RESEARCH REPORT

MANAGING RISK OF HIRE PURCHASE FINANCING AT SnF BANK

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CASE SYNOPSIS

SnF Bank Berhad had a legacy of high ratio of poor quality loan assets. The bank has felt the urgent need to change the investors' perception by improving its credit risk management and by adopting the best lending practices in loan evaluation. In 2009, the bank had a new CEO and a management reshuffle took place with the appointment of Mr. Ben Gan as the new Head of Hire Purchase Division. The latter was tasked to study the hire purchase portfolio specifically on the perspectives of improving the hire purchase business as well as to reduce its high default rate and non-performing loan (NPL) position. Mr. Gan did a study on the bank lending practices and credit lending policy before he introduced some drastic measures to improve the credit risk management of the hire purchase division. This case examines how the bank had successfully improved the quality of the loan assets through the implementation of new credit lending practices and applying new strategies in the hire purchase financing business.

One of the strategies used was to shift the financing concentration from financing new national cars and used cars to financing of non-national cars. In the past, new national cars constituted around 40 percent and used cars were 30 percent of the bank's hire purchase loan financed. After the implementation of the new measures, the number of new national cars financed ware reduced to only 10 percent. The same proportion (10 percent) was reported for the commercial vehicles. On the contrary, non-national made cars, such as Japanese and Korean cars, and Continental cars constituted 50 percent and 20 percent of the total financing respectively. This shift in concentration risk had resulted in the reduction of the bank's bad loan level. In addition, the bank had also implemented more stringent credit evaluation based on the model of the car as some models showed high default rate and had poor resale value. On top of that, the bank had also introduced a new credit underwriting policy for young loan applicants (age 26 to 33) and had their margin of finance reduced to 80 percent. Based on the bank record, this group of young applicants had higher default rate.

With these measures, the bank had achieved tremendous success in improving their loan quality. In fact, the bank turned out to be one of the best banks in term of hire purchase loan quality. Their default loan of two to three months had improved significantly from 18 percent in 2007 to 5 percent in 2013 while the NPL was reduced to 0.7 percent in 2013. Although the bank reduced its loan exposure to national cars, where they were the market leaders, this measure did not affect bank volume of hire purchase business. Indeed, as a result of implementing this measure, its volume of business had increased from RM2.0 billion in 2009 to RM3.6 billion in 2013.

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ABSTRACT

A new CEO was appointed for the SnF Bank and a management reshuffle was carried out with the aim of increasing the loan volume and to improve the quality of loan assets. Following the appointment of the CEO, in 2009, Mr. Ben Gan was appointed as the new Head of Hire Purchase Financing Division of the bank. On the first day in his new position, Mr. Ben had a meeting with the new CEO. He was given the task to improve the quality of the auto financing portfolio. After going through the bank reports, he decided to plan the strategies and the credit underwriting policies to manage the risk in hire purchase financing. This case is designed to assist students to identify risks and analyze the risks in consumer lending environment. The students will also learn how to mitigate risks in lending.

1.1 INTRODUCTION

In January 2009, Mr. Ben Gan was appointed as the new Head of Hire Purchase Financing Division of SnF Bank. He had vast experience in the banking industry and the top management of SnF Bank was very confident that he could bring the hire purchase financing division out of its problems. In his first meeting with the top management of the bank, Mr. Ben Gan was briefed on the current situation of the division where he considered as facing serious credit risk problem as evidenced by its high non-performing loans and default accounts. The top management had instructed him to investigate the causes of the problems and came out with good remedial strategies to overcome the problem. "This division is one of the most important divisions of the bank and loans from this division constituted for more than 30 percent of total loans of the bank. The rising non-performing loans and default account is not good for the bank as it will deteriorate the bank's profit, decrease the confidence of the stakeholders and will eventually affect the survival of the bank. So, that is why I hired you. I want you to investigate the root of the problems and solve them", said the Chief Executive Officer (CEO), who chaired the meeting, in the presence of Mr. Ben Gan.

