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Reasons for Creating Non-Performing Loans (NPLs) in ABC Company - A Case Study

D.G.Gunasekara
Department of Finance, Faculty of Management Studies and Commerce, University of Sri Jayewardenepura

***ABSTRACT**: Non-Performing loan is a sum of borrowed money upon which the debtor has not made scheduled payments for a specific period of time. Financial institution considers loan as an asset, while interest generated from loans is considered as revenue. If a loan becomes default it will fail to generate revenue to a financial institution. The Major objective of the case study was to examine the reasons for creating NPLs in ABC Company. Minor objectives investigated how NPLs impact on financial performance and mechanisms could take to reduce the NPLs amount of the ABC Company. Based on structured interview with the legal manager identified the major reasons to create NPLs. Secondary data collected from annual reports of ABC company for 30 quarters and analyzed the data used by simple regression and correlation. The study has identified most prominent reasons for creating NPLs were due to management practices of the company. The company granted unsecured loans without evaluating the credit worthiness of their customers. Provided loans for the uneducated people who were not aware regarding paying of interest component. Provided loans to people who do not have proper income. Based on government promises granted loan facility to start up new businesses. Macroeconomic factors like unemployment and inflation also impacted on the creation of NPLS. Since the P value of Regression analysis was 0.053, So NPL Ratio has an impact on Return on Assets (ROA). The correlation coefficient was -36.90%, which indicated there were a negative relationship between NPL Ratio and ROA. It revealed that NPLs had a negative impact on financial performance. To minimize NPLs Company could adapt risk-based strategy, tightening, loan portfolio supervision, hiring qualified debt collectors, 7 C's Concept can be used to evaluate the credit worthiness of customers. Loan officers should adapt proper communication mechanisms to communicate with borrowers*

***KEY WORD**: NPLs, ROA, Financial Performance, 7 C's Concept*

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I. INTRODUCTION AND LITERATURE REVIEW

Lending can be defined (according to Oxford dictionary) as the action of allowing a person or organization the use of a sum of money under an agreement to pay it back later. Loan portfolio is typically the largest asset and the predominant source of income for banks. In spite of the huge income generated from their loan portfolio, available literature shows that huge portions of banks loans usually go bad and therefore affect the financial performance of these institutions (Comptroller, 1998). Financial institutions normally grant loans by using deposits made by customers for a short or a long time period. A nonperforming loan (NPL) is a sum of borrowed money upon which the debtor has not made the scheduled payments for a specified period.

loaning it can be divided into two parts as secured loans and unsecured loans. A secured loan is when the borrower has committed to give the lender certain assets, such as a real estate property or a car, if he or she defaults. An unsecured loan is a loan that is not backed by an underlying asset. Unsecured business loans are easier to obtain than secured business loans for any business or an individual because your business does not need to supply collateral. While lending institutions can seize the collateral if your business defaults on a secured loan, a lender can't take any of your business' property if it defaults on an unsecured business loan unless he obtains a court order. If a business files a case for bankruptcy, even though the court may discharge unsecured loans, it will not discharge secured loans. Since unsecured loans are riskier for lenders, they include higher interest rates than secured business loans. So, the borrower has to pay more amounts for an unsecured loan rather than for a secured loan. Finally, in some cases, unsecured loans could become difficult to afford. In order to take unsecured loan facility, the borrower should have a proper credit history, otherwise the borrower's application may not be approved. The main advantage for financial institutions when granting unsecured loans is the huge amount of interest that can be charged, but at the same time, a disadvantage arises because the lender faces difficulties if the borrower dies or makes default on payments.

Customers who take unsecured loans from a bank or any other financial institution utilize them for renovating their home, marriage-related expenses, family vacations, children's education, starting new businesses, meeting unexpected medical expenses or any other emergencies. The interest rates on personal loans are higher than those on home, car or gold loans because of the greater perceived risk when sanctioning them. Normally, financial institutions concern eligibility criteria like age, occupation, income, capacity to repay the loan and place of residence. Maximum loan duration can be 1 to 5 years or 12 to 60 months. The amount of loan that can be borrowed usually depends on your income and varies based on whether you are salaried or self-employed. Usually, the banks restrict the loan amount such that your EMI (equated monthly instalment is a fixed payment amount made by a borrower to a lender at a specified date each calendar month) is not more than 40-50% of your monthly income. (The Economic Times)

Recently, banking industry has been facing problems due to increasing prices of vehicles, inflation, increase of interest rates and economic difficulties. So most of businesses move to micro finance facility. This is a type of an unsecured loan facility is granted by banks and financial institutions.

