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BAD DEBTS IN BANKING: MANAGEMENT AND PREVENTION STRATEGIES

Hety Devita *[1]
Universitas Mulia Balikpapan
Devita_hety@yahoo.com

Irsyad Kamal
Universitas Padjadjaran
irsyad.kamal@unpad.ac.id

Lukman Hakim
Perbanas Institute
abumufti2014@gmail.com

Abstract

This research produced key findings related to the causes, handling, and preventive efforts of non-performing loans. The analysis revealed that the main causative factors are the debtors' inability to manage their finances and economic fluctuations. This inability is often caused by miscalculations or a sudden drop in income, such as a decline in business sales or job loss. Conversely, economic turmoil such as inflation, high interest rates, or recession also exacerbates the situation, making it difficult for debtors to meet payment obligations. Dealing with non-performing loans requires a layered approach that is customized, depending on the specific conditions of the debtor and creditor. One effective method is loan restructuring, which involves modifying the terms and conditions of the loan to make it more affordable for the debtor. In addition, asset seizure and liquidation is also a last resort to reduce losses for creditors. Enforcement of credit risk management through stricter evaluation of creditworthiness and utilization of advanced technology is also important to minimize the risk of future non-performing loans. For the prevention of non-performing loans, continuous financial education and good communication with debtors are essential first steps. Financial education programs can help individuals and businesses understand better financial management, while proactive communication between lenders and borrowers provides early warning of potential financial problems. In addition, the implementation of stricter credit policies and closer monitoring of creditor performance are also important steps in the prevention of non-performing loans before the problem becomes unmanageable. Overall, the handling and prevention of non-performing loans requires good coordination and a comprehensive approach from various relevant parties. Lenders need to develop more sophisticated procedures and tools for risk evaluation and management, while borrowers need to be adequately educated on financial management. With these collective efforts, the risk of non-performing loans can be minimized and financial stability at the micro and macro levels can be better ensured.

[1] Correspondence author.

Keywords: Bad Debt, Banking, Handling Strategy, Prevention.

Introduction

Banking development has an important contribution to the country's economic growth. Banks function as intermediaries that connect those with excess funds with those in need through credit products. Credit provided to both individuals and businesses can significantly boost economic activity and investment. (Divya et al., 2024).. However, one of the inherent risks in lending is the emergence of bad debts.

Bad credit is a condition in which the debtor is unable or unwilling to fulfill his obligation to pay installments according to the agreement. This situation arises when debtors experience financial difficulties or choose not to pay debts, so that installment payments are more than 90 days overdue according to the rules. Bad debts not only have a negative impact on the debtor's business continuity, but can also disrupt the bank's financial performance, reduce liquidity, and on a broader scale can threaten the stability of the financial system as a whole. (Magaji & Ahmad, 2024). The increasing number of bad debts will reduce bank profitability, reduce liquidity, and increase the operational costs of collecting and restructuring loans. This can undermine customer and investor confidence in the stability and soundness of the bank (Naupada & Sahu, 2024). (Naupada & Sahu, 2023)..

Various factors can cause bad debts, from internal banks such as ineffective risk management, less prudent credit policies, to external factors such as macroeconomic conditions, government regulations, and market situations. Unfavorable economic conditions, such as a recession, can increase the number of debtors in default due to decreased income. On the other hand, sub-optimal internal bank policies can also contribute to an increase in credit risk (BECKER et al., 2020).

As the number of loan defaults increases, banks are forced to increase their reserves for possible losses on unpaid loans. This reduces the funds available for new loans, slows down banks' intermediation role, and weakens their ability to support growth through lending to productive sectors. Increased loan defaults may worsen the business climate (Ozili, 2021). Companies that do not pay their debts will lose the trust of investors and partners. Losing access to new loans can force firms to reduce investment, slow expansion, or even close down. This chain effect has the potential to increase unemployment as companies are forced to lay off workers. In addition, consumers caught in credit default tend to reduce spending, which in turn lowers demand in the economy. (Şenel, 2020).

The broad impact of loan defaults can include a decline in financial stability. If the number of loan defaults increases significantly, banks and financial institutions could face serious liquidity and solvency problems. This could trigger a widespread financial crisis, such as during the 2008 crisis, where a number of global financial systems almost collapsed. (Wulan et al., 2023).. Therefore, credit risk management and mitigation efforts such as debt restructuring or tight monetary policy by financial authorities are essential to maintain overall economic stability and health.

