UNIVERSITI PUTRA MALAYSIA

A CASE STUDY ON NON PERFORMING LOANS: HONG LEONG FINANCE'S EXPERIENCE

CHEW SHEK NEE

GSM 1999 15

A CASE STUDY ON
NON PERFORMING LOANS :
HONG LEONG FINANCE'S EXPERIENCE

BY: CHEW SHEK NEE
GSO1408

MALAYSIAN GRADUATE SCHOOL OF MANAGEMENT
UNIVERSITY PUTRA MALAYSIA
SERDANG, SELANGOR
1999

A CASE STUDY ON
NON PERFORMING LOANS :
HONG LEONG FINANCE'S EXPERIENCE

BY: CHEW SHEK NEE
GSO1408

THIS PROJECT PAPER IS SUBMITTED TO THE MALAYSIAN GRADUATE SCHOOL OF MANAGEMENT, UNIVERSITI PUTRA MALAYSIA FOR THE PARTIAL FULFILLMENT FOR THE REQUIREMENT OF MASTER OF BUSINESS ADMINISTRATION PROGRAM.

ACKNOWLEDGEMENT

I would like to express my sincere gratitude to Dr. Zainal Abidin Mohamed in giving invaluable advice and suggestions throughout the course of the preparation of this project paper.

Sincere thanks also go to both of my colleagues in giving their suggestions and guidance in completing this project.

ABSTRACT

HLFB is one of the leading financial institutions in the country. The company has achieved quantum leap in the increase of the number of branches at the end of 1993 with the acquisition of Visia Finance Berhad. The company was the first finance company in the country to computerize the deposit and loans business between 1981 and 1985. In 1999, HLFB has embarked on opening "In Store" branches.

The loan base of the company had increased rapidly, especially from year 1996 to 1997, from RM5,721 million to RM7,544 million and the loan base had grown by 32 percent within the stipulated period. Due to the high loan base, the company has embarked on loan regionalization (decentralization) in September 1996. With the regionalization, it reduces bottleneck in head office.

Non-performing loans (NPLs) of the company is rising, from RM177 million in December 1995 to RM1,166 million in March 1999. In terms of percentage, the rate had increased from 4.4 percent to 16.6 percent within the stipulated period. The Chief Operating Officer was very concerned on the rising NPLs and the manager of credit control department was requested to look into the issue.

In the past, the company had focussed its lending on corporate loans. The case reveals that corporate loans had contributed to majority of the

NPLs and Kuala Lumpur Main office and Johore Bahru Regional loan centre were the two offices that had the highest NPLs rate.

To overcome the problem faced by HLFB, two approached were recommended to implement for the reduction of NPLs rate. These two approaches are an immediate approach and preventive approach. Eight different ways to reduce the NPLs under immediate approach were recommended. A preventive approach is quality lending. This approach is used to prevent new loans from becoming problem loans. In this approach, more emphasize is based on quality instead of quantity. Recommendation was make to change the portfolio mix of the company, that is to go for more consumers lending instead of corporate lending, as the risk for corporate loans is higher.

To ensure a successful implementation and also to achieve a desirable result, HLFB must always improve the process by going through the process of Planning, Deploying and Reviewing.

PART 1

TABLE OF CONTENTS

PART 2

TABLE OF CONTENTS

1.0 INTRODUCTION

"Although I have been emphasizing on loan management system, I don't see any marked improvement in our loan management system. Transactions have been on-line but I still hear staff working overtime clearing their jobs at the Regional Centers. Non-performing loans have been in the increasing trend and there have been complaints that loan approvals were not fast enough and the Regional Managers were having hard times securing good loans", said the Chief Operating Officer, Mr. Lee Kam Chung.

The early morning meeting with the credit control and the credit evaluation department personnel' was convened to thrash out issues pertaining to the loan management system as well as the loan evaluation system. Kam Chung had been going round visiting the branches and regional offices, and he had been hearing grouses from those at the branches and in particular the regional offices. He pondered on whether the implementation of the loan management system and evaluation system had brought about increased efficiency and productivity. Why were there still a rise in NPL despite the economic is recovery?

