

Original Research Article

The impact of Delinquent Loans on Financial Performance of Banks in Ghana

ABSTRACT

Loan portfolio is the largest asset and the biggest source of income for banks; consequently, most banks advance huge portions of financial resources as loans to clients. Despite the stringent evaluation and monitoring strategies put in place by banks to ensure repayment of loans by borrowers, a considerable proportion of loans become delinquent. As a result, this study investigates into the impact of delinquent loans on financial performance (interest income and net profit) of banks in Ghana. A negative correlation between delinquent loans and interest income as well as net profit is evident in this study. At $\alpha = .05$, delinquent loans account for exactly 60.0% of the variation in interest income ($t = -7.362$, $P < .000$) while delinquent loans account for 52.1% of the variation in net profit ($t = -8.632$, $P < .000$). The negative relationship between the independent variable and dependent variables implies that an increase in delinquent loans reduces interest income as well as net profit. Comparatively, delinquent loans have larger negative effect on interest income than net profit of banks. Apparently, it is recommended that BiG embarks on effective and regular monitoring of the loan from the time of disbursement till the final repayment as a means of reducing delinquent loans and its antecedent negative impact on interest income and net profit. Periodic relevant training programs could also be organized for loan officers particularly in the area of risk management and management of delinquent loans.

Keywords: Delinquent Loans, Interest income, Net profit, Financial Performance, Ghana

1. INTRODUCTION

Loan portfolio is the largest asset and the biggest source of income for banks; therefore, most banks advance huge portions of financial resources as loans to clients [1], [2]. Globally, banks grant loans to customers as a way of enhancing financial performance (FP) [3], [4]. To this effect, banks in Ghana (BiG) also engage in giving loans to customers [5]–[8]. Banking institutions give loans to a broad category of customers; a significant portion of the loans go to corporate institutions while the remaining part goes to private individuals. Universal Banks (commercial and investment banks) provide loans to an estimated 65% of Ghana's total population in comparison with 15% by Microfinance Institutions (MFIs) which is partly due to the provision of microfinance services by universal banks [9]. This presupposes that universal banks advance loans to greater proportion of the Ghanaian banking population than the MFIs and this may be because the universal banks also provide microfinance services such as microcredit to clients. The universal banks are better positioned to participate in, if not dominate, the future of the microfinance market because universal banks are more able to offer a wide range of financial products and services including micro lending at a relatively lower interest rate [8], [10]. This gives the indication that universal banks offer micro-loans to poor clients in addition to clients in the formal banking sector thereby providing loans to greater proportion of the Ghanaian population. BiG have various forms of evaluation method to access the credit worthiness of the customers as well as monitoring strategies to check the repayment of loans by customers [11]. The evaluation and monitoring methods used by banks include preliminary screening, loan proposal assessment

by credit committee as well as monitoring and repayment. The evaluation of credit worthiness of customers as well as monitoring of loan repayment by customers is very crucial if universal banks are to recover loans advanced to customers in due time. As a result, many banks have credit department that carry these essential functions.

Despite the stringent evaluation and monitoring strategies put in place by banks to ensure repayment of loans by borrowers, there are quite a large number of customers who are unable to pay the interest that accrues on the loan and sometimes even the principal amount of the loan [1], [2], [12], [13]. Recent studies show that many BiG suffer from non-payment of loans by customers [6]–[8], [14]–[17]. Loan delinquency among BiG has become so crucial compelling most banks to adopt alternative means of recovering delinquent loans; including personal liability on banking staff for recovery of loans. Having realized the worsening situation of delinquent loans among BiG, the major question is to what extent do delinquent loans affect the financial performance (FP) of banks? Several works have attempted to analyse the impact of delinquent loans on banking institutions in Ghana [6], [14], [15], [17]. However, in assessing the impact of delinquent loans on FP, most studies were void of financial statements and largely concentrated on MFIs. Again, single case studies have been employed, limiting the generalization effect the findings. Apparently, a recent study that attempted to analyse the impact of delinquent loans on lending ability and FP of BiG focused on Small and Medium Enterprises (SMEs) lending and as such only net profit and lending ability were analysed [8]. The motivation for this study stems from the gap existing in literature on the trend of delinquent loans and the impact of the phenomenon on elements such as interest income, operating profit and even dividends paid to shareholders. The study investigates the impact of delinquent loans on FP of BiG.

