

**CHRISTIAN SERVICE UNIVERSITY COLLEGE**  
**SCHOOL OF BUSINESS**

**THE CAUSES AND EFFECTS OF LOAN DEFAULT ON THE PROFITABILITY OF  
RURAL BANKS: A CASE STUDY OF AMENFIMAN RURAL BANK**

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**A DISSERTATION SUBMITTED TO THE BUSINESS STUDIES, CHRISTIAN SERVICE  
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## **ABSTRACT**

This research was embarked upon to identify the causes and effects of loan defaults on the profitability of rural banks (a case study of Amenfiman Rural Bank). Specifically, the study sought to analyze the factors accounting for loan default in the rural banking industry, to determine ways of reducing loan defaults in financial institutions and to examine the effect of bad loans on the lending potential and profitability of rural banks. Questionnaires were administered to the employees of Amenfiman Rural Bank. Thirty (30) respondents were sampled out for the study. A combination of convenience sampling and the judgment sampling was used for the study. Findings from the research revealed that bad loans have been identified as one of the major factors affecting the profitability and survival of rural and community banks in Ghana. Most rural banks are unable to remain competitive in the turbulent financial sector/industry due to high default rate. Based on findings of this study, it is concluded that bad loans have a major negative effect on banks' profitability, lending potential and financial performance. The study recommended that, management should organize regular training programmes for credit staff in areas like credit management, risk management and financial analysis. This would sharpen the knowledge and skills of credit officers so as to improve on the quality of credit appraisal, prevent delayed loan approvals, enable credit officers appreciate the need to comply with credit policy and further enhance monitoring of credit.

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## **DEDICATION**

We dedicate this work to our mums and dads.

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# CHAPTER ONE

## INTRODUCTION

### **1.0. Background to Study**

The banking sector in Ghana have experienced a number of banks and other non-banking institutions such as rural banks, savings and loans, micro finance and credit unions failures; with loan default becoming the forerunner to these financial institutions ultimate failures in Ghana (Aballey, 2009). Loan default result from the inability of debtors to repay their loans and their interests within the specified timeresulting in adverse effects on the financial condition of the creditor (Agu & Okoli, 2013).Even though one of the major causes of serious banking problems continues to be ineffective credit risk management, the provision of credit remains the primary business of every financial institution in the world. For this reason, credit quality is considered a primary indicator of financial soundness and health of financial institutions. Default of loans and advances poses serious setbacks not only for borrowers and lenders but also to the entire economy of a country. Studies of banking crises all over the world have shown that poor loans (asset quality) are the key factor of bank failures. Stuart (2005) stressed that the spate of bad loans (non-performing loans) was as high as 35% in Nigerian commercial banks between 1999 and 2009. Umoh (1994) also pointed out that increasing level of non-performing loan rates in banks' books, poor loan processing, undue interference in the loan granting process, inadequate or absences of loan collaterals among other things, are linked with poor and ineffective credit risk management that negatively impact on banks profitability.

Logically, defaulting loans take their name from the fact that they are practically in opposition to the financial situation of the financial institution. By the time they are referred to as "bad loans", there is the fear that the amounts involved and their interest cannot be fully paid by the debtor (Awunyo-Vitor, 2013).According to the Monetary Policy Committee (MPC) of the Bank of Ghana's report on the economy, the Non-Performing Loans (NPL) ratio of the country deteriorated

from 16.2 percent in December 2009 to 17.6 percent as at December 2010. (Myjoyonline, 2011) In this regard, a financial loss is encountered instead of a profit, leading to adverse effects on the financial institution. Loan defaults need to be avoided in view of the fact that their effects are multidimensional; thus, they do not only hinder profitability among banks, but they also limit lending to the defaulting organization, individuals and other corporations. According to Kassim and Rahman (2008), some major reasons or causes of loan default are poor management skills and experience, non-existence of an efficient and effective loan policy, insufficient loan analysis, documentation errors, much emphasis on profit as against the quality of the loan to be granted, dishonest practices and attitudes, political and economic challenges in terms of depression and instability, unhealthy competition, inconsistent policy and regulation and political and social influences on the management of the banks.

Rural banking is the provision of financial services to poor and low-income households without access to formal financial institutions (Conroy, 2003). Rural bank programs provide loans, savings and other financial services to low-income and poor people for use in small businesses in rural areas (Mohammed & Hassan, 2008). Rural banks provide similar products and services to their customers as formal sector financial institutions however, the scale and method of delivery differ, but the fundamental services of savings, loans, and insurance are the same. Access to financial services is imperative for the development of the informal sector and also helps to mop up excess liquidity through savings that can be made available as investment capital for national development (World Bank-Africa Region, 1999). Rural banks have the potential to reduce poverty by bringing a significant improvement in the lives of the active poor in rural areas.

### **1.1. Statement of the Problem**

Many rural banks in Ghana have not survived in the banking industry due to loan defaults. These huge overdue balances (bad loans) in their books with its resulting consequences have resulted in

the collapse of rural banks such as Antoabiase rural bank in the Ashanti Region and both Kakum and Tano Agya rural bank in the Brong-Ahafo Region. Research studies have shown that bad loans make two major effects on banks. These effects are the limitation of bank's financial performance and lending potential (Ghana Banking Survey, 2011). According to Aballey (2009), loan portfolio is typically the largest asset and the predominant source of income for financial institutions. In Ghana, rural banks play an important role in the development of the economy. Huge bad loans could therefore affect their performance of this important role. In spite of the huge income generated from their loan portfolio, available literature shows that huge portions of rural bank loans usually go bad and therefore affect the financial performance of these institutions. Yet, ironically, causes of loan defaults among groups and individuals issues does not have a commiserate level of formal academic study. In view of the above, it is important to find out the causes of loan defaults among groups and individuals and its impact on the rural banks profitability. Therefore, critical examination is crucial to determine the possible causes and effects of loan default and to find appropriate remedies to prevent a collapse of such institutions as well as their liquidation.

## **1.2. Objectives of the Study**

The study is aimed at identifying the causes and effects of loan defaults on the profitability of rural banks (a case study of Amenfiman Rural Bank). The specific objectives of the study are;

- To analyse the factors accounting for loan default in the rural banking industry.
- To determine ways of reducing loan defaults in financial institutions.
- To examine the effect of bad loans on the lending potential and profitability of rural banks.

## **1.3. Research Questions**

The study is guided by the following questions;

- What are the factors accounting for loan default in the rural banking industry?
- What are the ways of reducing loan defaults in financial institutions?

- What are the effect of bad loans on the lending potential and profitability of rural banks?

#### **1.4. Significance of the Study**

The study will bring to the fore the impact of defaulted loans on the profitability of rural banks. In addition, the research will help to suggest alternatives to improve the operation of financial institutions in Ghana. The study is also expected to throw light on the weaknesses in the lending practices adopted by rural banks. The outcome of this study will also assist the banking industry to identify and develop methods and measures to reduce the effect of loan defaults to maximize profit, thereby increasing recovery rate as well. The management of these financial institutions could also use the outcome of this research in their operations so as to gain edge over their competitors within the industry. Lastly, the study will add up to the existing stock of knowledge on defaulting loans and the extent to which these loans affect the financial performance of banks in terms of profit maximization. It will therefore serve as a useful material for future research work by other related researchers.

#### **1.5. Scope of the study**

The study will focus on Amenifiman Rural Bank. The study will cover employees of Amenifiman Rural Bank. The period of the study will span from 2010 to 2016 for the various types of loans applicable in the bank. The purpose of choosing a rural bank is that, they are required to lend to small and medium scale businesses that do not have collateral.

#### **1.6. Limitations of the study**

The data collection was restricted to only the catchment areas of Amenifiman Rural Bank, which may fail to represent the actual scenario of the whole country.

## **1.7. Organisation of the Study**

The structure of the study encompasses five chapters. The chapter one includes the introduction, statement of problem, objectives of the study, research questions, significance of the study, scope of the study, limitations of the study and organisation of the study. The chapter two discussed the review of available literature on the topic. Chapter three introduced the methodology employed in the study to achieve the research objectives. The chapter four is the data presentation and analysis. Chapter five presented a summary of issues covered in the dissertation as well as the empirical and theoretical conclusion and recommendations.