"Mr. Lee, it has been better now since mid of this year. I agree that there are still matters that need to be iron-out and we are working towards it", said George Ng, the Manager, Credit Control Department. He oversees the loan management system of the organization. "During the recent months we have detected incidence of fraud in the loan application and we have tightened the credit evaluation system. More cross references were done with outside parties to confirm status of applicants. ", added Ms Jenny Oon, Manager of the Credit Evaluation Department.

"Both of you are aware that during these hard times organizational inefficiencies would adversely affect our bottom line. Already we have hit rock bottom last year and I want to see improvement this year", said Kam Chung.

"In the QSBM (Quarterly Strategic Business Meeting) the chairman had stressed on being competitive in the industry. Though this advice is not new to both of you, I can't seem to understand why our people are not geared towards this", added Kam Chung.

"George, I want you to look into the NPL matter urgently and to revert to me in the next two weeks. I want to know the cause to these issues as further delay will affect the bottom line", said Kam Chung

2.0 THE COMPANY

Hong Leong Finance Berhad (HLFB) was incorporated in Malaysia on May 6, 1968 as a public company and the paid-up capital was RM263 million. The company was one of the leading financial institutions in the country according to the Association of Finance Companies 1998 directory. HLFB was a licensed lending company providing financial services to the domestic market.

It provides a wide range of financial products including depository services such as savings, fixed deposits and unit trust, general and retail consumer financing such as hire purchase, housing property financing, share margin financing and stock financing. It also offers corporate financing which includes mortgage loans building finance, leasing, revolving credit, factoring and industrial hire purchase. Details of the products are as per appendix 1.1. It also issued the Visa credit card.

According to the Senior Manager of Operation Department, Mr. Low Seng Zin, since the incorporation of HLFB, there had been steady growth in the number of branches. As at end of 1998, HLFB have 82 branches located throughout Peninsular and East Malaysia. Table 1.1 indicated that the organization achieved quantum leap in the growth in of number of branches in end of 1993 with the acquisition of Visia Finance Berhad. With the acquisition, HLFB had strategically placed its business expansion in line with its mission statement "Your Community Financier" to reach out the general public.

TABLE 1.1

Hong Leong Finance Bhd - Growth of Branch Network

	1970	1980	1990	1993	1994	1995	1996	1997	1998
No. of branches	4	10	27	45	54	64	72	82	82

Numbers of employees increased to 1646 in 1998 from only 898 employees in 1995.

In 1999 it further embarked on opening "In-Store" branches. It was a tie-up arrangement with Carrefour. These "In-Store" branches were located in the Carrefour hyper-markets for the convenience of shoppers. It offered a wide range of facilities from deposits to loans. The first such "In-Store" branches was opened in Plentong, Johore Bharu in February 1999. It currently had five more such branches in the list.

The Chief Operating Officer who was very much concerned on the development of technology and in line with the advent of technology, had identified the use of IT as a critical success factor to achieve the company's vision and mission and had employed the use of computers since 1981. The current system is the UNIX-based client-server technology which supports:-

- On-line real-time architecture
- All branches linked to a central database via WAN
- 53 ATMs at the branches which is operational 24 hours a day.

As revealed by Seng Zin, HLFB was the first finance company in the country to computerize the deposit and loans business between 1981 to 1985 and also a pioneer member of the country's first combined multi-financial institutions ATM network, named GREAT.

In September, 1996 it was granted the Tier-1 status by Bank Negara Malaysia after having complied the CAMEL rating framework i.e. Capital adequacy, Asset quality, Management efficiency, Earnings performance and Liquidity position.

3.0 FINANCIAL PERFORMANCE

Table 1.2 indicates the financial statistics from 1994 to 1998 for profit before tax, shareholders funds, deposits, loans and advances. In 1998, the performance dipped abruptly in which profits was registered at RM16.0 million only. Despite that, its shareholders funds grew marginally in 1998. The decline in loans base was primarily attributed to the high interest rates, unfavorable exchange rate, the decline in general business activities and the growing concern on non performing loan. The country had experienced an economic slowdown since the third quarter of 1997 and the impact on the financial industry was felt in early 1998.

