

Public Trust Crisis Due to Non-Performing Loans and the Relevance of the Prudential Principle in Credit Agreements

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ABSTRACT: The stability of financial institutions depends not only on sound credit risk management but also on maintaining public trust. A surge in non-performing loans (NPLs) undermines depositor confidence, damages the reputation of banks, and may trigger broader systemic risk. This article investigates how non-performing loans contribute to a public trust crisis, and analyses the role of the prudential principle—embodied in credit agreements and banking regulation—in rebuilding or preserving trust. Drawing on empirical studies and legal frameworks in Indonesia and beyond, the paper examines both bank-specific and macroprudential determinants of NPLs, such as bank efficiency, capital adequacy, interest rate policy, and regulatory supervision (Prawira & Wiryono, 2022; Gustriani et al., 2022). It also scrutinizes how prudential banking principles—particularly the ‘5C’s of credit (character, capacity, capital, collateral, conditions)—are incorporated in credit agreements and regulatory norms (Camelia, Romizah, Ukhrowi & Syamsi, 2022; Kusumastuti, 2022). The findings suggest that while prudential principles are conceptually well-embedded in laws and banking practices, in many cases weak enforcement, regulatory gaps, complex legal procedures, and adverse economic conditions weaken their effectiveness. The conclusion argues for stronger legal safeguards, more rigorous regulatory oversight, simplified procedures for NPL recovery, transparency in banking operations, and reforms to ensure that prudential norms are not just formalities but functional tools in credit granting. The paper recommends policy actions for regulators, banks, and legislators to restore public confidence and reduce the incidence of problematic credit.

KEYWORDS: Non-Performing Loans; Public Trust; Prudential Principle.

I. INTRODUCTION

In recent years, many banking systems have experienced a growing tension between maintaining financial stability and preserving public confidence. One of the central sources of this tension has been the rising number of non performing loans (NPLs). NPLs can erode a bank’s profitability, reduce its capacity to grant new loans, increase funding costs, and ultimately threaten solvency. Beyond these financial and technical implications, NPLs also have profound effects on public trust. Deposit holders, investors, and the general public expect banks to act prudently, manage risk properly, and honor their commitments. When banks are seen to be lax, when credit risk assessment is weak, or when recovery procedures are slow or opaque, trust is undermined. Without trust, the social legitimacy of banking institutions suffers, potentially exacerbating financial instability. This paper investigates the dual phenomenon of NPLs and public trust erosion, positing that the prudential principle embedded in credit agreements and banking regulation is key to bridging the gap. The prudential principle refers to the obligation of banks to act with caution in their credit policies, to carry out rigorous credit assessments, to ensure adequate collateral or guarantees where appropriate, and to maintain sufficient capital and reserves. In many jurisdictions, this principle is formalized via statutes, regulations, supervisory oversight, and contractual terms in loan agreements.

In the Indonesian context, research shows that bank efficiency and profitability are important determinants of NPLs. Prawira and Wiryono (2022) found that banks with higher profitability tend to maintain lower levels of NPLs, indicating more effective risk management. Similarly, Gustriani, Suhel, Melliny, Pertiwi, and Nida (2022) revealed that bank size correlates with more prudent financing and lower non performing assets, though macro prudential instruments such as the macro prudential intermediation ratio (MIR) do not always have a significant individual effect. These findings highlight that while internal bank conditions and regulatory tools matter, there remains a persistent gap between prudential theory and practice. Another dimension is legal and procedural. Camelia, Romizah, Ukhrowi, and Syamsi (2022) examined unsecured loans in relation to the prudential banking principle under Indonesian banking law. They argued that unsecured credit may still comply with prudence, provided banks verify the debtor’s repayment capacity and other elements of the 5C framework. Kusumastuti (2022) examined subsidized housing loans and noted that despite regulations mandating prudence, delays, inadequate debtor screening, and incomplete collateral frequently led to

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defaults, reducing public confidence. These studies confirm that formal legal provisions are not always sufficient to ensure prudential banking practices.

