Non-Performing Loan (NPL)

Case Study

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1. Introduction

Non-Performing Loans (NPLs) are a key indicator of credit risk in the banking sector, referring to loans for which borrowers fail to meet scheduled principal or interest payments for an extended period, typically 90 days or more. Rising NPL levels signal deterioration in asset quality and pose significant challenges to banks' financial performance by increasing loan-loss provisions, reducing profitability, and weakening liquidity positions (Salas et al., 2024). Persistent NPL problems can undermine confidence in the banking system and threaten overall financial stability, particularly in bank-dominated economies.

The issue of non-performing loans is especially critical in developing and small economies where banks serve as the primary source of financing for households and businesses. Limited capital market alternatives increase reliance on bank credit, making the banking sector highly sensitive to credit risk shocks. High NPL ratios often compel banks to adopt conservative lending practices, thereby restricting credit flow to productive sectors and slowing economic growth (Bhowmik & Sarker, 2024). As a result, effective NPL management is not only vital for individual banks but also essential for sustaining macroeconomic stability.

In Bhutan's financial system, the banking sector plays a central role in supporting key economic activities such as hydropower development, construction, trade, agriculture, and small and medium enterprises. The concentration of lending in a few sectors, combined with exposure to project delays, income volatility, and external economic shocks, increases vulnerability to loan defaults. An escalation in NPLs can therefore have broader economic consequences, affecting business continuity, employment generation, and national development priorities. Understanding the drivers of NPLs in Bhutan is thus of considerable policy and institutional importance.

Non-performing loans are influenced by a range of factors that operate at the bank-specific, borrower-specific, and macroeconomic levels. These include internal bank practices such as credit appraisal standards, monitoring and recovery mechanisms, as well as external factors like economic growth conditions and regulatory environments (Salas et al., 2024; Ozili, 2025). However, most existing research relies heavily on large-sample quantitative methods, which, while useful for identifying general patterns, may not fully capture institution-specific practices and contextual dynamics, particularly in smaller banking systems.

Given these limitations, a case study approach offers a valuable methodological alternative by enabling an in-depth examination of real-world banking practices and borrower behavior within a specific institutional and economic setting. Such an approach allows for a richer understanding of how internal processes and environmental factors interact to influence loan performance outcomes (Yin, 2018). This is particularly relevant for Bhutan, where empirical case-based evidence on NPLs remains limited.

Accordingly, this study adopts a case study approach to examine non-performing loans in a selected commercial bank in Bhutan. By focusing on internal bank practices, borrower characteristics, and contextual external factors, the study seeks to generate insights that can inform improved credit risk management and contribute to strengthening financial stability in the Bhutanese banking sector.

1.1. Research Objectives

The objectives of this study are:

1. To identify the key factors contributing to non-performing loans in the selected banking context.
2. To examine the influence of internal bank practices on loan repayment performance.
3. To explore contextual and external factors specific to the Bhutanese banking environment that affect NPL trends.

2. Background

This case study is situated within the commercial banking sector of Bhutan, focusing on a selected financial institution that plays a central role in credit intermediation within the economy. For confidentiality and ethical reasons, the institution is anonymized and referred to as Bank A. Bank A is a licensed commercial bank operating under the regulatory oversight of the Royal Monetary Authority of Bhutan (RMA) and provides a wide range of lending products, including retail loans, small and medium enterprise (SME) financing, and sector-specific credit to construction, trade, agriculture, and service industries.

Bhutan's banking sector is relatively small and highly concentrated, with commercial banks serving as the primary source of formal financing due to the limited development of capital markets and alternative financial instruments. Consequently, the performance of banks particularly the quality of their loan portfolios has significant implications for economic growth and financial stability. Recent regulatory reports indicate that while the banking system remains adequately capitalized, asset quality continues to be a key area of concern, with non-performing loans posing persistent challenges for credit growth and profitability (Royal Monetary Authority [RMA], 2023).

The operational environment of Bank A is shaped by a combination of economic, regulatory, and institutional factors. Economically, Bhutan's market is characterized by limited diversification and strong dependence on a few dominant sectors, notably construction, hydropower-related activities, government expenditure, and small businesses. This sectoral concentration increases banks' exposure to credit risk, as adverse developments in one sector such as project delays or cost overruns can directly affect borrowers' repayment capacity. Additionally, external shocks, including economic slowdowns and delayed payments in government-linked projects, have been identified as recurring challenges affecting loan performance in the Bhutanese context (RMA, 2022).