However, table 1.2 showed that there was a significant rise in its deposit placements by customers during the same period. This was primarily due to the high interest rates offered during the period. Deposits were significant source of funds to financial institution as it was relatively cheap compared to the borrowings from money market. However, during the economic downturn in 1997 and 1998, there was escalation in deposit interest rate. It surged as high as 13.5%. This had brought about increase in cost of funds to maintain its operations and lending activities.

TABLE 1.2

Hong Leong Finance Bhd - Summary of the Financial Highlights (in RM million)

	1994	1995	1996	1997	1998
Profit Before Tax	56	93	110	125	16
Shareholders' funds	198	299	349	466	510
Loans and Advances	3,213	4,060	5,721	7,544	6,945
Deposits	3,377	4,173	5,092	6,658	8,062

The published Profit and Loss account for the past 3 years (1996 to 1998) showed an increasing tread of its interest income from RM483 million to RM 682 million and RM 916 million for 1996, 1997 and 1998 respectively. With the decline in profitability, it earnings per share dropped from 39 cent to 2 cent during the same periods. Loan loss and provision increased from RM14 million to RM99 million from 1996 through 1998 (See Table 1.3).

TABLE 1.3

PROFIT AND LOSS ACCOUNT FOR THE FINANCIAL YEAR ENDED JUNE 30

	1996 RM '000	1997 RM '000	1998 RM '000	**(6 months)** **31-Dec** **1998** **RM '000**
Interest income	483,133	682,022	916,553	455,994
Interest expense	(296,350)	(449,993)	(699,618)	(374,497)
Net interest income	186,783	232,029	216,935	81,497
Loan loss and provision	(14,357)	(27,437)	(99,275)	(28,503)
	172,426	204,592	117,660	52,994
Non-interest income	20,305	22,073	9,296	15,666
Net income	192,731	226,665	126,956	68,660
Overhead expenses	(82,616)	(101,563)	(110,740)	(47,130)
Profit before taxation	110,115	125,102	16,216	21,530
Taxation	(44,184)	(40,821)	(12,338)	-
Profit after taxation	65,931	84,281	3,878	21,530
Transfer to statutory reserve	(16,483)	(42,140)	(970)	(5,383)
Profit after transfer to statutory reserve	49,448	42,141	2,908	16,147
Retained profits brought forward	43,297	76,680	98,528	101,436
Profit available for distribution	92,745	118,821	101,436	117,583
Proposed dividend	(16,065)	(20,293)	-	-
Retained profits carried forward	76,680	98,528	101,436	117,583
Earnings per share (sen)	39	45	2	16

Source: Hong Leong Finance Annual Report

4.0 BUSINESS PLAN

During the business plan and budget conference held in May, 1997, the following were formulated:

Group Industrial Master Plan (GIMP)

a. Achieve a profit before tax of RM400million.

b. Achieve 120 branch network

c. Deposit Base of RM16.1 billion

d. Loan Base of RM12.8 billion

e. Excellent customers Service

The achievement of profits, branch network, deposit and loan base were expected to be accomplished by the year of 2000. To achieve the Group Industrial Master Plan, HLFB strived to build a team of responsive, innovative and customer driven staff force. It also focused on building an electronic machinery that could respond to any challenges, any time, within a short span of time. A team of thinkers would also be build so that HLFB not only were able to respond to competitor's challenge but also able to understand customer needs in an environment of fast changing lifestyle. A series of customer modules would be initiated which when delivered lives up to their tagline of " Your Community Financier" whose objective is to bring world class products and services to satisfy the individuals' financial needs in the community including their business needs.