## CHAPTER TWO

### LITERATURE REVIEW

#### 2.0. Introduction

This chapter will present a comprehensive review of relevant literature in an attempt to position the study in an appropriate theoretical framework. Thus, it will discuss findings of related researches to this study.

#### 2.1. Loans

A loan is usually available on a fixed and spot basis and can be secured or unsecured. Loans are offered for specify amounts for specified periods. Mabvure et.al, (2012), describes loans in general as part of or a major component of the total assets of every bank. The lender cannot seek repayment prior to expiry of the period unless there has been some default. In a legal sense, a loan facility is a contractual promise between a lender and a borrower where the lender usually gives consent to the granting of an amount to a borrower, who intend undertakes to resettle same to the lender either in bulk or in instalments within a specified period of time. A loan may be classified as performing or non-performing.

**Performing loans:** A performing loan facility takes place when the agreement in terms of the payments of the principal and the interest component between the lender and the borrower are honour up to date. A release by the Bank of Ghana (2008), classified loans that has its principal amount together with the interest being resettled by the borrower as current. Again, to the Central Bank, an overdraft could also be classified as current or performing loan if there has been a consistent action on the facility with no indication of a hardcore of liability building up. This classification means that performing loans are loan facilities that have the interest and principal components repaid within the agreed or stipulated time. This category therefore constitutes huge

part of the quality asset portfolio of most financial institutions particularly banks in terms of the interest revenue that are generated by such resources.

**Non-Performing loans (NPLs):** NPLs are loans that are still in force; however, it is uncertain whether the debtors would be able to often honour their loan obligations. To Goldstein and Turner (1996), the build-up of NPLs is usually attributed to many factors such as economic downturn, macroeconomic instability, moral hazard, high interest rate, extreme dependence on overly high-priced inter-bank borrowings and insider borrowing. Bad loans result from the inability of debtors to repay their loans and their interests within the specified time (Aballey, 2009), resulting in adverse effects on the financial condition of the creditor (Aguand Okoli, 2013).

To Alton and Hazen (2001), NPLs are loans which have its ninety days or beyond past due or which have no longer accruing interest from it. This thought was corroborated by Hennie (2003), who also agrees in the form of an argument that NPLs are loans having no revenue generating from it. In the classification of Basu (1998), “bad or defaulting loans” were mostly used interchangeably with non-performing and impaired loans as noted by Fofack (2005). Berger and De Young, (1997) on other hand added the term problem loan to this tag of loan. These terms are therefore interchangeable used throughout this research work. Very often credit facilitates that have both its principal and interest in arrears for a long period of time as against the stipulated repayment schedule agreed upon by both parties are classified as defaulting loans or NPLs. Thus, any loan facility granted to a borrower that is not current in terms of repayment of its principal and interest as against the agreed repayment schedule is termed as non-performing

There have been divergent views by researchers in various countries on the descriptions of defaulting loans. Some adopted quantitative criteria such as number of days that the loan scheduled payments were due but to which it was not honoured while others used qualitative norms such as the background information about the clients’ financial status and the management judgment about

future payments of the loan. Defaulting loans take their name from the fact that they are practically in opposition to the financial situation of the bank. By the time they are referred to as “defaulting loans”, there is the fear that the amounts involved and their interest cannot be fully paid by the debtor (Awunyo-Vitor, 2013). In this regard, a financial loss is encountered instead of a profit, leading to adverse effects on the bank, the

### **2.1.1. Classification of Loans**

There are various ways of classifying loans. This process of loan classification helps banks to evaluate the loan facilities so as to be able to grant loans to grades based on the observed risk and other relevant features of the loans. The continual evaluation and categorisation of credit facility makes it possible for banks to monitor the quality of their loan facilities and then take corrective action whenever possible to counter decline in the credit quality of their loan portfolios. To Laurin et al (2002), banks should use more complex internal control classification systems to do away with the more standardized systems that the regulators of bank need in order to evaluate and report on the purposes which are intended to facilitate excessive monitoring. Loan advances portfolios of financial institutions are classified into various categories or types to determine the level of provisions to be made in conformity with the banking regulations stated in the Banking Act of 1963, Act 179. Kone (2006), classified the various loans as current, OLEM, substandard, doubtful and loss. The Central Bank of Ghana has also classified the loan facilities as the following:

**Current:** This type of loan facility take place when the debtor is up to date in honouring the loan obligation in terms of settling both the principal and the interest component as stipulated in the agreement. The indications that an overdraft facility is current would mean that there has been a regular action on the said account with no signs that a hardcore of debt is accumulating(Conroy, 2003).

**OLEM:** This is a facility that is presently secured by enough security, both as to the principal and the interest component, but its weak potential could create an undeserved credit risk, although not to the level of justifying this category as substandard. This category would include unusual advances due to the nature of the advance, customer or project, advances where there is a lack of financial information or any other advance where there is more than a normal degree of risk(Mohammed and Hassan, 2008).

**Substandard:** This type of loan advance shows a distinct loan weakness that endangers the insolvency of the debt incurred. It normally includes loans granted to debtors who are having cash flow element that is not enough in meeting the current maturing debt, loans to borrowers which are significantly undercapitalized, and loans to borrowers lacking sufficient working capital to meet their operating needs. Substandard loan advances are not secured by the current sound worth and paying capacity of the client. NPLs and receivables which are more or up to ninety days overdue but not up to the 180 days unpaid are also substandard loan. Thus, loan advances become unpaid when the principal or interest component is due and unpaid for 30 days or more(AguandOkoli, 2013).**Doubtful:** This type of loan advances indicates all the weakness features shown in the substandard loan category with other added features that the loan is not well-secured and the limitation making the liquidation in full on the basis of the facts currently existing together with the conditionality, values which could be highly doubtful. Even though the probability of loss is very high, the existence of certain strong indicative factors may work to the advantage and strengthening of the repayment, deferring its estimated loss categorisation until more exact status determined. NPLs and receivables having 180 days or more unpaid period but not up to the 360 days unpaid period are classified as doubtful loan advance.

**Loss:** Loss are said to be uncollectible and of such little value that their continuation as recoverable advances is not warranted. However, this does not indicate that there is no recovery value of the loan advance, but the practicability to defer writing off this type of loan even though partial

retrieval may be hampered in the future. This type of loan advance includes liquidated or insolvent companies with bad current asset and cash flow. Financial institutions should however not keep this loan advances within their records no matter the long-term effort made in recouping the advances. Losses should be taken in the period in which they surface as uncollectible. The NPLs and the receivables having the 365 days unpaid period or more are all termed as a loss(Mohammed and Hassan, 2008).

### **2.1.2. Causes of Defaulting Loans**

In finance default occurs when a debtor has not met his or her legal obligations according to the debt contract, example has not made a scheduled payment, or has violated a loan covenant (condition) of the debt contract. A default is the failure to pay back a loan. Default may occur if the debtor is either unwilling or unable to pay their debt. This can occur with all debt obligations including bonds, mortgages, loans, and promissory notes. (Wikipedia, 2011) A loan default occurs when the borrower does not make required payments or in some other way does not comply with the terms of a loan(Murray, 2011). According to Ahmad (1997), some of the main factors that lead to bad loans are the reluctant in loan resettlement coupled with diversifying the funds by the creditors and the deliberates lack of appropriate appraisal of the facility by the Loan Officers. Kwakwa (2009) have indicated that loans facility granted to corporate firms tend to result in high loan default rate as real GDP falls, and that the decline in the local currency against the major foreign bureaux in the exchange rate, have a direct repercussion on the repayment ability of borrowers. Again, as noted by Gorter and Bloem (2002), defaulting loans are generally caused by some factors that are likely to happen due to erroneous economic decisions undertaken by individuals and other circumstances such as unfavourable weather conditions and unexpected price changes for certain products which are sometimes beyond the realm of the individual. Whenever

this happens, loan holders ought to make allowances for a regular share of default in the form of bad loan provisions, or the risk could be spread through an insurance policy.

