The Arab Banks Vis-a-Vis the Problems of Internal Lending: The problem of Difficult Bank Loans [1]

First I would like to thank the chairman and members of the Board of Directors of the Union of Arab Banks for inviting me to lecture at this symposium, which is one of the valuable series of symposiums organized by the Union of Arab Banks in various fields of banking.

As you know, many banks are now facing problems. Probably the most important on the world level is difficult foreign debts, the settlement of which in our opinion requires the combined efforts of both creditors and debtors. Locally, there is the problem of difficult internal debts. Therefore, the subject of this lecture today will be the problem of difficult internal debts facing the Arab banks.

Generally speaking, talking about difficult internal bank debts necessitates in the beginning highlighting their nature, and the measures to be taken in an attempt to eliminate this phenomenon in the Arab world. Finally, allow me to outline the difficult internal debts facing the Kuwaiti banks.

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As for the problem’s nature, it can be said that the most important kind of loan risk lies in the debtor’s inability to service the debt and settle it in due time, which results in turning credit facilities into difficult debts. This kind of risk accounts for the major problems that always face any banking system. The success of any bank management in this respect usually depends on its capacity to accommodate profitability with risks probable from the use of bank funds.

Given that difficult debts represent one of the banking risks, a number of contingent circumstances might cause these probable risks to become a real problem. However, unless appropriate action is taken in due time by using suitable instruments, this problem would cause the national economy in general and the banking sector in particular to undergo a series of crises that would have an adverse impact on the State's economic activity.

Regarding the causes of domestic bank debts, we can generally say that there are common causes: some of these are external, resulting from international economic relationships, particularly those which govern commodity exports and imports and their effects on the country, while others are local, and are usually connected with the degree of economic advancement and in the developed industrial countries are quite different from those in the developing ones. However, it is beyond the scope of this lecture to mention the causes of difficult debts in the developed industrial countries, whereas those causing difficult internal debts in the developing countries - including the Arab countries - may be stated as follows:

First: Causes Relating to Demand for Credit:

Since loans that are extended to the government or to agencies and institutions guaranteed by the government do not face the problem of inability to pay, the situation is quite different for credit facilities to the private sector, whether provided to individuals or to projects. Very often, personal loans lack sufficient collateral, and most projects in developing countries are of small or medium size, and in most cases these projects do not apply an accounting system which enables the banks to evaluate their financial position accurately. Others which have accounting systems do not generally reflect their real position, either to evade paying taxes or to avoid declaring certain assets to be used as collateral to obtain loans from non-organized financing markets which occupy an important position in many of the developing countries.

Second: Causes Pertinent to the Supply of Bank Credit:

These causes are attributable to mistakes committed by bank management, either before or after the approval of credit facilities. For example, the bank management does not accurately examine the economic feasibility studies presented to the bank for project financing, nor does it scrutinize the information compiled about prospective clients. Furthermore, the bank management does not follow up on the loans and check whether they are appropriately used or not. Also, a part of these facilities is directed toward non-productive activities and the banks sometimes extend their personal loans as "favouritism", which plays an important role in this respect.

Third: Causes Relating to the Nature of the Developing Economy or Resulting from the State's Economic Ideology:

The developing economy is mainly characterized by instability, which can be attributed to many factors, including the following:

- Structural imbalance, as the economies of most developing countries depend on the production of one commodity, a crude material in general, whose prices and quantities are subject to volatility in the world market for this commodity, resulting in negative effects on the state's domestic economy.

- Connection with the world market, a fact which is reflected in the inability of domestic projects to compete with the increasing tendency in developing countries to import fully manufactured commodities.

- Many political changes, either in changing the regime completely or the governments frequently, a fact which results in unstable economic conditions in the country.

Fourth: The Problem of Foreign Debts and the International Economic System:

Apparently there is an interrelationship between the problem of foreign debts and difficult domestic debts in the developing countries, as a major part of these foreign debts is not directed to development purposes in these countries or because these funds are not used very effectively. Thus they have no significant effect on the growth rate of the national product. Moreover, the major portion of these loans may take place through banks under exclusive commercial conditions represented in a rise in interest rates and lending concentration in the American dollar, besides the increase in indebtedness resulting from the rise in the dollar exchange rate. All these factors, in addition to others, have caused the economic resources in these countries to be directed to servicing foreign debts and creating contractionary domestic conditions that have affected domestic economic activity and have precipitated a decline in the profits of these projects or real losses, which have left them unable to service the debts or settle the principal on fixed dates.

