An Investigation of The Causes and Challenges of Non-Performing Loans: A case of a Zambian Bank

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Abstract- Non-performing loans are a burden on any country's economy and exert downward pressure on its growth. The aim of the study was to investigate the causes and challenges of non-performing loans in the banking sector in Zambia using a quantitative method approach, with descriptive survey as the design. The research adopted a positivism, deductive approach, case strategy, mono method and cross section time horizon. The sampling technique used was the simple random sampling with a sample size of 78 respondents. Quantitative data analysis was used on primary data collected. The research findings indicated that economic down turn, high interest rates, loss of reliable income are some of the major causes and challenges of non-performing loans in the banking sector. The findings also showed that poor credit collection and monitoring contributes to the challenges of non-performing loans in the banking sector and thus contributing to higher levels of non-performing loans. NPLs are caused by moral hazard and imprudent lending practices by bank employees and owners. High Rate of Unemployment also contribute to causes of high NPLs. The study recommended that commercial banks should always have adequate information about its clients and continue strengthening their credit policies and ensure that there is continuous training for its staff. Banks needs to further have excellent risk management processes in place for them to manage credit risk. This will help in avoiding non-performing loans which would be a cost to the bank. In addition to this, the banks should take proper credit assessment and risk management techniques 'to minimize the bank exposure to a higher NPL.

Index Terms- Non-Performing Loans, Moral Hazard, Adverse Selection

I. Introduction

Commercial Banks play an important role in the development of an economy as they act as financial intermediaries in the financial system of any economy in the world. If the financial system has challenges and is not working well, it has an impact on the overall performance of the economy. Sustainable economic growth and development will only be achieved if the financial system is well developed and one of the characteristics is through lending and timely repayment of loans in the economy. Banks are faced with different types of risks which are influenced by different factors. According to Jarrah (2012), "the sources of risks facing financial institutions are systematic risk factors which have an impact on all financial institutions in the market and are beyond the banks control whilst non-systematic risk are related to the bank specific variables. Banks are currently faced with the growth of Non-Performing Loans which is a major challenge and problem in the financial sector and economy. Non-performing loans (NPLs) are important because they reflect the credit quality of the loan portfolio of banks, and in aggregate terms, reflect the credit quality of the loan portfolio of the banking sector in a country. An understanding of the factors that influence the level of non-performing loans is crucial for the risk management function of banks and for national bank supervisors responsible for banking stability.

Non-performing loans (NPLs) are commonly considered a micro prudential issue. Recently, however, the significant rise of problem loans has made the problem relevant to policy makers, who are concerned that high levels of NPLs will increase systemic risk and impair core functions, such as the supply of credit to the real economy (Draghi, 2017;

ESRB, 2019). The increasing amounts of Non-Performing Loans which have to be provided for in the financial institutions income statements or written off impact on the performance of the banking sector. Mabvure et al (2012) state that, high incidences of non-performing loans can potentially cripple the country's financial sector. According to Gosh, (2015), the weakening of a bank's asset quality may lead to a decrease in economic efficiency, impair social welfare, and weaken economic activity and financially threatening for the banking system. Banks generate their major income from loans which also constitute the greatest risk to the banks. Loans are classified as non-performing loans after being in default for more than 90 days. According to the International Monetary Fund, a loan is non-performing when payment of interest and /or principle are past due by 90 days or more, or interest equal to 90days or more have been capitalized, refinanced, or delayed by agreement or payment are less than 90 days overdue, but there are other good reasons such as debtor filing for bankruptcy, leading to misgiving that payments will be made in full.

The causes of nonperforming loans are usually attributed to the lack of effective monitoring and supervision on the part of banks, lack of effective lenders' recourse, weaknesses of legal infrastructure, and lack of effective debt recovery strategies (Adhikary, 2006).

According to Gorter and Bloem (2002), cited in Agnes (2010), non-performing loans are also 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. Other causes are mainly attributable to low GDP growth, high unemployment rate, banks' lending practices, low bank covenants, credit culture in the country, interest rates, supervisory and legal frameworks.

