

# BAD DEBT OF BANKS AND RECOMMENDATIONS FOR SOVLING

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**Abstract:** *Bad debt (or non-performing loan) is one of the issues attracting great interest of researchers today. Especially, researchers have focused on finding out the causes and effects of bad debt on the stability of the banking system and the economy. According to Louzis et al (2012), bad debt is considered a warning sign for financial crisis in the future if not being promptly monitored and handled. It is extremely necessary to find out the causes as well as analyze the impacts of bad debt on the economy and is an urgent issue to plan to prevent economic crises in the future. The paper analyzes the causes, the impacts of bad debt on entities in the economy and the situation of bad debt in Viet Nam in the period 2011-2020, thereby proposing solutions to help Vietnamese commercial banks limit their bad debts in particular and Viet Nam's banking industry develop more sustainably in general.*

• Keywords: *bad debt, non-performing loan, commercial banks.*

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Tóm tắt: *Nợ xấu (hay nợ khó đòi) là một trong những vấn đề thu hút sự quan tâm lớn của các nhà nghiên cứu hiện nay. Đặc biệt, các nhà nghiên cứu đã tập trung tìm ra nguyên nhân và ảnh hưởng của nợ xấu đến sự ổn định của hệ thống ngân hàng và nền kinh tế. Theo Louzis và cộng sự (2012), nợ xấu được coi là dấu hiệu cảnh báo khủng hoảng tài chính trong tương lai nếu không được quan tâm và xử lý kịp thời, việc tìm ra nguyên nhân cũng như phân tích tác động của nợ xấu đến nền kinh tế là vô cùng cần thiết. Bài viết phân tích nguyên nhân, tác động của nợ xấu đối với các chủ thể trong nền kinh tế và thực trạng nợ xấu ở Việt Nam giai đoạn 2011-2020, từ đó đề xuất các giải pháp giúp các ngân hàng thương mại Việt Nam xóa được nợ xấu nói riêng và ngành ngân hàng Việt Nam nói chung phát triển bền vững hơn.*

• Từ khóa: *nợ khó đòi, nợ xấu, ngân hàng thương mại.*

## 1. Introduction

Bad debt (Non-Performing Loan) greatly affects the existence and development of the commercial banking system as well as the development of the Vietnamese economy. In the recent years, especially in the context of COVID-19 pandemic, the situation of bad debt is increasing, causing great harm to the national

economy in general and the banking and financial system in particular, specially directly affecting businesses.

This fact poses a requirement for the State Bank of Viet Nam (SBV) and commercial banks to quickly come up with solutions to deal with bad debts. In fact, bad debt is not only a problem that needs to be solved by the commercial banking system, but it also requires a joint effort of the business community, especially the general direction from the SBV and the Vietnamese Government.

By researching the situation of bad debt in Viet Nam in the period 2011-2020, the author proposes solutions to help Vietnamese commercial banks limit their bad debts in particular and Viet Nam's banking industry develop more sustainably in general.

## 2. Theoretical framework

### 2.1. Bad debt and its classification

In the process of granting credit to customers, there are many factors making commercial bank's loans unsecured, which adversely affects the credit quality of the commercial banks. Therefore, it is necessary to have a measure to assess what are bad debts or uncollectible accounts.

According to the global credit institutions, a debt is considered bad debt when the interest and/

or principal are overdue for more than 90 days, or the unpaid interests of 90 days or more have been entered in principal, refinanced or late paid as agreed; or payments that are less than 90 days past due but there are solid reasons to doubt that they will be paid in full.

In Viet Nam, according to Circular No. 11/2021/QĐ-NHNN dated July 30<sup>th</sup>, 2021 of the SBV, debts are currently classified into five groups based on their risk status: standard debt, debt needing special attention, subprime debt, doubtful debt, and potentially irrecoverable debt. However, debts in group 3 (subprime debt), group 4 (doubtful debt) and group 5 (potentially irrecoverable debt) are regarded bad debts. Specifically, the Article 10, Circular No. 11/2021/QĐ-NHNN stipulates that debts that are overdue for interest or principal for more than 90 days to more than 360 days (ie from group 3 to group 5) are considered bad debts. Basing on customers' debt repayment, the commercial banks account loans into appropriate debt groups as follows:

\* Group 1 (standard debt) includes: Debts that are due and assessed as being able to fully recover both principal and interest on time; Debts that are overdue for less than 10 days and assessed as being able to fully recover overdue principal and interest and fully recover the principal and remaining interest on time.