This study analyses the financial statements of banks over the period of five years (from 2009 to 2013) to determine the trend of delinquent loans and the impact on the operations of the banks. This study analyses the impact of delinquent loans on FP of BiG by assessing the impact of delinquent loans on interest income and net profit.

2. RESEARCH OBJECTIVES

The main objective of the study is to analyse the impact of delinquent loans on the FP of BiG. The following specific objectives would be achieved in order to accomplish the above general objective:

- To assess impact of delinquent loans on interest income in the selected banks from 2009 to 2013.
- To examine the impact of delinquent loans on net profit in the selected banks from 2009 to 2013.

3. LITERATURE REVIEW

3.1 Performing Loans and delinquent loans

The World Bank Policy Research paper on loans in Sub-Saharan Africa in 2005 establishes a loan as the lending of sum of money [18]. A loan is an agreement between a creditor and a debtor where the creditor agrees to give a sum of money known as the principal amount to the debtor who promises to pay the principal usually with interest to the creditor either in one lump sum or in installments over a specified period of time [19], [20]. Lending entails a lending institution giving a loan for promise of interest and principal to be paid in return in the

future [21]–[23]. All loans given by BiG are in the form of money. Therefore, this study adopts the definition of loan as a sum of money lent to an individual or an organization. It is worth mentioning that loan could also extend to the lending of property. However, for the purpose of this study the definition of loan will be limited to the lending of sum of money since loans given by BiG are monetary. Where the borrower meets the set deadline for loan repayment, performing loans are defined [24], [25]. Consequently, a loan is said to be performing if the principal and interest are paid at the date agreed by both the creditor and the debtor. Performing loans add up to the valuable asset portfolio for banks because of the generation of interest income [7].

The term “delinquent loan” is synonymous to “non-performing loan”, “impaired loans”, “bad loans” and “problem loans” [2], [18]. As a result, the terms loan default, delinquent loan, bad loan and non-performing loan are used synonymously in this study. Delinquent loans are loans that are ninety days or more past due [26]. Loan could also be delinquent if the debtor is either unwilling or unable to pay the amount borrowed when it is due [25], [27], [28]. A loan default also occurs when the debtor does not make required payments or comply with the loan covenant or agreement between the borrower and the lender. Conclusively, delinquent loans are loans for which both principal amount and interest charges are outstanding contrary to the terms and conditions of the loan agreement between the borrower and the lender and mostly are at least 90 days overdue.

3.2 Impact of delinquent loans on banking institutions

Globally, several studies have acknowledged the impact of delinquent loans on banking institutions [2], [4], [18], [20], [26], [29]. Many studies have also recognized the impact of delinquent loans on BiG [7], [8], [30], [31]. Mostly emphasize is exerted on the negative impact of delinquent loans on the FP and the credit granting potential of banking institutions. Among the studied impacts, one effect is paramount; limitation on FP.

Loan portfolio forms a greater proportion of the assets of banks because it is the principal source of interest income [2], [7], [15]. The provisions for delinquent loans reduce total loan portfolio of banks and consequently reduces the interest earnings on such assets. Recent studies indicate a correlation between delinquent loans and operating profit of banks [1], [2], [32], [33]. A study conducted in 7 Asian countries (Thailand, Hong Kong, Singapore, Indonesia, South Korea, Malaysia, and Philippines) from 1992 to 1999, using regression analysis, empirically revealed that when banks increased delinquent loans significantly and negatively influence earnings on loans [34]. Revenues of banks depend on lending. As a result, FPs and success of banks depend on how effectively lending activities are managed. This presupposes that the amount of revenue BiG can generate partially depends on the amount of delinquent loans standing in the books since provisions would have to be made out of the available operating profits to cover delinquent loans.

