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# ANALYSIS OF THE CAUSES OF BAD CREDIT (Literature Review)

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**Abstract**

*Bad credit is one of the main problems faced by the banking sector, which can threaten financial stability and bank profitability. This research aims to analyze the causes of bad credit through the literature review method, by identifying and evaluating relevant scientific works. The research results show that the causes of bad credit can be categorized into four main factors: internal factors of the borrower, external factors of the borrower, internal factors of the bank, and regulatory and policy factors. The borrower's internal factors include poor management and weak financial capabilities, while external factors include unstable macroeconomic conditions and intense business competition. Internal bank factors include weak credit assessment processes and inappropriate credit policies, while regulatory and policy factors include less effective regulations and erratic changes in government policy. To reduce the risk of bad credit, banks and financial institutions are advised to improve credit assessment processes, tighten supervision of the use of funds, develop credit policies that are more flexible but based on in-depth risk analysis, and strengthen regulations and supervision. Macroeconomic risk mitigation strategies are also important to maintain financial stability. By implementing these strategic steps, it is hoped that the risk of bad credit can be minimized, support the stability and sustainability of the banking sector, and increase trust and security for all parties involved. This research emphasizes the importance of a comprehensive and coordinated approach in credit risk management to ensure the sustainability and stability of the financial system.*

***Keywords:*** *Bad Credit, Non-Performing Loans (NPL), Credit Risk Management, Banking Sector, Credit Assessment Process*

## 1. INTRODUCTION

Bad credit is one of the common problems faced by the banking sector, where this can have a significant impact on the stability of the financial system (Dewi et al., 2019). High levels of bad loans can result in a decline in bank profitability and can even trigger bankruptcy. Therefore, understanding the main causes of bad credit is very important for bank management in their efforts to avoid and manage credit risk effectively.

One factor that is believed to influence the level of bad loans is the macroprudential policies implemented by the authorities. Research conducted by (Yugita et al., 2017) shows that consumption credit interest rates have a positive influence on the risk of bad credit at Rural Banks in Indonesia. An increase in consumption credit interest rates causes the burden to be borne by borrowers to increase, thereby reducing people's desire to borrow and

ultimately increasing the risk of bad credit. On the other hand, reducing consumption credit interest rates can reduce the burden on borrowers, which in turn increases people's interest in borrowing and ultimately reduces the risk of bad credit.

Apart from that, company cash management can also affect the risk of bad credit. Managers who tend to want to maintain cash in amounts greater than needed can increase debt ratios and have high credit risks (Rahmadani et al., 2020). This is because when companies cannot maintain cash, they have to finance operational activities with higher financing rates. Thus, managerial policies in managing cash can have an impact on bank financial stability and the risk of bad credit.

Apart from macroeconomic factors and cash management, the characteristics of the bank itself can also influence the risk of bad credit. The capital adequacy ratio (CAR), non-performing loan ratio (NPL), loan to deposit ratio (LDR), and the ratio of operating expenses to operating income have been proven to be important determinants of bank profitability, which can further influence the bank's ability to manage the risk of bad credit. (Firmanila, 2023). Adequate capital adequacy can be a buffer for banks to absorb losses that may arise due to bad credit. Meanwhile, a high non-performing loan ratio can reduce profitability and cause banks to have to create larger loss reserves, which in turn will also have an impact on bad credit risk management (Maulana et al., 2021). Apart from that, bank operational efficiency is also important to maintain profitability which in turn can affect the bank's ability to manage bad loans. Loan to deposit ratios that are too high can increase the risk of bad loans, because banks may relax credit standards to achieve credit growth targets, which could result in the quality of the credit portfolio deteriorating (Wenno & Laili, 2019). Thus, factors related to bank characteristics, such as capital, asset quality, operational efficiency, and liquidity, play an important role in managing the risk of bad credit.

Apart from that, the quality of external auditors can also influence the risk management of bad loans by banks. Qualified auditors can help identify problematic credit problems early and encourage banks to take necessary corrective actions. Companies with better auditor quality tend to practice lower income smoothing, which can reduce the risk of bad credit. Therefore, selecting an external auditor who has a high reputation and competence is an important factor for banks in their efforts to manage the risk of bad credit (Rahmadani et al., 2020). When the economy is not doing well, people may have a hard time paying back the money they borrowed. This can happen if they lose their job or if things cost more than they can afford. If interest rates on loans go up, it can make it even harder for people to pay back what they owe. Also, if a company keeps too much cash on hand, they may end up borrowing more money than they can pay back. This can increase the chances of them not being able to repay their loans.