\* Group 2 (Debts needing special attention) includes: Debts that are overdue for less than 90 days; Debts adjusted by repayment term for the first time are still due.

\* Group 3 (Subprime debt) includes: Debts that are overdue from 91 to 180 days; Debts extended for the first time are still due; Debts exempted or reduced in interest due to customers' inability to fully pay interest as agreed; Debts in the period of recovery according to conclusions of inspection and examination agencies; Debts must be recovered based on the early debt collection decisions (because customers violating agreements) that have not been recovered within less than 30 days since the date of recovery decision issuance has been reported.

\* Group 4 (Doubtful debt) includes: Debts that are overdue from 181 days to 360 days; First-time rescheduled debt is overdue for up to 90 days according to the first rescheduled repayment

term; Debts rescheduled for the second time are still due; Debts to be recovered according to conclusions of inspection and examination agencies but not yet recovered within 60 days after the time limit for recovery; Debts that must be recovered under early debt recovery decisions of credit institutions or foreign bank branches (due to customers breaching agreements) that have not been recovered within a period of from 30 days to 60 days since the date of the decision to withdraw has been reported.

\* Group 5 (potentially irrecoverable debt) includes: Debts overdue for more than 360 days; First-time rescheduled debt is overdue for 91 days or more according to the first rescheduled repayment term; The second rescheduled debt is overdue according to the second rescheduled repayment term; Debts rescheduled for the third time or more; Debts to be recovered according to conclusions of inspection and examination agencies but not yet recovered more than 60 days after the time limit for recovery; Debts that must be recovered under early debt recovery decisions of credit institutions or foreign bank branches (due to customers breaching agreements) that have not been recovered within over 60 days since the date of the decision to withdraw is reported; Debts of credit institutions are under special control or foreign bank branches are frozen in capital and assets.

In general, no matter which group they are classified into, bad debts are a form of financial loss for commercial banks. Banks have to spend a lot of time and expense to handle these debts, especially bad debts can be harmful to their performance.

## 2.2. Effects of bad debt

In the market economy, the increase of bad debt is one of the inevitable things. However, if bad debt arises a lot and is not controlled, it will create a "blood clot" in the blood vessels of the economy, seriously affecting the Viet Nam's economic development. There are some effects of bad debt as below:

### 2.2.1. For commercial banks

The failure to recover debts (principal and/and interest and fees) causes the loss of commercial bank's capital, while these banks still have to pay interest in their performance, causing their profits

to decline. If the profit does not reach the target, the banks must use its own capital to compensate for the loss which may affect their operational scale. On the other hand, the high rate of overdue debt makes the reputation and confidence in the financial strength of banks degraded, leading to a decrease in the bank's ability to mobilize capital. More seriously, it can lead to risks of liquidity and the brink of bankruptcy and threatening the stability of the entire banking system.

#### 2.2.2. For customers

For borrowers who are not able to repay the principal and/or interest to the bank, they have almost no chance to access the bank's loans and even other sources due to the loss of their reputation. Other borrowers' opportunities to access bank loans are also more limited when credit risks force commercial banks to either tighten lending or even downsize their operations.

#### 2.2.3. For economy

The banking system has a close relationship with the economy because it is a channel to attract and provide capital/loans for organizations, businesses and individuals in the economy. Therefore, credit risk has a direct effect on the economy. At a low level, the longer the bad debt lasts, the greater the tangible and intangible cost is used to resolve bad debt.

In terms of tangible view, the mortgaged assets at banks will be increasingly worn out, damaged, and their value will gradually decrease. Meanwhile, if bad debts are quickly handled, these assets will be put to use quickly, creating value and surplus value for the economy. In terms of intangible view, as the process of bad debt settlement is prolonged, it will be difficult for Viet Nam to maintain the current credit rating. This has a negative impact on the investment environment. On the other hand, credit risk makes customers' opportunities to access capital to expand production and business activities or consumption limited, adversely affecting the growth ability of the economy.