We should not forget to mention the difficulties facing these countries due to the nature of the world economic system and limitations imposed on their exporting capacity, a fact which aggravates the severity of their economic cycles and finally affects the borrower-producer's ability to pay.

It can be said that difficult debts in most Arab countries are attributable to all the causes stated above, in addition to other causes related to Arab Gulf countries, among which are the banks' expansion of personal credit facilities and the repercussions of the Iran-Iraq war, which causes a lack of the stability necessary for economic activity in the region. However, the most important cause of difficult bank debts in the Arab Gulf countries lies in the extensive changes in the values of financial and real estate assets, which represent the major part of collateral presented to banks to obtain credit facilities.

Further, unfavourable international conditions may increase the capital inflow. And with declining absorptive capacity of domestic markets in the

Arab Gulf countries, most of these funds go to investment in limited assets represented in stocks and real estate. With the rise in domestic liquidity, speculation begins on the prices of these assets, which leads to an abnormal rise in prices and consequently in their value as collateral accepted by banks against credit facilities. But as this speculation is relaxed, it soon causes a sharp drop in the value of these assets and consequently in the values of collateral held by banks. Sale of these assets by the banks may aggravate the problem due to the economic recession accompanying the drop in speculation.

We conclude from this that difficult debts are attributable to several causes, some of which are unexpected. Therefore, measures taken to encounter this problem do not aim to avoid all credit risks, but to ease them and prevent them from becoming a "problem" which threatens not only the banking system but also the whole national economy.

Though we have taken into consideration that the details of difficult domestic debts may differ from one country to another according to the conditions of each, we can demonstrate the general framework which may overcome the problem of difficult domestic debts as follows:

1- The banks should follow a sound lending policy built on basic elements represented in careful examination of credit applications, splitting the risks and follow-up of execution:

The basic rule for establishing a good loan portfolio should be built on the basis of the bank adopting a clear and comprehensive written lending policy. These policies should be associated with a systematic method followed by the bank in examining its lending operations. Further, the bank officials should set their lending policy within a general framework built on the basis of granting credit facilities according to sound lending rules providing them with security and collectibility within a general employment policy providing protection to depositor and profitability to the shareholder besides servicing the society's financing requirements. One of the important factors to be considered, upon drawing up the lending policy, is that this policy should be flexible enough to enable the bank to move easily in response to the new variations in economic conditions. The bank should also allow for the development of its lending policy in view of its available financial resources, its personnel system and its present and future services provided to the community. In addition, the bank should allow for the regulatory structure set up by the bank to implement its lending policy, setting up an efficient system for internal loan auditing, extending reports to the board of directors and providing it with various statements covering the achievements of the lending system and the position of the loan portfolio.

Sound lending policy includes a number of criteria such as defining finance priorities, relative distribution of banks; maximum limits for loan maturities; interest rate levels; a collateral margin; financial information to be provided by borrowers, whether individuals or companies; external auditing conditions of clients' balance sheets; the grand total of outstanding loans according to certain items on the bank balance sheet; credit concentration; lending powers; defining problematic loans which may turn into difficult ones; type of information and reports to be submitted to the board of directors and the bank's method of loan follow-up. And for the provision of bases for good internal supervision over lending operations, the bank's lending policy should specify the type of records kept by the bank, the information and documents to be contained in the client's file, the filing method and the period of credit auditing. It is worth mentioning in this respect that the lending policy with its different criteria should be clear and written before the credit facilities are granted.

The failure of bank management in setting up a comprehensive lending policy constitutes one of the major causes lying behind many financial problems the bank faces as a result of an increase in the number and value of difficult loans. Thus, it can be noticed that setting up a lending policy for any bank aims at realizing an ultimate goal represented in reducing the number and value of this kind of loan. Thus, the lending policy should be set up to prevent causes leading to a rise in the values of loans that may become difficult. There are many causes leading to this type of loan, such as the provision of big credit facilities to members of the banks' board of directors and to companies owned by these members without the application of sound lending rules by the bank, the banks' interest in profit at the expense of risks, the banks' failure to abide by sound lending principles should the borrower be influential, the giving of loans based on insufficient financial information, incomplete loan agreements and the granting of loans based on personal self-content on the part of the banks' authorized officials. Other causes are weak supervision of loans, including the follow-up of clients during the loan period, the inefficiency of financial analysis systems at the bank, the expansion in providing exceptional lending and the over-granting of facilities for the sake of competition, without a base of sound lending principles.