Slower economic growth

Economic downturns are often seen as one of the main causes of lower debt and collateral quality and higher stocks of NPLs held by banks. The immediate consequence of large amount of NPLs in the banking system is bank failure as well as economic slowdown. The gross domestic product (GDP) growth is inversely related to non-performing loans, suggesting that an improvement in the real economy translates into lower non-performing loans. Economic growth means an increase in national income/national output. When there is slower rate of economic growth, living standards increase at a slower rate. The decrease in economic growth is accompanied by an increase in unemployment and a risk of deepening social polarization.

A healthy financial system promotes economic growth and as further stated by Schumpeter (1969), a weak financial system grappling with non-performing loans (NPLs) and insufficient capital could undermine growth. Non-performing loans (NPLs) are a burden for both lender and borrower; they contract credit supply, distort allocation of credit, worsen market confidence and slow economic growth. Morakinyo and Sibanda (2016), as cited by Zeng (2012), observed that loans in the economy as boosting total consumptions and resulting in yielding positive social utility while non-performing loans are viewed as a source of financial pollution (Minsky, 1964, 1995; Stiglitz & Weiss, 1981) that negates social utility. Zeng further argues that NPLs have two economic implications. Firstly, economic growth could decline if NPLs grow, causing resource allocation inefficiency. Secondly, capital requirements will increase as a result of the growth of NPLs as erosion of capital occurs due to funds being trapped in such entities, making it impossible for the banks to fund new, economically viable ventures.

Since the start of the global economic recession in late 2007, commercial banks' credit quality indicators have deteriorated significantly, due to the rise in unemployment rates, challenging business conditions and to some extent the significant increase in credit by consumers to support their expenditures. Slow economic growth is the key factor restraining the banking system's development.

Morakinyo and Sibanda, (2016) state that earlier economists focused on the importance of banks as a driver of economic growth. In 1911, Schumpeter argued that a weak banking system grappling with non-performing loans and insufficient capital or with firms whose credit worthiness has been eroded because of high leverage or declining asset values are examples of financial conditions that could undermine growth, just as a healthy financial system promotes growth. Furthermore, financial development through capital efficiency and growth in productivity can affect the economic growth rate (Hondroyiannis, Lolos, & Papapetrou, 2005).

Linking up with Schumpeter (1969), Hou and Dickinson (2007) maintained that the effect of NPLs on the economy is that resources are tied down in unproductive sectors thereby impeding economic growth and economic efficiency, which then impacts negatively on the banking system's lending behaviour. This outcome can ultimately lead to credit crunch, a situation where financial institutions restrict credit supply below the average level identified for a given market condition (Gertler & Kiyotaki, 2010). Banks shy away from engaging in new credit risk, which ordinarily would have resulted in an equilibrium position, hence creating a scenario of excess loan demand. This defensive action by financial institutions, which includes reducing credit extension to even viable projects, limits the ability of the overall economy to grow.

Lack of effective monitoring and supervision

It is widely accepted that bank regulation and prudential supervision exists to promote an efficient and competitive banking system; to prevent the occurrence of unnecessary financial disruptions caused by banking panics and failures; and to reduce depositor's risk exposure to episodes of financial distress.

In order to ensure effective credit monitoring, it is essential to examine credit monitoring tools. At the ground level, we should periodically receive a certified statement of actual cost of the project from the borrower. The actual cost as per the certified statement submitted by the borrower should be compared with the projected statement of project cost to be incurred at each stage of the project. For cost overrun, if noticed, close monitoring is called for to prevent the account from turning into NPLs.

Due to inefficient management of advancing loans without regard to credibility of borrowers, compromising regulations and socio-economic political pressures, the Greece financial sector took a downturn in the financial crunch of 2007 according to Louzis (2012). In their seminal paper, Berger and DeYoung (1997) examine the relationship between loan quality, cost efficiency and bank capital. They find that banks devoting few resources to credit selection and monitoring, even if they are more cost-efficient in the short term, will have a larger amount of NPLs in the future. The same effect occurs when managers do not have the skills to measure credit risks and to properly assess loans collaterals.

