



CAPTON

3 Strategies for Reducing Non Performing Loan (NPL) Ratios

“ By the end of 2020, the US had \$127.6bn in NPLs, and Europe was battling a €401bn wave of new bad loans ”

NPLs during Black Swan Events

According to Goldman Sachs, the current state of non-performing loans, regardless of which part of the world you live in, is increasing or will increase to unprecedented levels. During the 2009 Financial Crisis, the number of non-performing loans (NPLs) doubled. The downward trend that ensued has now been reversed by the COVID-19 global pandemic.

NPLs have different geo-political characteristics, with the USA markets being the earliest to address this issue after the 2008 crisis. COVID-19 has impacted NPLs differently across different regions. USA has deferred the potential crisis by leveraging government 'pandemic programs' that reduced bankruptcies, but by the end of 2020, the US had [\\$127.6bn \(up from \\$95bn end of 2019\) in NPLs](#), and Europe was battling a [€401bn wave of new bad loans](#). In APAC, which is more densely populated, retail loans are much higher, with unemployment rates much higher too. Gartner suggests a 15-20% impact in NPLs in the US but in APAC it could be much worse at almost 40%.

In 2009, the financial crisis was triggered by the financial sector. Banks were able to find out how much exposure they had to real estate. They could categorize how much of their loan book was in real estate and view it as a loss. The global pandemic did not originate from the financial sector so it wasn't clear which sector was or was not impacted. It appeared that the Pharmaceutical industry and IT industry were safe but what else was safe? Even now, Banks and financial institutions aren't able to see or predict which industries or loan portfolio areas are safe.

Impact of NPL Ratios

NPL ratio is the amount of loans written off and non-payment of a loan beyond 90 days to the total loaned amount. The impact of NPLs on lenders' profitability is in two key areas:

- (1) When a loan is not recovered, there is a NET loss
- (2) There is an increase in costs to manage NPLs since traditionally, managing NPLs involves manual processes, paper based workflow requiring both human capital and time



There are several stakeholders for whom a lenders' NPL Ratio is important:

Financial Analysts



Financial analysts use the NPL ratio to assess the quality of loan portfolios within and between banks. Lenders with high NPL ratios are perceived as taking high risks which could lead to bank failures.

Economists



Economists take a broader view of financial markets and use NPL ratios to predict potential instability.

Investors



Investors favor banks with low NPL ratios as being lower risk investments than those with high ratios. They use NPL ratios to guide their choices on where to invest their money.

In general, higher ratios of non-performing loans are associated with lower growth rates of performing loans. Banks with higher decreases in their ratio of non-performing loans tend to lend more to the real economy. For example, Japanese megabanks are facing weakening credit quality of domestic borrowers, after reporting the [highest non-performing loan ratios](#) in more than three years for the March-end quarter.

3 Strategies for Reducing NPL Ratios

As we have entered the new normal of a still-in-pandemic 2021, it is important to safeguard yourself from increasing NPLs. Certainly, nobody predicted, for example, that the number of loans with forbearance requests would [increase by over 1000%](#) during each two-week period in March 2020.

So whether you are below or above the national NPL average, there are 3 key strategies you can leverage:

- (i) **Detect potential NPLs early**
- (ii) **Decrease cost collection**
- (iii) **Prevent NPLs with better borrower analysis**



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Detect Potential NPLs Early

99%

**accuracy
in NPL
prediction**

3-12

**months
in advance**

Loans are usually classified as non-performing if the borrower defaults on the loan, declares bankruptcy or loses the income needed to repay the debt. Since the probability of loan repayment reduces significantly after 90 days, non-payment beyond 90 days has become the de facto standard for designating a loan as a non-performing loan. But “past due” payment is a lagging indicator and doesn’t give a bank the opportunity to proactively rectify the situation.

There are many early indicators that the borrower has a growing need for cash. A borrower may be applying for multiple credit lines. Or over-using overdrafts. They may be late supplying information or not paying their suppliers. If these indicators are assessed early enough, the bank can reach out to the borrower proactively and create a more positive repayment outcome.

Early Warning Systems for NPL detection that leverage AI/ML as well as behavioral analytics can predict NPLs months in advance. Prediction accuracy increases with increase in data — 7 years being ideal! Some banks have seen 99% accuracy in prediction that a loan could potentially turn into a non-performing loan. An example of such an Early Warning System is [Capton\(™\) AI NPL EWS](#) which can predict NPLs 3, 6, 9 and even 12 months in advance. These AI-powered early warning systems can provide accurate predictions derived from powerful models.