According to Cambridge Dictionary loan is an amount of money that is borrowed, often from a bank, and has to be paid back, usually together with an extra amount of money that you have to pay a charge for borrowing. When the economy is booming NPL are lower, but during the recession higher. (Ozili, 2019). International Monetary Fund (IMF, 2009) states that a non-performing loan is any loan in which interest and principal payments is more than 90 days overdue or more than 90 days' worth of interest has been refinanced. (Hennie & Sanja, 2009) define NPLs as assets not generating income, because for a bank or any other financial institution loans are considered as assets, normally characteristic of an asset is generating funds but when a loan is default it is unable to generate funds to the company.

As a result of inefficient credit management systems a number of financial institutions in the world have collapsed or faced for financial troubles. (Pierre, 2017). (Roche, 2013)explains that loss of employment can be arisen due to different kind of reasons such as retrenchment, retirement, sacking or firing as a result of conducting strikes, misconduct and many other factors. When such a thing takes place an individual has automatically struggling to pay back the loan to commercial banks or other financial institution will lead that loan amount become default. According to (Omondi, 2014) inflation depreciates the value of money, which means a percentage increase in inflation results into a similar percentage fall in value of the country's currency. Due to exist of a negative relationship between non-performing loans & inflation, if inflation increases non-performing loans also increase of a financial institution & negatively impact on financial performance.

A study conducted by (Waweru & Kalani, 2008) based on commercial banks in Kenya using a statistical analysis indicated that high interest rates charged by banks are one of the internal factors that leads to create of non-performing loans. Under certain circumstances, the borrower uses money for medical expenses instead of using it for the intended purpose. Such as due to illness, borrowers will find it difficult to honor their loan obligations because sometimes in order to treat for an illness large amount of money have to be spent. So the general health of the borrower should be taken into consideration and health of a close relative when granting the loan facility (Araka, Mogwambo, & Otieno, 2018) .

(Kolapo, Ayeni, & Oke, 2012) in their study identify influences of the credit risk on performance of banks by took a sample of five banks in Nigeria & data collected from 2000 to 2010. Credit risk is measured by taking the ratio of non-performing loans to loans plus advances, total loans to advances plus deposits and ratio of loan loss provisions while performance is measured by return on assets. Fixed effect model used in the study and according to results of regression analysis, non-performing loans and loan losses provisions are adversely affecting the performance while total loans to advance plus deposit ratio has a positive significant effect on the performance. This provided an evidence in order to maximize the profits of the bank industry, they should improve their loan administration processes.

(Salike & Ao, 2018) took a sample that consists of 947 banks from 12 Asian economies over the period of 2001-2015. Researchers used panel data for this study. From this study they able to identify that impaired loans over gross loans have a significant negative impact on bank's profitability. The study by (Bardha & Mukherjee, 2016) addressed that what should be the critically maximum or permissible level of NPAs that a bank can tolerate, given its portfolio of various risky and risk-free assets and its operational expenses. Based on the actual financial performance of the bank determined that tolerable level of NPAs at each bank. The increase in differences between actual NPA and tolerable levels of NPA at a bank led to severe NPA problems and vice versa.

(Rufai, 2013) investigated the efficiency of credit risk management of the bank's performance and also examined how credit risk impact on profitability, as well as researcher study the relationship between interest income and bad debt (non-performing loans) of the Union Bank PLC. Based on the findings, he revealed that credit risk affects the performance of banks and for the banks to maintain high interest income. The researcher also found out that adequate attention should be given to credit risk management, and also bank loans should be adequately reviewed from time to time to assess the level of risk. Every loan should be secured with collateral, so if borrowers become default bank able seize the collaterals.

In a study by (Maggi & Guida, 2009) did a study to identify effects of NPLs on the cost structure of the commercial banking system, it was found that it is extremely costly to the banking system if a loan become non-performing. This will lead to arise adverse effects for efficiency & effectiveness of the banking sector. The study of (Kalfaoui, Ben Saaâda , 2015)revealed that lower nonperforming credit rates increased the profitability of banks. This investigation was done by considering a sample of Tunisian banks. And also based on findings revealed that reason behind a bank became most profitable is due to significant interest on the repayment of loans granted by banks.

The major objective of this study is to examine the reasons for creating NPLs in ABC Company. Minor objectives investigated how NPLs impact on financial performance and mechanisms could take to reduce the NPLs amount of the ABC Company.