At a higher level, when banks fall into a difficult situation leading to bankruptcy, the domino effect is very likely to occur in the whole banking system, causing a crisis for the entire economy, negatively affecting the social life and national development. The rapid increase of bad

debt is one of the main causes of the crisis in the banking system.

### 2.3. Causes of bad debts

*Firstly*, most commercial banks pursue the business goal of fast credit growth to achieve their profit plans while their risk management capacity in loans is still limited and slowly improved. In addition, recent years, a large amount of credit capital and many commercial banks have focused on investing in risky fields, such as real estate. When the real estate market freezes and real estate prices falls deeply, they will cause a rapid increase in bad debt.

*Secondly*, the provision of credit capital to businesses for their working capital or project investment is also one of the reasons for the increase in the bad debt ratio. The fact that commercial banks are under pressure to meet business targets in credit granting, with the lack of strict management and governance in the credit capital use by enterprises, has caused effectiveness of loans. Therefore, it leads to the bank's insolvency.

*Thirdly*, in some periods, economic policies, specially macro-economic policies lacks stability, affecting the production and business and the solvency of customers. The system of mechanisms and policies on asset handling is inadequate, so that affects the handling of assets and liabilities of commercial banks.

*Fourthly*, the capital market has not yet developed commensurately, so the banking system still plays the role of a channel funding for investment and development. Therefore, the main risk of the financial system is the risk of the banking system. At the same time, because Viet Nam's growth model for many years still depends on in-breadth investment and use of loans, the bad debt of the economy is mainly bad debt of the banking system.

*Fifthly*, the moral of some banking staff has declined mean while the professional capacity of the staff has not kept pace with the development of the banking industry. There are many negative aspects in the credit process such as appraisal, approval and monitoring of loans.

*Sixthly*, non-performing loan increased because banking inspection and supervision for a long time had not been highly effective in

detecting, preventing and promptly handling violations and risks in granting credit activities of commercial banks, especially violations of credit regulations and excessive investment in a high-risk areas.

### 3. Situation of bad debt of commercial banks in Viet Nam

Bad debt is a normal problem in banks, because credit activities are always risky. During their operation, credit institutions always incur bad debts. From the analysis of the causes of bad debt, the increase in bad debt does not mean that the banking system is the cause because the arising of bad debts is usually caused by the borrower's inability to repay the debt. To measure the bad debt of commercial banks, people use the bad debt ratio. It is calculated by the bad debt balance/total loan balance. According to regulations of the SBV, bad debts include outstanding loans of groups 3,4,5. If a commercial bank has a large bad debt ratio, it shows that the credit quality of the bank is not good, and the credit risk is high because customers cannot repay the loan. According to regulations of the SBV, commercial banks with bad debt ratio  $\leq 3\%$  are considered to have good credit quality. Following are the bad debt ratios of 20 typical commercial banks in Viet Nam (NCB, NamABank, HDBank, Eximbank, VPBank, SCB, VIB, OCB, SHB, MSB, MB, Techcombank, Sacombank, LPB, ABB, ACB, BIDV, VCB, Vietinbank, Agribank):

**Table 1. Non-Performing Loanratio of Viet Nam's commercial banks for the period 2011-2020 (%)**

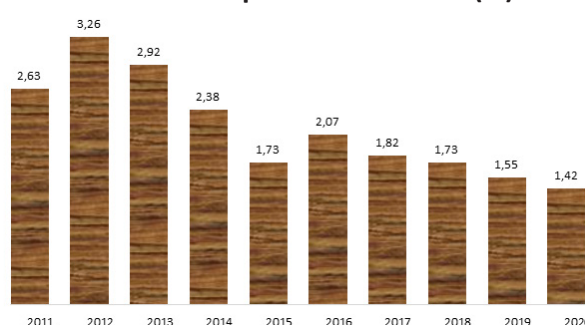
Year	Number	Minimum	Maximum	Mean	Std. Deviation
2011	20	0.56	7.25	2.63	1.68358
2012	20	1.32	8.80	3.26	1.98084
2013	20	0.82	6.06	2.92	1.27288
2014	20	0.49	5.15	2.38	1.14241
2015	20	0.34	3.41	1.73	0.69112
2016	20	0.68	6.81	2.07	1.31744
2017	20	0.46	4.59	1.82	0.93817
2018	20	0.54	3.20	1.73	0.65578
2019	20	0.38	2.95	1.55	0.58745
2020	20	0.50	3.00	1.42	0.63467

