# IDENTIFYING THE FACTORS AFFECTING NON-PERFORMING ADVANCES: ON LENDING OFFICERS PERSPECTIVE

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## Abstract

*Core income generation source for any commercial bank is "Lending". The asset value of a bank is several times of its equity. The largest portion of asset base of a bank consists of advances to customers. Non Performing Advances are the main threat to an asset base of a bank. Deterioration of even a small portion of its asset base would severely impact the equity and the stability of a bank. Hence, Key function of any bank is managing Non-performing Advances. The purpose of this research is to identify factors affecting to Non-Performing Advances in the perspective of Lending Officers context. Identified four factors by the author are Training and knowledge of the Lending Officers, Risk assessment, Monitoring and follow up and financial stability of the borrower. The principal under the research is common to all commercial banks in general. The survey was carried out using Simple random sampling method for selection of Lending Officers. Quantitative method was used to gather data through a self-administered questionnaire. Relationships for the identified factors were analyzed using SPSS 17.0 software through Spearman's coefficient of correlation. Recommendations of the study are that Non-performing Loans could be managed through enhancing the Training and Knowledge of Lending Officers by adequate credit exposure. Further, it is recommended that, bank need to consider Risk assessment and financial stability of the borrower. Also, continuous monitoring and follow up of Loans.*

**Keywords:** Non Performing Advances, Lending Officers, Risk assessment, Financial stability of the borrower

## 1 INTRODUCTION

### 1.1. Evolvement of the Banking Industry in Sri Lanka

Banking industry in Sri Lanka has become important aspect towards Sri Lanka's economy due to its rapid growth throughout the years. The banking industry consist Private and Government Local Commercial Banks, Private International Banks, Savings Banks, Merchant Banks and Leasing and Development Banks by which Central Bank of Sri Lanka (CBSL) acts as the governing body for all banks.

Before the year 2000, the banks practiced aggressive approach towards its customers and customers had to go behind the banks to their financial requirements. Today banking practices has changed to more proactive approach and banks play a vital role and have become a key influential factor in our day to day financial requirements and as well as in the infrastructure and economic development activities which have been progressing in Sri Lanka. The banks who adopted this change managed to take hold of the massive market share especially in the Retail Banking business in the market.

## 1.2. Non-Performing Loans/Advances

Lending is the heart of the banking industry. Advancing which is the basis of lending has two main components namely, Loans and Demand deposits (Current Accounts). This research is focusing on both Loans and Demand deposits for the study purpose. Demand deposits which is also called Current account are form of a loan product. Hence, throughout this study, the author will use the terms Non-Performing Loans (NPL) and Non Performing Advances (NPA). Both terms are same in the dictionary form.

Most of the banks, out of 50% - 75% of total assets are Advances which generate operating income and give greater risk exposure to the bank. Hence, managing advances have positive effect on the performance of the bank as well as borrower and a country as a whole. High growth of Non Performing Advances will arise due the failure to manage which will be threatened to bank asset base. There are new banks in the pipeline to join to the banking sector and existing banks are expanding their branch networks. Hence, it is essential to regulate and monitor the banks to have healthiness of the financial sector.

According to International Monetary Fund(IMF,2009), a Non performing Loan is ‘Any Loan in which interest and principal payments are more than 90 days overdue or more than 90 days’ worth of interest has been refinanced. The Basel Committee called Non-Performing Loans as loans left unpaid for a period of 90 days. A loan is considered as Non-Performing when payment of interest and/or principal is past due for 90 days or more. (Statistics Department International Monetary Fund, 2005).Further, according to Investopedia

(httpwww.investopedia.com/terms/n/nonperformingloan.asp), a Non performing loan is a sum of borrowed money upon which the debtor has not made his or her scheduled payments for at least 90 days.

For the development of any economy, competent and well-functioning financial sector is an essential factor. Quality advances can be categorized as an indicator of a healthy financial sector. Unsound financial sectors reflect highest numbers of Non Performing Advances. Some advances given by lending institutions become non-performing and eventually resulting bad debts, giving adverse consequences for the institutions performance. The cause for Non-Performing Advances varies from different countries, and developed and developing countries it has multidimensional aspects. Some of the reasons for loans fail to perform can be categorized into two sections namely, Bank specific factors (Micro economic conditions) and Macro economic conditions.