Aside from how the economy is doing and how much money a bank has, the bank itself can also affect how likely it is to have customers who don't pay back their loans on time. Things like how much money the bank has compared to how much it lends out, how

many loans aren't being paid back, and how efficient the bank is at running its business all play a role in how well the bank can handle the risk of customers not paying back loans. If a bank has enough money saved up, it can handle losses better. But if too many customers aren't paying back their loans, it can hurt the bank's profits and they may have to set aside more money for potential losses. How efficiently a bank operates is also important, as a bank that lends out too much money compared to what it has saved up may be at a higher risk for customers not paying back loans. Overall, things like how much money the bank has, the quality of its loans, how efficiently it runs its business, and how easily it can access money all play a big role in how well a bank can handle the risk of customers not paying back loans (Firmanila, 2023)

## 2. RESEARCH METHOD

This research method uses literature review, which is a research method that aims to identify, evaluate and interpret scientific works that are relevant to a particular research topic. In the context of analyzing the causes of bad credit, a literature review helps collect and analyze research that has been conducted previously to provide in-depth insight into the factors that contribute to this problem. Literature review is an essential research method for collecting, evaluating, and synthesizing existing knowledge about the causes of bad credit. Through a systematic approach, researchers can provide in-depth insights and recommendations that impact credit risk management practices in the banking sector.

The analysis was carried out by integrating findings from various studies to provide a comprehensive understanding of the causes of bad credit. Interpretation of analysis results helps in identifying patterns, trends and gaps in existing research, and provides a basis for recommendations for better policies and practices in credit risk management.

## 3. RESULTS

Based on the literature analysis that has been carried out, several main causes of bad credit in the banking sector can be identified. These results are grouped into four main categories: borrower internal factors, borrower external factors, bank internal factors, and regulatory and policy factors.

### Borrower Internal Factors

**Poor Management**: Many studies indicate that inefficient and incompetent management is one of the main causes of bad credit. Bad credit or Non-Performing Loans (NPL) is one of the main problems faced by banks. High levels of NPLs can be caused by several factors, such as poor bank management, weak supervision, and unstable economic conditions (Mohammad Zain et al., 2022). (Putranto, 2022) Previous studies has shown that inefficient and incompetent management is one of the main causes of bad credit (Anastasiou,

2016). This is because poor management can result in unprofessionalism in the process of assessing credit worthiness, monitoring borrowers, and handling problem loans. Research conducted by Mardi and Faradila found that poor management, measured through the BOPO (Operating Costs to Operating Income) ratio, had a significant negative impact on bank profitability as proxied through ROA (Return on Assets). This finding is similar to the results of Leon and Ericson's study which shows that NPLs are loans that experience difficulties in repayment, which can be caused by poor bank management. However, it should be noted that the NPL problem is not only caused by bad management. Other factors such as unstable economic conditions can also influence a bank's NPL level. As explained by Padachi et al., the global economic and financial crisis that occurred several years ago has encouraged an increase in NPLs and NPFs in various countries, including Malaysia. Furthermore, Khemraj and Pasha also emphasized that high NPLs often trigger banking crises in several countries, such as in East Asia and Sub-Saharan Africa (Khan et al., 2020; Mohamed et al., 2021).

**Weak Financial Capability:** Research also finds that borrowers with weak or unstable financial conditions are more vulnerable to bad credit. Company financial difficulties, which are often referred to as financial distress, are conditions where the company experiences severe liquidity problems and is unable to fulfill its financial obligations (Agustin & Andryanto, 2023). This can be caused by various factors, such as political costs, cash management, and poor auditor quality. (Rahmadani et al., 2020) Financial ratio analysis is a way to predict the possibility of financial distress in a company. (Assaji & Machmuddah, 2019). Previous studies have shown that companies with weak or unstable financial conditions have a higher risk of experiencing bad credit (Herbowo & Saputri, 2023). Financial ratios such as liquidity, solvency, and profitability can be used to identify early signs of financial distress. For example, companies with low levels of liquidity or high levels of debt will have difficulty meeting their short-term obligations.