High lending rates

According to Collins and Wanjau (2011), Interest rate is defined as the cost incurred by the borrower for the use of money they borrowed from a lender or a financial institution. This price has an impact on the financial performance of the commercial banks in particular through its loan or credit extended. This rate normally fluctuates as per creditworthiness of the borrowers and depends upon the loan's objectives (WorldBank, 2018). Thornton et al, (2015) defined it as the interest rate charged by banks to the private sector. The deregulation, characterized by abnormally high-interest rates, is the major reason behind most of the banking and financial crises as stated by Fofack, (2005). The Non-Performing Loans increase significantly in response to higher interest rates (Castro, 2013). According to Espinoza & Prasad (2010), when economy is going down and the interest rates are going high, Non-Performing Loans will rise. An increase in interest rate weakens loan payment capacity of the borrower therefore non-performing loans and bad loans are positively correlated with the interest rates.

High interest rate have a significant and positive relationship with Non-Performing Loans. When banks increase interest rate, there is an additional payment burden on borrowers resulting in increased defaults (Stiglitz and Weiss, 1981; Reddy, 2002; Boyd and Nicolo, 2005; Keeton and Morris, 1987; Fofack, 2005; CollinDufresne & Goldstein, 2001; Asari et al, 2011). Some of the studies have also shown a weaker or insignificant relationship between interest rate and Non-Performing Loans (Kaplin et al, 2009; Patnaik and Shah, 2004; Epinoza and Prasad, 2010). The study of Sinkey (2002) shows that increase in interest rate negatively impacts the loan defaults. Similarly, the study of Rajan and Dhal (2003) indicates a significant association of high cost of borrowing and Non-Performing Loans (NPLs).

Banks with high interest rate charges comparatively face higher default rate or non-performing loans. Sinkey and Greenwalt (1991), Rajan and Dhal (2003) and Waweru and Kalini (2009) in their respective studies in the US, India and Kenya on the commercial banks indicated that high interest rate charged by the banks is one of the internal factors that leads to incidence of non-performing loans. Messai and Jouini (2013); Farlan et al, (2012); Chikoko et al, (2012) and Vatansever and Hepşen (2013) assert that high interest rate charged on borrowers increase the level of non-performing loans. On the same note Louzis, Vouldis and Metaxas (2010) indicated that floating interest rate raised major problem to borrowers thereby increasing the level of non-performing loans. Waweru and Kalani (2009) affirm that high interest rate charged on borrowers will force them to indulge in risky activities and it is usually accepted by risk borrowers. According to Khemra, Saba, & Pasha, (1987), banks which charge relatively higher interest rates and lend excessively are likely to incur higher levels of non-performing loans.

Rising government arrears

A further factor affecting the rise in NPLs is the amount of sovereign debt, which curbs investments (Makri et al., 2014; Ghosh, 2015) and weakens the banking system when it is high, thus accentuating the possibility of a crisis (Reinhart and Rogoff, 2011).

Poor Management of Loan Portfolio

Poor loan portfolio management has been cited as another important cause of non-performing loans by different scholars. According to Messai and Jouini (2013), Management inefficiencies are positively related with future rise in NPLs. Waweru and Kalani (2009) assert that non-performing loans are caused by poor credit risk management practices. Well-structured credit philosophy and credit culture will reduce management inefficiencies hence reduce non-performing loans. This is a controllable cause of non-performing loans hence Fernández, Jorge and Saurina (2000) cited in Waweru and Kalani (2009) indicated that growth of bank lending and prudential guidelines are always on the agenda of bank supervisors. Waweru and Kalani (2009) further indicated that it is difficult for banks to follow prescribed guidelines in a competitive environment where lending institutions compete for market share and profits. However, failure to follow prescribed guidelines in lending increases non-performing loans which can lead to bank failure. In this case it is mandatory to follow prudent lending practices. Some banks have un-sound credit assessment procedures and they insist on credit quantity at the expense of quality loan book. There are also issues of poor risk consciousness among lenders which increases NPLs (Ning-ning, 2009).