Ahmad, (1997), mentioned some important factors that cause loan defaults which include; lack of willingness to pay loans coupled with diversion of funds by borrowers, wilful negligence and improper appraisal by credit officers. In addition, Hurt and Fesolvalyi (1998), cited by Kwakwa, (2009) found that, corporate loan default increases as real gross domestic product decline, and that the exchange rate depreciation directly affects the repayment ability of borrowers. Balogun and Alimi (1988) also identified the major causes of loan default as loan shortages, delay in time of loan delivery, small farm size, high interest rate, age of farmers, poor supervision, non-profitability of farm enterprises and undue government intervention with the operations of government sponsored credit programmes. Moreover, Akinwumi and Ajayi (1990) found out that farm size, family size, scale of operation, family living expenses and exposure to sound management techniques were some of the factors that can influence the repayment capacity of farmers.

According to Olomola (1999), loan disbursement lag and high interest rate can significantly increase borrowing transaction cost and can also adversely affect repayment performance. Berger and DeYoung, (1995) indicated that, improper selection of an entrepreneur, deficient analysis of project viability, inadequacy of collateral security/equitable mortgage against loans, unrealistic terms and schedule of repayment, lack of follow up measures and default due to natural calamities are the causes of loan defaults. Okpugie (2009) also indicated that, high interest charged by the banks has been discovered to be the reason behind the alarming default. This was also confirmed by Vandel (1993), who also found that high interest rates charged by banks tend to facilitate default by borrowers.

According to Bridge (1998), bad loans accounted for most banks which were in distress and the major causes of these bad loans were insider lending, macro-economic instability and lending to high risk borrower. Insider lending was identified as one main factor of bad loans that led to collapse of local banks. In Nigeria for instance, insider loans which were all unrecoverable accounted for 65% of the total loans of the four local banks that were liquidated in 1995 (NDIC, 1994). According to the study it was cleared that much of the loans of the Uganda local banks taken over by the Bank of Uganda (BOU) in 1995 were granted the various directors and employees of the local banks. The study concluded that insider lending posed a threat to soundness of the lending due to the fact that most of these facilities were employed in speculative projects such as real estates which were not able to generate short term returns to pay back the loans. This means that moral hazards were thus severe in those banks. The case of most rural banks cannot be exempted from insider loans. Most loans contracted from other lending firms are shared among senior managers and board of directors.

### **2.1.3. Ways of Reducing Loan Defaults**

Kohansal and Mansoori (2009) are of the view that, lenders devise various institutional mechanisms aimed at reducing the risk of loan default (i.e. pledging of collateral, third-party credit guarantee, use of credit rating and collection agencies, etc.). Kay Associates Limited (2005) cited by Aballey (2009) states that bad loans can be restricted by ensuring that loans are made to only borrowers who are likely to be able to repay, and who are unlikely to become insolvent. Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision. Loan repayments should be monitored and whenever a customer defaults action should be taken. Thus, banks should avoid loans to risky customers, monitor loan repayments and renegotiate loans when customers get into difficulties.

**Monitoring of loans:** Monitoring is an integral part of loan administration processes. This enables the bank to acquaint itself with the progress of work. Monitoring guides credit officers to know the

status of the loan whether repayments are made as contained in the loan agreement. Constant monitoring prevents loan diversion. Rouse (1989) recognises that regular monitoring of loans enhances the lenders image in the eyes of the customer but it is an area where many lenders ignore but if carried out properly, the occurrence of loan defaults will reduce drastically. Koontz (2001) maintains that, loans should be monitored during the repayment period of the loan. The banks should ensure that the loan is being used for eligible purposes; the quality of the loan will be maintained in the future and its repayment sources are protected in order to guard against unacceptable deterioration of the credit and the corpus of the bank. Should a borrower show signs of such deterioration, the Bank should be able to take action before a loss would result. Aballey, (2009) observed that, monitoring of loans can minimize the occurrence of loan defaults through the following major purposes that it serves:

- Ensure the utilization of the loan for the agreed purpose.
- Identify early warning signals of any problem relating the operations of the customer's business that are likely to affect the performance of the facility.
- Ensure compliance with the credit terms and conditions.
- It enables the lender discuss the prospects and problems of the borrower's business.

**Credit analysis:** Aballey, (2009) defined credit analysis as the process of evaluating an applicant's loan request or a corporation's debt issue in order to determine the likelihood that the borrower will live up to his/her obligations. The Credit Policy of some rural banks in Ghana identifies credit analysis to be in two-phases: phase one is a preliminary credit evaluation to determine whether the applicant will be able to qualify for a loan of the desired amount. This phase includes a review of preliminary plans and specifications, project cost breakdown, feasibility studies, financial projections for the completed project, and an analysis of the borrower's most recent budgets, financial statements, bond ordinances/resolutions, and rate structure. Various factors are considered during the preliminary credit review. These factors include the feasibility of the project, the borrower's financial condition, its ability to cover its existing and potential debt payments, current

and projected user rates, and other revenue sources and the economic stability of the borrower. While the bank has final responsibility to determine whether the loan applicant's credit history and security is sufficient to be able to approve the loan, it works closely with the stakeholders on the project cost estimates and the economic pro-formal for the proposed project. In some situations, projects are modified so the loan applicant can handle the project and still meet the minimum credit requirements.

Applications passing the preliminary credit review move on to the second phase of the credit approval process. Borderline applicants are advised of their status and are free to continue in the process if they so choose, with the understanding that the bank has concerns that need to be addressed. There are no guarantees at this point that any of the projects will be granted a loan. That decision only comes after a more detailed final credit evaluation is completed. Phase two of the credit evaluation takes a closer look at the project and the borrower. The banks also complete a more extensive analysis of the financial status of the applicant. This will include additional financial information such as the last four years' financial statements (audited, if available), detailed debt information, budgets, system data, local economic characteristics and other information deemed necessary. Staff will prepare ratio and trend analyses, projections, review rate structures, and review the local industry information to determine the borrower's ability to repay the loan. While all applicants are subjected to the preliminary credit review, institutions with existing loans that are being repaid according to the loan terms can quickly pass through review process.

## **2.2. Assessment of Loan Portfolio Quality**

The parameters applied in assessing loan portfolio quality include the following:

**Overdue loan ratio:** This measures the proportion of overdue loans in the gross loan portfolio outstanding. A declining ratio is desirable but this should not emanate from new credit facilities granted. A healthy situation should be from recoveries of overdue outstanding (Mohammed and Hassan, 2008).

**The NPL ratio:** The NPLs are aggregate of substandard, doubtful and loss categories, which pose high degree of difficulty for recovery. The ratio is also referred to as high risk and is derived by relating the component to total loan portfolio. An increasing trend depicts development of a hardcore portfolio, arising from weakness in the credit management process. A tolerable prudential limit is 25%(Conroy, 2003).

**Loss category to total NPL ratio:** This determines the loss component in the entire non-performing loan portfolio. An increasing trend is unacceptable since this indicates persistent deterioration in the loan portfolio quality. An increasing trend exhibited by the loan portfolio quality ratios shows an unfavourable development, which requires the institution of far reaching measures to strengthen credit management. These may include taking decision based on objective appraisal report, attesting to a good track record of the customer, effective monitoring of utilization of funds to forestall any diversion, supervision to ascertain state of activities being financed, and instituting recovery schedule among others(Aguand Okoli, 2013).

### **2.3. Credit Risk Management System of Banks**

Numerous researchers have studied reasons behind bank problems and identified several factors (Bridge and Harvey, 1998). Problems in respect of credit especially, weakness in credit risk management have been identified to be the main part of the major reasons behind banking difficulties. Loans forms huge proportion of credit as they normally account for 10 – 15 times the equity of a bank (Kitwa, 1996). In this way, the business of banking is potentially faced with difficulties where there is small deterioration in the quality of loans. Poor loan quality starts from the information processing mechanism (Liuksila, 1996) and then increase further at the loan approval, monitoring and controlling stages. This problem is magnified especially, when credit risk management guidelines in terms of policy and strategies and procedure regarding credit processing do not exist or are weak or incomplete. In order to minimize loan losses as well as credit risk, it is

crucial for banks to have an effective credit risk management system in place (Basel 1999). As a result of asymmetric information that exists between banks and borrowers, banks must have a system in place to ensure that they can do analysis and evaluate default risk that is hidden from them. Information asymmetry may make it impossible to differentiate good borrowers from bad ones (which may culminate in adverse selection and moral hazards) have led to huge accumulation of non-performing accounts in banks (Gobbi, 2003).