Public trust, once eroded, imposes significant costs. Depositors may withdraw funds, banks may face higher funding expenses, market discipline weakens, and regulatory intervention becomes more intrusive. The importance of prudential norms in credit agreements is therefore twofold. First, as preventive mechanisms that reduce the incidence of problematic loans. Second, as instruments of accountability and transparency that reassure stakeholders. The application of the 5C's, which consist of character, capacity, capital, collateral, and conditions, serves as a practical benchmark. However, the extent to which these factors are genuinely assessed, rather than merely formalized in documentation, determines their effectiveness in preventing NPLs. Challenges persist in many developing financial systems. Supervision is often under resourced, enforcement mechanisms are weak, and loan recovery procedures involve lengthy litigation or ineffective collateral execution. Moreover, external economic shocks such as inflation and interest rate hikes exacerbate the risk of loan defaults. These systemic vulnerabilities demonstrate the need for stronger legal safeguards and regulatory reforms to align prudential norms with actual practice. Banks must not only comply with the letter of the law but also embrace prudence as an operational principle in credit decision making.

This paper therefore seeks to answer three interrelated concerns. First, how NPLs affect public trust and the broader legitimacy of the banking system. Second, how prudential principles are codified in laws, regulations, and credit agreements. Third, how enforcement and practice can be strengthened to restore and preserve trust. The discussion integrates perspectives from law, finance, and regulatory policy, emphasizing that maintaining trust is not only an economic imperative but also a legal and ethical obligation. By situating the analysis within the framework of the prudential principle, the paper contributes to ongoing debates about financial stability, accountability, and consumer protection. The remainder of this study will demonstrate that prudence must be embedded not only in statutory provisions but also in the daily practices of financial institutions. Regulators, legislators, and banks must work in concert to ensure that prudential principles are effectively enforced, transparent, and responsive to evolving risks. Ultimately, the strength of public trust in financial institutions depends on the credibility of prudential norms and their consistent application in credit agreements.

II. FORMULATION OF THE PROBLEM

1. How do non performing loans contribute to a crisis of public trust in banking institutions, and what are the legal and financial mechanisms through which trust is affected?
2. To what extent are prudential principles as embodied in banking laws, regulations, and credit agreements effective in preventing non performing loans, and what legal or regulatory reforms are needed to ensure these principles restore public confidence?

III. RESEARCH METHOD

This study employs a qualitative research design with a library-based approach. The choice of qualitative method is grounded in the need to provide a comprehensive juridical and conceptual analysis of how non-performing loans (NPLs) impact public trust and how the prudential principle functions within credit agreements. Unlike quantitative methods that rely on statistical measurement, the qualitative approach allows for a deeper interpretation of legal texts, regulatory frameworks, and academic debates. It emphasizes understanding the meanings, concepts, and practices underlying prudential banking rather than measuring numerical correlations. The primary data source consists of secondary materials obtained through a literature study. Relevant academic journals, books, statutory instruments, court decisions, and regulatory guidelines issued by financial authorities form the basis of the analysis. Priority is given to scholarly publications from the past five years to ensure contemporaneity, although seminal works and statutory texts of lasting relevance are also included. The literature study enables the researcher to identify theoretical perspectives, policy debates, and empirical findings related to NPLs, prudential banking principles, and public trust. The collected materials are analyzed using a descriptive-analytical technique. First, the study identifies the main legal provisions and principles embedded in banking regulations and credit agreements. Second, it synthesizes findings from different authors to map areas of convergence and divergence. Finally, it evaluates the implications for public trust and formulates recommendations for legal reform and regulatory practice. Through this method, the research aims to generate normative insights that are both theoretically grounded and practically relevant.

IV. DISCUSSION

A. Non Performing Loans Contribute To A Crisis Of Public Trust In Banking Institutions, And What Are The Legal And Financial Mechanisms Through Which Trust Is Affected

The phenomenon of non-performing loans (NPLs) represents a multidimensional challenge in the banking sector because it not only undermines the stability of financial institutions but also erodes public trust, which is the cornerstone of any credit-based economy. In Indonesia, the presence of NPLs has frequently been linked to weak implementation of prudential principles, particularly in cases where banks extend credit without adequately assessing the repayment capacity of borrowers. The public perceives such failures as indicators of systemic weaknesses, thereby triggering distrust toward both banks and regulators. This