Therefore, structure of the paper is organized as follows. Section 1.1 of the paper introduces the concept and tried to justify the possible reasons behind the study through a brief review of literature. Section 1.2 clearly mentioned the basic research objectives of the paper. Section 1.3 clarifies the data and methodology of the paper. Finally, section 1.4 interprets the result and concludes

1.2 Research Objectives

The major objective of this study is to examine the reasons for creating NPLs in ABC Company. Minor objectives investigated how NPLs impact on financial performance and mechanisms could take to reduce the NPLs amount of the ABC Company.

1.3 Research Methodology and Data Analysis

The main purpose of this study is to identify reasons for creating non -performing loans in ABC Company. Here researcher has conducted structured interview with the legal manager and identify the reasons for this problem. As a data collection method researcher has used primary data collection method. When considering the research approach, this study can be an inductive study. Here the research choice is qualitative.

Other than main purpose here researcher has investigated impact of non-performing loans on the financial performance of ABC Company. When considering the research approach, this study can be a deductive study. Here the research choice is quantitative because quantitative approach typically concentrates on measuring, collecting and analysing numerical data and applying statistical tests. Hypotheses have been tested with correlation and Simple Regression because the focus of this study is to identify the relationship between two variables as a minor objective. Here the study is expected to cover quarters from December 2011 to March 2019 period of time. Financial performance here is measured using profitability. Profitability can be measured using several types of ratios. So, researcher selects Return on Assets (ROA) as the indicator in order to measure the profitability. For this study Return on Assets (ROA) is selected as the dependent variable & Non-Performing loans to total loans (NPL Ratio) is selected as the independent variable. Researcher used secondary method in order to collect data. And also, data collected quarterly. Secondary data is collected from Interim financial statements, Annual reports of ABC Company. Data analytical technique is decided base on type of data. In quantitative approach data in numerical form, therefore using STATA software analyses data to test the correlation between two variables and also test significance of the influence of the independent variable on the dependent variable.

Simple regression model was used to test the significance of the influence of the independent variable on the dependent variable. Here impact of non-performing loans on the financial performance explained in the study.

$Y = B0 + B1X1 + e$

Where, Y = Return on Assets (ROA) - Dependent Variable

X1 = Non-Performing loans to total loans (NPL Ratio) - Independent Variable

B0 = Constant

B1 = Regression coefficient or change included in X value

e = Error term

Hypothesis of the study

H0: Non-performing loans to total loans (NPL Ratio) has no impact on Return on Assets (ROA)

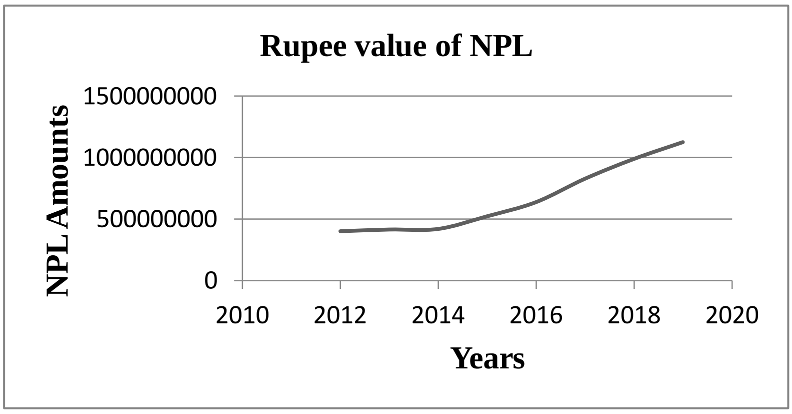
H1: Non-performing loans to total loans (NPL Ratio) has impact on Return on Assets (ROA)

Ethics are norms or standards that will help to distinguish between right & wrong. Ethics in research mean an investigator has a moral obligation to protect the participants from harm, unnecessary invasion of their privacy & promotion of their well-being. When conducting research, researcher has the responsibility to use the data that obtain from ABC Company only for the research purposes. And also, the researcher should get the consent of the Company which is used as the participant in the research study by explaining the purpose of the study.

1.4 Findings and Interpretation

1. Positive trend of Non-Performing loans

Figure 1: positive trend of Non-Performing Loans



Source: Annual reports of ABC Company

From March 2012 to March 2019 based on annual data Non-Performing loan (NPL) rupee amounts are indicated in the above graph. In this diagram, a positive trend can be observed, which means non-performing loans are continuously increasing over the time period. This is mainly due to management practices of the selected company and macro-economic factors.

1.1 Management Practices

When considering management practices, the main reason behind the creation of non-performing loans in ABC Company is granting of unsecured loans by the company. From 2012 to 2014 company did not grant unsecured loans, but after 2014, they came over micro finance facility and granted unsecured loans to their customers without evaluating credit worthiness like some of their peers.