2- Internal Loan Auditing:

We mentioned before, that sound lending policy should be simultaneously associated with a systematic method of loan auditing, applied by the bank to discover any credit problem and take necessary measures that would early prevent the occurrence of any problem. This kind of auditing should not be made only when the credit period expires but should be continuous throughout the duration of the loan. Internal auditing enables the bank to classify credit facilities on acceptable bases so that appropriate provisions are deducted according to facilities classification. Realizing the importance of internal auditing, the modern bank organization includes an independent department to examine bank facilities and find out any credit problem. In my opinion, an effective internal loan audit can be made by a combined effort of both an independent auditing department and loan managers, as the latter are more closely connected with clients and are more aware of their problems. This will enable the auditing team to discover any real problems in due time.

3- An effective role should be played by central banks and monetary authorities in view of their responsibility in this respect:

On the one hand, regulations should be imposed on banks to rationalize their policy in credit provision and the control of its usage. Necessary amendments to these regulations can be made whenever needed, in light of new developments. Further, the Center of Risk should be developed and supported to facilitate the process of providing information requested by banks about creditors or applicants for credit facilities. On the other hand, supervising bank solvency and building up provisions are among the most important factors that help to absorb any risks facing banks as a result of difficult debts.

Further, the central banks in the countries qualified to have money and financial markets, must take part in advancing and developing these markets, as an advanced financial market would provide effective services in circulating capital between investors and borrowers. This constitutes a substitute for lending from banks, in addition to the briskness added by an advanced financial market to economic activity in general.

Now allow me to tackle the facets of this problem in Kuwait.

The Facets of the Problem in Kuwait:

During 1984 the Kuwaiti banks faced the problem of difficult debts, when some debtors abstained from paying for real or alleged causes. The Central Bank of Kuwait undertook a number of measures to comprehend and remedy the problem and to maintain the sound financial position of the Kuwaiti banks, taking into consideration the debtors' special circumstances.

Credit facilities matters had been rather natural from the early seventies until the beginning of that period, when credit facilities witnessed high growth rates which did not jeopardize the general economic situation or the financial position of the Kuwaiti banks because most of these credits were directed to productive units of the private sector which were capable of paying and expanded under the impact of the optimistic outlook which prevailed in the country during that period.

However, at the beginning of the eighties several developments precipitated unnatural economic activities in Kuwait. The average interest rates had begun to decline in the international market by the end of 1981, causing an increase in the tendency for capital to stay home, the result of which was a liquidity surplus with the banks and investors. These events coincided with the decision to prohibit the establishment of new shareholding companies. And due to narrow local investment opportunities, investors moved to establish new Arab Gulf companies with Kuwaiti capital. Shares of these companies were traded on the parallel market in Kuwait, the "Al-Manakh Market". With the continuation of the liquidity surplus, speculation began on the stocks of these companies, which quickly extended to include the stocks of Kuwaiti companies in the official market. The phenomenon led to a sharp rise in the market value of financial assets and consequently to an increase in the value of investment and commercial real estate, particularly with the expansion in post-dated dealings, which created a substantial and unorganized credit market, separate from the organized market.

These factors were associated with structural changes in domestic credit facilities provided by commercial banks, which led in 1980 to an increase of 80% above their levels in 1978. There was also a qualitative change represented in the banks' expansion in personal loans, which were basically directed into speculation, as their rate of increase reached 100% in 1980, compared with 1978. Further, banks provided credit facilities against collateral of financial and real estate assets valued then at market prices which were abnormally high due to speculation.

Despite all procedures already taken by the Central Bank in the area of banking supervision, the sharp rise in speculation hindered these procedures from playing their required role. Desirous of high rates of profit, banks raced to offer credit facilities, and the total personal, real estate and financial credits extended by commercial banks to the private sector in 1981 rose by 40% and by the end of the second half of 1982 these credits increased by 56% above the corresponding period in 1981.

Since the middle of 1982 a number of factors had reacted to create conditions adverse to those dominating the Kuwaiti economy during the preceding period. These factors were depressive, having negative effects on economic activities in general and on the sectors benefiting from credit facilities in particular and the reflections of these factors on banks.