**Borrower External Factors**

**Economic Conditions**: macroeconomic conditions such as recession, high inflation and rising interest rates can increase the risk of bad credit. In the financial sector such as banking and capital markets, macroeconomic conditions are one of the factors that have an important role in driving a country's economic development. When the financial sector grows well, there will be more financing in the real sector, so that increasing financing in the financial sector will increase physical capital development which can contribute positively to economic growth. Several macroeconomic variables that are often used by analysts to assess macroeconomic conditions include GDP, inflation rate, inflation, interest rates, exchange rates, current account and budget deficit (Nadzifah & Sriyana, 2020). Previous research shows that macroeconomic conditions such as inflation, exchange rates and interest rates influence banking performance, including profitability levels and the risk of bad credit. For example, high inflation can increase the burden on debtors, thereby

increasing the risk of bad credit (Pratiwi & Kurniasari, 2023). Likewise, an increase in interest rates can cause an increase in credit installments, with the consequence of a higher risk of bad credit (Abd. Majid, 2017).

**Business Competition:** a high level of competition in the lending industry can reduce profit margins and increase the risk of bad credit. Profitability in the banking sector is influenced by various factors, such as the level of efficiency, credit risk, and level of credit distribution (Dewi & Ariyanto, 2018). Previous research shows that poor efficiency and credit risk management can reduce bank profitability (Dewi & Ariyanto, 2018). On the other hand, a high level of credit distribution can increase bank profits. In the world of banking, currency exchange rates can also influence the level of profitability because it determines real investment returns. (Winarni et al., 2022) Bank performance can be analyzed using financial ratios such as Return on Assets (ROA) to measure the extent to which the bank has carried out activities. operates well and provides profits (Khotimah & Asytuti, 2020). Therefore, understanding the factors that influence bank profitability is important for management to improve the company's financial performance.

**Internal Bank Factors**

**Weak Credit Assessment Process:** Inadequate credit assessment processes are often the root of bad credit problems. Bad credit has become an increasingly important issue in the banking industry, especially in developing countries. One of the main causes of bad credit is an inadequate credit assessment process. In the process, banks must carry out a comprehensive assessment of prospective debtors to ensure their ability and good faith in repaying loans (Firdaus & Salmah, 2021). However, banks often ignore important aspects in credit assessment, such as the character and financial condition (capacity) of the debtor. For example, banks sometimes only focus on the guarantees provided by debtors without carefully assessing their ability to repay loans. In addition, weak information and documentation verification processes also contribute to poor credit assessment quality.

**Inappropriate Credit Policies:** Credit policies that do not suit the borrower's risk profile also contribute to the increase in non-performing loans. Bad credit is one of the main challenges faced by financial institutions, especially banks. Poor credit performance can impact bank profitability and even the financial stability of the system as a whole (Mustaidah & Fauzan, 2021) Several factors that can influence the level of bad loans include inappropriate credit policies, declining economic performance, and other external factors. Credit policies that do not match the borrower's risk profile can cause an increase in bad loans. Research shows that banks with high-risk credit portfolios tend to have higher levels of Non-Performing Loans  on the other hand, banks with better credit risk management will have a lower NPL ratio. In addition, disbursing large amounts of credit has the potential to increase the number of bad loans which can have an impact on reducing bank profits. If

credit expansion is less controlled and distributed less carefully, it will create greater risks. To maintain the LDR ratio, banks must always maintain or increase the amount of credit provided to the public, in addition to collecting funds from the public.

### Regulatory and Policy Factors

**Less Effective Regulations**: Studies show that regulations that are not strict in credit supervision and enforcement can increase the risk of bad credit. Credit management is a very important aspect in the banking industry, because credit is the main source of income for banks. However, banks often face problems with non-performing loans (NPL) which can threaten the bank's financial stability. Research shows that the level of efficiency, credit risk, and level of credit distribution have a significant influence on bank profitability (N. P. I. P. Dewi & Ariyanto, 2018). One of the causes of non-performing loans is ineffective supervision and enforcement of regulations. Banks are required to maintain the ratio of non-performing loans (NPL) below the maximum limit set by the regulator. When the non-performing loan ratio is high, banks must provide larger loss reserves, thereby affecting profitability. In addition, efforts to recover bad loans also incur additional costs for banks. Ineffective supervision and enforcement of regulations can cause moral hazard among bank managers, so that they tend to ignore the principle of prudence in distributing credit. As a result, the risk of bad credit becomes higher, which ultimately has a negative impact on the bank's financial performance.

**Changes in Government Policy:** Changing fiscal and monetary policies can affect borrowers' financial stability and their ability to repay loans. During the financial crisis, the Indonesian government has taken various policies to overcome liquidity problems and encourage economic growth (Silalahi & Chawwa, 2012). On the fiscal side, the government is trying to maintain domestic demand with several fiscal stimuli and trade policies. On the monetary side, interest rate policy was launched in December 2008 with the aim of reducing bank credit interest rates and several unconventional monetary measures and policies have also been taken to overcome liquidity problems. In addition, there is close coordination between the Ministry of Finance, the Central Bank and other institutions in order to maintain financial markets and macroeconomic stability. The policy steps taken during the crisis have been formulated in a timely manner with the ultimate goal of sustainable economic growth while maintaining macroeconomic stability in Indonesia (Bathaluddin et al., 2012).

