

Bank-Specific and Social Factors of Non-Performing Loans of Pakistani Banking Sector: A Qualitative Study

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Abstract

Purpose: This study aims at building up a model clarifying the relationship among bank-specific, social factors and non-performing loans on one hand and on the other hand, exploring this model in the setting of Pakistani Banking sector as limited interest has been given in existing literature in defining the relationship among bank specific, social factors and non-performing loans.

Design/ Methodology/ Approach: Based on the interpretive phenomenological approach, the study explores various influencing factors of Non-Performing Loans in unique setting of Pakistani Banking sector. The methodology helps analyse data about bank-specific and social factors of Non-Performing Loans as well as to have an insight in examining the nature of their relationship with each other.

Findings: The results show that various bank-specific factors like lenient credit terms, monitoring, bank ownership, bank size, diversification of loans and credit assessment have significant effect on Non-Performing Loans, whereas interest has a weak significance on NPLs. Thus, banks should carefully look after these factors in order to control NPLs. The social factor like corruption has an insignificant effect on NPLs and political pressure has been an important factor in explaining the Non-Performing Loans, especially in case of state owned banks. The government needs to lessen down the level of interference in the financial decisions of the state owned banks so that these banks can independently make their credit decisions without any political pressure.

Originality/value: This ground-breaking work on Non-Performing Loans and its factors may help the entire Pakistani banking sector to control Non-Performing Loans.

Keywords: Non-Performing Loans, bank-specific factors, social factors, financial crisis, Pakistan.

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Introduction

The prime sources of bank incomes are loans and advances. The main objective of banks, like any other business, is to earn and maximise profit, so it is understandable that the more banks will lend the money, the more they will earn and the better will be their profitability but while releasing loans, banks should keep a very close eye and must be careful. It is quite natural that banks try to lend for safe ventures at one hand and to increase the profitability on the other. Therefore, the banks must be extremely vigilant when it comes to giving loans at a riskier avenue because the situation can be financially unenviable if there is a large amount of loans default. It can ultimately lead to insolvency of the banks.

Non-Performing Loans (NPLs) have been defined differently in previous studies e.g. the study of Obamuyi (2009) defines NPLs as if the principal amount and interest are paid according to the terms and conditions, then a loan is said to be performing otherwise non-performing. According to SBP (BSD, Circular No. 2 dated June 03, 2010), a loan can be divided into three categories: Firstly, if principal amount and interest are overdue by 90 days, it will be termed as substandard. Secondly, if these are overdue by 180 days, it will be termed as doubtful and lastly, if these are overdue for a year then a loss. Furthermore, the overdue period of loan should be 30 days to be considered as NPLs in case of MFBs (Micro Finance Banks) and 90 days in case of consumer financing commercial banks.

In this context, the literature of Malaysia shows that in past, NPLs are not properly provisioned. It also indicates a need of an adequate system of measuring NPLs. It has been seen in the past that a financial crisis can be initialised through NPLs as in case of Asian financial crisis of 1997 (Isa, 2011; Nanto and Sinha, 2002). Over the period of last decade, NPLs have been realised as main factor of bank failures by almost all the world. Owing to these failures, the regulatory bodies have to close the banks (Brownbridge, 1998). The problem of NPLs is confronted in both developed and developing countries (O. Masood, 2009). The most famous US financial crisis of 2007 was also due to NPLs (Abedola, Yosaff and Dahalan, 2011).

The story of Pakistani Banking sector does not show a pretty picture either. NPLs have been on a higher side in Pakistani Banking sector but recently they have been enormous which is very harmful for economy (O. Masood, 2009). As per the study of Farhan, Sattar, Chaudhry and Khalil (2012), NPLs of Pakistan are reported at Rs. 608.748 billion in March, 2012. So there is a dire need to find out the factors affecting NPLs in the context of Pakistani Banking sector. The study of Pakistani banking sector shows that NPLs are on an increasing trend. Because of high interest rates, borrowing cost in-

creases thus increasing loan defaults (SBP, 2010). On the other hand, countries like India, Bangladesh where lending rate shows decline, NPLs rates are also seen to come down. (Misra and Dhal, 2013).

Previous studies have explained the role of Macro-Economic and Bank Specific determinants of NPLs (Saba, Kouser and Azeem, 2012; Badarand Yasmin Javid, 2013; Zhang, 2011). But there is limited number of studies available in the context of Pakistani Banking sector. The distinctive feature of this study is usage of qualitative approach in context of determining the factors responsible for affecting NPLs in Pakistani Banking sector. This research paradigm is unique in itself and has not been used in the context of Pakistani Banking sector. In this study, the determinants of NPLs are classified into two categories which are bank specific and social. This has not been seen in literature till present date in the context of Pakistani Banking sector.