Source: Statistics from SPSS26.0

The statistics in Table 1 show that commercial banks in Viet Nam have focused on credit risk management, so the bad debt ratio has also been

controlled. In the period 2011-2020, the average bad debt ratio of all banks was  $< 3\%$ , except in 2012 which was 3.26%. Especially, in 2019, 2020 despite being affected by the COVID-19 pandemic, the credit risk and debt collection is done well by all banks, so the bad debt ratio is below or equal to 3%. This will be seen more clearly in the chart below:

**Figure 1. Average bad debt ratio of commercial banks in the period 2011-2020 (%)**



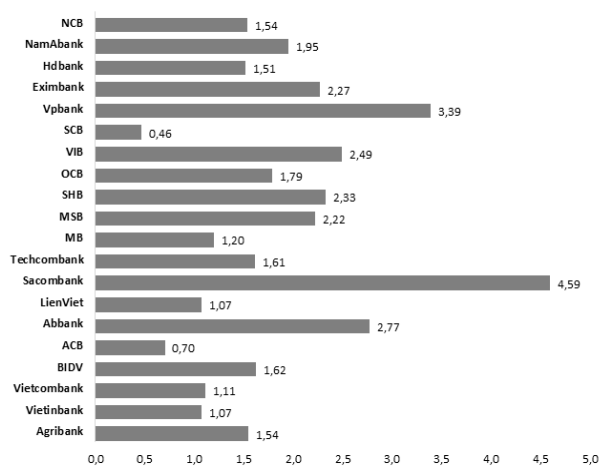
Source: Synthesized by author

The Figure 1 shows that in the period 2011-2020, the average bad debt ratio of Vietnamese commercial banks fluctuated, at a low level and ranged from 1.42% - 3.26%. 2012 was the year with the highest average bad debt ratio of banks at 3.26%, followed by 2011 with a bad debt ratio of 2.63%. In 2011, Sacombank was the bank with the lowest bad debt ratio of 0.56% and SCB with the highest ratio of 7.25%. In 2012, Eximbank got the best credit quality with the lowest bad debt ratio of 1.32%, while SHB was the bank with the highest bad debt ratio of 8.8%.

For a long time (2006-2010), the Vietnamese Government has implemented a loose monetary policy. Credit was the main source of investment to develop the economy and mainly invested in the real estate market that impaired credit quality and led to high inflation. In addition, the impact of the global recession has caused businesses that have not had consumable goods and negatively affected their production and business activities, leading to enterprises stopping production or going bankrupt. On the other hand, the real estate market is quiet and frozen, which also leads to a high rate of real estate bad debt and of banks. Commercial banks in Viet Nam have well implemented measures of credit risk management,

so the bad debt ratio and capital loss rate are controlled. In 2020, despite being affected by the COVID-19 pandemic, the bad debt ratio of commercial banks is quite well controlled, all < 3%. Specifically:

**Figure 2. Non-performing loan ratio of Vietnamese commercial banks in 2020 (%)**



Source: Synthesized by author from financial statements of commercial banks

The bad debt ratio of commercial banks in 2020 is different among banks. Techcombank was the bank with the lowest bad debt ratio of 0.50% and VPbank is the bank with the highest bad debt ratio of 3%. Commercial banks in 2020 all have bad rates < 3%. The bad debt ratio of banks in 2020 is at a low level below regulations. It means that Vietnamese commercial banks have performed well in loan management. Despite being a difficult year for Viet Nam's economy due to the impact of the COVID-19 pandemic, in 2020, credit risk management has been well implemented from credit appraisal to inspection, supervision and loan recovery.

### 5. Solutions for managing bad debt in commercial banks

The Government's moves in recent times have shown that the handling of bad debt is a top priority in the plan to reform and restructure the banking industry. Bad debt in the commercial banking system has become a national problem, so it is not only the tasks of commercial banks, but also the State. However, the arising of bad debt comes from the operation and management of the commercial banks themselves, the solution

to prevent and handle bad debts in the most effective way and to minimize the lowest possible impact for the national economy, should come from commercial banks.