Banks are in the business of managing risk. The banks are exposed to Credit risk, Liquidity risk, Interest rate risk and Exchange rate risk. The main risk attributed to lending function of banks is the Credit Risk. Credit creation is the main income generating component of a bank which leads to Credit Risk. Risk arising as a failure of borrowers/counterparties to meet their debts/contractual obligations is referred as Credit Risk which is also called Financial Risk. This relates to both On Balance Sheet items- Loans and Overdraft and Off Balance Sheet items - Letters of Credit, Letters of Guarantees, Shipping Guarantees of the bank. Internal determinant of bank performance can be evaluated through Credit Risk. Higher exposure of Credit Risk, will lead the bank to experience financial crisis. Credit Risk can be diversified. The credit risk cause due to other risk elements embedded to loans, mainly Credit Default Risk. It is the loss resulted due to loan being not repaid by the borrowers.

The focus of the study is mainly on default risk at retail banking levels or as commonly used in the industry, the branch banking context. The default risk is mainly associated with Non-Performing Advances. Advances are categorized as Non-performing since such category of assets no longer perform the function of generating income for the bank. Non-Performing Advance is a byproduct of lending process.

### 1.3. Research Problem Identification

In Sri Lanka immense competition has been created for massive market share among banks due to increased number of Licensed Commercial Banks. Today, there are new entrants into the market and smaller banks are offering various products and services to its customers in feasible manner and gaining few profit margins. It is mainly due to attract business from other competitors in the market. Loans are the major assets which derive higher income source to any bank. Therefore, Loan products always give Risk and Reward to the bank.

Since the competition is high among banks, they tend to create flexible terms to their credit evaluation process rather than quality lending to retain existing customers and canvass more business which will finally lead to high growth of Non Performing ratio. High levels of Non-Performing Loans are linked with bank failure and crisis in the financial industry. Failure of one bank will impact on whole banking industry. The bank recorded moderate growth in Loans and Advances. This was attributable to the relatively high liquidity in most of the banks. The bank experienced an increasing trend in non-performing advances during the years. The growth reported by the bank in assets was well above the growth in profits resulting decrease in Return on Assets. However, the ratios of the bank continue to remain well above the industry average ratios.

Usually in Bank's core banking system continues to operate under the CBSL provisioning policy to classify non-performing loans without any manual intervention. Further, branches are supported with Central Recoveries Department. However, there is a significant growth in non-performing advances effects to the profitability of the organization. Hence, it is necessary to do a research to identify factors affecting to Non-performing loans which finally effect to the Profitability.

The author tries to open the eyes of the bank, and to think forward about outdated recovery process and to rethink about as to why micro factors which are specific to banks create Non-Performing loans. As a leading private commercial bank of Sri Lanka, although bank has best credit monitoring system and dynamic recovery team, loan defaults are rising year on year. Hence, Lending officers must be vigilant in lending process.

## 2 REVIEW OF LITERATURE

### 2.1. Micro economic factors affecting Non Performing Advances (Bank Specific Factors)

Macroeconomic factors effecting to Non-Performing Loans are cannot be limited since it is beyond the control of the bank. However, through maximizing the efforts to eliminate bank specific factors, improvement can be obtained falling loans to default.

In a study, focusing commercial banks of United States for the period 1982 to 1996, the researcher, Keeton (1999) found that Non performing Loans are related with rapid credit growth of the bank. Further studies by Joseph F. Sinkey and Mary B. Greenwalt (1991) for large commercial banks in United States revealed excessive lending end result is higher loan loss rate. Salas and Saurina (2002) studied about Spanish banks found that credit growth is associated with Non-Performing loans.

Credit terms are important in lending for approving process. Hence, lenient credit terms lead to poor loans. Rajan and Dhal (2003) studied about Indian commercial banks found credit terms lead to Non-Performing loans. In a study conducted by Jimenz and Saurina (2005) on Spanish banks from 1984 to 2003 concluded that Non Performing loans are associated with lenient credit terms. Credit terms are identical to banks' lending authorities. Managers are the representatives of whole bank in branch levels. They are reputed among general public for their performance. When the economy has changed for the benefit of customers as well as for financial, Managers always try to increase their loan portfolio to improve their performance and finally to improve bank earnings. This type of activities final outcome will be default loans. Rajan (1994) this types of manners by Managers and found that short term decisions taken by Managers considering their reputation lead to bad loans. Further, Weinberg (1995) revealed based on economic conditions, Managers alter credit terms for the purpose of smooth functioning of lending activities. In Sri Lankan context, in the year 2009, Seylan Bank Plc. financial crisis mainly due to lenient credit terms. A study by Waweru and Kalini (2009) suggested Non Performing Loans occur due to lack of appropriate skills of the Lending officers and preparing proposals immediately without evaluating in depth seeking urgent approval. A study about commercial banks of United States for the period 1980 to 1990 by Koch and MacDonald (2003) where rapid changes were occurred in the market in the said period, revealed banks are granting facilities to marginal borrowers which finally lead to higher risk. Hence, the summary of the above paragraph is poor credit policies practice by banks occur bad loans.