Credit risk management is very vital to measuring and optimizing the profitability of banks. The long-term success of any banking institution depends on effective system that ensures repayments of loans by borrowers which is critical in dealing with asymmetric information problems, thus, reduce the level of loan losses (Basel, 1999). Effective credit risk management system involves establishing a suitable credit risk environment; operating under a sound credit granting process, maintaining an appropriate credit administration that involves monitoring, processing as well as enough controls over credit risk (Greuning and Bratanovic 2003). Top management must ensure, in managing credit risk, that all guidelines are properly communicated throughout the organization and that everybody involved in credit risk management understands what is required of him/her. Sound credit risk management system (which include risk identification, measurement, assessment, monitoring and control) are policies and strategies (guidelines) which clearly outline the purview and allocation of a bank credit facilities and the way in which credit portfolio is managed; that is, how loans were originated, appraised, supervised and collected (Greuning and Bratanovic 2003).

The activity of screening borrowers had widely been recommended by Derban et al, (2005) among others. The theory of asymmetric information from prospective borrowers becomes critical in achieving effective screening. In screening loan applicants, both qualitative and quantitative techniques should be used with due consideration for their relative strength and weaknesses. It must be stressed that borrowers' attributes, assessed through qualitative models can be assigned numbers with the sum of values compared to a threshold. This technique is termed as "credit scoring"

(Heffernan, 1996). The rating systems, if meaningful, should signal changes in expected level of loan loss (Santomero, 1997). Chijoriga (1997) posited that quantitative models make it possible to among others, numerically establish which factors are important in explaining default risk, evaluate the relative degree of importance of the factors, improving the pricing of default risk, be more able to screen out bad loans application and be in a better position to calculate any reserve needed to meet anticipated future loan losses.

Establishing a clear process for approving new credit and extending existing credit and monitoring credits granted to borrowers (Mwisho, 2001) are considered important when managing credit risk. Instruments such as covenants, collateral, credit rationing, loan securitization and syndication have been used by banks in developing countries in controlling credit losses. It has also been identified that high-quality credit risk management staff are critical to ensuring that the depth of knowledge and judgment needed is always available, thus ensuring the successful management of credit risk in banks (Mwisho, 2001).

Supervisors of banks more often than not, place considerable importance on formal policies which are laid down by their boards and aggressively implemented by management. This is most critical with regard to banks' lending function, which stated that banks adopted sound systems for managing credit risk (Zech, 2003). In order to appropriately analyse credit risk factors, banks' chief credit risk officers are required to have detail understanding of the principal economic factors that drive loan portfolio performance and the relationship between those factors. Most credit risk officers in the banking industry analyse factors such as; inflation, the level of interest rates, the GDP rate, market value of collaterals among others, for banks in mortgage financing. Also, traditional financial management texts posit that credit manager would take note of the five Cs of credit – character, capacity, capital, collateral and conditions to evaluate the probability of default (Casu et al, 2006). These factors are in line with the arbitrage pricing theory of Stephen Ross which is the most applicable to loan portfolio management.

## **2.4. Effects of Bad Loans on the Banking Institutions**

Banks derive most of their income from the interest they charge on loans they disburse which contribute to the profitability of these banks. In view of this, when such loans end up as not performing, the financial strength of these banks are affected. As stipulated in the banking regulations, banks undertake enough provisions and charges for bad loan that is impairment charges and therefore the impact is undesirably on the financial performance these banks. As indicated in the Bank of Ghana Act (2004) on the loan acquisition policy, loans attain non-performing tag if it is at least ninety days unpaid period, which will make it to invite certain basic rate of 25%, 50% and 100% for substandard, doubtful and loss, respectively.

To Bloem and Gorter (2001), even though NPLs tend to affect negatively all the financial institutions, the impact is however felt more by those within the commercial banks and mortgage financing institutions which usually possess large chunk of loan facilities. This ultimately hampers the ability of these financial institutions in granting further loans to respective applicants. Large defaulting loans could lead to dwindling confidence level of both depositors and foreign investors who may adopt strange position against the banks which might result in a negative signal and liquidity problems. Bad debts policy tends to reduce total loan portfolio of the financial institutions thus affecting the interest earnings on such assets. Banks thus experience huge cost of operation through this direction. Bad debt could result in banking challenges which might eventually leads liquidation of banks having unprecedented NPLs as confirmed by some of the existing literary works. Demirguc-Kunt et al., (1989) as cited in Berger and De Young(1997) confirmed by saying that financial institutions undergoing failings might have high amount of bad debts prior to failure and therefore the quality of asset at its disposal is a statistically enough predictor of bankruptcy.

## **2.5. Theoretical Framework**

**Adverse Selection Theory:** Pagano et al (1993) showed that information sharing reduces adverse selection by improving banks information on credit applicants. The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender). The party that knows less about the same specific item to be transacted is therefore in a position of making either the right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of non-performing loans in banks (Bofondi and Gobbi, 2003).

**Moral Hazard Theory:** The moral hazard problem implies that a borrower has the incentive to default unless there are consequences for his future applications for credit. This result from the difficulty lenders have in assessing the level of wealth borrowers will have accumulated by the date on which the debt must be repaid, and not at the moment of application. If lenders cannot assess the borrowers' wealth, the latter will be tempted to default on the borrowing. Forestalling this, lenders will increase rates, leading eventually to the breakdown of the market (Alary and Goller, 2001).

**Financial Sustainability Models:** Classic microeconomic theory suggests that financial sustainability can be modelled through a Marginal-Revenue- Marginal-Cost approach (Jackson and McConnell, 1980). The means for determining the behaviour, including viability, of a competitive entity is to calculate and compare, at each price level, amounts that each additional unit of output would add to total revenue on the one hand, and to total cost on the other. That is, in comparing the marginal revenue and the marginal cost of each successive unit of production, any unit whose marginal revenue exceeds marginal cost should be produced and any unit marginal cost whose exceeds marginal revenue should not. The equilibrium point where marginal revenue equals marginal cost is the key to the output-determining rule that suggests the entity will maximize profits

or minimize losses by producing at that point where marginal revenue and marginal cost equals (Jackson and McConnell, 1980).

## **2.6. Review of Empirical Literature**

At large, the main effect of defaulting loans on banks is the fact that increasing bad loans limit the financial growth of banks (Karim, Chan and Hassan, 2010). This consequence is as a result of the fact that bad loans deprive banks of the needed liquidity and limit their capability to fund other potentially viable businesses and make credit facilities available to individuals. Karim et al. (2010) argues that there are a lot of other viable businesses that the bank cannot explore as a result of the fact that its funds are caught up in bad loans. In the face of these consequences, the bank experiences a shortfall in generated revenues (Ghana Banking Survey, 2013), and this translates into reduced financial performance (Nawaz et al. 2012). Another basic effect of bad loans on the bank is a reduction in the bank's lending potential (Karim et al., 2010). Though this has been acknowledged earlier, it is important to discuss it as a primary independent effect. Banks make a greater part of their revenues and profit from lending activities (Nguta and Huka, 2013). As a result, when banks lose much of their lending capital to bad loans, it is likely that a greater part of their revenue is lost. Once revenue is lost in one financial year, the capability of the bank to provide access to credit facilities to other businesses and individuals would practically fall in the following financial years. This means that the bank would fail to lend, or it would reduce its amount allocated to lending in the next financial year.

Azeem (2012) in their study on determinants of non-performing loans in the US banking sector for the period 1985-2010 using OLS regression model for data analysis and found that real total loans have positive significant effect on non-performing loans, while interest rate and GDP per capital has a negative significant association with non-performing Loan (NPLs). Similarly, Vogiazas and Nikolaidou (2011) investigated the determinants of defaulting loans in the Romanian banking sector

during the Greek crisis for the period 2001- 2010. Their findings indicated that construction and investment expenditure, unemployment and inflation rate and the Romanians external debt to GDP and M2 narrow money and intermediate money) influence the credit risk of the country's banking system. Hamisu (2011) studied credit risk and the performance of Nigerian banks using descriptive, correlation and regression techniques for a sample of banks from 2004- 2008. Their findings reveal that credit risk management has a significant impact on the profitability of Nigeria banks and that the management of banks needs to be cautious in setting up a credit policy that might not negatively affects profitability of banks. Further implications of their study findings, was that the management of banks also need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits.