## 4. DISCUSSION

The research results show that the causes of bad credit are multifactorial and interrelated. Therefore, a comprehensive and integrated approach is needed to overcome this problem.

**The Importance of Efficient Management**

Good management in a borrowing company is essential to ensure that cash flow and business operations run smoothly, so that the ability to repay the loan can be guaranteed. Training and management capacity development can help reduce the risk of bad credit. A thorough creditworthiness analysis, including assessment of management capabilities, capital, and collateral, is essential to minimize mac credit risk. There needs to be a strict supervision system to monitor and control the use of loans, so that they can immediately detect and overcome possible problems (Palilingan & Pangemanan, 2018). Apart from that, financial institutions also need to pay attention to other factors that can influence the risk of bad credit, such as the quality of the loan. (Rahmadani et al., 2020). Meanwhile, managers of borrowing companies must ensure that cash flow and business operations run smoothly, Good management and effective managerial development are very necessary to ensure that the borrowing company can fulfill their obligations and men (Palilingan & Pangemanan, 2018).

**Strict Monitoring and Evaluation**

Banks must improve the credit assessment process by using more rigorous and data-based methods. Strict supervision of the use of funds by borrowers is also important to ensure that funds are used according to their original purpose. Handling Problematic Financing: Financial institutions must immediately follow up on financing that is starting to show signs of problems, such as late payments. Steps that can be taken include restructuring, intensive collection, and if necessary, execution of the guarantees provided (Riduwan et al., 2021). Apart from that, banks also need to develop a credit information system to monitor debtor credit history and prevent double financing. Determining credit limits and diversifying loan portfolios are also strategic steps to manage financing risks that could become problematic (Wibowo et al., 2020). Education and Training for Debtors: Financial institutions must provide comprehensive education and training to debtors so that they can manage their business well. (Mustaidah & Fauzan, 2021) This will increase the debtor's ability to run a business and fulfill their loan payment obligations (Wibowo et al., 2020). Apart from that, financial institutions must also provide ongoing business assistance and consultation for debtors to ensure business sustainability.

Compliance with Regulations: Financial institutions must ensure full compliance with all applicable regulations and provisions, including those related to providing credit, monitoring and handling problematic financing. This is not only to avoid sanctions, but also to build good governance practices and protect the interests of all stakeholders. Complete and Accurate Documentation: Financial institutions must ensure complete and accurate financing documentation, including assessment of debtor eligibility, collateral, and risk analysis. This is important to strengthen the legal position of financial institutions in

handling problematic financing and ensuring the implementation of the precautionary principle.

**Credit Policy Adjustments**

Banks need to develop credit policies that are flexible but based on comprehensive risk analysis. Diversifying credit portfolios can also help reduce risks concentrated in one particular sector or type of borrower. The elements contained in providing credit include trust, agreement, time period, risk and remuneration (Firdaus & Salmah, 2021). Before providing credit, the bank must ensure confidence in the debtor's ability to repay the credit provided. To assess credit worthiness, banks generally use the 5C criteria, namely character, capacity, capital, collateral and condition. In developing flexible credit policies, banks can consider the characteristics and needs of debtors, especially micro, small and medium enterprises (MSMEs). (Palilingan & Pangemanan, 2018) For example, providing more flexible collateral requirements or providing credit products with longer tenors. Long, In addition, credit portfolio diversification can also help reduce risks that are concentrated in one sector or type of borrower (Palilingan & Pangemanan, 2018). Financing for micro, small and medium enterprises (MSMEs) has an important role in supporting economic growth, but is often constrained by access to funding sources. The government has provided various financing schemes that can be utilized by MSMEs, such as the People's Business Credit (KUR) program which makes it easier to obtain funding (Aristanto et al., 2020). One of the keys to the success of this program is the bank's ability to manage higher financing risks in the MSME segment.

## 5. CONCLUSION

This research aims to analyze the causes of bad credit through the literature review method, which identifies and evaluates relevant scientific work. Based on the results of the literature analysis, it can be concluded that bad credit is caused by various interrelated factors, which can be categorized into four main groups: borrower internal factors, borrower external factors, bank internal factors, and regulatory and policy factors.

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