Therefore, handling loan defaults is a special challenge for banks. Various strategies can be applied such as loan restructuring, intensive collection, or loan write-offs. However, only relying on handling after loan default is not enough. (Chu & Li, 2022). Prevention of loan defaults through stricter credit assessment, strengthened risk management, and customer education and financial literacy are essential to maintain the health of a bank's loan portfolio.

This study aims to examine in depth the main causes of loan defaults, effective handling strategies, and prevention methods that can be applied in the banking sector.

Research Methods

The study conducted in this research uses the literature research method. Literature research method is a set of techniques used to collect, analyze, and present relevant information on a particular topic from secondary text sources. This method is often used in academic and scientific research to support or reject hypotheses by accessing previous studies. (JUNAIDI, 2021); (Abdussamad, 2022); (Wekke, 2020).

Results and Discussion

Credit and Risk Theory

The theory of lending in the banking system explains how banks and financial institutions facilitate loans to individuals, companies, or governments, and the principles that underpin this process. The theory covers aspects of credit assessment, risk management, interest rates, collateral, and lending policies. The essence of credit theory is to assess the creditworthiness of borrowers through a comprehensive analysis of their ability and intention to repay the loan. (Diakomihalis, 2022). This is often done by reviewing a prospective borrower's credit record, income, and assets. This theory also includes banking regulations that aim to maintain financial stability and reduce the risk of bankruptcy through provisions such as capital adequacy ratios and bank liquidity. (Sarris, 2022).

Credit risk is the potential loss faced by a bank or financial institution due to the failure of the debtor to fulfill the obligation to pay the loan or interest in accordance with the agreed agreement. This risk is one of the key elements that must be managed in the banking system because it has a direct impact on the financial stability and profitability of banks. (Duruechi et al., 2023).. Factors contributing to credit risk may include changes in economic conditions, declines in debtor income, poor management, and external events such as natural disasters or financial crises. Banks use various analytical tools and assessment techniques such as financial ratio analysis, score-based credit scoring, as well as probability of failure modeling to measure and manage this risk (Serbina, 2022). (Serbina, 2022).

Credit risk management involves several strategic measures to mitigate the negative impact of potential payment defaults. These include diversification of the loan portfolio to reduce exposure to certain sectors or individuals, provision of guarantees or collateral to reduce the risk of loss, as well as the implementation of strict credit policies. Banks also conduct periodic assessments of their loan portfolios, and may restructure or actively pursue collection of non-performing loans. (Kazak, 2024). Within the regulatory framework, financial institutions are supervised by banking authorities that set capital adequacy standards and liquidity requirements to ensure that they have sufficient buffers to cover potential credit losses. (Nitani & Legendre, 2021).

Credit risk assessment models and methods are important tools that banks and financial institutions use to evaluate the potential risks associated with extending credit to borrowers. One commonly used technique is credit score analysis, where historical data on payment habits, amount of debt owed, and credit history are combined to produce a numerical score that reflects the creditworthiness of an individual or company (Choudhary & Jain, 2021). (Choudhary & Jain, 2021).. In addition, financial ratio analysis is also used to assess the financial health of potential borrowers by examining ratios such as debt-to-income ratio, liquidity ratio, and profitability ratio. A holistic view is obtained by combining the outputs of various quantitative and qualitative models to make an overall decision on credit risk. (Park & Shin, 2021).

Other more complex techniques include probabilistic modeling and the utilization of machine learning technology. Probabilistic models such as Value at Risk (VaR) and Expected Loss (EL) project potential losses based on probability distributions of various default scenarios. On the other hand, machine learning technology applies intelligent algorithms to detect patterns and anomalies in big data that may not be visible through conventional methods. (Wang & Wang, 2024). This allows banks to update their risk models in real-time based on incoming data, improving the accuracy of risk assessment. Stress simulations are also often conducted to gauge the resilience of credit portfolios to extreme conditions such as economic recession or interest rate spikes, so that banks can take more proactive mitigation measures. (Ross et al., 2021).

Overall, credit risk is an important aspect of the financial management of banks and financial institutions, relating to potential losses due to the failure of debtors to fulfill payment obligations. Effective credit risk management involves various strategies and policies to mitigate negative impacts, including portfolio diversification, strict implementation of credit policies, and periodic evaluation of the credit portfolio. (Obeid, 2020).