Bofondi and Ropele (2011) investigated the macroeconomic determinants of bad loans of Italian banks for the period 1990-2010 using quarterly data and found that defaulted loans are positively associated with the unemployment rates, lending rates and negatively associated with the GDP growth rate. Similarly, Ekanayake and Azeez (2015) investigated the determinants of non-performing loans in licensed commercial banks in Sri Lanka for the period 1999- 2012 and found that the level of non-performing loans can be attributed to both macro-economic conditions and banks specific factors. Their study results reveal that non-performing loans tends to increase with deteriorating banks efficiency and there was a positive correlation between loan to asset ratio and non-performing loans. They also observed that banks with high level of credit growth is associated with a reduced level of non-performing loans, while larger banks incur lesser loan defaults compared to smaller banks. However, the study found with regards to the macro economic variables, that non-performing loans vary negatively with growth rate of GDP, while inflation was positively related to the prime lending rate.

## **CHAPTER THREE**

### **METHODOLOGY**

#### **3.0. Introduction**

This chapter presents the methodology used to carry out the study. It discusses the research design, profile of Amenfiman Rural Bank, population and sample size, data collection procedure, data collection instrument and data analysis.

#### **3.1. Research Design**

Research design is a plan that promotes systematic management of data collection. Design and methodology dictate what is needed to answer your research questions. The study adopts a descriptive study approach. According to Pilot and Hurgler (1995), descriptive survey aims predominantly at observing, describing and documenting aspects of a situation as it naturally occurs rather than explaining them. The design provides a more accurate picture of events at a point in time. Fraenkel and Wallen (1993) continued that one big advantage of the descriptive survey design is that it has the potential to provide us with a lot of information obtained from quite a large sample of individuals. Creswell (2003) is however of the view that a descriptive study involves measurement, classification, analysis, comparison and interpretation of data. According to Creswell (2002), a descriptive study identifies and defines the problem, selects tools for collecting data, describes, analyzes and interprets the data.

#### **3.2. Profile of Amenfiman Rural Bank limited**

Amenfiman Rural Bank limited, one of the leading Rural Banks in Ghana was the first Rural Bank established in the western region and the fourth in Ghana in 1980 to provide essential banking services to rural and peri-urban communities in which we operate. The bank was incorporated under the Ghana companies code 1963 (Act 179) and received its certificate to commence business in May 1980 and also licensed under the banking Act 2004 (673) to engage in the ordinary business of

banking. The bank is dedicated to mobilizations of surplus funds from its catchment areas and channeling of such funds into viable and profitable economic ventures by lending to individuals and groups in all sectors and also to small and medium enterprises, thereby creating wealth alleviating poverty. Our core mandate is to accept deposit, provide lending, and cash management services and related financial services and support for enterprise growth. The bank has successfully executed this mandate and provided the necessary catalyst for rural community development and also promoted growth by creating jobs and improving the lives of its clients. Our products which are tailor made to suit the needs of our customers include savings account, current account, investment accounts, loan products and funds transfer services both local and international. Our flexible and hybrid savings and investment products have provided the platform to inculcate savings habits in the people especially the low-income earners of our target market including farmers and petty traders.

### **3.3. Population and Sample Size**

The population of a research is the study of a large group of interest for which a research is relevant and applicable. The target population of this study comprised all the workers of Amenfiman Rural Bank limited (Santase branch). All the 30 employees of the bank were sampled for the study.

### **3.4. Sampling Technique**

Sampling Technique is the process by which relatively small number of individuals or measures of individuals, objects or events is chosen and analysed in order to find out something about the entire population from which it was chosen. A combination of convenience sampling and the judgment sampling (where employees who are good prospects for accurate information were selected), will be adopted for this study. Convenience sampling is a non-probability sampling technique where subjects are selected because of the convenience of accessibility and proximity to the researcher. Convenience sampling allowed the selection of the most accessible respondents while judgment

sampling helped in identifying respondents that seem appropriate. Hence, employees who have been with the company for a period of over six months were chosen for the study.

### **3.5. Data Collection Procedure**

There are two main sources from which data will be collected. These are primary sources and secondary sources. Primary data was obtained from employees through the administration of questionnaires during the field work. The questionnaire used in this study was the self-completion type. Self-completed questionnaires are the ones which are handed directly to the respondent who completes it and hands it back to the researcher. Secondary data was also obtained from journals, articles, books, reports, publications, electronic books and from the internet. Literature obtained from secondary sources regarding loan defaults were reviewed to identify factors that cause them. Secondary data is crucial for any researcher because it allows the researcher to know what has been done in the area of interest and the procedures that were used to come out with those findings.

### **3.6. Data Collection Instrumentation**

A questionnaire was chosen as the data collection instrument. The questionnaire had close-ended questions which respondents were asked to tick the appropriate answer. The questionnaires were divided into various sections to capture the critical areas spelt out in the objectives for the study. The questions were thoroughly explained to the respondents after copies of the questionnaire were handed to them. The purpose was to help the respondents understand the relevance of the research and provide their independent views on the questionnaire items given them. To have a valid and a reliable data, the researcher ensured that the questionnaires were well prepared which allowed error minimization. A total of thirty (30) questionnaires were sent out and were distributed to the employees. The researcher also undertook direct observation of work processes and procedures within the institution.

### **3.7. Data Analysis**

The present study will employ quantitative techniques for data analysis to achieve the set objectives. The Statistical Package for Social Sciences (SPSS v.16.0) will be used to analyze the data collected. Tables and other statistical inferences will be made from the data gathered. Representations like charts, pie charts etc. will be used to ensure easy and quick interpretation of data. Responses will also be expressed in percentages. Data from the completed questionnaire will be checked for consistency. The items in the questionnaire were grouped based on the responses given by the respondents and coded for easy usage.

## CHAPTER FOUR

### FINDINGS AND ANALYSIS OF DATA

#### 4.0. Introduction

This chapter provides the empirical findings that have been gathered for the study. In the chapter, tables and diagrams have been used to make the connection between the text and the study conducted clearer. Furthermore, it shows the demographic information of the respondent and the statistical analysis of the information collected from the respondents.

#### 4.1. Demographic Analysis

This section focuses mainly on the profile of the respondents. The major issues would be on their age group, gender and the departments in which they work in.

##### 4.1.1. Age of Respondents

The table provides the respondents age-group information. The study revealed that, majority of the respondents representing 50% were between the ages 28-32 years. On the other hand, 30% representing 9 persons were between the ages of 32-37 years. Again, 20% representing 6 persons was between the ages of 23-28 years.

*Table 1: Age of Respondents*

| <b>Age</b>   | <b>Frequency</b> | <b>Percentage</b> |
|--------------|------------------|-------------------|
| 23-28 years  | 6                | 20%               |
| 28-32 years  | 15               | 50%               |
| 32-37 years  | 9                | 30%               |
| <b>Total</b> | <b>30</b>        | <b>100</b>        |

*Source: Field Survey, 2018*

##### 4.1.2. Gender of Respondents

The gender of the respondents was established in order to determine the ratio of male to female at Amenfiman Rural Bank. Out of the total respondents, 53% of the respondents representing 16

persons were males whiles 47% representing 14 persons were females. This shows that, there are more male employees at Amenfiman Rural Bank than female employees.

**Table 2: Gender of Respondents**

| <b>Gender</b> | <b>Frequency</b> | <b>Percentage</b> |
|---------------|------------------|-------------------|
| Female        | 14               | 47%               |
| Male          | 16               | 53%               |
| <b>Total</b>  | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### **4.1.3. Which department do you belong to**

Table 3 below depicts that, 33% of the respondents representing the majority of the respondents are Back office staff and Tellers. However, 20% representing 6 persons are marketers at the bank whiles 14% representing the minority are retail bankers.