Insider Lending and Moral Hazard

Shingjergji (2013) and Waweru and Kalani (2009) indicated that NPLs are caused by moral hazard and imprudent lending practices by bank employees and owners. Bank management might engage in insider lending and charging exorbitant interest to risky clientele in order to maximize return which promotes moral hazard. Brownridge (1998) cited in Waweru and Kalani (2009) stated that insider loans are considered to be major contributors to failed banks. According to the Reserve Bank of Zimbabwe Monetary Policy Statement (2014) non-performing loans are increased by insider loans. This is a confirmation of researches done in other countries.

Waweru and Kalani (2009) indicated that in Kenya, moral hazard and insider loans perpetuate imprudent lending behaviour in the financial services sector. Some banks with weak internal control suffer from moral hazard (Ning-ning 2009). Borrowers usually engage in more risky activities than what was agreed with the bank.

High Rate of Unemployment

Shingjergji (2013), Messai and Jouini (2013), Farlan et al, (2012) and Vatansever and Hepşen (2013) agreed that high rate of unemployment in any country has a positive relationship with increased NPLs. Louzis, Vouldis and Metaxas (2010) added that unemployment affects the borrowers' source of income which weaken the ability to repay borrowed funds. There is a strong positive relationship between NPLs and high rate of unemployment Lazea and Luga (2012).

3. Methodological Approach

The quantitative research approach was used in this study, with descriptive survey as the design. The population of the study was made up of 150 staff comprised of lending officers, operations officers and branch managers in Lusaka District found in Lusaka province of Zambia. Using the Yamane Taro (1967) formula, 108 respondents were selected for the study. The simple random approach was used. The researcher used a structured questionnaire to gather data from the respondents. However, only 78 respondents returned complete filled in questionnaires. This represents a 72.22% response rate. The data collected from the respondents was coded and processed using Statistical Package for Social Science (SPSS) whilst descriptive statistical tools such as frequencies and percentages were used. Tables and graphs were used to present the results.

Results and Discussion

Non-Performing Loans are a big challenge in banks

Table 4.4. shows that 70.5% of the respondents stated that NPLs are a big challenge in the banks. 19.2% of the respondents were not sure that NPLs are a challenge whilst 10.3% of the respondents disagree that NPLs are a big challenge in banks. It can be observed that from the responses from the respondents, NPLs are a big challenge in the bank.

Table 1. NPLs are a big challenge in banks

Respondents	Frequency	Percent
Agree	55	**70.5**
Neutral	15	**19.2**
Disagree	8	**10.3**
Total	**78**	**100.0**

Source: Survey Data (2021)

Economic downturn

According to table 4.5 below, 60.3% of the respondents strongly agree that economic down turn has contributed to increasing levels of NPLs in the banks and 28.2% agree giving a total of 88.5% of the respondents agreeing that NPLs have increased due to economic down turn. 5.1% of the respondents are not sure whilst 6.4% of the respondents disagree that economic down turn has contributed to the increasing levels of NPLs

Table 2. Economic down turn

Respondents	Frequency	Percent
Strongly Agree	**47**	**60.3**
Agree	**22**	**28.2**
Not Sure	**4**	**5.1**
Disagree	**5**	**6.4**
Total	**78**	**100.0**

Source: Survey Data (2021)

Interest rates impact NPLs

Table 4.6 Shows that 43.6% of the respondents strongly agree and 23.1% agree that interest rates have a significant impact on NPLs. 14.1% respondents are not sure whilst 19.2% disagree. It can be observed that the majority of respondents agree that interests do have an impact NPLs.

Table 3. Interest rates impact NPLs

Respondents	Frequency	Percent

Strongly Agree	**34**	**43.6**
Agree	**18**	**23.1**
Not sure	**11**	**14.1**
Disagree	**15**	**19.2**
Total	**78**	**100.0**

Source: Survey Data (2021)

NPLS can be controlled if banks strengthen supervision of loan appraisals

According to Table 4.7, 64.1% strongly agree and 25.6% agree that NPLs can be controlled if banks increase the system of loan appraisals whilst 10.3% of the respondents disagree that NPLs can be controlled if banks increase the system of loan appraisals. This would therefore reduce Indo Bank Zambia experiencing NPLs

Table 4. NPLS can be controlled if banks strengthen supervision of loan appraisals