Another potential gap which still needs to be filled is the classification of NPLs. There is justification available in previous literature which has identified the loans into three types: consumer, business and mortgage loans (Louzis, Vouldis and Metaxas, 2012) but there is shortage of studies in this context. In addition, the conduct of bank specific and social factors on NPLs in three phases, which are pre-crisis, during crisis and post crisis, has been seen in the studies of Louzis, Vouldis and Metaxas (2012) and Park and Zhang (2012). This aspect has been ignored in the literature available previously on Pakistani Banking sector.

The review of literature also reveals that there are some variables on which limited research has been done with context of developing countries like Pakistan. These include various bank specific variables (Regulatory environment, corporate governance) and social variables (Corruption, political pressure) (Khemraj and Pasha, 2009; Boudriga, Taktak and Jellouli, 2009a, 2009b). The next section on theoretical framework includes various subsections on national and international aspects of factors of Non-Performing Loans. Remaining of the paper will discuss the research methodology, results, findings, discussion, conclusion, limitations and future research discussion.

Theoretical Framework

Abedola, Yusoff and Dalahan (2011) are of the view that Non-Performing Loans are a huge danger not only for a single country but also for the entire world as it has been observed in case of US financial crisis in recent times. The study of Brownbridge (1998) explains that Non-Performing Loans are one of the chief reasons for the failure of many banks in the world. In addition, if these Non-performing Loans are not controlled then the resources



of a concern are blocked resulting in low profitability.

NPLs in the context of Pakistani Banking sector

NPLs in Pakistan are on a roller coaster ride because according to report of State Bank of Pakistan (SBP), amount of NPLs of banking sector, in the year 2012, has reached to Rs.176.77 billion. Therefore, there is ominous need of studying about Non-Performing Loans and its factors. Banks in recent years are facing default risk, which is one of the major causes of banks' failure. Pakistani banking sector is facing four types of risks: Market risks, Credit risks, Liquidity risks and Operational risks. Problem arises when the borrowers fail to return the loans, thus increasing Non-Performing Loans (NPLs) and ultimately declining profitability. Therefore, there is a need to study the factors of Non-Performing Loans in the setting of Pakistani Banking sector.

Bank-Specific and Social Factors of Non-Performing Loans

There is a lot of literature available on the impact of macro-economic factors on NPLs, but fewer studies are available which present the effect of bank-specific determinants of Non-Performing Loans (NPLs). The banks tend to expand loans in periods of financial stability, so that they can earn more. In this practice, they often give an impression of ignoring various crucial factors. Therefore, this becomes the reason of loan defaults (Weinberg, 1995). In order to verify it, various researchers have supported this hypothesis (Salas and Saurina, 2002).

Bank-Specific Factors

i. Lenient Credit Terms and NPLs

The study of Taktak and Jellouli (2009a, 2009b) indicate some factors which can reduce NPLs. These factors are foreign capital presence, appropriate capitalisation and prudential provisional policy. To expand credit, banks have to ease the standards of credit terms, monitor the borrowers and decrease the interest rates. The study of Jesus and Gabriel (2006) points out that hard behaviour, moral hazard, agency problems and disaster nearsightedness are the basic factors behind the lenient terms of credit. The authors carried out their study on the Spanish Banking sector from the period 1984 to 2003. Furthermore, they linked the lenient credit terms with Non-Performing Loans. When the economy is intensifying, bank managers are found to exercise leniency in giving credit because lower credit expansion means lesser income generation which indicates poor performance. This herd be-

haviour results in giving loans to some borrowers and having low capacity to repay (Rajan, 1994). The banks of US during 1980 and early 1990, because of cut-throat competition, expanded credit among borrowers without regard to tight credit terms. This resulted in high loan defaults and caused failure for many banks (MacDonald and Koch, 2003).

ii. Monitoring and NPLs

The study of Hughes, Mester and Moon (2001) shows that those banks, which incur more expenses on assessing the borrowers, are less proficient in financial operations but these banks have lower NPLs. Various studies show that state-owned banks are less efficient because they concentrate more on monitoring the NPLs. Salas and Saurina (2002) are of the view that inefficient bank management causes NPLs. The loans are more secured if the banks keep a continuous check on the borrowers where the banks need to give their borrowers full attention, so they are not relaxed at any stage about repayment of their loans. It has been seen that less monitoring of borrowers lead to NPLs (Agresti, Baudino and Poloni, 2008). Proper monitoring of the borrowers can be done by time to time checking on their value of stocks, accounts, financial statements and determining the updated value of securities. Regular visits to borrowers, for giving them pieces of advice on various financial issues, are also an effective way of following up loans. In case, if the borrowers are not properly monitored, then there are more chances that NPLs can increase.

