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Loan Default Rate and its Impact on Profitability in Financial Institutions

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Abstract
Purpose: The purpose of this paper was to identifying the loan default rate and its impact on profitability, and determining ways of reducing loan defaults in microfinance institutions.
Design/methodology/approach: The study adopted both qualitative (case study) and quantitative methods respectively. Financial institutions were selected to gather data, which was acquired from answers obtained from our administered questionnaire and also through interviews. The population of the survey constituted the management and non-management staff and customers of First Allied savings and loans limited, Eden Microfinance and Opportunity International savings and loans Limited.
Findings: Hypotheses of the study will be analyzed using correlation and regression. Results of the study show that there are high positive correlation between the constructs of loan default rate and profitability of the various microfinance institutions.
Keywords: Loan default rate, profitability, microfinance institutions

1. Introduction

Micro financing is the provision of financial services to poor and low income households without access to formal financial institutions (Conroy, 2003). Microfinance programs provide loans, savings and other financial services to low-income and poor people for use in small businesses (Mohammed and Hassan, 2008). These institutions include rural banks, community banks, cooperative banks, thrift banks, credit cooperatives and microfinance NGOs. According to Otero (1999), the aim of micro-finance is not just about providing capital to the poor to combat poverty on an individual level, it also has a role at an institutional level. It seeks to create institutions that deliver financial services to the poor, who are continuously ignored by the formal banking sector. MFIs provide similar products and services to their customers as formal sector financial institutions. The scale and method of delivery differ, but the fundamental services of savings, loans, and insurance are the same. Notwithstanding, to date most efforts to formalize microfinance have focused on enterprise lending (loans for enterprise formation and development) which remain by far today the dominant product offered by microfinance (Nourse (2001), Woller (2002a)). This, however, has slowly begun to change. Increasingly today MFIs have begun to offer additional products, such as savings, consumption or emergency loans, insurance, and business education. Nourse (2001) reviews the context and rise of microfinance products and argues there is a need for savings and insurance services for the poor and not just credit products. He goes on to argue that microfinance need to provide tailored lending services for the poor instead of rigid loan products.
The main goal of Ghana's Growth and Poverty Reduction Strategy (GPRS II) is to ensure "sustainable equitable growth, accelerated poverty reduction and the protection of the vulnerable and excluded within a decentralized, democratic environment". The intention is to eliminate widespread poverty and growing income inequality, especially among the productive poor who constitute the majority of the working population. According to the 2000 Population and Housing Census, 80% of the working population is found in the private informal sector. This group is characterized by lack of access to credit, which constrains the development and growth of that sector of the economy. The observation was stressed in the International Monetary Fund Country report on Ghana of May 2003 that "weaknesses in the financial sector that restrict financing opportunities for productive private investment are a particular impediment to business expansion in Ghana."
Microfinance perceived as a financially sustainable instrument meant to reach significant number of poor people of which most are not able to access financial service because of the lack of strong retailing financial intermediaries. 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). Microfinance as a sector has the potential to reduce poverty by bringing a significant improvement in the lives of the active poor who are largely women. Microfinance in Ghana has made some remarkable strides in the Country especially within the private sector. Among these achievements are as follows:
The introduction of microfinance into the Country has made it possible for operators of small businesses to access credit facilities which hitherto were difficult to access due to difficult modalities by the formal financial institutions. Even though the amount involved are modest not huge, it supports their businesses to some extent.

Microfinance provides people with capital to start and or expand their businesses. Small businesses with microfinance support have grown into Medium Enterprises creating employment opportunities for others.

Microfinance projects and programs have gone a long way in building the capacity of clients in the areas of loan management, customer care, pricing, marketing and selling on credit as well as on social and community issues.

The role of microfinance institutions in developing local economies cannot be over emphasized especially in developing countries like Ghana. This role has particularly been played through the establishment of Rural and Community banks as major microfinance institutions. In Ghana for instance, the total loans advanced to clients by all community and rural banks was GH¢71.63 million in 2005 and this increased to GH¢115.10 million in 2006, thus indicating 35.4 per cent increase (Bank of Ghana, 2007).

It is known that loans advanced by rural banks are normally for purposes such as housing, petty trading, and as "start-up" loans for farmers. There are other instances where credit is given to groups consisting of a number of borrowers for collective enterprises, such as: Irrigation pumps or leasing land for cooperative farming (Aryeetey et al, 1994). In 2006 alone, a total of GH¢160.47 million was extended to clients, which represents 48.8 per cent higher than the previous year's total loans and advances granted by these rural banks. The upward-trending of Non-Bank Financial Institutions (NBFIs) credit to individuals, small businesses, groups and others indicates marked improvements in level of microfinance in the country (Bank of Ghana, 2007).