Delinquent loans adversely affect the ability of banks to cover all expenses including taxation banks which tend to have large loan portfolios [8], [35], [36]. Provision for doubtful loans reduces the net profit of banks and consequently reduces the amount of dividends paid to shareholders [37]–[39]. Study of the financial statement of banks indicates that bad loans have a direct effect on the net profit of banks [40]. This is because charge for bad debts is treated as expenses on the statement of comprehensive income and as such impact negatively on the net profit of banks. In Ghana, Barclays Bank Ghana Limited increased delinquent Loan charge from GH¢5,540,000.00 in 2007 to GH¢46,890,000.00 in 2008 and the results was a loss glaring in its 2008 financial statement partially due to the huge charge for bad debts which increased [41], [42]. This gives the indication that banks make adequate provisions and charges for bad loan portfolios affecting the return on investment (ROI) of the shareholders, thereby adversely affecting the ability of banks to even pay relatively higher

dividends to shareholders (especially banks with greater bad loan portfolios). Banks usually declare dividend only after making the required provision for delinquent loans. Consequently, delinquent loans could have an adverse effect on shareholders earnings. Provision for delinquent loans reduces the net profit of banks and in turn reduces the dividends paid to shareholders.

Despite the research related evidence given on delinquent loans and subsequent impact on FP of banks, evidence of delinquent loans and its impact on income statement elements such as interest income, operating profit as well as net profit is still lacking, hence the motivation for this research.

3.3 Conceptual framework

In conceptualizing the impact of delinquent loans on FP of banks, it is considered that, interest income, operating profit and net profit are significantly influenced by delinquent loans. Figure 1 shows the hypothesized relationships between delinquent loans and interest income, operating income and net profit.

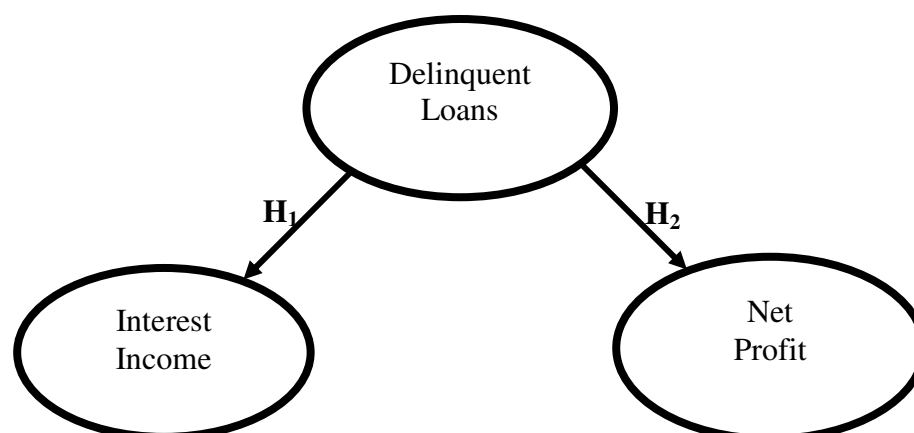


Figure 1: Conceptual framework for impact of delinquent loans on FP of banks
Source: Authors' Construct

3.4 Hypotheses:

H_0 : Delinquent loan does not have significant impact on x_i

H_a : Delinquent loan has a significant impact on x_i

For $i = 1, 2$ and X_1, X_2 represent interest income and net profit respectively.