They grant loans for uneducated people this people who are sometimes not aware about payment of interest for the loan they have taken. They feel they are paying more than the amount they bought and stop paying the interest portion for the finance company.

Also, this finance company provides loans for the people who do not have a proper income. Especially for women to startup a new business and to develop women employability. These people are also struggling to pay back the loan amount because their targets are still not achieved and they do not have alternative income sources to settle the due amount.

Not only that the finance company relies on the promises given by the government and grant loans for the people to startup new businesses. The government has made promises to the ABC Company & other finance companies in the industry that, if people are unable to pay back the loans provided by the finance company, the government will refinance that amount to the finance company. Therefore, even the people who are capable of paying the loans are giving up to pay the due amount due to this government promise. But the government has not taken any action to refinance these loan amounts yet. Further, in 2018 government introduced a policy and asked financial institutions to grant loans for the eastern province farmers, but these people are free from the repayment of the loan according to the government-introduced policy. When other provinces farmers also got to know about this and they also gave up paying the installments for the loans they have already taken even though policy is only applicable for eastern province farmers.

The Company's inefficient credit management systems also led to the continuous increase in non-performing loans. Even the company provided loans for people who are willing to startup a new business, whether these borrowers actually utilize these funds for that aim or not will not be reviewed by this finance company so borrowers use these funds for multiple uses other than the main objective.

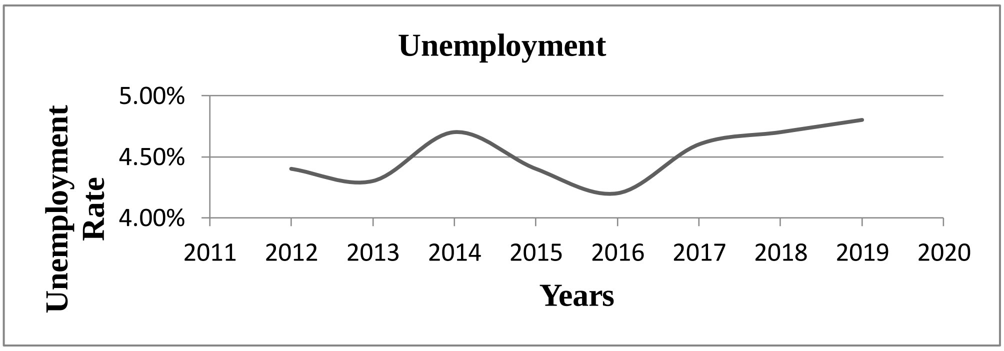
1.2 Macro-economic factors

Through the research study researcher found out that micro economic factors also lead to arise non-performing loans. As a result of sudden market changes prices of goods increase or demand increase borrowers have less money to pay off their loans. This can lead to an increase in non-performing loan amounts. When prices of the real estate market decline lenders are able to get fewer amounts by seizing the properties in response to default loans.

Another reason behind loans become default is credit culture because sometimes people are taking loans without thinking about their future and because others are taking loans, irrespective of their financially wisdom.

Sometimes unexpected job losses of employees and collapses of companies can also be a reason for borrowers struggling to pay back loans on time. It is proved that providing of secured loans also will not perform well in some cases. When inflation occurs in a country, it will lead to reduce that country's currency value, which has a major impact on creating non-performing loans. By observing the following graphs, it can be identified how the unemployment and inflation in Sri Lanka can have an impact on creating non-performing loans**.**

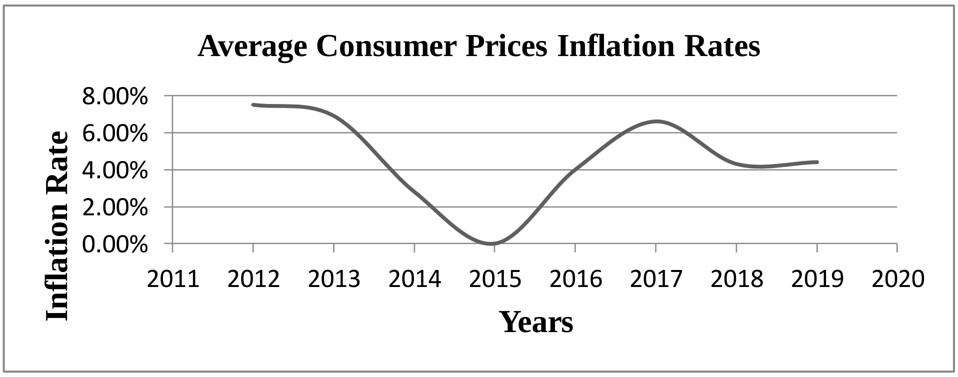
Figure 2: Unemployment



Source: Central Bank of Sri Lanka

Even though fluctuations can be observed from 2012 to 2016, after 2016 there is a positive trend in unemployment. This positive trend impacts on creating non-performing loans.