Extension of credit facilities is one of the major activities of all Microfinance institutions including Savings and Loans Companies, Rural banks, Financial Non-Governmental Organizations (FNGOs) and credit Unions. This is usually evidenced by the large proportion that loans constitute in the overall operating assets of these lending institutions. Healthy loan portfolios are therefore vital for lending institutions in view of their impact on Liquidity, lending capacity, earnings and profitability of the Microfinance Institutions. Microfinance Institutions (MFIs) currently provide financial services to an estimated 15 per cent of the country's total population as compared with 10 per cent for the commercial banking sector. (J.Obuobi and G. Polio, 2010).

Nonetheless some of the loans given out by the lending institutions unfortunately are not paid back and eventually result in bad debts with adverse consequences for the overall financial performance of the institutions. The issue of loan defaults becoming an increasing problem that threatens the sustainability of microfinance institutions. The causes of the problem are multi-dimensional and non-uniform among different literatures.

Unsettled loans are always a source of misery for lenders because if a microfinance has too much of it on its balance sheet, it can adversely affect its operations in terms of liquidity, profitability, debt- servicing capacity, Lending capacity and ability to raise additional capital. The incidence of non-performing loans in the Ghanaian banking and non-banking industries including microfinances has been on the rise in recent years as their loan portfolio increases despite efforts by these financial institutions to deal with it.

2. Literature Review

2.1 Determinants of Default Rates

2.1.1 Loan Default Defined

Loan default can be defined as the inability of a borrower to fulfil his or her loan obligation as at when due (Balogun and Alimi, 1988). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (1980) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

2.1.2 Causes of Loan Defaults

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, one major problem which the banks in India are facing is the problem of recovery and overdue of loans. The reasons behind this may vary for different financial institutions as it depends upon the respective nature of loans.

Here an attempt is made to find out some of the causes of default of loans due to which financial institutions are facing the problems of overdue of loans. The recovery officers of different banks are interviewed for finding out the causes of defaults. These reasons may be useful for the Banks for the better recovery of loans in future. After surveying different banks, the following were identified to be the main causes of default of loans from industrial sector: 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.

Many factors have been identified as major determinants of loan defaults. Okorie (1986) shows that the nature, time of disbursement, supervision and profitability of enterprises which benefited from small holder loan scheme in Ondo State, contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans.

Poor academic performance is the number one reason for student departure, and departure before degree completion is the number one reason for student loan default (Volkwein and Cabrera, 1998).

Moreover, in a recent study of Mortgage loan defaults, the most frequently cited causes of defaults were curtailment of income (36%), excessive obligations (19%), unemployment (8%), illness of principal mortgagor or family member (6%) and marital difficulties (3%). (Merritt, 2009)

Okpugie (2009) also indicated that, high interest charged by the microfinance banks has been discovered to be the reason behind the alarming default. A microfinance loan is a facility granted by a microfinance bank to an individual or a group of borrowers, whose principal source of income is derived from business activities involving the production or sale of goods and services.

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 Gorter and Bloem (2002) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of non-performance in the form of bad loan provisions, or they may spread the risk by taking out insurance.

The problem of non-performing loans is widespread. Nishimura, Kazuhito, and Yukiko, (2001) state that one of the underlying causes of Japan's prolonged economic stagnation is the non-performing or bad loan problem. They explain that some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This delayed structural reforms and prevented the financial intermediary system from functioning properly.

Most of the defaults arose from poor management procedures, loan diversion and unwillingness to repay loans, Kohansal and Mansoori (2009). According to them a number of factors can cause loan defaults some of which are;

1. Interest rate ceilings usually imposed by the government
2. Monopoly power in credit markets often exercised by informal lenders
3. Large transaction costs incurred by borrowers in applying for loans
4. Moral hazard problems

2.2 Ways of Reducing Loan Defaults

Golden and Walker (1993) identify the 5Cs of bad credit, which represent things to guard against to help prevent the effect of the bad loans or the defaulted loans.

1. Complacency refers to the tendency to assume that because things were good in the past they will be good in the future. Common examples are over reliance on guarantors, reported net worth or past loan repayments success because things have always worked out well in the past.

2. Carelessness involves poor underwriting typically evidenced by inadequate loan documentation, lack of current financial information or other pertinent information in the credit files and a lack of protective covenants in the loan agreement.