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distrust is magnified when loan defaults become widespread and are followed by revelations of regulatory negligence, inadequate supervision, or even moral hazard behavior by bank officials. The situation is comparable to international experiences, particularly in countries such as the United States and several European Union members, where crises arising from bad loans have historically undermined confidence not only in individual institutions but also in the financial system as a whole (Beck & Keil, 2022). The crisis of public trust linked to NPLs in Indonesia must also be understood against the backdrop of its legal framework governing credit agreements. Credit contracts in Indonesia are legally binding instruments under the Civil Code and reinforced by sector-specific regulations such as the Banking Law and Financial Services Authority (OJK) regulations. These frameworks impose obligations on banks to apply prudential principles in extending credit. However, when the prudential principle is not strictly implemented, it creates an environment conducive to the accumulation of NPLs. This mismanagement does not go unnoticed by the public, as news of high NPL ratios is often widely reported and discussed. The public interprets such trends as evidence of banks' inability to manage risks responsibly. By comparison, in the European Union, banking supervision is more centralized through mechanisms such as the Single Supervisory Mechanism under the European Central Bank, which directly monitors significant banks and imposes strict NPL reduction targets, thereby aiming to restore and maintain public trust (Eberl & Weber, 2021).

The erosion of public trust in Indonesia is exacerbated by the fact that credit agreements often involve consumers who lack bargaining power compared to banks. Borrowers frequently find themselves in rigid contractual structures where risks are disproportionately shifted onto them. When defaults occur, borrowers not only face legal action but also experience reputational and economic damage. This generates widespread narratives of unfairness, feeding into broader skepticism toward the banking sector. In contrast, in jurisdictions such as the United States, consumer protection laws in the context of credit agreements provide borrowers with stronger safeguards, and mechanisms like debt restructuring or loan forgiveness programs exist to mitigate the social consequences of widespread defaults. These measures do not eliminate distrust entirely but reduce its intensity by signaling that both banks and regulators share responsibility for addressing financial distress (Jagtiani & Lang, 2020). From a comparative legal perspective, the issue of prudential principles in managing credit agreements plays a decisive role in shaping public perceptions. In Indonesia, prudential regulation has evolved substantially since the Asian Financial Crisis of 1997–1998, when NPL ratios soared and trust in the banking sector collapsed. Despite these reforms, instances of banking failures due to poor risk assessment continue to occur, suggesting gaps between regulatory ideals and practical enforcement. Global practice shows a similar pattern: countries that implement prudential principles rigorously, with transparent reporting requirements and strong accountability for bank management, tend to maintain higher levels of public trust even in times of financial stress. For example, during the COVID-19 pandemic, several European countries enforced loan moratoria under strict prudential monitoring, ensuring that temporary surges in NPLs did not translate into permanent distrust in the banking system (Demirgüç-Kunt et al., 2021).

Another dimension worth analyzing is the role of regulatory institutions in maintaining public trust amid NPL crises. In Indonesia, the OJK is mandated to ensure that banks adhere to prudential standards, including maintaining NPL ratios below certain thresholds. However, enforcement challenges, limited supervisory capacity, and sometimes overlapping institutional responsibilities weaken this framework. When the public observes that NPLs are rising while regulators remain passive, trust in both banks and regulators is undermined. Comparatively, in countries such as South Korea, the strict regulatory approach by the Financial Supervisory Service has contributed to relatively lower NPL ratios, while proactive interventions in the form of debt restructuring schemes have been employed to sustain confidence in the financial system (Shin & Kim, 2022). The interaction between law, finance, and public perception is evident when NPLs become politicized. In Indonesia, high-profile cases of failed banks or unresolved bad loans often generate public debate, questioning not only the competence of banking institutions but also the credibility of the state's financial governance. The absence of effective legal remedies for affected borrowers reinforces the perception of an unjust system. On the other hand, in the European Union, the political narrative surrounding NPLs often emphasizes collective solutions, such as the establishment of asset management companies that purchase and manage bad loans, thus preventing direct social fallout. This mechanism not only stabilizes financial institutions but also reassures the public that systemic risks are being actively addressed (Bruno et al., 2020).