From a regulatory perspective, Bank A operates within a prudential framework established by the RMA, which includes guidelines on loan classification, income recognition, provisioning, and capital adequacy. These regulations are designed to strengthen risk management and enhance the resilience of the banking sector. However, banks often face institutional constraints such as limited credit information, challenges in post-disbursement monitoring, and capacity limitations in risk assessment, particularly when lending to SMEs and project-based borrowers. Recent studies emphasize that in small banking systems, institutional practices and regulatory enforcement play a critical role in shaping non-performing loan outcomes (Ozili, 2024).

The specific case examined in this study relates to Bank A’s loan portfolio over a recent operational period during which non-performing loans were observed to be persistent, with indications of a gradual increase in certain loan segments. Rather than focusing on individual borrowers, the case examines broader lending patterns, internal processes, and operational practices associated with loan appraisal, monitoring, and recovery. Insights are drawn from staff directly involved in credit assessment and loan management, allowing the study to capture institutional perspectives on the emergence and management of NPLs.

By situating the case within Bhutan’s unique economic and regulatory environment, this background provides essential context for understanding the dynamics of non-performing loans. It also establishes a foundation for analyzing how borrower behavior, institutional practices, and external conditions interact to influence loan performance, which is explored in subsequent sections of the study.

3. Literature Review

Non-performing loans (NPLs) are widely recognized as a critical indicator of asset quality and credit risk in the banking sector and are commonly defined as loans overdue for 90 days or more and no longer generating income. From a theoretical perspective, credit risk theory explains NPLs as a result of borrowers' inability or unwillingness to repay, while macroeconomic cycle theory emphasizes the role of economic fluctuations in influencing loan performance. These frameworks suggest that NPLs arise from the interaction of external economic conditions and internal bank management practices, making them a systemic issue rather than an isolated institutional problem (Tshering, 2016; Singh, 2017).

Empirical evidence from regional and international studies supports the importance of macroeconomic and bank-specific determinants of NPLs. International research consistently finds that economic growth, measured by GDP, is negatively associated with NPLs, while economic downturns increase default risk. Studies across Europe, Asia, and developing economies highlight GDP growth, unemployment, inflation, interest rates, and bank profitability as significant predictors of NPL behavior. In the Bhutanese context, Tshering (2016) finds that GDP significantly reduces NPLs, while profitability and capital adequacy ratios are inversely related to loan defaults. Similarly, Singh (2017) demonstrates that macroeconomic conditions significantly influence NPLs at the bank level and that rising NPLs adversely affect financial performance indicators such as ROA and ROE, aligning Bhutan's experience with international findings.

Despite these contributions, the existing literature on NPLs in Bhutan remains limited in scope and depth. Most studies rely on single-institution case analyses or short time horizons, restricting the generalizability of findings across the financial system. Moreover, while recent research on Bhutanese banks examines capital structure and financial performance, it does not explicitly integrate NPL dynamics, leaving asset quality risks insufficiently explored. The absence of comprehensive, multi-institutional, and longitudinal studies creates a clear research gap, justifying the need for a focused case study to deepen understanding of NPL determinants in Bhutan's financial sector (Tshering, 2016; Singh, 2017; Tshering et al., 2024).

4. Methodology

4.1. Research Design

We adopted a case study research design focusing on a single commercial bank operating in Bhutan. The case study approach was considered appropriate because the issue of non-performing loans is context-specific and influenced by internal institutional practices as well as external economic conditions. By concentrating on one bank, we were able to examine the issue in depth and capture detailed insights into credit-related challenges within a real-world banking environment.

A single-case design was selected to allow for focused analysis and practical feasibility. The selected bank plays a significant role in the Bhutanese banking sector and is representative of the challenges faced by commercial banks in managing loan portfolios in a small and bank-dominated financial system. This design enabled us to explore NPL-related issues holistically rather than relying solely on aggregate or cross-country data.

4.2. Data Source

The study relied exclusively on primary data collected through a structured survey. The survey targeted bank employees directly involved in lending, credit appraisal, loan monitoring, and recovery processes. These respondents were considered well-positioned to provide informed perspectives on the factors contributing to non-performing loans and the effectiveness of existing credit management practices.

