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Non-Performing Loans of Commercial Banks: A Review

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ABSTRACT

This literature review delves into non-performing loans (NPLs), focusing on their underlying causes, the effects they have on commercial banks, and various management strategies. By synthesizing insights from over 20 years of research, the review highlights how both macroeconomic factors such as economic downturns, rising unemployment, and inflation, and microeconomic factors like inadequate risk management and aggressive lending practices contribute to the rise of NPLs. The discussion extends to the significant ways NPLs affect bank profitability, including reduced interest income, increased provisions for loan losses, and liquidity challenges. Following the 2008 global financial crisis, regulatory measures have been crucial in addressing NPL growth, but their effectiveness can vary depending on the strength of local regulatory environments. The review emphasizes the need for proactive management strategies, such as loan restructuring and improved credit risk assessments, to help maintain bank stability and prevent future NPL issues. Moreover, it identifies critical gaps in current literature and points to potential directions for future research on NPLs, particularly in both developed and emerging markets. Overall, this review aims to provide a clearer understanding of NPLs and their implications for the banking sector

Keywords: Non-performing loans (NPLs), Commercial banks, Macroeconomic factors, Credit risk management, Loan restructuring

INTRODUCTION

Banks are crucial to the development of any economy or financial system, making it essential for these institutions to maintain good health. One characteristic often associated with banks is their financial fragility, particularly when adverse conditions affect the quality of their assets. A key determinant of a bank's performance is the quality of its loan portfolio, which is closely tied to the issue of loan defaults. When borrowers or companies struggle to meet their scheduled loan repayments, the loans transition to a non-performing status. This shift poses a significant risk to the health of the commercial bank involved. Therefore, ensuring the stability and solvency of banks is of utmost importance [1, 2]. Numerous studies have been conducted worldwide to explore various aspects of non-performing loans (NPLs) and their implications for banking systems [2, 3]. While existing research offers valuable insights, this particular study aims to address important gaps that have yet to be explored. The ongoing heterogeneity in previous works and the fact that NPLs remain at the epicenter of financial crises underscore the need for continued research in this area [4]. Unlike many other studies that primarily focus on panel data analysis using established methodologies, this research employs a systematic literature review coupled with meta-analysis. Although this method is commonly used in fields like medicine and sociology [5], its application in economics has been less frequent. This reluctance can be attributed to several factors, including the diverse nature of economic issues, which complicates the synthesis of results, and the absence of a detailed guide tailored specifically for systematic literature reviews in economics [6, 7]. Additionally, there is a prevailing belief that the varied accuracy of estimates in different areas stems from the need for a consistent understanding of cost-benefit analysis in meta-studies [8, 9]. By addressing these challenges, this work aims to contribute significantly to the literature on NPLs and their impact on financial stability.

The economic development of a country heavily relies on effective financial intermediation, with banks playing a crucial role in channeling surplus funds into productive investments. A well-functioning financial sector is essential for sustainable economic growth, as it not only reflects the overall economic health but also influences it. However, like any other industry, banks face various risks, particularly in the context of heightened competition and financial liberalization, which expose them to the increasing threat of loan defaults [10, 11]. The accumulation of non-performing loans within bank portfolios can erode interest income, making it a pressing concern for financial stability [12]. Several factors contribute to the rise of default loans, which can be categorized into internal and external influences. Bankers must grasp these factors and devise strategies to mitigate the associated risks. Indicators of credit risk include loan growth rates, sector turnover, overall economic growth, and inflation [13]. Systemic risk often arises from contingent liabilities, with rapid withdrawals of deposits being a common precursor to bank failures, exacerbated by adverse rumors that trigger asset fire sales [2, 14]. Understanding systemic risk is vital, as it is closely linked to the concept of asymmetric information, which can lead to reckless banking behavior when mechanisms to mitigate its effects fail [15]. Furthermore, risk-taking behavior is influenced by the central bank's monetary policy, suggesting that the trade-off between acceptable risk levels should not solely rest on the interests of shareholders and managers. It is crucial to recognize the underestimation of systemic risk and the neglect of stabilization measures, emphasizing the need for countercyclical monetary policies to maintain financial credibility and stability [3, 16].

This review aims to interpret and summarize studies related to non-performing loans (NPLs) and their impact on commercial banks, particularly in the context of banking management accounting. It emphasizes the need for future research and seeks to expand our understanding of how NPLs intertwine with management accounting within the banking system. Currently, the banking sector relies heavily on its resources, but a significant portion is tied up in non-performing loans. The management of these loans carries considerable social and economic significance, as they can lead to capital, operational, solvency, and liquidity issues. These challenges ultimately diminish the stability of banks and restrict their ability to lend in the future [17, 3]. Additionally, non-performing loans negatively affect profitability and operational capacity, particularly when funds are tied up in loan restructuring efforts [2].