According to Seng Zin, over the past years the Training unit under the

Human Resource department had been active in upgrading the level of staff competency in the company. However, during those times HLFB had been plagued by high staff turnover, which had resulted in the outflow of trained personnel causing discontinuity in staff succession plan and drop in moral. The computerized system had been completed and had been periodically enhanced to improve existing systems. However, there are still a lot to be done to catch up with the enhancements to the present systems due to the interruptions of new products being constantly introduced. As new products been introduced the programs to these products needs to be incorporated in the loan system. HLFB had successfully introduced a series of innovative products which had enhanced the revenue of the company. And in the area of customer service, HLFB has introduced the CFCs, the Community Financial Consultants to act as assistance for customers financial needs.

Business Direction

For the financial 1997/98, HLFB directed their attention on the following issues:

a. Developing a new breed of Managers

   As new branches are opened, managers will be required to manned it with their team of personnel.

b. Changing the loan portfolio mix

   Composition of portfolio mix with interest calculation on flat rate versus pegged to base lending rate had shifted from 60:40 ratio to 50:50 ratio over two years. Flat rate loans were those that the rates were fixed at the inception of the loan. Loans that are pegged to base lending rate are those that were charged with floating rate with certain percentage margin above the base lending rate. As the base lending rate moved either downward or upward, the interest rate to these type of loans would also moved accordingly. Floating rate loan would help to cushion the impact of interest rate risks to HLFB during the time of increasing cost of funds.

c. Growth in size

   i. To justify paid up capital and returns to shareholders

   ii. Ability to withstand large losses

   iii. For competitive edge

   iv. Economies of scale

Key marketing concept was mass marketing, with concentration of efforts on selected or preferred customers.

a. Priority in the innovation of BLR rated loan products

b. Continuing efforts to increase deposit base.

c. Advertising campaign to gain corporate mileage and brand value

d. Continue to pursue IT development

Critical Success Factors

According to Seng Zin, HLFB's critical success factors towards the GIMP had been identified into four areas; that were the Human Resource Management, then Customer Service Excellence, followed by Innovative Products and finally Research and Development in processes and Information Technology. The critical success factors were aimed to strive for the success of the GIMP.

5.0 THE INDUSTRY

The finance companies, under the supervision and control of Bank Negara Malaysia (BNM), have expanded their operations substantially to become the second largest mobilisers of public deposit funds in the country after commercial banks, as well as the second most important institutional source of private sector credit. They operate in the short-to-medium-term credit market, extending mainly hire-purchase finance, leasing, housing loans, term loans for business and private purposes. They offer savings and fixed deposit facilities to their clients.

Over the last decade, finance companies have benefited tremendously from the strong economic growth and deregulation of the banking industry. Bigger finance companies are currently allowed to participate in the interbank money market and issue negotiable certificate of deposits. Other new services like interest-free banking, financial guarantees and one-month fixed deposits are currently offered by finance companies. There are less reliant on vehicle hire purchase business but more diversified into lending to industrial hire purchase and corporate loans. This has enabled the finance companies as a whole to play a more effective role in the nations economic development. There was active participation by the finance companies in helping the Bumiputra community, small scale enterprises, petty traders and hawkers, and financing of low cost houses through various schemes implemented by BNM.

A two-tier regulatory system was introduced in 1996 as part of the effort to build a core of well-managed and well-capitalized financial institutions. Under the system, finance companies which met the eligibility criteria set by BNM (designated as Tier-1 finance companies) are allowed to provide a broader range of services and operate in a more liberal environment. Among these are the provision of factoring and remittances (within Malaysia) services, participation in venture capital financing and special funds established by BNM, issuance of NID's (Negotiable Instrument of Deposits) up to five times the capital funds, and granting of unsecured business loans up to a maximum of RM500,000. To date, four finance companies including HLFB have been accorded the Tier-1 status. Due to the large number of finance company, the government has decided that the finance company merged to form a larger entity so that they can become competitive. The exercise to merge smaller finance companies with anchor finance companies was on-going.

