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Effect of Financial Development on Non-Performing Assets : Evidence from Developing Asian Countries[1]

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Abstract

The research examines the link between financial development, structure, performance, and NPAs. The sudden failure of banks in developing economies of Asia is largely driven by banking instability due to a high level of NPAs and increasing banking fraud. Hence, it is crucial to investigate the position of NPAs in developing Asian countries and thereby propose measures to resolve the problem of bad loans. On country-level data from 23 developing Asian economies from 2005 to 2020, the author used a dynamic panel data model to identify the association between financial development/structure/performance and NPAs. We find the improvements in performance metrics such as banking efficiency, profitability, diversification activities, and loan loss coverage ratios contribute to a decrease in the level of NPAs. Higher financial development also aids in the reduction of nonperforming assets because of the increase in resources of the banking sector. Further found the importance of financial structure indicators like banking competition and concentration in reducing the level of NPAs

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I. Introduction

NON-PERFORMING ASSETS or NPAs reflect the quality of the loan portfolio of banks. National banks, supervisory authorities, and international agencies devise vast number of policies and regulations to maintain a stable and well-functioning financial system as well as safeguard the rights of all stakeholders. Despite this, there are worst incidences of declining bank asset quality, which poses significant questions for banks, their administrators and credit controllers. Bank's ability to fulfill its financial

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This study also acknowledges the importance of financial structure indicators like banking competition and concentration on nonperforming assets where banking competition and concentration are negatively associated. Empirical findings of this study supported the 'too big to fail' hypothesis which means higher capitalization may secure high profitability but at the same time it leads to a higher level of NPAs due to reckless behaviour of bank managers in lending operations. Hence, the study suggested that a better credit monitoring process is a prerequisite for better asset quality management and for ensuring banking stability by controlling NPAs in developing economies. The author encounters a few limitations during the study. There is two years lag in data and analysis conducted on unbalanced data because of unavailability of data.

Our results have policy implications. For the smooth functioning of banking sectors, banking regulators should have a proper understanding of the important determinants of NPAs to form policies and regulatory measures to reduce their risk. Poor supervision of lending standards of all banks and other non-banking financial institutions results in banks engaging in poor credit portfolios that lead to the problem of NPAs in developing countries. Central bank regulators need to acknowledge the role of financial development in influencing the level of NPAs and further, ensure regulation and supervision of the credit lending process of the banking sector. This investigation of the effect of financial variables on NPAs will help financial regulators and individual banks in adopting appropriate financial measures for mitigating the NPAs which are required to restore the sound banking system, preserve financial stability and prevent recessionary economic trends.

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