*Firstly*, it is necessary to rebuild and re-manage the process of credit granting at commercial banks. Accordingly, it is necessary to standardize and synchronize, and at the same time strictly supervise the implementation of the credit granting process, regardless of the size of the commercial banks. This is the root and fundamental cause to reduce the ratio of bad debt, potentially irrecoverable debt. In fact, commercial banks have initially increased their management in risk, but achieved modest results.

*Secondly*, there must be sanctions and measures to control credit risks during the operation of commercial banks. There have been many cases of bad debt arising from customers who are considered as "big", "VIP", "traditional", "loyal", "potential" customer of commercial banks. As granting credit to this type of customers, commercial banks can by pass measures to ensure credit safety to quickly serve customers.

*Thirdly*, the pressure on reaching business targets also causes commercial banks to loosen their management to capital use of customers, leading to high bad debt ratio. Therefore, in order to ensure the safety of the credit capital system, the SBV needs to take drastic actions to control the annual credit growth of commercial banks to control the fast growth of these banks.

*Fourthly*, commercial banks continue to strictly implement Circular No. 01/2020/TT-NHNN of the SBV on supporting people and businesses affected by the COVID-19 pandemic by taking the following measures: (i) Support debt restructuring for customers; (ii) Reduce lending interest rates for existing outstanding loans; (iii) Implement programs and credit packages for preferential loans, helping the Government in regulating the macroeconomic balance, stabilizing the money market, interest rates and exchange rates.

*Fifthly*, the SBV needs to control bad debts for the real estate sector by restricting lending to

businesses that are non-specialized in real estate investment and business and limit investment capital for real estate projects. In addition, businesses are encouraged to use many different sources of capital such as issuing stocks and bonds, and mobilizing capital contributions from private investors.

*Sixthly*, in the complicated context of COVID-19 pandemic, the bad debt ratio of the Vietnamese banking system will increase day by day. To speed up the handling of bad debt in general and to implement the Decision on approving VAMC's development strategy to 2025, with orientation to 2030 in particular, VAMC needs to complete the establishment and put into operation the debt exchange floor in the 2021-2025 period. Beside that, VAMC needs to propose to state agencies to complete the legal corridor on developing the debt trading market, issuing debt valuation standards to create legal basis for implementing as soon as the exchange floor comes into operation.

*Seventhly*, the Vietnamese Government and ministries, sectors need to study and build a legal corridor for the securitization of bad debts according to the following methods:

- *Method 1*: If enterprises with a good history of business administration are facing difficulties in repaying the principal or because their on going investment projects have not been put into operation, commercial banks should consider to transfer a part of the principal debt in to medium-term bonds. This is to support liquidity and help businesses survive and develop.

- *Method 2*: Converting overdue debt and bad debt into shares. At the same time, changing the creditors of banks into major shareholders to hold the majority of shares if their businesses are likely to survive and develop after restructuring. This is a fairly common method in the world. For Viet Nam, there have been many successful cases, not only helping enterprises from the risk of bankruptcy but also preserving the capital of banks. In addition, in order for the securitization process to be successful, as a co-creditor, commercial banks need to actively show their social responsibility and coordinate with

businesses to handle bad debts. At the same time, commercial banks should use their subsidiaries such as debt management companies, securities companies or fund management companies to actively participate in the securitization process.

*Eighthly*, the State needs to exempt value-added taxes, corporate income tax, etc. for debt trading activities to promote the formation and development of the debt market. The exemption of taxes on debt trading activities will reduce the loss of bad debts, promote private investors to participate in the debt market. At the same time, it will not cost the state budget. The state needs to exempt corporate income tax for issuance of corporate bond. This helps reduce deposit interest rates and helps the commercial banking system to mobilize long-term capital instead of short-term as well as promote the securitization of debts. In addition, the State should also reduce 50% of value added tax in economic sectors such as construction, production of building materials, real estate business, ship repair, and shipping that are facing difficulties to help these enterprises reduce the burden of tax costs, and contribute to reducing bad debts for banks.

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