**Table 3: Department**

| <b>Response</b> | <b>Frequency</b> | <b>Percentage</b> |
|-----------------|------------------|-------------------|
| Teller          | 10               | 33%               |
| Back office     | 10               | 33%               |
| Marketers       | 6                | 20%               |
| Retail Bankers  | 4                | 14%               |
| <b>Total</b>    | <b>30</b>        | <b>100%</b>       |

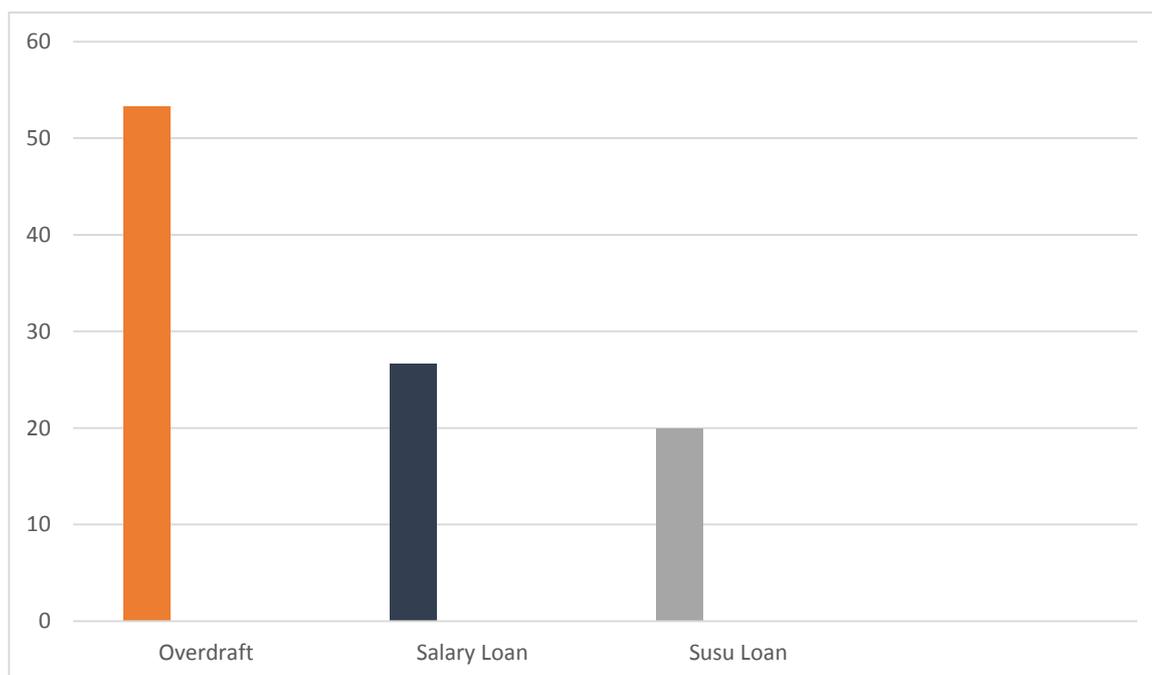
*Source: Field Survey, 2018*

### **4.2. Main Information**

This section seeks to answer the research questions of the study.

#### **4.2.1. Credit Facilities Applied For**

When asked which of the banks facilities was the most applied, majority of the respondents representing 53% of the respondents said overdraft. On the other hand, 27% said salary loan whiles the minority representing 20.0% said susu loan. Figure 1 captures the data gathered.



**Figure 1: Credit Facility Applied For**  
**Source: Field Survey, 2018**

#### 4.2.2. Duration of Loan Facility

From the findings, 43% of the respondents representing 13 persons said that the duration of a loan facility is 6 months for an overdraft. However, 30% of the respondents said there are also loans facilities that have a duration of 12 months while 27% of the respondents said there are loans that have a duration of more than 24 months.

**Table 4: Duration of Loan Facility**

| Response            | Frequency | Percentage  |
|---------------------|-----------|-------------|
| 6 months            | 13        | 43%         |
| 12 months           | 9         | 30%         |
| 24 months and above | 8         | 27%         |
| <b>Total</b>        | <b>30</b> | <b>100%</b> |

**Source: Field Survey, 2018**

### 4.2.3. Ranking of Bad Loan Facility

In Table 5 below, the research showed that, 63.0% of the respondents said that the bank ranks a loan facility bad when it goes 6 months above the day it was supposed to be paid while 37.0% of the respondents said that their bank ranks a loan facility bad after 12 months of its repayment date.

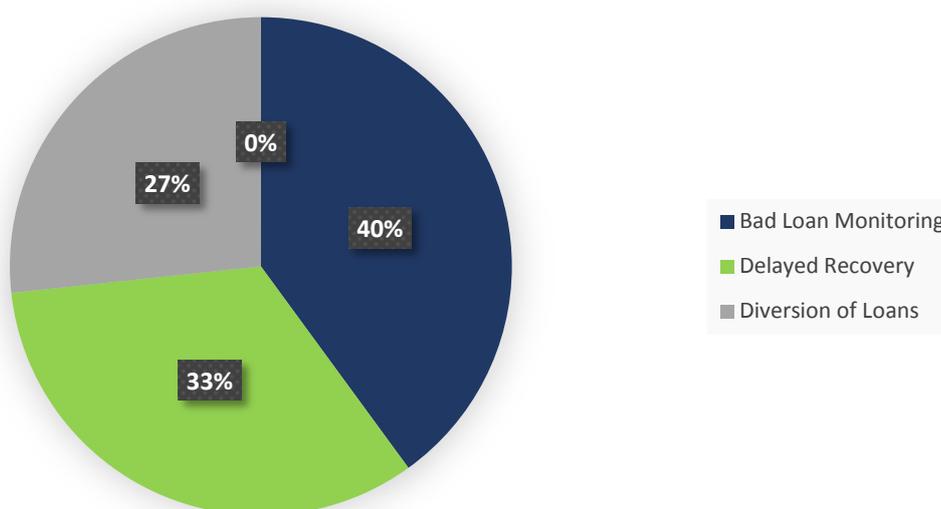
**Table 5: Ranking of Bad Loan Facility**

| Response            | Frequency | Percentage  |
|---------------------|-----------|-------------|
| 6 months and above  | 19        | 63%         |
| 12 months and above | 11        | 37%         |
| <b>Total</b>        | <b>30</b> | <b>100%</b> |

*Source: Field Survey, 2018*

### 4.2.4. Factors that Cause NPLs in the Bank

From Figure 2 below, 40.0% of the respondents representing 6 persons said that bad loan monitoring is the greatest factor that causes NPLs in the bank. However, 34% of the respondents said that delayed recovery is also a factor to the cause of NPLs in the bank while 26% of the respondents said diversion of loans is also another factor that cause NPLs in the bank.



**Figure 2: Factors that Cause NPLs in the Bank**

*Source: Field Survey, 2018*

#### 4.2.5. Non-compliance with Credit Policy

From the study, 70% of the respondent representing 21 persons responded that non-compliance with credit policy of the bank account for the bad loans, while 30% of the respondents said that they disagree to the fact that non-compliance with credit policy of the bank accounts for bad loans.

**Table 6: Non-Compliance with Credit Policy**

| <b>Response</b> | <b>Frequency</b> | <b>Percentage</b> |
|-----------------|------------------|-------------------|
| Yes             | 21               | 70%               |
| No              | 9                | 30%               |
| <b>Total</b>    | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### 4.2.6. Reason for Non-Compliance

In Table 7 below, majority of the respondents representing 53% persons said that, management pressure accounts for non-compliance of credit policy of the bank while 47% of the respondents said that customer pressure accounts for the non-compliance of the credit policy of the bank.