iii. Bank Ownership and NPLs

Several studies highlight that state-owned banks are less efficient because they concentrate more on monitoring the NPLs. Therefore, the NPLs are lower in the state-owned banks (Hu, Li and Chiu, 2004). Moreover, this study also outlines that the state-owned banks produce lower NPLs than private sector in case of Taiwanese banking sector. This study used a panel data set of commercial bank for time periods from 1996-1999. The findings of García-Marco and Robles-Fernández (2008) reveal that private banks are likely to produce higher NPLs than state-owned banks. However, the study of O. Masood (2009) indicates that the Pakistani banks which are taken under state control in the 1970s showed a very poor performance as far as their efficiency is concerned. This can be seen from the figures of NPLs. These state-owned banks possess 88% to 96% of NPLs in the whole banking sector. Owing to this poor performance, government reconsidered its thinking and allowed private banks operations in Pakistan through reforms of 1991. Therefore, there remains an argument that which type of the bank creating



more NPLs and this needs an in-depth analysis because there is also literature available in negation of that concept.

iv. Bank Size and NPLs

Small banks have a tendency to give riskier loans than larger banks. The reason is that small banks give credit to small firms and these small firms have non-reliable financial data. Due to this, the lending decisions of small banks become riskier. The studies of Rajan and Dhal (2003), Jesus and Gabriel (2006), Quagliariello (2007) and Pain (2003) show that there is a strong association between bank size and NPLs. The literature also supports that there is a significant and negative relationship between NPLs and banks' size. According to Hu, Li and Chiu (2004), bank size is negatively associated with NPLs. Large banks do not hesitate to take excessive risks as these see the government as their last resort in case of failure, whereas small banks cannot take this risk (Stern and Feldman, 2004). Contrarily, Salas and Saurina (2002) are of the view that there is no significant relationship between NPLs and bank size but in case of Pakistan, the state-owned banks, which are bigger in size, incur major portion of NPLs (Omar, 2009). In this concept, there are a number of questions which still require to be answered. Firstly, whether concept of bank size defines NPLs? Secondly, can bank size contribute, negatively or positively, towards NPLs in the context of Pakistani Banking sector?

v. Diversification of Loans and NPLs

Another thread of literature explains that lack of diversification of loans can increase NPLs. The study of Louzis, Vouldis and Metaxas (2012) explains that diversification of loans is necessary in order to control Non-Performing Loans. NPLs are negatively associated with bank size and proportion of non-interest incomes as a share of total income. The study of Stroh (2004) fails to find any advantage of diversification of loans in case of US Banking sector. According to this study, there is no benefit of diversification of loans. There is also lack of literature that what types of loans are being affected the most (consumer loans or business loans or mortgage loans)? Therefore, it is a potential area which still needs to be explored in the context of Pakistani Banking sector.

vi. Interest and NPLs

The study of Salas and Saurina (2002) shows that increase in interest rate has negative impact on the loan defaults. Similarly, the study of Rajan and Dhal (2003) indicates a significant association of high cost of borrowing and Non-Performing Loans (NPLs). Various researchers have given a variety of

findings about this relationship. According to some researchers, high interest rate has a significant and positive relationship with Non-Performing Loans. They are of the view that when banks increase interest rate, there is an additional payment burden on borrowers resulting in increased defaults (Khemrajand Pasha, 2009; Dash and Kabra, 2010). Some of the studies have also shown a weaker or insignificant relationship between interest rate and Non-Performing Loans (Kaplin et al., 2009; Patnaik and Shah, 2004; Espinoza and Prasad, 2010).

The above literature shows different school of thoughts about the contribution of interest rate to NPLs. According to one point of view, interest rate is a significant and positive contributor of NPLs and the other explains that it is an insignificant factor of NPLs. An added interesting point is that there is no qualitative research available on this concept in Pakistani Banking framework. Therefore, in-depth analysis is required to have a rich finding about strength of the relationship between interest rate and NPLs in Pakistani Banking background.

vii. Risk Assessment and NPLs

The banks, which incur more expenses on assessing the borrowers, are less efficient in financial operations but also these banks have lower NPLs (Hughes, Mester and Moon, 2001). A weak risk assessment can also play a role in increasing NPLs so we can say that NPLs are caused by poor credit assessment. While giving credit, the repute of borrowers to repay loan and the market value of securities are not adequately assessed which become key reasons behind NPLs (Petersson and Wadman, 2004). The study of Guo (2007) shows that the banks use their personal experiences in giving loans rather than using historical data, mature credit portfolio management skills and centralised information system.

Social Factors

i. Corruption and NPLs

There is limited literature available on corruption and its impact on NPLs. In fact only one study of Goel and Hasan (2011) has empirically explained the relationship between corruption and Non-Performing Loans. The study of La Porta, Lopez-de-Silanes, Shleifer and Vishny (1997) explains the relationship of corruption and bank lending through law and finance theory. According to this theory, the Non-Performing Loans (NPLs) can be avoided, if there is support provided to banks in lending by adequate supervision of legal institutions. The banks are encouraged to expand lending if legal institutions exercise discipline in enforcing legal contracts. The reason is



that banks have the surety that they can take legal actions against the borrowers, who are not willing to pay loans. This can reduce the amount of NPLs.

ii. Political Pressure and NPLs

Khawaja and Mian (2005) present the only empirical study related to information sharing and corruption in setting of Pakistan. This study shows that lending of political firms is 45% greater than other firms. These political firms incur Non-Performing Loans, 50% more than any other firms. State-owned banks are main creditors of these political firms as private-owned banks do not take political pressure. The loans of these State-owned banks are turned to bad due to weak implementation of legal framework and political pressure.