3. Communication ineffectiveness refers to when a Lenders credit objectives and policies are not clearly communicated. This is when loan problems can arise. Management must effectively communicate and enforce loan policies and loan officers should make management aware of specific problems with existing loans as soon as they appear.

4. Contingencies refer to lenders tendency to play down or ignore circumstances in which a loan might result in default. The focus is on trying to make a deal work rather than identifying downside risk.

5. Competition involves following competitors behavior rather than maintaining the lenders own credit standards. Doing something because another lender is doing it does not mean it is a prudent business practice.

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. 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, collection agencies, etc.).
Again, loan repayment should be constantly monitored and whenever there is a default in repayment, a quick action should be taken. The Microfinance should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments, and renegotiate loans whenever borrowers get into difficulties. (Kay Associates Ltd, 2005)
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.

3. Research Methodology

3.1. Research Design

Research is a process of steps used to gather and evaluate information in order to increase understanding on an essential topic. It consists of three steps, namely posing a question, collecting data to answer the question, and presenting an answer to the question (Creswell, 2009). The research design for the current study refers to a quantitative form. This research concentrates on the relationship among variables more than on testing activity impact, and uses correlation design. Based on the described research objective, this study will adopt a correlation design. Correlation design allows us to predict an outcome and know the relation between variables.

3.2 Study Area

The study was conducted in Accra the capital city of Ghana and Kumasi. The location of the cities makes it the commercial center and a nodal point from which roads radiate to the central business areas of the regions. The financial sector was chosen because it is one of the fastest growing industries in Ghana.

3.3 Population and Sampling

The population of the survey constituted the management and non-management staff and customers of First Allied savings and loans limited, Eden Microfinance and Opportunity International savings and loans limited in Ghana. The researchers used the simple random sampling. The study used a sample size of five hundred and twenty (520) and due to adequate time the researchers devoted for the data collection, the researchers were able to get five hundred and one (501) questionnaires that were administer

4. Data Analysis

The purpose of this paper is to identify the loan default rate and its impact on profitability, and determining ways of reducing loan defaults in microfinance institutions in Ghana. Loan default can be defined as the inability of a borrower to fulfill his or her loan obligation as at when due (Balogun and Alimi, 1990). Also, problem of recovery and overdue of loans and deficient analysis of project viability are predicators and profitability is a criterion variable. Based on analysis of the collected data and using description statistics for demography, it was found that most respondents were male at 58.8% and the most of the research participants (44.1%) are aged between 25 and 40. Additionally, most people (40.6%) have some undergraduate education level and most respondents are married (55.2%).

Table 1: Correlations between problem of recovery and overdue of loans, deficient analysis of project viability and profitability.

		Profitability	Problem of recovery and overdue of loans	Deficient analysis of project viability
Profitability	Pearson Correlation	1	0.593**	0.622**
	Sig. (2-tailed)		0.000	0.000
	N	501	501	501
Problem of recovery and overdue of loans	Pearson Correlation	0.593**	1	0.521**
	Sig. (2-tailed)	0.000		0.004
	N	501	501	501
Deficient analysis of project viability	Pearson Correlation	0.622**	0.521**	1
	Sig. (2-tailed)	0.000	0.000	
	N	501	501	501

To achieve the research objective the relationship between problem of recovery and overdue of loans, deficient analysis of project viability and profitability should be assessed, and from table 1, the Pearson correlation was

utilized. There is a strong relationship between problem of recovery and overdue of loans and profitability with a correlation coefficient of 0.593 at the 0.01 level (2-tailed), deficient analysis of project viability and profitability with a correlation of 0.622 at the 0.01 level (2-tailed), and even though the main purpose was to know the impact of loan default rate on profitability, the researchers found out that there is a strong relationship between problem of recovery and overdue of loans and deficient analysis of project viability with a correlation coefficient of 0.521 at the 0.01 level (2tailed). These relations are positive, meaning proper management of loans given to clients will results in higher profitability of firms.

5. Conclusion

The study was conducted to examine the role of advertising in branding financial products. The study adopted both qualitative (case study) and quantitative methods respectively. Financial institutions were selected to gather data, which was acquired from answers obtained from our administered questionnaire and also through interviews

The statistical findings showed significantly that proper management of loans given to clients will yield more profits for the firms. Also there was a significant relationship between the problem of recovery and overdue of loans and profitability. The relationship between deficient analysis of project viability and profitability was also positive. Lastly, there was a significant relationship between the problem of recovery and overdue of loans and deficient analysis of project viability.

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