Trust is further eroded when NPL crises intersect with issues of corruption and collusion. In several Indonesian cases, bad loans have been linked to politically connected borrowers who escape liability despite large defaults. Such practices create a perception of inequality before the law, in which ordinary borrowers are penalized while elites are shielded. This undermines not only trust in banks but also faith in the rule of law. In contrast, although similar issues exist globally, stronger enforcement mechanisms in jurisdictions like the European Union reduce the frequency of such cases. For instance, the European Banking Authority requires transparent disclosure of large exposures, thereby minimizing opportunities for politically motivated credit allocation (Nouy, 2019). A significant comparative insight emerges from the way different jurisdictions integrate prudential principles into the architecture of credit agreements. In Indonesia, prudential principles are often articulated as general obligations without clear operationalization in credit contracts, leaving banks with significant discretion. This gap creates opportunities for imprudent lending practices that eventually result in NPLs. By contrast, in the United States and the European Union, prudential principles are embedded into the contractual and supervisory framework with greater precision, including requirements for stress

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testing, borrower income verification, and mandatory risk disclosures. These practices not only reduce the likelihood of defaults but also enhance transparency, which is essential for sustaining public trust (Laeven & Levine, 2020).

The crisis of public trust associated with NPLs also reflects broader socio-economic dynamics. In Indonesia, a large proportion of borrowers are small and medium enterprises (SMEs) that are particularly vulnerable to economic fluctuations. When banks impose rigid repayment obligations without considering the economic realities of these borrowers, the resulting wave of defaults is perceived as systemic unfairness. This perception contributes to the narrative that banks prioritize profits over social responsibility, thereby intensifying distrust. In the European Union, policy responses have been more balanced, with targeted financial assistance to SMEs during crises to prevent large-scale defaults and their associated reputational damage to banks (Holton et al., 2021). Public trust in the banking sector is not merely an abstract concept; it has tangible implications for financial stability and economic growth. When trust is eroded by NPL crises, individuals and businesses become reluctant to engage with banks, preferring to hoard cash or rely on informal financial systems. This behavior reduces the effectiveness of monetary policy and hampers economic development. The global financial crisis of 2008 demonstrated how widespread distrust could destabilize entire economies. Indonesia has not experienced a crisis of that magnitude in recent years, but recurrent concerns over NPLs serve as reminders of the fragile nature of public trust in financial institutions. Effective implementation of prudential principles remains central to preventing such crises and ensuring sustainable economic growth (Allen et al., 2022).

The comparison between Indonesia and global practices highlights the importance of regulatory credibility, contractual fairness, and institutional integrity in maintaining public trust. Indonesia faces unique challenges due to structural weaknesses in its banking system, including a high proportion of credit concentrated in certain sectors and limited financial literacy among borrowers. Addressing these issues requires not only stricter enforcement of prudential principles but also broader reforms to enhance transparency, accountability, and consumer protection. The global experience demonstrates that trust can be rebuilt through a combination of legal reforms, effective supervision, and proactive policy measures that balance the interests of banks and borrowers. Unless these measures are implemented consistently, the recurrence of NPL crises will continue to undermine confidence in the banking system and the broader financial order.

B. The Prudential Principle In Maintaining The Stability Of Credit Agreements And Restoring Public Trust In Banking Institutions Relevancies

The prudential principle serves as a foundational mechanism for ensuring the integrity of credit agreements and plays a crucial role in restoring and maintaining public trust in banking institutions. Its relevance becomes increasingly evident during times of financial instability when the risks of default and non-performing loans rise sharply. In Indonesia, the prudential principle is enshrined within the regulatory framework of the Financial Services Authority (OJK) and implemented through requirements such as adequate capital reserves, sound risk management, and strict credit assessment procedures. These mechanisms are intended to ensure that banks do not extend credit irresponsibly, thereby reducing the probability of systemic defaults. However, the effectiveness of the prudential principle is not merely a matter of regulation but also of consistent enforcement. When the principle is implemented rigorously, it functions as a safeguard that reassures the public of the stability and reliability of credit agreements. Conversely, lax enforcement undermines its relevance and fuels skepticism about the resilience of the banking system (Utami & Handayani, 2021).

The comparative dimension demonstrates that the prudential principle is universally acknowledged across jurisdictions as indispensable to financial stability. In the European Union, its application is codified under the Capital Requirements Regulation and Directive (CRR/CRD IV), which demand rigorous stress testing and transparency in lending practices. These measures help sustain public trust by demonstrating that banks are resilient even under adverse economic scenarios. By contrast, in Indonesia, despite the existence of prudential norms, challenges remain in translating them into transparent credit agreements that borrowers can understand and rely upon. This gap between normative ideals and contractual realities diminishes the perceived relevance of the prudential principle in the eyes of the public. For example, clauses in credit agreements often place disproportionate burdens on borrowers without explicitly reflecting the prudential safeguards imposed on banks, thereby creating an asymmetry that undermines trust (Beck & Keil, 2022).