There is a need to explore the social factors of Non-Performing Loans with reference to Pakistani banking sector, which are missing in previous literature. Therefore, it can be concluded that there is limited literature available on exploring relationship of NPLs and social factors like corruption and political pressure in setting of developing country like Pakistan and certainly indicates a possible gap.

Selection of Theories

There are a number of theories which can be helpful in explaining the factors of Non-Performing loans. I have selected moral hazard theory, law and finance theory, asymmetric information theory and adverse selection theory. The rationale of selection of these theories is that these can help this research, which demands a more in-depth analysis of bank-specific factors of NPLs, which is unique in itself. The theory of law and finance will help to find the answer about the concept of social factors like corruption and political pressure. Theories of asymmetric information, moral hazard and adverse selection will assist to find out about the bank specific concepts like lenient credit terms, poor risk assessment, interest rate and monitoring. In addition, these will facilitate this research to add value in the limited research in the context of Pakistani Banking sector by providing a holistic understanding of bank-specific and social factors of NPLs.

Research Methodology

The qualitative nature of methodology is suitable when in-depth analysis of the phenomenon is required. We can also say that qualitative research is used where there is something to explore (Creswell and Miller, 2000).

There is limited number of studies available on Non-Performing Loans and its factors. Infact, there is no research available in the context of Pakistani Banking sector, which can conduct a qualitative inquiry in addressing the issue of Non-Performing Loans and its factors. Therefore, qualitative phenomenology is adopted in this study because it helps the researcher to attain rich information and in-depth understanding of the bank-specific and social factors of Non-Performing Loans.

The Purposive sample of 12 bank managers was selected who had experience of banking for more than 5 years. There are a number of gaps indicated by literature relating to Non-Performing Loans and its factors relating to Pakistani banking sector. The premeditated selection consisted of active bank managers dealing in loan advancement. Face-to-face interviews were conducted in Urdu language as it was convenient for the participants. The participants had the right to pull out from the study at any time. All the interviews were recorded after taking due permission from the participants.

Results

Presentation of Demographic Survey

Demographic profile of the respondents in Table 1 shows that almost 75% of the respondents have banking experience ranging from 6 to 10 years whereas 25% have experience between 11 to 15 years. Almost 84% of the respondents are between the ages from 31-40 years whereas 8% of the respondents belong to 41-50 years and 8% to 20-30 years age group. The demographic profile further shows that 92% of the respondents are married and 8% of the respondents are unmarried. The salary status of most respondents is above Rs.60,000 (84%). The rest of the respondents have salary package in the ranges of Rs.41,000-Rs.50,000(8%) and Rs.20,000-Rs.30,000(8%). All of the respondents are related with Pakistani Banking sector of Lahore region. The demographics also reveal that 25% of the respondents are on the post of Relationship Managers in Credit, 17% are Assistant Vice Presidents, 17% are Assistant Managers, 17% are managers, 8% are Assets Managers, 8% of the respondents are Credit Managers and remaining 8% are Relationship Associates. All the respondents have qualification of Masters degree. 50% of the respondents are related with Conventional banks and other 50% respondents are serving in Islamic banks.



Table (1) Demographic profile of Bank Managers

Sr. #	Interviewee	Age	Marital Status	Post in Bank	Experience in banking	Current Salary (in Rs.)	Qualification	Mode of Bank
1	Pervaiz	31-40	Married	Relationship Manager	6-10 years	41,000-50,000	Masters	Islamic Bank
2	Ahmad	31-40	Married	Assistant Manager	6-10 years	Above 60,000	Masters	Conventional Bank
3	Aslam	31-40	Married	Relationship Manager	6-10 years	Above 60,000	Masters	Islamic Bank
4	Ali	31-40	Married	Assistant Manager	6-10 years	41,000-50,000	Masters	Islamic Bank
5	Salman	31-40	Married	Manager	11-15 years	Above 60,000	Masters	Conventional Bank
6	Atif	31-40	Married	Credit Manager	6-10 years	Above 60,000	Masters	Conventional Bank
7	Tariq	31-40	Married	Manager	6-10 years	Above 60,000	Masters	Conventional Bank
8	Nau-man	31-40	Married	Relationship Manager	6-10 years	Above 60,000	Masters	Islamic Bank
9	Saleem	41-50	Married	Manager Assets	11-15 years	Above 60,000	Masters	Conventional Bank
10	Wa-seem	31-40	Married	Assistant Vice President	11-15 years	Above 60,000	Masters	Islamic Bank
11	Imran	31-40	Married	Assistant Vice President	6-10 years	Above 60,000	Masters	Islamic Bank
12	Irfan	20-30	Single	Relationship Associate	6-10 years	20,000-30,000	ACCA	Islamic Bank

Findings

The responses generated by in-depth interviews are grouped under several themes to confer above mentioned research questions.