Sitting in his office after the long meeting, Mr. Ben Gan started designing his work plan. He could feel the challenge awaiting him, and need to structure his plan well in order to solve the hire purchase financing division's problems. He believed that he should start his work with a thorough analysis of the situation before coming out with strategies to overcome the problems.

1.2 OVERVIEW OF SnF BANK

SnF Bank is a locally incorporated bank, headquartered in Kuala Lumpur, Malaysia. A wholly owned subsidiary of SnF Holdings Berhad, which is listed on Bursa Malaysia, it offers both retail and corporate banking services. Started operations in January 2001 following the merger of two banks, it then became the subsidiary of SnF Holding Berhad as a result of its merger with SnF Finance Berhad in June 2005. Currently, it has 100 branches all over the country and always ready to offer the best services in order to fulfil the needs of its customers. The banking business can be divided into the consumer banking and business banking. The consumer banking consists of products and services such as deposit, loans, cards, hire purchase, bank assurance, unit trust and remittance while the business banking includes business loan, trade finance, small and medium (SME) business and contract financing.

1.3 HIRE PURCHASE FINANCING

Hire purchase financing (HPF) has been a common form of financing offered by banks to customers for the acquisition of motor vehicles. HPF involves three parties, namely the dealer, the hirer and the hire purchase owner. The dealer refers to the supplier of the goods. The hirer is the customer who acquired the goods on hire purchase while the hire purchase owner is the financier who provides the fund to acquire the goods. The contract that binds the three parties is called the Hire Purchase Agreement. During the tenure of the agreement, the hirer can freely use the goods, but the ownership of goods is still with the hire purchase owner until the hirer has fully paid down the amount financed. The hire purchase business is governed by the Hire Purchase Act 1967 Act 212. HPF has been commonly used by car dealers, credit and finance companies to finance the motor vehicles. However, after the merger of finance companies with banks, banks today handle the bulk of the HPF of motor vehicles. Unlike housing loan, HPF of motor vehicles is a risky business because the bank is financing a depreciating asset.

1.4 CASE BACKGROUND: FINANCING ACTIVITIES OF THE BANK

SnF Bank had a large exposure in the hire purchase activities; particularly in the financing of transport vehicles. Loans to this economical unit constituted for about 30 percent of the bank's total loan portfolio and had turned out to be one of the highest economic units receiving loans from the bank. Loans to the transport vehicle unit had become an important financing activities of SnF Bank ever since its merger exercised with SnF Finance in 2005. To SnF Bank, the hire purchase loan formed an important loan portfolio in their book. Hence a high default rate of the hire purchase loan had a significant effect on the profit of the bank. The merger exercised had turned SnF Bank into a one-stop centre where SnF Bank later served various products and services previously offered by SnF Finance. The loans and advances provided by SnF Bank are shown in Table 1.

Table 1:Loans and Advances of SnF Bank Analysed by Economic Units (in percentage)

YEAR	2005	2006	2007	2008
Securities	3.412	2.492	2.361	1.076
Transport vehicles	29.452	30.195	32.955	30.730
Landed property:				
– Residential	17.749	15.647	15.690	14.443
– Non-residential	3.336	3.012	5.474	7.205
Fixed assets other than land & building	0.033	0.036	0.733	0.630
Personal use	2.861	3.256	3.683	4.112
Credit card	0.520	0.564	0.697	0.611
Consumer durables	0.060	0.037	0.027	0.010
Construction	0.209	0.141	2.918	1.966
Working capital	0.337	7.685	19.188	36.271
Others	42.032	36.935	16.275	2.946

Source: Annual Report of SnF; various issues

Examining Table 1, Mr Ben Gan found that SnF Bank had a high concentration of loan to the transport vehicle unit. At the same time, NPL of the economic unit also showed a rising trend where it increased consistently from year to year. NPL of the transport vehicle unit increased from 2.93 percent in 2005 to 4.96 percent in 2006. As of 2007, the NPL of the transport vehicle unit was 4.81 percent. Although the NPL of the bank decreased slightly in 2007, the NPL was still higher than the industry average, which was 2.7 percent. Further, the bank's default account (defined as 2 and 3 months in arrears) was 18 per cent and 16 percent in 2007 and 2008 respectively. These figures were higher than the industry average, which was 10.0 percent.