The relevance of the prudential principle also lies in its ability to balance the interests of lenders and borrowers. A credit agreement grounded in prudential considerations ensures that loans are extended only to borrowers with verified repayment capacity and under terms that reflect their economic conditions. This not only protects the bank's balance sheet but also prevents borrowers from being trapped in unsustainable debt. In the United States, the implementation of prudential standards is integrated into consumer protection frameworks such as the Dodd-Frank Act, which mandates stricter mortgage lending criteria and requires transparent disclosures. These safeguards reassure the public that credit agreements are not instruments of exploitation but regulated contracts designed with systemic stability in mind (Jagtiani & Lang, 2020). Indonesia can draw lessons from these practices, especially in enhancing consumer protection mechanisms that embed prudential safeguards directly into loan contracts. Furthermore, the prudential principle strengthens the accountability of banking institutions by imposing duties that extend

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beyond profitability. Public trust is closely tied to perceptions of fairness and responsibility, and banks that visibly apply prudential measures are more likely to maintain credibility even when individual defaults occur. During the COVID-19 pandemic, for example, several European countries operationalized the prudential principle by implementing loan moratoria and restructuring programs under regulatory oversight, thereby demonstrating solidarity with borrowers while preserving systemic stability (Demirgüç-Kunt et al., 2021). These actions reinforced the relevance of prudential norms as tools not only of risk management but also of social legitimacy. In Indonesia, the introduction of loan restructuring policies by OJK during the pandemic was a step in this direction, though gaps in consistency and transparency limited their effectiveness in fully restoring public trust.

Another critical aspect of relevance is the adaptability of the prudential principle in responding to evolving risks. In a digital economy where financial technology companies and peer-to-peer lending platforms are reshaping credit markets, traditional prudential standards must evolve to remain effective. Failure to extend prudential oversight to these new actors can create parallel risks that undermine public trust in the broader financial system. Comparative experiences, such as the European Banking Authority's inclusion of fintech under prudential supervision, highlight the importance of adaptability in maintaining the principle's relevance. For Indonesia, this means expanding prudential regulation to encompass not only conventional banks but also emerging digital financial institutions, ensuring that credit agreements across the spectrum adhere to the same standards of fairness and stability (Arner et al., 2020).

Ultimately, the prudential principle remains highly relevant because it embodies the legal and ethical obligation of banks to operate with caution, responsibility, and transparency. Its application ensures that credit agreements are not merely private contracts but also instruments of public trust, carrying implications for the stability of the entire financial system. Where prudential norms are consistently enforced and visibly integrated into banking practices, public trust is strengthened. Where they are neglected or inconsistently applied, the credibility of both banks and regulators deteriorates. Therefore, the relevance of the prudential principle cannot be overstated; it is essential not only for the technical management of credit risk but also for sustaining the legitimacy of banking institutions in the eyes of society (Allen et al., 2022)

V. CONCLUSIONS

The analysis of non-performing loans and the prudential principle demonstrates that public trust in the banking system is deeply interconnected with both financial performance and legal accountability. In Indonesia, recurring challenges with nonperforming loans reflect weaknesses in the enforcement of prudential principles within credit agreements, creating a perception of systemic vulnerability that erodes confidence among borrowers and the wider public. By comparison, global practices, particularly in the European Union and the United States, illustrate how rigorous application of prudential norms, supported by strong regulatory oversight and consumer protection mechanisms, can mitigate the negative effects of loan defaults and sustain institutional credibility. The prudential principle remains highly relevant because it extends beyond technical risk management to embody the ethical and social responsibility of banks. When effectively implemented, it reassures the public that financial institutions are committed to fairness, transparency, and stability. Conversely, when it is neglected or inconsistently applied, trust deteriorates, leading to economic behaviors that further destabilize the financial system. The comparative perspective highlights that the relevance of the prudential principle lies not only in its formulation but also in its adaptability to evolving risks, including digital financial innovations and global crises such as the COVID-19 pandemic. Therefore, strengthening the prudential principle in Indonesia requires stricter enforcement, broader integration into credit agreements, and greater transparency to align with international best practices. Only through such reforms can public trust be effectively restored and preserved, ensuring that credit agreements remain a stable foundation for sustainable economic development.

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