To measure and manage these risks, various model approaches and assessment techniques are used, both traditional ones such as credit profile analysis and funding ratios, as well as more sophisticated ones such as likelihood models and machine learning technologies. These methods enable financial institutions to make better and more informed decisions about potential risks, and to take more proactive precautionary measures to ensure their financial stability and business continuity.

Causes of Bad Credit

A non-performing loan (NPL) is a condition in which the debtor is unable to fulfill their debt repayment obligations according to the agreed schedule. The underlying causes of non-performing loans can vary widely and are often the result of a combination of factors. One of the main causes is changes in macroeconomic conditions (Tushaj & Sinaj, 2021). An economic recession, a drop in commodity prices, or an increase in interest rates can greatly affect a borrower's repayment capacity. When the economy worsens, the income of individuals or companies may decrease, resulting in an inability to repay debts on time. (Feng et al., 2023).

Another common cause is poor financial management on the part of the debtor. Many debtors experience difficulties in managing their cash flow, which results in them being unable to meet their debt obligations. Management's inability to plan and manage debt, as well as unwise financial decisions such as taking on new debt to cover old debt, often worsen the situation. In companies, factors such as lack of transparency and management oversight can also contribute to the emergence of bad debts. (Barraza & Civelli, 2020)..

Other external factors that can lead to bad debts are the condition of certain industries and regulatory changes. Industries that are high-risk or are experiencing difficult times, such as the mining sector when commodity prices decline, can cause many creditors to experience payment difficulties. In addition, sudden changes in government regulations or policies, such as stricter debt restructuring policies or changes in taxation, can affect the ability of debtors to meet their obligations. (Isabwa & Mabonga, 2020).

Finally, the character and intentions of the debtors themselves also play a significant role in the occurrence of bad debts. There are cases where the debtor does not have good intentions to repay the debt or deliberately delays payments. In some cases, acts of fraud or deception are also a contributing factor to bad credit. Therefore, an in-depth and thorough assessment of a prospective debtor's character before granting credit is essential to minimize this risk. Utilizing technology and data to evaluate the habits and integrity of debtors can help financial institutions identify and mitigate potential bad credit risks from the start.

Bad Debt Prevention

Preventing bad debts requires a comprehensive approach, starting from the pre-lending stage to regular credit monitoring. One of the crucial first steps is to conduct an in-depth credit assessment of the prospective debtor. (Singh, 2020). Banks and financial institutions should utilize modern credit analysis tools that include evaluation of historical credit data, financial statement analysis, and background checks. Using big data technology and machine learning algorithms can improve accuracy in assessing credit risk, thus enabling financial institutions to make smarter, data-driven lending decisions. (Surasmi & Udayana, 2023).

In addition to proper credit assessment, it is also important to implement strict risk management policies. These policies should include limits on credit that can be granted based on the borrower's ability to pay and diversification of the credit portfolio to reduce the risk of concentration in certain sectors or individuals. Financial institutions should also consider strict credit terms, such as adequate collateral and additional guarantees, to ensure protection against potential losses. (Altınbaş & Hanişoğlu, 2023).

Regular credit monitoring is the next important step in preventing bad debts. Financial institutions should have a monitoring system that can identify early signs of payment problems, such as late payments or a decrease in the debtor's income. (Ciobu & Sajin, 2022).. With early detection, financial institutions can take preventive measures, such as offering debt restructuring programs or providing financial advice to debtors. In addition, training and educating debtors on good financial management can also help them manage their debts more effectively and avoid bad debts. (Diakomihalis, 2022).

Finally, improved communication between financial institutions and debtors also plays an important role in preventing bad debts. Open and transparent communication allows both parties to proactively resolve issues that may arise. Financial institutions should encourage debtors to report changes in their financial condition as soon as possible so that necessary adjustments can be made. By strengthening the relationship between financial institutions and debtors, the risk of bad debts can be minimized and both parties can work together to reach a win-win solution.

Impact of Bad Debt

Bad credit has a number of significant negative impacts for both individuals and financial institutions. For individuals or debtors, defaulting on loans can lead to a poor credit record, which in turn affects their ability to obtain credit in the future. (Barodawala, 2023). A drop in credit score can result in higher interest rates and stricter loan terms. In addition, debtors may face legal action, such as asset seizure or bankruptcy, which could have a lasting impact on their financial stability and personal well-being (Lackhoff, 2021). (Lackhoff, 2021).