Given the profound implications of NPLs, there is a pressing need for improved oversight and enhanced management and control strategies within banks. This includes standardizing operations, assessing attractiveness and effectiveness, and minimizing competition among banks, both domestically and internationally [1, 18]. Moreover, it is essential to eliminate ambiguities in banking operations, alert bankers to transaction risks, and strengthen risk management frameworks [7]. The shift in perspective toward risk management has transformed banking operations from merely addressing deficits to proactively managing risks [4]. In this evolving landscape, non-financial transactions are gaining prominence, necessitating a specialized form of management accounting known as banking management accounting [6]. Despite these developments, there remains a notable gap in the literature, as no systematic review has yet been conducted on the intersection of management accounting and credit risk management.

METHODOLOGY

The methodology for this review implements a structured approach to identifying, evaluating, and synthesizing relevant studies on non-performing loans (NPLs). The inclusion criteria targeted high-quality sources, such as peer-reviewed journal articles, working papers, and reports published by reputable institutions like the International Monetary Fund (IMF), World Bank, and European Central Bank (ECB). The review focused on literature published in English between 2000 and 2023, with particular emphasis on capturing insights into NPLs during and following the 2008 financial crisis. Priority was given to studies discussing global trends in NPLs, particularly in commercial banking sectors within developed regions (the U.S. and Europe) and emerging markets (India, China, and Sub-Saharan Africa). Studies were excluded if they were not peer-reviewed, did not focus on banking, or were published before 2000 unless they were foundational to the field.

A rigorous search strategy was applied across multiple academic databases, including Google Scholar, Scopus, EBSCOhost, JSTOR, and Web of Science. A combination of keywords and Boolean operators was used, including terms such as "non-performing loans," "NPLs and commercial banks," "causes of NPLs," "impact of NPLs on profitability," "NPL management strategies," and "NPLs in emerging markets." To ensure high relevance, search filters were applied, narrowing the focus to peer-reviewed articles and reports published between 2000 and 2023. This systematic approach enabled the identification of studies that addressed the main themes in NPL research, including their causes, consequences, regulatory interventions, and management strategies.

After gathering relevant studies, a systematic process of data extraction and analysis was conducted. Initially, titles and abstracts were screened to exclude irrelevant content. Then, full-text reviews were carried out for articles that met the inclusion criteria, with key data points such as research objectives, methods, findings, and regional focus captured in a standardized extraction template. Thematic analysis was used to identify recurring patterns, such as differences between macroeconomic and microeconomic factors driving NPLs, their effect on bank profitability, and the implementation of regulatory frameworks for resolution. These findings were synthesized into a comprehensive report that outlined common insights while also highlighting gaps and areas for future research.

RESULTS

The literature review on non-performing loans (NPLs) highlights several key findings regarding their causes, effects, and management approaches. A prominent pattern in the research is that NPLs are driven by both macroeconomic

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and microeconomic factors. On a macroeconomic level, conditions such as economic recessions, rising unemployment, and inflation contribute to an increase in NPLs, as borrowers struggle to meet their loan obligations. On the microeconomic side, inadequate risk management, weak internal controls, and aggressive lending during economic booms are significant contributors to NPL accumulation in banks. Moreover, research suggests that emerging markets are more susceptible to these issues due to their less diversified economies and weaker regulatory frameworks, which often lead to higher NPL ratios compared to those in more developed nations.
NPLs have a substantial negative impact on the financial performance of commercial banks, affecting profitability and overall stability. High NPL ratios are associated with reduced income from loan interest, higher loan loss provisions, and constrained liquidity. The review also emphasizes the critical role of regulatory measures in managing NPLs, particularly following the 2008 financial crisis. Policies such as tighter capital requirements, asset quality assessments, and the establishment of asset management companies have helped control NPLs in various regions, although the success of these interventions is influenced by the robustness of local institutional frameworks and enforcement capabilities. Additionally, the literature points to the necessity of proactive NPL management, including loan restructuring and enhanced credit risk practices, as vital strategies for reducing future NPL levels and maintaining financial system stability.

CONCLUSION AND IMPLICATIONS FOR FUTURE RESEARCH

This review highlights the complex interplay of macroeconomic, institutional, and borrower-specific factors in driving NPLs in the banking sector. The impact of NPLs on bank profitability, liquidity, and stability underscores the importance of sound credit risk management practices and regulatory oversight. While much of the existing research has focused on developed economies, there is a need for further studies on NPL trends in emerging markets, where financial systems are evolving rapidly. Additionally, future research could explore the long-term efficacy of various NPL resolution mechanisms, as well as the role of technological innovations in improving loan monitoring and recovery efforts. In conclusion, addressing the challenges posed by NPLs requires a multifaceted approach that includes robust macroeconomic policies, stringent regulatory frameworks, and sound risk management practices at the bank level.

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