4. METHODOLOGY

Quantitative research approach was used in this study. The data used in this study are secondary in nature. Secondary data on delinquent loans, interest income, operating profit and net profit are used in this study. The data were sourced from the published annual reports and financial statements of ten banks (Cal Bank Limited, Barclays Bank Ghana, Ecobank Ghana Limited, Ecobank Ghana Limited, Fidelity Bank Ghana Limited, Ghana

Commercial bank (GCB), Guaranty Trust Bank (GTB), Societe Generale Ghana Limited (SG Ghana), Zenith Bank Ghana Limited, Home Finance Company (HFC) Bank Ghana Limited and Unique Trust (UT) Bank. Data used cover a period of 5 years; 2009-2013. Consequently, 50 yearly observations of the variables are incorporated in data analysis. Access to the data was not a problem as these were published annually in the print and electronic media for public consumption. This made it easier to collect high quality data which would not have been of the same quality if collected it in its primary form. IBM SPSS Statistics version 21 was used to analyze the secondary data. Correlation and regression analysis was performed to determine the impact of delinquent loans on interest income, as well as net profit.

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181 5. RESULTS AND DISCUSSION

182

183 5.1 Impact of delinquent loans on interest income

184 Table 1 shows the model summary of the relationship between delinquent loans and interest
185 income. From the table, delinquent loans account for exactly 60.0% of the variation in
186 interest income. This indicates that delinquent loans limit the interest earnings of banks to a
187 greater extent.

188 **Table 1. Model Summary (Prediction of Interest Income)**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1				
1	.780 ^a	.608	.600	112.60934

189 a. Predictor: (Constant), Delinquent Loan

190

191 Table 2 illustrates an ANOVA test on the prediction of interest income from delinquent loans.
192 The test specifies whether regression is a better way of expressing the relationship between
193 bad loans and interest income. At $\alpha = .05$, the $P < .000$ indicate statistically significant
194 predictor (delinquent loans) for the dependent variable (interest income). Additionally, $P =$
195 $.05$ implies a good fit data for the regression model. Consequently, there is enough evidence
196 not to accept the null hypothesis (Delinquent loans have no significant impact on X_1).

197 **Table 2. ANOVA (Prediction of Interest Income)**

Model		Sum of squares	Df	Mean Square	F	Sig
	Regression	944784.503	1	944784.503	74.505	.000 ^b
1	Residual	608681.452	48	12680.864		
	Total	1553465.954	49			

198 a. Dependent Variable: Interest income

199 b. Predictor: (Constant), Delinquent loan.

200

201 Table 3 shows the coefficients of predicting interest income from delinquent loans. From the
202 table, delinquent loans significantly predict net profit at $\alpha = 0.05$ ($P < 0.05$). Additionally, a
203 unit change in delinquent loans decreases the conditional proportion of interest income by

204 8.9%. This indicates that delinquent loans have negative effect on interest. From the table,
205 $\beta_0 = 73.822$, $\beta_1 = -8.874$. The relationship between the two variables can be expressed
206 as follows:

207 **Interest income = 73.822 – 8.874 x_1**

208 The regression equation signifies that every 1 unit increase in Delinquent loans reduces
209 interest income by 8.874. The relationship indicates that delinquent loans have negative
210 effect on the interest earning potential of banks. Delinquent loans therefore limit the financial
211 performance of banks.

212 **Table 3. Coefficients (Prediction of Interest income)**

Model	Unstandardised Coefficients		Standardised Coefficients		t	Sig.
	B	Std. Error	Beta			
(Constant)	73.822	21.540			3.427	.001
1 Delinquent Loan	-8.874	1.028	-.780		-8.632	.000

213 a. Dependent Variable: Interest income

214
215 **5.2 Impact of delinquent loans on net profit**

216 From Table 4, the coefficient of determination (R²) is quite high at 52.1%. This signifies that
217 delinquent loans account for 52.1% of the variation in net profit. Table 5 specifies whether
218 the regression model gives a better estimate on the relationship between delinquent loans
219 and net profit.

220 **Table 4. Model Summary (Prediction of net profit)**

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.728 ^a	.530	.521	112.98263

221 a. Predictor: (Constant), Delinquent Loan

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223

224 Table 5 is an ANOVA test on the prediction of net profit from delinquent loans. At $\alpha = 0.05$,
225 the p-value of 0.000 signifies statistically significant predictor for net profit. Moreover, $P <$
226 0.05 implies a good fit data for the regression model. As a result, there is enough proof not
227 to accept the null hypothesis (Delinquent loans have no significant impact on X_2).