1.5 CASE ANALYSIS: MANAGING HIRE PURCHASE FINANCING PROBLEMS

Looking at the high NPL of the transport vehicle unit, Mr Ben Gan had conducted an investigation to identify the cause of the problem. From the investigation, he found that a lot of car dealers, who sold cars to the bank customers, intentionally inflated the price of the used car so as to assist the customers to get a 100 percent financing from the bank. As a result, high numbers of customers received financing more that their eligibility, which led to a high credit risk to the bank. For that reason, he told his staff, “it is very crucial for you to know who are the dealers. This will help us to solve the problem concerning over financing.” In addition to that, Mr. Ben Gan also found that the largest defaulters’ age group was between 26 to 33 years old; a reflection of those who had just graduated with unstable income. Further, as for the type of car model, he found that the highest default rate was from buyers of national cars.

To address the issues, Mr Ben Gan had instructed his staffs to reduce financing used cars and focus more towards new cars. He also instructed his staffs to finance more of non-national made cars instead of financing the national made cars, as he found that a lot of loans for national made cars ended up as default. As a result, loans for used cars decreased from 30 percent to 10 percent and the proportion of new national cars was reduced to 10 percent, while the proportions of Japanese and Korean cars and Continental cars were increased to 50 percent and 20 percent respectively. The proportions are best shown in Figure 1 and Figure 2 below;