Factors of Non-Performing Loans (NPLs)

The interview data highlighted various themes as factors of Non-performing Loans. The respondents considered bank-specific, economic and social factors to be the major factors of NPLs. They also pointed out that in order to control NPLs, it is very essential to identify and minimise these factors. One of the respondents highlighted some of the bank-specific factors affecting NPLs in the following way:

There may be a lot of factors, e.g. if banks do not work in good faith, you

know that customer is not capable of attaining loan yet you sanction him loan. Being a banker if you compromise any of the regulations, then there are chances of more NPLs. If you realise about the importance of money, given a loan, as your own you will definitely visit the borrower at least once a month to see the utilisation of your money. (Ahmad)

Another respondent accepted the role of social factors in explaining NPLs as per following:

Sure there is effect of social factors on NPLs. There is influence of political pressure and corruption in every field of our country. (Nauman)

This is also quite evident from the previous literature that the bank-specific and social factors have great influence on NPLs. The study of Salas and Saurina (2002) in Spain verifies this in case of bank-specific factors. On the other hand, there are studies available which highlight the role of social factors on NPLs like study of Goel and Hasan (2011).

Majority of the respondents are on agreement that NPLs do seriously affect the performance of banks. This statement of a respondent mutually represents the view of all in the following way:

Certainly, they do significantly affect the performance of banks. The reason is that whenever NPL will be booked, it will directly hit the profit of the banks. As previously I have told you that when a loan has an overdue period of 90 days, we have to keep a provision of 25% and that provision comes from profit. (Tariq)

But there is also negation of the concept discussed above. As one of the respondent does not consider NPLs affecting the performance of the banks: As you can see from the balance sheet of State Bank of Pakistan that about 50% of the loans are taken by the government which is considered as risk free investments. Therefore, the banks have no financial issues as their income on these government loans is secured. If government does not pay within 90 or 180 or even 360 days, this loan will not be included in the list of NPLs. Thus, it can be inferred that profitability of banks is not affected by NPLs in Pakistan. (Salman)

Bank-Specific factors of Non-Performing Loans (NPLs)

The sample of interviewed participants highlighted a number of bank-specific factors of NPLs. The most common are explained as under:

i- Lenient Credit Terms and NPLs

Majority of the respondents are of the view that if the terms and conditions of sanctioning loans are lenient then the NPLs can increase. A respondent gives his opinion by saying:

While sanctioning loans we have to look into its terms and conditions. Prac-



tically, we verify the 5 C's. These 5 C's are character, collateral, capital, condition and capacity. Certainly, in case of relaxing any of the aspect of loan sanctioning rules, the chances of NPLs will increase. (Waseem)

The respondents also reveal that credit terms are very important for the financial performance of the banks and must be strictly followed. One of the respondents describes these terms in the following manner:

While sanctioning loans we fulfil certain criteria known as CLPs (Credit Loan Proposals). This includes financial analysis of customers, financial analysis of the industry to which he belongs, analysis of the management of the company etc. This also includes the repo of the business. If the customer has been working in the market for a long period of time then this factor is also highly rated while sanctioning a loan. The financial health of the business is also being monitored. If a business is not of such calibre to give return to repay the loan, then to invest in that business will be wastage. (Pervaiz)

The views of all respondents are in accordance with the literature.

ii- Monitoring and NPLs

The participants feel that monitoring is one of the most important tasks of the banks. As money does not belong to banks so they should be very careful in investment decisions. While utilising these funds, selection of ventures and their continuous monitoring are very essential. As one of the participant said:

If you realise about the importance of amount, given as a loan, you will definitely visit the borrower at least once a month to see the utilisation of your money. Similarly when there is money of bank involved, same sense of urgency is required which is present in case of personal amount. But if you did not properly monitor your loans, then you are attracting the loan to be included in NPLs. Therefore, proper monitoring and check and balance are vital. (Ahmad)

Similarly another participant verifies this phenomenon as per the following statement:

The category in which there is leniency shown in lending and are not properly monitored that category will show maximum defaults. (Aslam)

iii- Bank Ownership and NPLs

Majority of the respondents are at the same view point as far as bank ownership is considered. They are of the opinion that privately owned banks commit much lesser NPLs than state owned banks. This can be seen from the following views of a respondent:

As our regulations are very strict and are followed in almost all the banks but

there may be difference in their strength of monitoring. But private banks are more concerned about their profitability than the state owned banks. In private banks more work is being taken from the staff resulting in improved growth than the state owned banks. (Ahmad)

The views of another participant are also important to share as he does not consider the ownership a significant factor of NPLs. His views are quoted here to share this concept with another angle:

It all depends on the surveillance of the banks on their loans. It does not matter that it's a private-owned bank or a state-owned bank, which one will follow the pre-requisites before sanctioning loans and proper monitoring after advancement of loans will control NPLs. (Atif)

As per above, Atif thinks that the ownership of banks do not matter, whether they are state owned or privately owned. What really matters is the level of inspection by the banks.

iv- Bank Size and NPLs

There are differences of opinion among the respondents in case of bank size and its effect on NPLs. According to one school of thought, bank size is a significant factor of NPLs. This can be explained from the following statement:

The large bank has the luxury of investing more in a commodity than the small bank, so when there will be a large portfolio of a bank, the effect of NPLs in large bank is minimised. Whereas in case of small banks, they have limited investments so they have to face more risks in case of NPLs. (Ali)

On the contrary, the other view point negates that concept. This category of respondents believes that bank size has no significance in creating NPLs. This can be seen from the following statement:

The bank size does not matter in case of incurring NPLs. If a bank, either big or small, properly follows the pre-requisites of sanctioning a loan and monitor it, then there are lesser chances of it converting into a Non-performing Loan. (Amir)

We can see from the statements that there are differences in opinion among the respondents regarding effects of bank size on NPLs.

v- Diversification of Loans and NPLs

All the participants develop consensus that diversification of loans plays a vital role in controlling Non-Performing Loans. One of the participants explained this in the following manner:

Sure the banks have to diversify loans. Without this feature, they cannot operate their business operations safely. Moreover, international conditions are quite different from our own culture. Therefore, we have to look into



our own culture before conducting any type of business activity. We have to look into the situation of various industries before investing and the higher management guides us about taking exposures in certain items. (Saleem) This above response reveals that Pakistani Banking sector has a different environment if compared with other countries specially the developed ones like US. Therefore, we find a different angle of this concept in the study of Stiroh (2004), which fails to find any advantage of diversification of loans in case of US Banking sector.

Another quote from one of the participants can help to understand this concept more clearly:

Certainly, it is a tool to control NPLs. If the bank continues to invest in a particular project and that project fails, then there is a great chance that the amount will be converted into NPLs. On the other hand, if the bank invests in different sectors, there will be fewer chances of NPLs. It can also be learned from a famous quote that says, "Do not put all your eggs in a single basket". (Atif)

Atif considers diversification to be imperative for survival of the banks

vi- Interest and NPLs

Interest has been pointed out by some respondents as one of the major factors of explaining the NPLs. One of the respondents has said:

First bank-specific factor of NPLs may be lack of proper monitoring. It means that when a particular loan was going... The banks show inflexible attitude in case of charging interest. Sometimes the borrower agrees to pay 50% of interest along with the principal, but even then banks do not show any softness. The banks can restructure the loans and can make easy installments of the amount. (Nauman)

While discussing interest as a factor of Non-Performing Loans, most of the respondents do not indicate it as an important factor. Some of the respondents are of the view that due to inflation, interest puts an extra burden on borrowers, which becomes reason of their default.

vii- Risk Assessment and NPLs

The respondents have declared that risk assessment is very important for increasing or decreasing NPLs. There are a number of views given by the respondents. Some of the views of respondents are given as under:

Actually, assessment is a process which filters the good borrowers and bad borrowers. Therefore, it is the most important bank-specific factor. For example, if a borrower has given a security which does not justify the amount of loan, then he may not care for the repayment of the loan resulting in in-

creasing NPLs. (Pervaiz)

Due to poor assessment on the part of the bank, it directs towards wrong selection of business sector to be invested. For example, before sanctioning a loan for a plaza it should be assessed that whether that location has the worth that a plaza can attract businessmen to open their shops in that plaza or not. (Saleem)

The importance of Risk Assessment can be judged through the fact that every bank has a separate risk Assessment Department (RAD) and it evaluates the risks of lending. This department can even cancel a proposal, even after approval from the finance department, if it thinks that it's not suitable for investment. (Irfan)

A weak Risk assessment can also play a role in increasing NPLs. We can say that NPLs are caused by poor credit assessment. While giving credit the repute of borrowers to repay loan and the market value of securities are not adequately assessed which become key reasons behind NPLs (Petersson and Wadman, 2004). The study of Guo (2007) shows that the banks use their personal experiences in giving loans rather than using historical data, mature credit portfolio management skills and centralised information system. This causes NPLs to grow at even a higher pace.