These factors can be divided according to their nature into two kinds: local and external, although both interacted to produce the results indicated above. Local factors were the decline in rates of demand for goods and services, particularly in view of the change in the unusual pattern of consumption which prevailed in the previous period, coupled with the feeling that the wealth of individuals and institutions was decreasing as a result of a decline in the value of financial and real estate assets. External factors were represented in the decline in oil prices, which affected the size of public revenues and consequently the volume and trends of expected growth in public expenditure, which constitutes the main impetus of economic activity. Furthermore, the continuation of the Iran-Iraq war aggravated the state of anxiety and adversely affected economic activity. In addition, it brought about a decrease in re-export activity for many reasons, among which were the opening of new ports in some neighbouring countries and their tendency to import directly from foreign markets.

All these factors worked altogether, leading to two significant results: first, the lack of rationalism on the part of banks regarding the provision of credit facilities during the past period; and second, the Al-Manakh crisis with its consequent decline in asset values and the deterioration in the financial positions of many clients borrowing from banks. The efforts of these institutions to face the problems of their financial positions led to a deceleration in their performance rates, which resulted in the limitation of options available to them for tackling the imbalances in their financial positions. This brought about a decrease in clients' capability to serve and settle their debts to banks and eventually led to the emergence of non-performing bank debts vis-a-vis the Kuwaiti banks.

In addition to many supervisory measures already taken by the Central Bank shortly before the emergence of the non-performing debt problem, the Central Bank took other measures to meet this problem. The Central Bank's policy in this connection covers two aspects, as follows:

First: The Central Bank limited the problem by setting “rules and principles classifying credit facilities and computing their pro-visions and profits.” These rules defined the non-performing credit facilities according to technical and objective criteria such as the maturities of facilities, exceeding drafting limits, paying of loan interests and instalments and legal proceedings against clients or their declaration of bankruptcy. The Central Bank's instructions to the banks provided that they should build up a general provision of 5% against the portion not covered by collateral in performing credit facilities and build up specific provisions at a rate ranging from 15% to 100% against the portions not covered by collateral in the non-performing facilities and according to the causes of irregularity. Further, the Central Bank issued instructions regarding the assessment of financial and real estate portfolios and the bases of fixed assets depreciation so as to define the banks' real financial positions.

Second: The Central Bank established a program to limit and solve the problem, namely the difficult credit facilities settlement program, which was approved by the Council of Ministers in August 1986. The provisions of this program shall apply to non-performing facilities which were extended before the implementation of this program to residents whose financial positions show deficits. This program also stressed that debt settlement must be based upon the joint participation of both debtor and creditor. Further, this settlement shall be made within the debtor's ability to pay, provided that the debtor should be allowed reasonable housing and income that will maintain a dignified living for himself and his family.

Furthermore, the program set a number of detailed matters including:

- Setting unified settlement procedures by which all banks shall abide during the period in which information is collected about the debtor's financial position, indicating the rules to be followed upon the settlement.

- Maintaining sound financial positions for the Kuwaiti banks by providing them with appropriate support.

- The State's commitment to maintaining the shareholders' equity as it was on December 31, 1985 and to guarantee the rights of depositors.

To prove its serious application and maintenance of banks' rights, the program specified the creditor bank's right to resort to legal and judicial measures if the debtor fails to submit the required information within the specified period, if the debtor rejects the settlement program prepared by the bank, if the bank discovers after the settlement has been concluded that the settlement was based on inaccurate and misleading financial information given by the debtor, or if the debtor reneges on his obligations as stipulated in the settlement agreement.

It is worth mentioning, however, that banks did not actually begin implementing the settlement program until the beginning of this year, in the wake of completing the necessary settlement measures. And in the light of the latest relevant data and information, it can be said that the program has achieved great progress in solving the problem of difficult bank debts.

Taking into consideration the lessons learnt from this problem, the Central Bank is working to develop a number of rules and procedures that suit the conditions of the Kuwaiti economy and aim at lessening credit risks by means of rationalizing bank policy in granting and following up credit, and encouraging credit facilities to be directed to productive economic sectors. These rules and procedures also aim at protecting the Kuwaiti banks' financial positions by means of setting criteria for bank solvency and by building up provisions necessary to meet difficult debts. Further, the Central Bank seeks to strengthen the role of the financial market in promoting and encouraging savings and in channelling these savings into investments by setting rules which add flexibility to trading in the market whether by diversifying savings outlets, or converting financial assets into liquid assets as soon as possible and at the lowest cost, or in moving from one investment area to another.