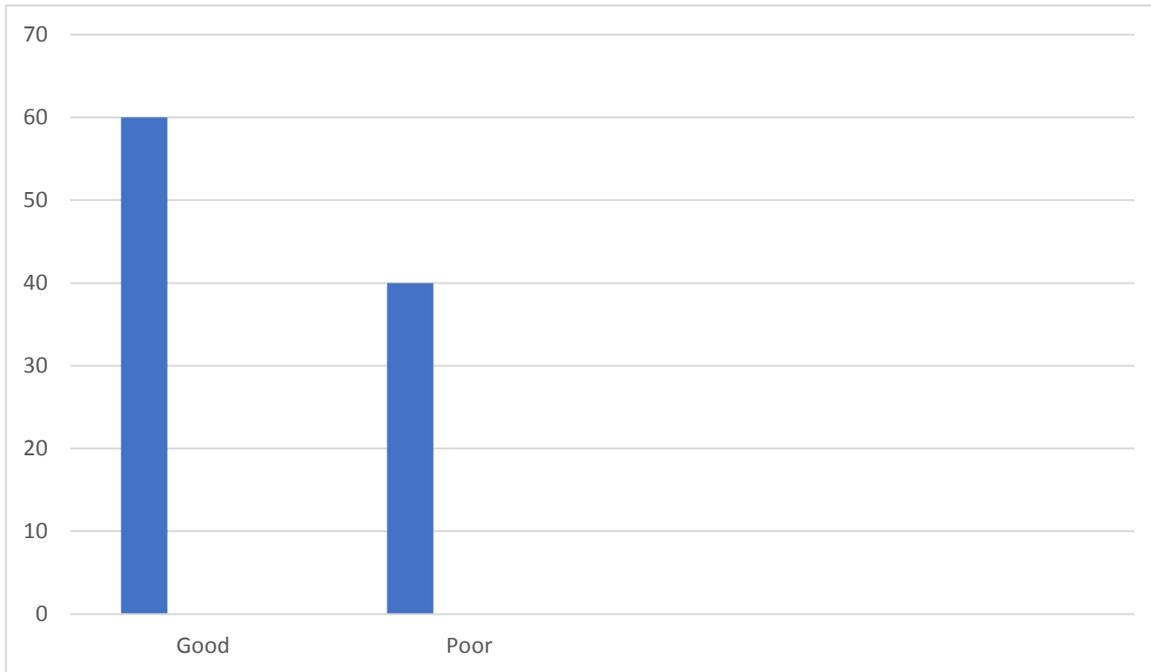
**Table 7: Reason for Non-Compliance**

| <b>Response</b>     | <b>Frequency</b> | <b>Percentage</b> |
|---------------------|------------------|-------------------|
| Customer pressure   | 14               | 47%               |
| Management pressure | 16               | 53%               |
| <b>Total</b>        | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### 4.2.7. Attitude of Clients Towards Loan Repayments

From the data gathered in Figure 3 below, 60% of the respondent said that there is a good attitude towards loan repayments by their customers while 40.0% of the respondents said there is a poor attitude towards loan repayment by clients.



**Figure 3: Attitude of Clients Towards Loan Repayments**  
**Source: Field Survey, 2018**

#### **4.2.8. The Attitudes of Clients Towards Repayments of Overdue Loans**

The research gathered that, 43% of the respondents representing 13 persons asserted that clients have a poor attitude towards repayments of overdue loans. On the other hand, 30% of the respondents also asserted that clients have worse attitudes towards repayments of overdue loans while 27.0% of the respondents said clients have good attitudes towards repayments of overdue loans.

**Table 8: Attitudes of Clients Towards Repayments of Overdue Loans**

| <b>Response</b> | <b>Frequency</b> | <b>Percentage</b> |
|-----------------|------------------|-------------------|
| Good            | 8                | 27%               |
| Poor            | 13               | 43%               |
| Worse           | 9                | 30%               |
| <b>Total</b>    | <b>30</b>        | <b>100%</b>       |

**Source: Field Survey, 2018**

#### 4.2.9. Loan Default Rate

From the data gathered in the table below, 57% of the respondents said there is a moderate rate in the loan default while 43% said there is a high rate of loan default.

*Table 9: Loan Default Rate*

| <b>Response</b> | <b>Frequency</b> | <b>Percentage</b> |
|-----------------|------------------|-------------------|
| High            | 13               | 57.0%             |
| Moderate        | 17               | 43.0%             |
| <b>Total</b>    | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### 4.2.10. Interest Rate Cause Loan Defaults

From the data gathered, 73% of the respondent representing 22 persons asserted that the interest rate of a bank is one of the causative factors for loan defaults while 27% of the respondents asserted that interest rate of the bank does not cause loan defaults.

*Table 10: Interest Rate Cause Loan Defaults*

| <b>Response</b> | <b>Frequency</b> | <b>Percentage</b> |
|-----------------|------------------|-------------------|
| Yes             | 22               | 73%               |
| No              | 8                | 27%               |
| <b>Total</b>    | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### 4.2.11. Effective Monitoring of Loans by Credit Officers

In Table 11 below, the respondents were asked which factors hindered effective monitoring of loans by credit officers. Majority of the respondents representing 37% said ineffective supervision by management is a factor that hinders effective monitoring. Lack of logistics was also another factor (33.3%) while 30% of the respondents said under staffing is another factor that hinders the effective monitoring of loans by credit officers.

**Table 11: Effective Monitoring of Loans by Credit Officer**

| <b>Response</b>                       | <b>Frequency</b> | <b>Percentage</b> |
|---------------------------------------|------------------|-------------------|
| Lack of logistics                     | 10               | 33%               |
| Under staffing                        | 9                | 30%               |
| Ineffective supervision by management | 11               | 37%               |
| <b>Total</b>                          | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### **4.2.12. Loan Types that Records the Highest Default Rate**

In Table 12 below, the respondents were asked the type of loans that records the highest default. 37% of the respondents said that susu loan while 27% of the respondents said that salary loans. On the other hand, 20.0% of the respondents said that trading/ business loan records the highest default rate while 17% of the respondents said agricultural loan records the highest default loan.

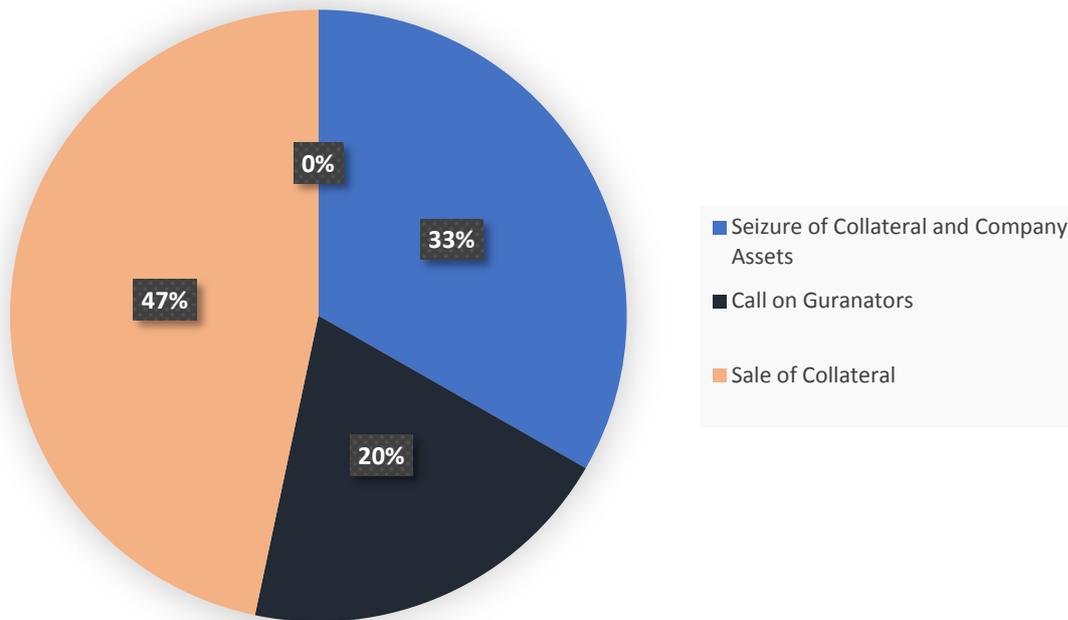
**Table 12: Loan Types that Record the Highest Default Rate**

| <b>Response</b>         | <b>Frequency</b> | <b>Percentage</b> |
|-------------------------|------------------|-------------------|
| Agricultural loans      | 5                | 17%               |
| Trading/ Business loans | 6                | 20.0%             |
| Susu loans              | 11               | 37%               |
| Salary loans            | 8                | 27%               |
| <b>Total</b>            | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

#### **4.2.13. Recovery of bad loans**

From the data gathered in Figure 4 below, 47% said the sale of collateral provided by clients is the best way to recover bad loans from clients. On the other hand, 33% of the respondents also asserted that seizure of collateral and company assets is the way to recover a loan from clients, while 20.0% of the respondents said that calling on guarantors is the best way to recover loans from clients.