228 **Table 5. ANOVA (Prediction of net profit)**

Model	Sum of squares	Df	Mean Square	F	Sig.
Regression	691873.811	1	691873.811	54.201	.000 ^b

1	Residual	612723.551	48	12765.074
	Total	1304597.362	49	

- 229 a. Dependent Variable: Net profit
 230 b. Predictor: (Constant), Delinquent loan.

231
 232 Table 6 shows the coefficients of predicting net profit from delinquent loans. From the table,
 233 delinquent loans significantly predict net profit at $\alpha = 0.05$ ($P < 0.05$). Additionally, a unit
 234 change in delinquent loans decreases the conditional proportion of net profit by 6.9%. This
 235 indicates that delinquent loans have negative effect on net profit. From the table, $\beta_0 = 7.280$,
 236 $\beta_1 = -6.911$. The relationship between the two variables can be expressed as follows:

237 **Interest income = 7.280 – 6.911 x_2**

238 The regression equation denotes that every 1 unit increase in Delinquent loans reduces net
 239 profit by 6.911. The relationship indicates that delinquent loans have negative effect on the
 240 net profit of banks.

241 **Table 6. Coefficients (Prediction of net profit)**

Model	Unstandardised Coefficients		Standardised Coefficients		
			Beta	t	Sig.
	B	Std. Error			
(Constant)	7.280	18.255		.399	.692
1 Delinquent Loan	-6.911	.939	-.728	-7.362	.000

- 242 a. Dependent Variable: Net profit

243 6. CONCLUSION

244
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 246 Regardless of the stringent evaluation and monitoring strategies put in place by banks to
 247 ensure repayment of loans by borrowers, there are quite a large number of customers who
 248 are unable to pay the interest that accrues on the loan and sometimes even the principal
 249 amount of the loan. Consequently, this study was conducted to analyse the impact of
 250 delinquent loans on financial performance of ten banks in Ghana, namely; Cal Bank Limited,
 251 Barclays Bank Ghana, Ecobank Ghana Limited, Ecobank Ghana Limited, Fidelity Bank
 252 Ghana Limited, Ghana Commercial bank (GCB) Guaranty Trust Bank (GTB), Societe
 253 Generale Ghana Limited (SG Ghana), Zenith Bank Ghana Limited, Home Finance Company
 254 (HFC) Bank Ghana Limited and Unique Trust (UT) Bank. From the findings of this study, a
 255 negative correlation between delinquent loans and interest income as well as net profit is
 256 evident. This clearly indicates that there is a negative relationship between delinquent loans
 257 and financial performance of banks in terms of interest and net profit (return on investment)
 258 earning potential. The relationship between delinquent loans and interest income as well as
 259 net profit is further expressed in a regression analysis. At $\alpha = 0.05$, delinquent loans
 260 account for exactly 60.0% of the variation in interest income ($t=-7.362$, $P < .000$) while
 261 delinquent loans account for 52.1% of the variation in net profit ($t=-8.632$, $P < .000$). The
 262 negative relationship between the independent variable and dependent variables implies that
 263 an increase in delinquent loans reduces interest income as well as net profit of BiG.

264 Comparatively, delinquent loans have larger negative effect on interest income than net
265 profit of banks. Therefore, this study recommends that BiG embarks on effective and regular
266 monitoring of the loan from the time of disbursement till the final repayment as a means of
267 reducing delinquent loans and its antecedent negative impact on interest income and net
268 profit. Periodic relevant training programs could also be organized for loan officers
269 particularly in the area of risk management and management of delinquent loans.

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DEFINITIONS, ACRONYMS, ABBREVIATIONS.

BiG: Banks in Ghana

FP: Financial Performance