The survey instrument consisted of closed-ended and open-ended questions. Closed-ended questions were used to capture structured responses on key issues such as credit assessment practices, monitoring mechanisms, and perceived causes of loan default. Open-ended questions allowed respondents to elaborate on institutional challenges, borrower behavior, and contextual factors affecting loan performance.

4.3. Data Collection Procedure

Data collection was conducted over a specified period using a survey questionnaire developed in line with the research objectives. Prior to administering the survey, necessary permission was obtained from the concerned authorities of the selected bank. Respondents were informed about the purpose of the study and assured that participation was voluntary.

The questionnaires were distributed either electronically or in printed form, depending on respondent accessibility. Adequate time was provided for respondents to complete the survey to ensure thoughtful and accurate responses. Ethical considerations were strictly followed throughout the process. Respondent anonymity and confidentiality were maintained by excluding personal identifiers, and all collected data were used solely for academic purposes.

4.4. Data Analysis

The survey data were analyzed using a thematic analysis approach. Responses from open-ended questions were carefully reviewed and coded to identify recurring patterns and key themes related to non-performing loans. Initial codes were generated based on frequently mentioned issues, which were then grouped into broader thematic categories such as borrower-related factors, internal bank practices, and external economic conditions.

For closed-ended survey items, descriptive analysis was used to summarize response patterns and highlight dominant trends. The integration of qualitative themes with descriptive survey results enabled us to develop a comprehensive understanding of the factors influencing non-performing loans in the selected bank. The findings were interpreted in relation to the study objectives to draw meaningful conclusions.

5. Case Description

5.1. Overview of the Selected Case

The case examined in this study involves a selected commercial bank operating within Bhutan’s banking system. The bank provides a range of financial services, including corporate lending, retail loans, and credit facilities for priority sectors such as construction, trade, agriculture, and small and medium enterprises. Lending activities constitute a major portion of the bank’s operations, making effective credit risk management central to its performance.

The bank follows established lending policies and regulatory guidelines issued by the monetary authority. Loans are classified into performing and non-performing categories based on repayment status and duration of default. Non-performing loans are identified when borrowers fail to meet scheduled repayment obligations for a specified period, after which recovery and monitoring mechanisms are initiated in accordance with internal procedures.

5.2. Credit Management and Loan Monitoring Processes

The loan management process within the bank involves several stages, beginning with loan application and appraisal, followed by approval, disbursement, monitoring, and recovery. Credit appraisal includes assessment of borrower eligibility, repayment capacity, collateral adequacy, and compliance with internal credit policies. Once loans are disbursed, they are subject to periodic monitoring to track repayment performance and detect early signs of stress.

Loan accounts that show delayed repayments are flagged for follow-up actions, which may include borrower communication, restructuring, or initiation of recovery measures. The bank maintains internal records and reports on loan performance to support decision-making and regulatory compliance.

5.3. Key Stakeholders

Several stakeholders are involved in the lending and loan management processes of the selected bank. These include bank management responsible for strategic oversight, credit officers and risk management personnel involved in loan appraisal and monitoring, and recovery units tasked with managing overdue and non-performing accounts. Borrowers, including individuals and business entities, are central stakeholders whose repayment behavior directly affects loan performance.

Regulatory authorities also play a role by setting prudential guidelines, classification norms, and reporting requirements related to non-performing loans. Together, these stakeholders form the institutional framework within which lending and NPL management activities take place.

5.4. Structure of the Case

The case focuses on the bank's loan portfolio and NPL management practices over a defined period. During this period, the bank continued routine lending operations while monitoring loan performance and managing overdue accounts through established procedures. Information for the case was obtained through survey responses from bank staff and institutional documentation, providing a factual account of lending practices and loan performance conditions within the selected context.

6. Findings and Analysis.

6.1. Borrower-Related Factors Contributing to Non-Performing Loans

Survey responses indicate that borrower-related factors play a significant role in the occurrence of non-performing loans. A majority of respondents identified irregular income flows, business downturns, and poor financial management as major contributors to repayment difficulties. Borrowers engaged in sectors such as construction and small-scale trade were frequently perceived as being vulnerable to cash flow disruptions.

Several respondents noted that borrowers often underestimated project risks or overestimated repayment capacity at the time of loan application. One respondent stated that *"borrowers are usually optimistic during loan appraisal, but actual income realization is much lower than projected."* Such responses suggest that repayment challenges are not always intentional but arise due to mismatches between expected and actual cash flows.