**Figure 4: Recovery of Bad Loans**  
**Source: Field Survey, 2018**

#### 4.2.14. Effects of Bad loan on Banks

Out of the 30 respondents, 47% of them asserted that bad loans affect the bank’s profitability, while 33% of the respondents said that bad loans affect the banks’ lending ability. On the other hand, the minority of the respondents representing 20% of the respondents said bad loans affect the banks’ operations.

**Table 13: Effects of bad loan on the bank**

| <b>Response</b>                | <b>Frequency</b> | <b>Percentage</b> |
|--------------------------------|------------------|-------------------|
| Affects bank profitability     | 14               | 47%               |
| Affects bank operations        | 6                | 20%               |
| Affects banks’ lending ability | 10               | 33%               |
| <b>Total</b>                   | <b>30</b>        | <b>100%</b>       |

**Source: Field Survey, 2018**

#### 4.2.15. Reduction of Non-Performing Loans

Out of the 30 respondents, 67% of the respondents asserted that proper scrutiny of applicants will help reduce loans default at the bank while 33% of the respondents asserted that constant follow-ups will help reduce non-performing loans at the bank. Table 14 below captures the findings.

*Table 14: Reduction of Non-Performing Loans*

| <b>Response</b>               | <b>Frequency</b> | <b>Percentage</b> |
|-------------------------------|------------------|-------------------|
| Proper scrutiny of applicants | 20               | 67%               |
| Constant follow-ups           | 10               | 33%               |
| <b>Total</b>                  | <b>30</b>        | <b>100%</b>       |

*Source: Field Survey, 2018*

## CHAPTER FIVE

### SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

#### 5.0. Introduction

After carefully analyzing the data in the previous chapter, the summary of the study, its conclusion and recommendations are made in this chapter.

#### 5.1. Summary

The main purpose of the study was identifying the causes and effects of loan defaults on the profitability of rural banks (a case study of Amenfiman Rural Bank). The specific objectives of the study are;

- To analyze the factors accounting for loan default in the rural banking industry.
- To determine ways of reducing loan defaults in financial institutions.
- To examine the effect of bad loans on the lending potential and profitability of rural banks.

The study adopted a descriptive study approach. The target population of this study comprised all the workers of Amenfiman Rural Bank limited (Santasi branch). All the 30 employees of the bank were sampled for the study. Convenience sampling was used as the sampling technique. Questionnaires were used as the data collection instrument. The Statistical Package for Social Sciences (SPSS) was used in the analysis of data.

The first objective of the study was to analyze the factors accounting for loan default in the rural banking industry. Results gathered from the study shows that, bad loan monitoring, delayed recovery and diversion of loans are the causes of loan default at the bank respectively.

Another objective of the study was to determine ways of reducing loan defaults in financial institutions. The study revealed that proper scrutiny of applicants and constant follow-ups respectively are the two major ways that can help reduce non-performing loans at the bank.

The last objective had to do the effect of bad loans on the lending potential and profitability of rural banks. The respondents pointed out that, bad loans affect the bank's profitability, banks' lending ability and banks' operations respectively.

## **5.2. Conclusions**

Bad loans have been identified as one of the major factors affecting the profitability and survival of rural and community banks in Ghana. Most rural banks are unable to remain competitive in the turbulent financial sector/industry due to high default rate. Based on findings of this study, it is concluded that bad loans have a major negative effect on banks' profitability, lending potential and financial performance.

## **5.3. Recommendations**

1. It is recommended that management should organize regular training programmes for credit staff in areas like credit management, risk management and financial analysis. This would sharpen the knowledge and skills of credit officers so as to improve on the quality of credit appraisal, prevent delayed loan approvals, enable credit officers appreciate the need to comply with credit policy and further enhance monitoring of credit.
2. Another important way of minimizing loan defaults is through regular and effective monitoring and supervision of loan facilities granted to clients. This would prevent diversion of funds into business ventures other than the agreed purposes, help credit officers assist customers who are facing some business management problems such as improper records keeping, and overtrading that affect their business operations.

3. Furthermore, to ensure effective monitoring of loans, management should ensure that credit offices at all branches, are adequately resourced in terms of staff, vehicles and other logistics, to support monitoring activities. Again management needs to show commitment through the provision of these resources at all branches.
4. The Bank should also resource the Recovery Department to enable them carry out their functions very well to recover the overdue loans. The Department should also be involved in the monitoring of loans from the day the loans are granted.
5. It is recommended that loans granted to customers should be well secured in terms of adequacy of the collateral provided and also ensure that proper legal documentation is put in place. This would reduce the losses arising from problem loans and minimize the effects of such loans in the form of bad debt provisions, on the financial performance of the bank.
6. Clients who have outstanding loans but operate profitable businesses can be refinanced to increase their cash flow generation capacity to be able to repay the outstanding loan balance. The outstanding loan balance should also be rescheduled to match the new cash flow from the business. This will bring back the facility to current and also reduce the high provision for bad and doubtful debts made on non-performing loans.
7. The bank should establish a product research and development department to study the performance of all the Bank's products so that those which are not doing well can be repackaged to make them much more marketable.

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**APPENDIX**  
**CHRISTIAN SERVICE UNIVERSITY COLLEGE**  
**QUESTIONNAIRE**

The researcher is undertaking a topic on “the causes and effects of loan defaults on the profitability of rural banks (a case study of Amenfiman Rural Bank)”. The information you will provide will be used for academic purposes only and will be treated with confidentiality. Kindly answer the questions below.

**SECTION A: Personal Data**

- i. Age  
 23-28       28-32       32-37       Above 37
- ii. Gender  
 Female       Male
- iii. For how long have you been working at Amenfiman Rural Bank?  
 0-3 years       3-6 years       6 years and above
- iv. Which section of the bank do you work at?  
 Tellers    Back office    Marketers    Retail Bankers    Personal Bankers  
 Other

**MAIN INFORMATION: SECTION B**

1. What types of credit facilities are normally applied for in your bank?  
 Overdraft  
 Salary Loan  
 Commercial Loan  
 Susu Loan  
 Funeral loan  
 Others
2. What is normally the duration of your Loan facility?  
 6 months       12 months    24 months and above
3. How does your bank rank a loan facility bad?  
 6 months and above       12 months and above       24 months and above
4. In your opinion, which of the following are the factors which cause NPLs in your bank?  
 bad loan monitoring       delayed recovery    diversion of loans  
 unwillingness to repay loans    Others
5. Do you think non-compliance with credit policy of the bank accounts for bad loans?  
 Yes       No

6. If yes above, which of the following account for that?  
 Customer pressure       Management pressure    Board pressure  
 all the above
7. What are the attitudes of your clients towards loan repayment?  
 Better  Good  Poor  Worse
8. What are the attitudes of clients towards the repayment of overdue loans?  
 Better       Good  Poor  Worse
9. How is the loan default rate in your bank?  
 High       Moderate  Low
10. Do you think high interest rates can cause loan defaults?  
 Yes       No
11. Which of the following factors hinder effective monitoring of loans by credit officers?  
 lack of logistics    under staffing    ineffective supervision by management    inadequate motivation  poor attitude of staff
12. Which of the following loan types record the highest default rate?  
 Agricultural loans    Trading/Business loans    Transport loans  Susu loans    Salary loans
13. How do you recover bad loans from your clients?  
 Through court action       Seizure of collateral and company assets  
 Call on guarantors       Sale of collateral provided by clients
14. What are the effects of bad loans on the bank?  
 affects banks profitability    affects banks operations    affect bank's lending ability
15. How can non-performing loans be reduced at the bank?  
 adherence to credit policy    proper scrutiny of applicants    constant follow-ups    considerable interest rate    others

**THANK YOU**