Decrease Cost Collection

“(To decrease ‘cost collection’ expenses...it is much better if the lending department can work with the customer”)

In the banking and credit markets, a problem loan is one of two things: It can be a commercial loan that is at least 90 days past due, or a consumer loan that is at least 180 days past due. In either case, this type of loan is also referred to as a non-performing asset (or non-performing loan). Most banks make provisions for credit losses and postpone the final disposal of non-performing loans. But if the underlying collateral asset loses value, the bank could suffer further losses. Moreover, by holding a non-performing loan for a long time there are more costs — such as potential returns if the asset were “performing” as projected.

To decrease the “cost collection” expenses a bank would incur in going after NPLs, it is much better if the lending department can work with the customer and try to resolve the issue. Waiting for the customer to default and then waiting 45 days to be transferred to the Loan Workout Department just erodes profitability. Again, using an [Early Warning System](#) that predicts the probability that a loan could default, can help the lender work with the borrower to avoid loan defaults.

Prevent NPLs With Better Borrower Analysis

The best strategy to reduce NPLs is, of course, to prevent them from occurring in the first place by thoroughly analyzing the borrowers profile. Whether in commercial or consumer lending, it is critical to Know Your Customer (KYC) and understand their risk profile. Profile details cover a vast amount of data – for example, loan details like loan amount and interest rate.

With digitization of Core Banking Systems, it is easy to access account details like newly opened account, revolving balance & total balance. Traditional lending can view personal details like employment type, employment duration, home ownership and annual income. Historical data like payment history (earliest credit line, previous delinquencies, FICO high/low), collection history (recoveries, payments made, late



56%
of bankers
find “the
manual
collection of
data and
subsequent
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with the client”
as their biggest
challenge in
starting the
loan process.

payment), and hardship history, all provide a rich understanding of the borrower’s profile.

There are several solutions that optimize the loan decisioning process. Until recently, collecting client data was a labor intensive process. In a recent poll conducted by Moody’s Analytics, the question was asked “What is your biggest challenge in initiating the loan process?”, to which [56% of bankers](#) surveyed answered “the manual collection of data and subsequent back and forth with the client”.

Banks and other financial institutions have [yet to improve their lending processes](#) via technology. Although there is a great deal of adoption of AI in banking, it is mainly consumer facing applications like chatbots that have become ubiquitous. But now there are several loan origination and loan decision solutions emerging, for example Capton AI [Intelligent Credit Scoring \(ICS\)](#) applies over 25 attributes — beyond traditional FICO — and enables loan decisioning in 30 seconds!

As the loan decisioning workflow is being optimized, it serves as a great deterrent strategy for preventing NPLs by increasing the analysis and validation of borrowers.



Enable loan decisioning in 30 seconds



Over 25 data attributes — beyond traditional FICO



“ At the end of last year, American households held \$14 trillion in debt ”

3 Strategies for Reducing NPL Ratios

“The world’s largest banks are preparing for a dramatic rise in defaults and bad loans as the coronavirus outbreak wears on consumers, businesses and social safety net systems around the world” — As the world’s banks brace for a [rise in loan defaults](#) thanks to COVID-19, JPMorgan Chase, Bank of America, and Wells Fargo have warned that they are setting aside billions of dollars to guard themselves against customers and clients who may not be able to fulfill their loan obligations. At the end of last year, American households held \$14 trillion in debt — including more than \$900 billion in credit card debt, and more than \$1.3 trillion in auto loans — according to the Federal Reserve Bank of New York.

In the second half of 2021, it is extremely likely that with the economic and financial stress from a coronavirus pandemic that has sent unemployment soaring and shuttered non-essential businesses across the country, many may not be able to fulfill their loan obligations. Therefore a judicious approach to reducing the NPL Ratios with 3 key strategies — ***detecting, reducing collection costs and preventing NPLs*** — should utilize innovative tools and AI/ML technologies for predicting NPLs with high accuracy and with long forecast horizons.

For more information on timely strategies and AI solutions to proactively predict NPLs, contact Capton Inc.

Contact Us

CAPTON

capton_team@capton.com

+1 (855) 208 5688

www.capton.com