These findings are consistent with prior research highlighting borrower income instability and weak financial discipline as key drivers of loan default, particularly in developing economies where businesses are sensitive to economic shocks (Bhowmik & Sarker, 2024).

6.2. Internal Bank Practices and Credit Management Issues

The survey results reveal that internal bank practices also influence loan performance outcomes. Respondents highlighted weaknesses in credit appraisal, monitoring, and follow-up mechanisms as contributing factors to NPL accumulation. In particular, limited post-disbursement monitoring and delayed identification of stressed accounts were frequently mentioned.

Some respondents indicated that while credit policies exist, their implementation is occasionally constrained by workload pressures and resource limitations. As one respondent noted, *"monitoring is done, but not as frequently as required due to staff shortages."* This suggests a gap between policy design and operational execution.

These findings align with existing studies that emphasize the role of bank-specific factors such as credit assessment quality and monitoring effectiveness in determining NPL levels (Salas et al., 2024). Weak internal controls can amplify the impact of borrower-related risks and lead to delayed corrective actions.

6.3. External and Contextual Factors

External and contextual conditions were also identified as important determinants of non-performing loans. Respondents pointed to economic slowdowns, project delays, and sector-specific risks as factors affecting borrowers' repayment capacity. Macroeconomic uncertainty and changes in market conditions were perceived to disproportionately affect small businesses and individual borrowers.

In the Bhutanese context, dependence on a limited number of economic sectors was viewed as increasing systemic vulnerability. Respondents noted that shocks affecting key sectors often have spillover effects on loan performance across the bank's portfolio. These observations support the view that macroeconomic and structural factors play a critical role in shaping NPL trends (Ozili, 2025).

6.4. Regulatory and Institutional Environment

Survey findings also suggest that the regulatory and institutional environment influences NPL management practices. Respondents acknowledged that regulatory guidelines provide a structured framework for loan classification and provisioning. However, some respondents indicated that regulatory compliance requirements can limit flexibility in loan restructuring and recovery processes.

Despite these constraints, regulatory oversight was generally viewed as necessary for maintaining discipline and transparency in credit operations. This finding is consistent with the literature emphasizing the role of effective regulation in mitigating excessive risk-taking and containing credit deterioration (Yin, 2018).

6.5. Synthesis of Findings

Overall, the findings indicate that non-performing loans in the selected bank result from an interaction of borrower-related challenges, internal bank practices, and external economic conditions. Borrower income instability and sectoral vulnerabilities are compounded by operational constraints in credit monitoring, while broader economic factors further influence repayment capacity.

The thematic analysis demonstrates that addressing NPLs requires a comprehensive approach that strengthens credit appraisal, enhances monitoring and early warning systems, and accounts for contextual economic realities. These findings directly address the research objectives and provide a foundation for the discussion and recommendations presented in subsequent sections.

7. Discussion

7.1. Interpretation of Key Findings

The findings indicate that non-performing loans in the selected bank arise from a combination of borrower-related factors, internal bank practices, and external economic conditions. Borrower income instability and sector-specific risks emerged as dominant contributors to loan default. This can be explained by the structure of the Bhutanese economy, where many borrowers depend on a limited number of sectors that are highly sensitive to project delays, seasonal income fluctuations, and market conditions. When expected cash flows do not materialize, borrowers face difficulties in meeting repayment obligations, leading to loan deterioration.

Internal bank practices, particularly in credit monitoring and follow-up, were also found to influence loan performance. While credit policies and appraisal procedures exist, operational constraints such as staff workload and limited resources appear to affect the effectiveness of post-disbursement monitoring. Delayed identification of stressed accounts reduces the opportunity for early intervention, thereby increasing the likelihood of loans becoming non-performing. This suggests that NPLs are not solely the result of borrower failure but also reflect institutional capacity and process-related challenges.

External and contextual factors, including economic slowdowns and sectoral concentration, further explain the persistence of NPLs. In a small and open economy, macroeconomic shocks can quickly translate into reduced business activity and lower borrower repayment capacity. The interaction between these external conditions and internal bank practices helps explain why NPLs remain a recurring challenge despite regulatory oversight.

7.2. Comparison with Previous Studies

The findings of this study are broadly consistent with existing empirical literature on non-performing loans. Prior studies have identified borrower income instability, weak financial management, and adverse macroeconomic conditions as key drivers of NPLs, particularly in developing and emerging economies (Bhowmik & Sarker, 2024). The present case study reinforces these conclusions by providing institution-level evidence from the Bhutanese banking context.