For financial institutions, bad debts increase the risk of real financial losses. When a large number of loans become non-performing, the bank or lender may experience liquidity constraints and decreased profitability. This can also affect the bank's capital adequacy ratio, which in turn impacts their ability to provide new loans to other customers. The costs associated with debt collection and legal proceedings can also increase the operating expenses of financial institutions. (Stanley, 2023).

More broadly, bad debts can have a negative impact on economic stability. When many debtors default on their loans, the banking sector can become vulnerable and potentially trigger a financial crisis. Banks that incur large losses may need to be rescued by the government, which could consume public funds and cause an additional burden on the state budget. A decline in public confidence in the banking system can also reduce investment and slow economic growth. (Vidaro et al., 2024).

Social impacts cannot be ignored either. Widespread bad credit can exacerbate economic inequality and aggravate social hardship, especially among low-income households. Failure in credit management can result in financial and mental stress for many individuals and families, ultimately negatively impacting their productivity and quality of life (Acosta & Cortés, 2022). Therefore, it is important for all parties involved, including governments, financial institutions, and individuals, to work together to manage and prevent bad credit risk to avoid these negative impacts.

Bad Debt Management Strategy

Dealing with bad debts requires a comprehensive and multifaceted approach to minimize losses and improve finances for both borrowers and financial institutions. One of the main strategies is loan restructuring, where lenders and borrowers work together to change the terms and conditions of the loan. (Maslenkova, 2023). This could include extending the tenor, lowering the interest rate, or reducing the principal to make payments more affordable for the borrower. Through this approach, the debtor gets some relief, while the lender has a better chance of recovering some or all of the funds that have been lent. (Dominguez, 2023).

In addition to restructuring, it is also important to strengthen credit risk assessment from the outset. Financial institutions should improve credit assessment procedures through a more in-depth analysis of the debtor's ability to repay the loan. (Betz et al., 2020). This could involve using advanced technologies such as artificial intelligence and big data analytics to project creditworthiness more accurately. This more rigorous assessment allows lenders to only approve loans to individuals and businesses that can truly afford to repay, reducing the risk of future bad debts. (Chiang & Niehaus, 2024).

The strategy for handling bad debts should also include better asset management. Asset seizure and liquidation can be done when other efforts, such as restructuring or renegotiation, have failed. Banks or lenders can reduce losses by selling seized assets at a fair price. (Paul et al., 2021). Effective management of this process can help mitigate losses and recover some of the capital expended. However, it is important to ensure this process is conducted in a transparent and legally compliant manner to avoid further potential legal disputes. (Poulle et al., 2024).

Finally, education and communication with borrowers is an equally important aspect. Ongoing financial education programs can help individuals and businesses better understand financial management and the importance of repaying loans on time. (Mansilla-Fernández, 2020). Lenders need to establish open and proactive communication with borrowers to provide early warning when there are signs of financial problems. In addition, mentoring and financial counseling programs can help borrowers find appropriate solutions before the situation reaches a critical point. (Tushaj & Sinaj, 2021).

Through a combination of these strategies, the risk and impact of bad debts can be managed more effectively, maintaining financial stability at both the individual and systemic levels.

Conclusion

Key findings on the causes of bad debts show that the main factors are the debtor's inability to manage finances and economic instability. Debtors' incompetence is often caused by miscalculations or a sudden drop in income, such as cases where businesses face a drop in sales or layoffs. On the other hand, economic instability, such as inflation, high interest rates, or recession, also worsens the ability of debtors to fulfill their payment obligations.

Dealing with bad debts requires a multi-layered and customized approach, depending on the specific circumstances of the debtor and creditor. One of the most effective methods is loan restructuring, which involves modifying the terms and conditions of the loan to make payments more affordable for the debtor. In addition to restructuring, asset seizure and liquidation can also be carried out as a last resort to reduce losses. Lenders should also strengthen their credit risk management through more stringent creditworthiness assessments and the use of advanced technology to minimize the risk of future bad debts.

Bad debt prevention starts with education and good communication with borrowers. Ongoing financial education programs can help individuals and businesses understand better financial management, while proactive communication between lenders and borrowers can provide early warning of potential financial problems. In addition, the implementation of stricter credit policies and more frequent monitoring of creditor performance are important steps in bad debt prevention before problems become insurmountable.

Overall, handling and preventing bad debts requires good coordination and a comprehensive approach from the various parties involved. Lenders need to develop more sophisticated procedures and tools for risk assessment and management, while borrowers need to be educated on financial management. With these collective efforts, the risk of bad debts can be minimized and financial stability at the micro and macro levels can be better ensured.

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