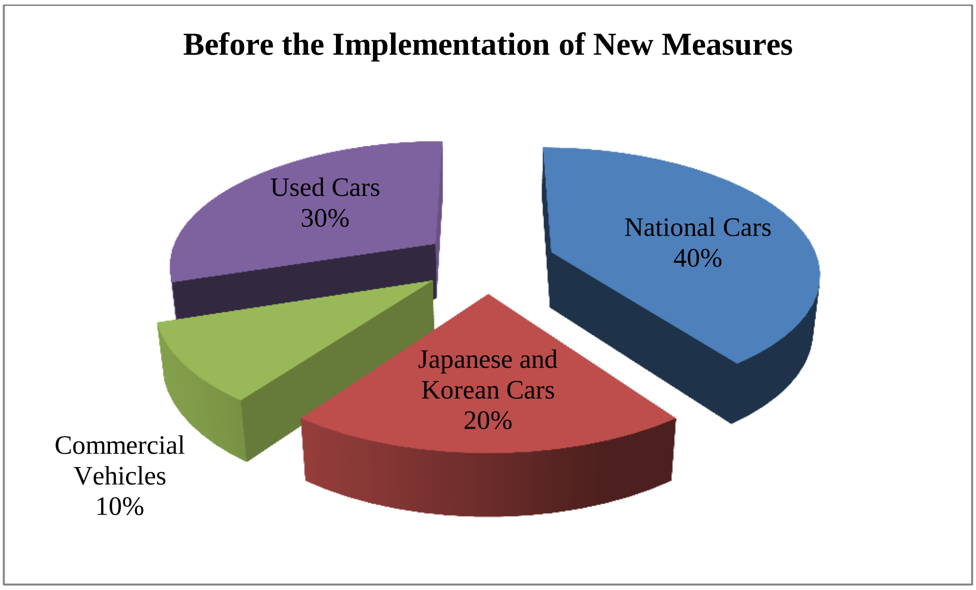

Figure 1: Loan Concentration before the Implementation of the New Strategy

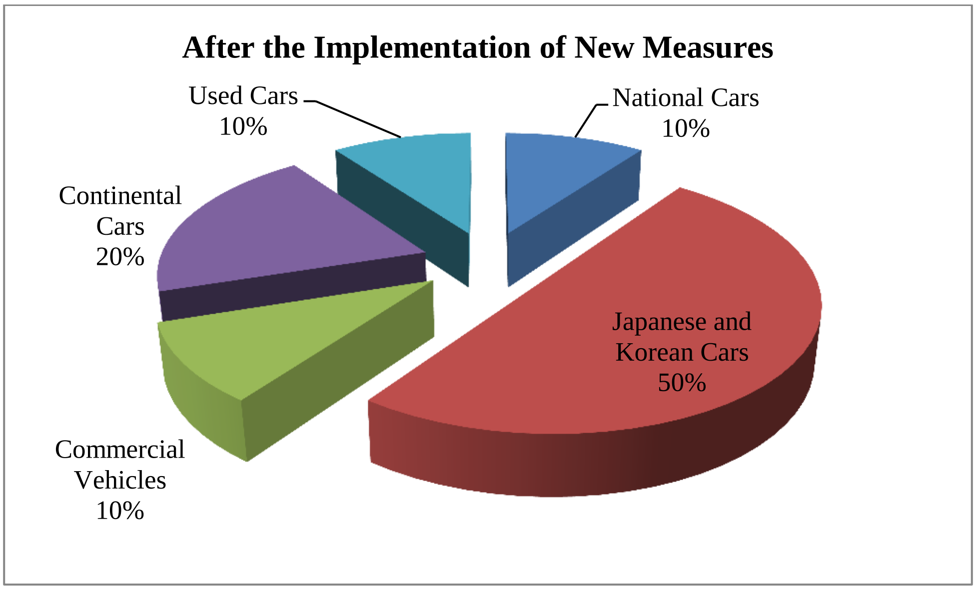

Figure 2: Loan Concentration after the Implementation of the New Strategy

Further, in order to ensure the success of his strategies, Mr. Ben Gan had also reshuffled the functions and role of his staffs. He separated the functions of his marketing officer and credit officer, which previously handled by a same person, to be independent of each other.

As a result of Mr Ben Gan's strategies, SnF Bank had achieved tremendous success in its loan asset quality. The tremendous success was shown by the drastically decreased in the NPL of the hire purchase financing division, especially the transport vehicle unit which is the most important economic unit in the division; decreased from 4.81 percent in 2007 to 0.71 percent in 2013. Further, the bank's default loan of two to three months had also decreased from 18 percent in 2007 to 5 percent in 2013. These achievements had made Mr Ben Gan very proud as the hire purchase financing division had turned out to be the most successful division in managing NPL. The CEO of the bank then, asked Mr Ben Gan to circulate a report containing the NPL data and default loan of two to three months of his division, together with explanations on strategies implemented by his division to other divisions in the bank so as to motivate the divisions to work hard to reduce their NPLs. Abide to the instructions, Mr Ben Gan had instructed his staff to prepare the data. His staff then sent him the NPL and default account data of transport vehicle unit; the most significant economic units of the division. The data were as follows;

Table 2: NPL of Transport Vehicle Unit of SnF Bank for the Year 2007 to 2013

Year	NPL (%)
2007	4.81
2008	1.41
2009	1.40
2010	1.08
2011	1.21
2012	0.57
2013	0.71

Table 3: Two and Three-Month Default for the Year 2007 to 2013

Year	2 & 3-Month Default (%)
2007	18
2008	16
2009	13
2010	9
2011	7
2012	6
2013	5

1.6 Conclusion

Mr. Ben Gan had browsed through all the information prepared by his staff. He wanted to make sure the report that he was going to submit contained all the information needed and instructed by the CEO. In his report, Mr. Ben Gan explained the main risks faced by the bank in the hire purchase finance business. Besides, the measures taken by him to improve the NPL and defaulting rate suffered by his divisions and the strategies taken in overcoming them. He was hoping that his report could provide some insight to other divisions and assist them in solving their NPL problems.

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