A study by Rajan and Dhal (2003) about commercial banks of India revealed that bank size is utmost important in Non Performing Advances. The same result was found out by Salas and Saurina (2002) in a study of Spanish banks. Further, Berger and De Young (1997) about United States banks, Jimenz and Saurina (2006) reveal the same answer. It suggests that small banks take small business and loan defaults are less risky than large banks.

Efficient management of cost plays a vital role in managing Non Performing Advances. If managers incur higher cost for monitoring activities loan defaults can be reduced. A study by Giovanni and Grimard (2002) found operating efficiency assist Non Performing Advances.

Berger and De Young (Problem Loans and cost efficiency in commercial banks, 1997) draw attention to the relationship between bank specific characteristics and problem loans. Specially, Berger and Young formulated a mechanism, namely ‘bad luck’, ‘bad management’, ‘skimping’ and ‘moral hazard’. Among four main hypotheses developed by them, following two are mainly related to bank specific factors and variables.

- **‘Bad management’ hypothesis:** low cost efficiency is positively associated with increase in future Non-Performing Loans. The proposed justification links bad management with poor skills in credit scoring, appraisal of pledged collaterals and monitoring borrowers.
- **‘Skimping’ hypothesis:** banks which devote less effort to ensure higher loan quality will be more cost efficient, however there will be an increased number of Non-Performing Loans in the long run.

Poor Risk assessment lead to bad loans are reveled the empirical literature. C. Brown (1993) discussed that at the inception of the loan interest margin receive to the bank must include the probable risk associate with the risk. A study by Guo Ning (2007) about Chinese commercial banks, found that banks without paying attention to regional and industrial risk, historical data and management skills of the borrower lend depending on personal experience lead to bad loans.

# 3 METHODOLOGY

The conceptual framework was developed based on the identified key four factors relating to Non-Performing Loans, which were identified through Literature Review.

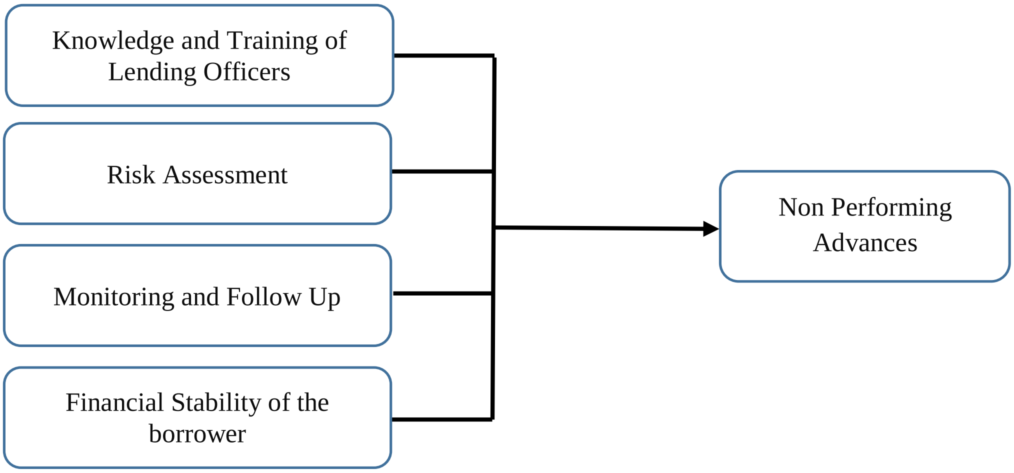


**Figure 01: Conceptual Framework of the Study**

Accordingly, the following hypotheses were advanced.