There was also increasing intense competition for loans in the industry and costs of deposits were rising; resulting in narrow margins. Inflation was causing a rise in the cost of operations. Due to economic downturn, the industry's bottom line was being squeezed thin, the return on assets and the return on shareholder's funds had been lowered if not diminished. In the past the respective financial institutions chose their customers, today customers have the choice of selecting their bankers. The constant changes and increasing complexity of customer's needs required the competing firm to constantly develop efficient, innovative, and dynamic services to their customers. They have to continuously improve their quality of services through information technology to gain the advantage of speed and accuracy.

In comparison to the top 10 of the finance companies in the country, the performance of HLFB was above the average of the top 10 finance companies. In 1997 it was in the 4th position in terms of assets base (Appendix 1.2).

6.0 COMPETITORS

HLFB served all segment of the market regardless of their ages and races, individual or corporation. According to Association of Finance Companies 1998 directory, the company was ranked fourth in 1997 with a total assets of RM8.2 billion, after Mayban Finance Berhad, Arab-Malaysian Finance Berhad and Public Finance Berhad.

Besides facing the competitors from other finance companies, HLFB was also facing competition from commercial banks, credit issuing house and merchant banks. Due to higher operating cost for a finance company in which their cost of funds were generally higher than the banks, HLFB offered secondary lending activities as compared to the banks. However, within the finance companies in the industry, its pricing on the loans and deposits interest rates was considered very attractive and competitive. Thus, it was able to remain as a premier lending institutions in the country.

According to Kam Chung, being a member of a well diversified Hong Leong Group of companies, HLFB enjoyed synergistic effects of joint collaborations between member companies in the group. It benefited in terms of facilities utilization's, cultural awareness as well as having a common objectives of improving the overall organizational profit. It was common for the company to compare notes of mutual interest and to arrange business programs to assist one another such as cross selling of financial services.

7.0 THE MALAYSIAN ECONOMIC OUTLOOK

The Malaysian economy was affected when the financial turmoil hit the small South East Asian economies in 1997. However, there was growing optimism that recovery had finally started. For starters, the first quarter's negative 1.3 per cent in real GDP, a marked improvement from the minus 10.3 percent was recorded in the fourth quarter of 1998 (See Table 1.4).

The positive growth in the manufacturing sector for three consecutive months reinforced the notion. However, recovery will not be broad-based, meaning that not all the sectors will recover at the same rate. The main sectors that would contribute more significantly to recovery were the manufacturing and services sectors. Although hurt by falling prices, the agriculture sector posted good gains during the first few months of 1999. Meanwhile, the mining sector continued to decline, largely due to the drop in production of crude oil. The construction sector will remain negative in 1999.

TABLE 1.4

Quarterly Real GDP (Percentage change)

	1998				1999
	Q 1	Q 2	Q 3	Q 4	Q 1
Agriculture	-2.1	-6.9	-4.0	-4.8	-3.5
Mining	0.4	0.3	1.2	5.1	-2.3
Manufacturing	-5.8	-10.3	-18.9	-18.6	-1.1
Construction	-14.5	-19.8	-28.0	-29.0	-11.9
Services	2.2	1.9	-3.7	-3.4	0.1
Real GDP	-3.1	-5.2	-10.9	-10.3	-1.3

Source: Department of Statistics

8.0 REGIONAL LOAN CENTRE

HLFB had been growing rapidly. The number of branches had increased from 27 branches in 1990 to 82 branches in 1998. Loans and advances recorded a sum of RM5,676 million in 1998 compared to RM432 million only in 1988.

The increasing number of branches and loan base had caused bottleneck in head office especially in the processing of consumer loan such as hire purchase and housing loans. Even though some branch managers had been given certain loan approving authority, however, such branches were still faxing and sending application to Head Office for approval due to the absence of the branch managers in the event they were out for marketing and visitation of clients, or the loan amount have exceeded the branch manager's approving authority. As a result, the applications would have to go through head office and it incurred more cost due to faxing, phone calls and paper cost.

Approval authority granted to the regional loan centre was only for the consumer loans, however the authority limit was very low. No loan approval authority was given to the loan centre manager for commercial loan. All the commercial loans such as bridging loans and term loans would have to go through the head office irrespective of the loan amount.