Similarly, the role of bank-specific factors such as credit appraisal quality and monitoring effectiveness aligns with global findings reported by Salas et al. (2024), who emphasize that internal bank characteristics significantly influence NPL ratios across countries. However, unlike large-sample quantitative studies, this case study highlights how operational constraints and implementation gaps, rather than policy absence, contribute to loan performance issues.

The importance of external and institutional environments observed in this study also supports recent research emphasizing the relevance of structural and contextual factors in shaping NPL behavior (Ozili, 2025). The findings extend this literature by demonstrating how sectoral concentration and economic scale intensify these effects in small banking systems like Bhutan's.

7.3. Practical Implications

The findings of this study have several practical implications for bank management and policymakers. First, strengthening post-disbursement monitoring and early warning systems could help identify repayment stress at an earlier stage and reduce the transition of loans into non-performing status. Improving staff capacity and allocating adequate resources to credit monitoring functions may enhance the effectiveness of existing policies.

Second, borrower assessment processes could be refined to incorporate more conservative income projections and sector-specific risk considerations. Enhanced borrower financial literacy and closer engagement with high-risk sectors may also support better repayment outcomes. From a policy perspective, regulators may consider providing flexible yet prudent frameworks for loan restructuring during periods of economic stress, particularly in sectors critical to national development.

7.4. Theoretical Implications

From a theoretical standpoint, this study supports credit risk and financial intermediation theories that emphasize the interaction between borrower behavior, institutional practices, and macroeconomic conditions in determining loan performance. The findings highlight the limitations of viewing non-performing loans solely through macroeconomic or bank-specific lenses, underscoring the value of integrative and context-sensitive approaches.

By adopting a case study methodology, the research contributes qualitative evidence to a literature largely dominated by quantitative analyses. This adds depth to existing theoretical frameworks by illustrating how institutional processes and contextual realities shape credit risk outcomes in small economies. The study therefore reinforces the relevance of case-based research in advancing understanding of non-performing loans beyond statistical associations.

Conclusion

This case study examined the factors contributing to non-performing loans (NPLs) in a selected commercial bank in Bhutan, with a particular focus on borrower-related characteristics, internal bank practices, and external contextual conditions. Using a case study approach and primary data collected from bank employees involved in credit management, the study provides institution-level insights into the dynamics of loan performance within Bhutan's banking sector.

The findings indicate that NPLs arise from a complex interaction of multiple factors rather than a single cause. Borrower-related issues such as irregular income flows, business volatility, and weak financial management emerged as significant contributors to loan default, particularly among borrowers operating in vulnerable sectors like construction and small-scale trade. These challenges are closely linked to Bhutan's economic structure, where sectoral concentration and dependence on project-based income heighten repayment risks.

Internal bank practices were also found to play an important role in influencing NPL outcomes. Although formal credit policies and appraisal frameworks are in place, limitations in post-disbursement monitoring, delayed identification of stressed accounts, and resource constraints reduce the effectiveness of credit risk management. These operational gaps increase the likelihood that early warning signs go unaddressed, allowing repayment problems to escalate into non-performing loans.

External and contextual factors, including economic slowdowns, sector-specific shocks, and project delays, further compound borrower repayment difficulties. In a small and bank-dominated economy such as Bhutan, these external shocks tend to have amplified effects on loan performance. While the regulatory framework provides structure and discipline for NPL classification and provisioning, it also imposes constraints on flexibility in loan restructuring, particularly during periods of economic stress.

Overall, the study concludes that effective management of non-performing loans requires a comprehensive and integrated approach. Strengthening credit appraisal processes, enhancing post-disbursement monitoring, improving early warning systems, and incorporating sector-specific risk assessments are essential for mitigating NPL risks. At the policy level, supportive and adaptive regulatory measures can further enhance banks' ability to manage credit risk without compromising financial stability.

By adopting a case study methodology, this research contributes to the limited empirical literature on non-performing loans in Bhutan and highlights the importance of context-specific institutional practices. The findings underscore that addressing NPLs is not only a matter of borrower discipline but also of institutional capacity and economic structure. Future research could extend this analysis by incorporating multiple banks or longitudinal data to provide a broader perspective on NPL dynamics within Bhutan's financial system.

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