Social Factors

The most prominent social factors emerged from the interviews are described in the next paragraphs:

i- Corruption and NPLs

Majority of the respondents are of the opinion that due to strict implementation of the rules and regulations by the regulator, which is State Bank of Pakistan, corruption is not seen in banking sector of Pakistan. Therefore, most of the respondents considered corruption as an insignificant factor of NPLs. The following can explain this:

Corruption has no significance and it does not explain NPLs. The reason is that there is a lot of check and balance on us. Even after my signatures a proposal is verified by a number of officials. Therefore, anything missed by me may be found out by any of these officials. (Tariq)

Some of the respondents give example of a state owned bank which has been involved in corruption. But they did not consider private banks as victim of corruption due to support from the higher management. This can be seen from the following statement of a respondent:

Definitely, in government sector, we have examples that there is political influence in government banks. So by using these pressures, such securi-



ties are given which do not justify the loan or the loans are taken but these are not utilised for the purpose for which they are taken or banks are not allowed to keep proper check and balance on their loans. Therefore, by the use of corruption and political pressure, NPLs can increase. (Ahmad)

Most of the respondents are of the view that in all the banks, whether government or private, corruption is minimised due to the strict implementation of regulations of State Bank. However, respondents consider that government banks are a little weak in monitoring.

ii- Political Pressure and NPLs

There is only one respondent who does not comment on this issue. Majority of the respondents agreed on the point that political pressure can be a factor in influencing NPLs. Let's see the following statement of a respondent:

In my opinion, state owned banks take political pressure which can be seen from the example of BOP scam. Whereas privately owned banks have a strict system and they do not come under political pressure. (Salman)

Discussion

The Non-Performing Loans are a big hazard for the entire world because it has been seen in the case of even developed countries like the US that it can initiate a banking crisis (Adebola, Wan Yousaff and Dahalan, 2011). The NPLs are very dangerous for the profitability and solvency of a financial institute. Therefore, to explore the relationship among bank-specific, social factors and non-performing loans in the setting of Pakistani Banking sector, this research study was conducted. Built on qualitative phenomenological approach, the following themes emerged:

- factors of Non-Performing Loans;
- bank-Specific factors of Non-Performing Loans;
- social factors of Non-Performing Loans and

This research also highlights that in order to increase profit the banks may show leniency in credit terms. This can lead to poor performance of the banks. The findings suggest that while giving credit, 5C's are important to be considered which include character, condition, collateral, capacity and capital. In case, any of these is relaxed there will be adverse effects on the performance of the banks. The importance of strictly applying the credit terms is also acknowledged by the respondents and it has been found that while sanctioning loans credit terms like analysis of customers, financial analysis of the industry to which he belongs, analysis of the management of the company, investigating the repo of the business, financial health etc

should be followed. When the economy is growing, bank managers are found to exercise leniency in giving credit because lower credit expansion means lesser income generation which indicates poor performance. This herd behaviour results in giving loans to some borrowers, having low capacity to repay. Therefore, there are loan defaults due to the lenient credit terms. This has been verified by the study of Rajan (1994).

The current study also finds out that monitoring plays a very important role in controlling NPLs. The participants have discussed that if any loan is issued without proper monitoring then there are great chances that this loans will end in default. The bank is the custodian of money given by the customers and that amount should be invested after following certain procedures which can ensure the trustworthiness of the borrowers. The study of Agresti, Baudino and Poloni (2008) also supports this finding. Another finding indicated in this study is that the most important aspect in monitoring is worth of business, whereas collateral is given least importance in the monitoring procedure by most of the banks. We can also look this factor through lenses of theory of moral hazard, which indicates that when the borrowers get the amount of loan, they take control of money of the bank, so there is a need of monitoring the borrowers.

Another finding of this study is in regard of bank ownership as a factor of Non-Performing Loans. The conducted study found out that banks operating under private ownership commit lesser defaults than the state owned banks. The respondents believe that the main reason for this is more attention and activeness shown by the private banks than the state owned banks. This finding has found support from the study of O. Masood (2009) but there is also literature available which indicates that private banks are the main culprits of leaking NPLs than the state owned banks like study of Hughes, Mester and Moon (2001). But this study was conducted in the Taiwanese Banking sector. Some of the participants also think ownership to be insignificant in explaining the NPLs. Their point of view is that due to adequate and continuous inspection by State Bank of Pakistan, as a regulator, has strengthened the monitoring systems of all types of banks. Therefore, as far as NPLs are concerned, ownership does not affect it.

The concept of bank size reveals very interesting findings as per opinions given by the participants. There exists one school of thought which judges bank size to be one of the most vital factor affecting NPLs significantly. The advocates of this school of thought give reason that larger banks have the capacity to survive the effects of NPLs due to large portfolios, whereas small banks cannot enjoy this luxury. "Too big to fall" is the basic idea behind this theme. The studies of Rajan and Dhal (2003) and Quagliariello (2007) support this argument. On the contrary, the other school of



thought believes that bank size is not a significant factor of Non-Performing Loans. They give reason that if a bank, whether big or small, does not follow the terms of sanctioning the loans strictly it can incur NPLs (Salas and Saurina, 2002). But as per Pakistani banking sector is concerned the current study is the only one which describes the relationship between bank size and NPLs in the Pakistani environment. Therefore, it is found in the study that there is a significant and negative relationship between bank size and NPLs and I find support from the literature for this theme as explained above.