**Hypotheses of the Study**

- H1[a]: Knowledge and Training of Lending Officers **have** a relationship on Non Performing Advances.
- H2[a]: Risk Assessment **has** a relationship on Non Performing Advances
- H3[a]: Monitoring and Follow up **have** a relationship on Non Performing Advances.
- H4[a]: Financial stability of the Borrower **has** a relationship on Non Performing Advances.

Lending officers of several commercial banks were considered as the primary targeted population for this study. 'Simple Random Sampling' under 'Proportionate Sampling Method' was used for sample selection process. Sample size of 190 was calculated using the sample size calculator. 'Confidence Level' was assumed as '95%', 'Confidence Interval' was taken as '5'. The method used to gather primary data for this research was self-administered questionnaire and obtain responses of the areas identified as **Dependent variable** and

**Independent variables**. 45 questionnaires were completed and collected and the response rate was 23.6%. Collected data were processed through Microsoft Excel and extracted into a SPSS spreadsheet. Since the data collected are ordinal and ranked data, the quantitative analysis was performed using SPSS 17.0 software through SPEARMAN'S Coefficient.

# 4 RESULTS AND DISCUSSION

Out of 45 respondents, majority respondents were Male (80%). Majority of the respondents belongs to 30-35 year (40%) and the second largest group between 35-40 year (28.9%) age categories. Further, majority of the respondents have Secondary education (40%) and Tertiary education (31.1%). Majority of the respondents were currently in Assistant Manager (44.4%) and Manager (24.4%) positions in the bank. This clearly reflects higher positions in the bank branch level have respondent to the survey which was finally contributed to quality data. Majority of the respondents have 14-21 years (62%) of experience in the bank. This clearly depicts that majority of respondents had rich experience in bank. Majority of the respondents have 01-05 years (44%) and 05-10 years (29%) of experience in bank credit process. Since majority of the respondents have many years of experience in bank credit process, helped to capture quality data.

For the testing of Hypothesis 1, independent variable was Knowledge and Training of Lending Officers and the dependent variable was Non-Performing Advances. Since, p-value<significant level or (0.000<0.01) have very strong evidence to accept H1a and reject H10. Hence, conclude that Knowledge and Training of Lending Officers has a significant **Moderate Negative** relationship towards Non-Performing Loans. Hypothesis 2, independent variable was Risk Assessment and the dependent variable was Non Performing Advances. Since, p-value<significant level or (0.000<0.01) have very strong evidence to accept H2a and reject H20. Hence, conclude that Risk Assessment has a significant **Moderate Negative** relationship towards Non-Performing Loans. Hypothesis 3, independent variable was monitoring and Follow up and the dependent variable was Non-Performing Advances. Since, p-value<significant level or (0.000<0.01) have very strong evidence to accept H3a and reject H30. Hence, conclude that Monitoring and Follow up has a significant **Strong Negative** relationship towards Non-Performing Loans. Hypothesis 4, independent variable was financial stability of the Borrower and the dependent variable was Non-Performing Loans. Since, p-value<significant level or (0.000<0.01) have very strong evidence to accept H4a and reject H40. Hence, conclude that financial stability of the Borrower has a significant **Strong Negative** relationship towards Non-Performing Loans.

# 5 CONCLUSION AND RECOMMENDATIONS

The results revealed that, based on the respondents view it was evident that Knowledge and Training of Lending Officers and Risk Assessment has "**Moderate Negative"** relationship with Non-performing Loans. It was further revealed according to the literature review a study by Waweru and Kalini (2009) suggested Non-Performing Loans occur due to lack of appropriate skills of the Lending officers and preparing proposals immediately without evaluating in depth seeking urgent approval. Further, Rajan (1994) found that short term decisions taken by Managers considering their reputation lead to bad loans. Monitoring and follow up, financial stability of the borrower has "**Strong Negative"** relationship with Non-Performing Loans. The training arm of the bank must have a mechanism to improve the credit related training sessions. Extra expenditure on refreshing the knowledge Lending Officers of the bank through training programs will definitely be an investment but not a cost. Further, bank must have an effective credit process that will incorporate proper customer selection and healthy credit analysis. If proper attention was given by the bank, borrowers give more attention to repay the loans. Hence, bank must provide adequate staff for monitoring purpose, failing which lead loan defaults. Bank must periodically visits the borrowers to have an understanding about the business activities that they are engaged in and give necessary advices when needed for the growth of the business which will finally give favorable feed backs to the banks for quality loans.

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