Respondents	Frequency	Percent
Strongly Agree	**50**	**64.1**
Agree	**20**	**25.6**
Disagree	**8**	**10.3**
Total	**78**	**100.0**

Source: Survey Data (2021)

Loss of reliable source of income

Table 4.8 shows that 70.5% of the respondents strongly agree and 21.8% agree that loss of reliable source of income increases the levels of non-performing loans, whilst 7.7% of the respondents strongly disagree

Table 5. Loss of reliable source of income

Respondents	Frequency	Percent
Strongly Agree	**55**	**70.5**
Agree	**17**	**21.8**
Strongly Disagree	**6**	**7.7**
Total	**78**	**100.0**

Source: Survey Data (2021)

Aggressive lending leads to large NPL volumes

According to table 4.9, it indicates that 56.4% of the respondents agree that aggressive lending leads to large NPL volumes whilst 19.2% agree. 12.8% disagree and 11.5% strongly disagree that aggressive lending leads to large NPL volumes.

Table 6. Aggressive lending leads to large NPL volumes

Respondents	Frequency	Percent
Strongly Agree	44	**56.4**
Agree	15	**19.2**
Disagree	10	**12.8**
Strongly Disagree	9	**11.5**
Total	**78**	**100.0**

Source: Survey Data (2021)

Company failures influences the level of NPLs

Table 4.10 shows that 66.7% of the respondents strongly agree and 29.5% agree that company failures influence the level of NPLs whilst 3.8% of the respondents disagree that company failures influence the level of NPLs

Table 7. Company failures influence the levels of NPLs

Respondents	Frequency	Percent
Strongly Agree	52	**66.7**
Agree	23	**29.5**
Disagree	3	**3.8**
Total	**78**	**100.0**

Source: Survey Data (2021)

Reduced buying ability of consumers contributes to NPLS

Table 4.13 below revealed that 57.7% of the respondents strongly agree whilst 19.2% agree that reduced buying ability of consumers contributes to NPLs whist 10.3% disagree and 12.8% of the respondents strongly disagree

Table 8. Reduced buying ability of consumers contribute to NPLs

	Frequency	Percent
Strongly Agree	45	**57.7**
Agree	15	**19.2**
Disagree	8	**10.3**
Strongly Disagree	10	**12.8**
Total	**78**	**100.0**

Source: Survey Data (2021)

Inadequate mechanisms to gather and disseminate credit information

Table 4.14 shows that 12.8% agree that there are inadequate mechanisms to gather and disseminate credit information whilst 10.3% of the respondents are not sure. 25.6% of the respondents disagree and 51.3% strongly disagree that there are inadequate mechanisms to gather and disseminate credit information

Table 9. Inadequate mechanisms to gather and disseminate credit information

Respondents	Frequency	Percent
Strongly Agree	58	**74.4**
Agree	11	**14.1**
Disagree	9	**11.5**
Total	**78**	**100.0**

Source: Survey Data (2021)

High NPLs adversely affect fresh credit proposals and credit growth

According to table 4.16 below, 56.4% of the respondents strongly agree that higher NPLs may adversely affect attitude towards fresh credit proposals and credit growth. 19.2% agree whilst 12.8% of the respondents disagree and 11.5% strongly disagree.

Table 10. High NPLs adversely affect fresh credit proposals and credit growth

Respondents	Frequency	Percent
Strongly Agree	44	**56.4**
Agree	15	**19.2**
Disagree	10	**12.8**
Strongly Disagree	9	**11.5**
Total	**78**	**100.0**

Source: Survey Data (2021)

5. Conclusion

The research concluded that economic down turn, high interest rates, loss of reliable income are some of the major challenges of non-performing loans in the banking sector. The research also showed that poor credit collection and monitoring contributes to the challenges of non-performing loans in the banking sector and this also contributes to higher levels of non-performing loans.

The research also showed that rising government arrears have continued to contribute to the causes of NPL due to the fact that it curbs investment. Poor loan portfolio management has been cited as another important cause of non-performing loans. NPLs are caused by moral hazard and imprudent lending practices by bank employees and owners. High Rate of Unemployment also contribute to causes of high NPLs.

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