All the participants are on the same point that diversification of loans is imperative for controlling NPLs and is a significant factor of Non-Performing Loans. This finding is not in accordance with the study of US banking sector carried out by Stroh (2004). But the current study is important as it is conducted in Pakistani Banking sector and it also finds support in literature (Louzis, Vouldis and Metaxas, 2012). The financial situation in Pakistan is very vulnerable and if large investment is made in a particular project then in case of its failure, there is a great chance that the amount will be converted into NPLs. On the other hand, if the bank invests in different sectors, the chances of NPLs will be fewer. It can also be learned from a famous quote that says, "Do not put all your eggs in a single basket". Therefore, the banks have to invest in different sectors so that if one sector incurs a loss others may strengthen it.

Interest also emerged as a theme in the findings. There are mixed opinions regarding interest as a factor of NPLs. Some participants support the role of interest in explaining NPLs. They give reasons that if banks show relaxation in payment of interest then many Non-Performing loans can be turned into performing. Literature has given different views about interest. For example, the studies of Khemraj and Pasha (2005) and Dash and Kabra (2010) show that high interest rate has a significant relation with NPLs. As the interest rate is increased, there is an extra burden on the borrower, resulting in defaults. Therefore, interest can play a significant role in explaining the Non-Performing Loans.

Risk Assessment has also been reported as an important factor of NPLs. Due to lack of appropriate credit assessment, banks cannot correctly categorise the borrowers. The participants are of the view that due to pressure of targets, bank officials tend to relax some pre-requisites of sanctioning loans. The theme defined in the current study can be seen through the lenses of theory of asymmetric information (Auronen, 2003). This theory explains that lack of information benefits the borrowers and ultimately results in Non-Performing Loans as it is quite difficult to separate good and bad borrowers. The consequences of this can be moral hazards and adverse

selection problems.

In this study, themes of two social factors have emerged which are corruption and political pressure. As far as corruption is concerned, the participants insist that due to strict implementation of the regulations by the State Bank of Pakistan, corruption does not significantly affect the NPLs. The current study finds out a very weak effect of corruption on NPLs. But the literature negates it and considers it as significant. The reason given is that as due to corruption the borrowing tends to increase, therefore, there are more chances of borrowers to default (Beck, Demirgüç-Kunt, Laeven and Maksimovic, 2006). Participants acknowledge a very weak impact of corruption in increasing Non-Performing Loans in the state owned banks. They reject the chances of corruption in private sector. The reason given for this weak impact is that there is comparatively less attention given on monitoring by the state owned banks, if compared with the privately owned banks.

The theme of political pressure has emerged as another important factor of Non-Performing Loans. The interviews of participants reveal that officers of private banks are supported by the top management, therefore, political pressure does not affect their working, resulting in not affecting NPLs. The current study points out the state owned banks to be accepting the political pressure and the example of a Pakistani government bank (BOP) proved its significance on NPLs. The loans of these State-owned banks are turned to bad due to weak implementation of legal framework and political pressure (Khawaja and Mian, 2005).

Conclusion

In this study, we have explored to advance understanding that how bank-specific and social factors contribute to Non-Performing Loans. Theories of asymmetric information, moral hazard, law and finance theory, the literature and interviews of the Pakistani bank managers, all did help in this cause. This study has not only built up a model clarifying the relationship among bank-specific, social factors and non-performing loans but this has also been done in the setting of Pakistani Banking sector where there is limited or no in-depth research is available in explaining the relationships. It is seen that in the context of Pakistani Banking sector, various bank-specific themes like lenient credit terms, monitoring, bank ownership, bank size, diversification of loans and credit assessment have significant effect on Non-Performing Loans, whereas interest has a weak significance on NPLs. Thus, banks should carefully look after these factors in order to control NPLs. The social factor like corruption has an insignificant effect on NPLs and political pressure has been an important factor in explaining the Non-Performing



Loans, especially in case of state owned banks. The government needs to lessen down the level of interference in the financial decisions of the state owned banks so that these banks can independently make their credit decisions without any political pressure. The policy makers and practitioners should keep these bank-specific and social factors under consideration before designing any further policies to control Non-Performing Loans.

Limitations and future research directions

By far, this study is limited in its focus and scale. Its findings cannot be generalised to all Pakistani Banking sector. The findings replicate the views of male bank managers. Further research should consider the female bank managers as well who have household tasks along with their banking job. This research uses a small sample of 12 male bank managers from one geographical location (Lahore) of Pakistan. Carrying out a study with larger sample from diverse geographical areas may help to simplify the findings to larger samples of banking sector.

Validity of this research study is limited to the understanding of the responses and the aptitude to recognise themes. Interviews of bank managers could be interpreted as bias on the part of the researcher. There are some factors which still need further exploration with reference to Non-Performing Loans such as government interference, war on terror, role of HR. These concepts did emerge from the findings of current study and can open new dimensions in designing policies for controlling NPLs. Last but not the least in future, the NPLs can be explored category wise i.e. which category of loans is facing maximum number of defaults.

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