtful

Principal or interest remains unpaid or where credit line is exceeded or expired, for one hundred and eighty days to less than one year.

(e) Loss

Which principal or interest remains unpaid or where credit line is exceeded or expired, for one year or more.

The NPL Ratio

The NPL ratio (non-performing loan ratio) measures the share of a bank's loan book that is not being repaid as agreed. It is the most widely used indicator of a bank's asset quality.

NPL Ratio = (Non-Performing Loans ÷ Total Gross Loans) × 100

Non-performing loans: loans classified as Substandard, Doubtful or Loss, generally those 90 days or more past due.

Total gross loans: all loans outstanding, before deducting provisions.

Borrower Related Factors

Unexpected events affecting the borrower’s financial situation e.g., Losing a job, Loss of income sources

Mismanagement of finances by the borrower e.g., diversion of funds

Poor business management – lack of financial literacy, weak accounting, or poor entrepreneurial skills leading to business failure.

Bank / Institution Related Factors

- Inappropriate loan product design
- Poor loan appraisal and risk analysis
- Ineffective information systems
- Poor loan monitoring post disbursement

Macroeconomic and External Causes

- Economic downturns; recessions, inflation, or currency depreciation reducing borrower income and repayment capacity.
- Sector-specific shocks; e.g., falling commodity prices hurting farmers or traders in export markets.
- Political instability and insecurity; discourages investment and disrupts borrower businesses.
- Regulatory and legal challenges; weak enforcement of contracts, slow court processes, or inadequate insolvency frameworks.
- Natural disasters; floods, droughts, pandemics (like COVID-19) disrupting business cash flows.

Financial Impact

Reduced Interest Income

NPLs stop generating interest, directly cutting into banks' core revenue stream.

Increased Provisioning & Write-offs

Lenders must set aside provisions (reserves) to cover potential losses, reducing net profits.

Capital Erosion

High NPL levels consume bank capital, weakening capital adequacy ratios.

Liquidity Pressure

Funds locked in bad loans cannot be recycled into new lending, constraining cash flow.

Operational Impact

Higher Recovery Costs

Legal processes, collateral repossession, and recovery staff add significant costs.

Diversion of Management Attention

Senior management must spend time managing problem loans instead of focusing on growth.

Strained Customer Relationships

Aggressive recovery actions (seizure of assets, litigation) may damage reputation.

Strategic / Market Impact

Reduced Lending Capacity

With capital tied up in NPLs, banks become cautious and reduce new lending, especially to SMEs and risky sectors.

Loss of Competitiveness

High NPLs make lenders charge higher interest rates to cover risks, discouraging borrowers.

Reputation Risk

Persistent high NPL ratios can harm investor, depositor, and regulator confidence.

Regulatory & Compliance Impact

Stricter Supervision

Regulators may impose corrective actions, restrictions, or higher capital requirements.

Increased Risk of Sanctions

Non-compliance with provisioning guidelines (e.g., IFRS 9, central bank rules) may attract penalties.

Potential Insolvency

If unchecked, NPLs can push a bank into failure, triggering mergers, bailouts, or liquidation.

Recovery Strategies for NPLs

Reminders & Follow-up

Letters, SMS, telephone calls and personal visits to remind the borrower of the overdue amount and request payment.

Demand Notices

Formal written notices giving the borrower a clear deadline to clear the arrears.

Restructuring / Rescheduling

Changing the repayment terms (longer period, lower instalments, temporary reduction of interest, or moratorium) to make repayment manageable for a genuine borrower facing temporary difficulty.

Recovery Strategies for NPLs

Compromise / One-Time Settlement (OTS)

The bank accepts a reduced amount as full and final settlement of the debt.

Used when full recovery is unlikely and the cost of prolonged recovery is high.

Requires proper approval according to the bank's internal policy.

Enforcement of Security (Collateral)

The bank takes possession of the assets pledged as security (primary or collateral security).

The assets are then sold (auctioned) and the proceeds are used to reduce the outstanding loan.

This is one of the most effective recovery methods when good security was taken at the time of sanction.

Legal Action

Filing a suit in a court of law for recovery of the debt.

In some countries, specialised recovery forums or tribunals exist to speed up the process.

Legal action is time-consuming and costly, so it is usually taken as a last formal step before write-off.

Write-off (Last Resort)

After all reasonable recovery efforts have been exhausted, the bank may write off the remaining balance.

Writing off does not mean the bank forgives the debt. The bank can still continue recovery efforts.

Write-offs require proper approval and affect the bank's profitability because the amount is charged against provisions or profits.