Figure 3: Inflation



Source: Central Bank of Sri Lanka

After 2015 this graph reflects an increasing trend in the inflation, which will also lead to creation of non-performing loans. As a result, 2014-rupee values of non-performing loans have gradually increased.

2. Regression Analysis

This analysis is used to identify relationships among variables. The following output was obtained by analyzing the time series data set.

Figure 4: Regression Analysis

. reg d2_roa d2_npl_ratio

Source	SS	df	MS			
				Number of obs	=	28
				F(1, 26)	=	4.10
Model	.001143792	1	.001143792	Prob > F	=	0.0533
Residual	.007256207	26	.000279085	R-squared	=	0.1362
				Adj R-squared	=	0.1029
Total	.008399999	27	.000311111	Root MSE	=	.01671

d2_roa	Coef.	Std. Err.	t	P>|t|	[95% Conf.	Interval]
d2_npl_ratio	-.1787175	.0882799	-2.02	0.053	-.3601794	.0027444
_cons	.0003191	.003161	0.10	0.920	-.0061785	.0068167

.

Source: Compiled by the Author

So based on the above data regression equation can be built as follow;
ROA =0.00003191-0.1787175npl_ratio
Since the *p* value for regression analysis is 0.053, researcher does not reject the null hypothesis under the 10% level of significance. That means β1 is significance (*p*<0.1). So researcher can conclude that NPL Ratio has an impact on ROA.
Based on the final result correlation coefficient between ROA and NPL Ratio is -36.90%, which indicates that there is a negative relationship between ROA and NPL Ratio

To overcome the issues when comes to recovery, the financial institution can use credit management which is the early recognition and proactive management of distressed loans, which can protect a lender from exposure to undue risks. Such credit risk strategies that can be used by the finance company are risk-based pricing which means lenders may charge a higher interest rate to borrowers who are more likely to default, and lending to a small number of borrowers facing a high degree of unsystematic credit risk, called concentration risk . Lenders reduce this risk by diversifying the borrower pool. Another method that can be adapted is tightening which means lenders can reduce credit risk by reducing the amount of credit extended, either in total or to certain borrowers. Another method that can be use is loan portfolio supervision and in order to do so today's technology can play a significant role. Credit risk management helps to ensure that loans are matched with ability to repay, help to project the default loans, and also based on that able to take relevant measures in order to minimize the default loans. And also by hiring qualified debt collectors and competent personnel financial institution can enhance periodic credit risk monitoring of their loan portfolio to reduce the level of NPLs.

The existing management practices of the finance company can be improved by using different mechanisms. The 7C's concept can be used to evaluate credit-worthiness of the borrowers as a means of minimizing bad loans. Loan officers should adapt proper communication mechanisms to communicate with the borrowers regarding the payment of interest for the loan they have taken. It is recommended that ABC Company need to invest on debt collections and this will entail hiring qualified and experienced debt collectors, lawyers so as to increase mitigation of defaulters. To solve the challenge of non-performing loans in relation to support for the women employability, researcher suggests that the financial institutions should ensure that the borrower have viable means of repayment. Otherwise, borrowers do not have alternative income sources to settle the due amount, if target income is not generated from their new business. It is also recommended that the finance company should not merely rely on the government promises and they can come to an agreement with the government to refinance existing default loan they have promised to refinance or else, the institution should stop granting loans for the people who are recommended by the government. Also existing default loans can be refinanced through adapting flexible repayment mechanisms like reducing the agreed interest rate and increasing the loan repayment period. The researcher further suggests that the bank can offer professional advice to the loan collector on possible means of efficiently investing the loan to ensure the needed return on investment is attained. The financial institution should evaluate whether the aim of taking the loan for the business purposes by the companies is achieved or not by ensuring that the customers who collect loan maintain proper account records from which they monitor the progress of the customer's business in comparison with what is expected.

This will help the financial institution to identify when a customer's business is not performing well, so that suitable actions can be taken before it is too late.

Also, by the collaborating with the government and the Central Bank, punishments can be imposed on defaulters of bank loans that mostly lead to NPLs. ABC Company should set their own standards on the minimum value of collateral in relation to the amount of money being loaned to a customer. Because after 2014 this company started to grant unsecured loans, and as a result continuous growth in non-performing loans can be observed.

By following the above-mentioned recommendations ABC Company would be able to reduce the level of non-performing loans.

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