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Original Article

Nonperforming Loans and Performance of Financial Institutions in East Africa: Evidence from Kabale District, Uganda

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ABSTRACT

This research evaluated the performance of financial institutions in the Kabale district in relation to the effect of non-performing loans. The following research goals served as the study's direction: to evaluate the effects of nonperforming loans on financial institutions, to evaluate the credit monitoring and recovery practices employed by financial institutions, and to ascertain the connection between loan evaluation and the performance of financial institutions. The study adopted a descriptive survey design. The population of the study included 10 financial institutions. A sample size of 149 respondents was used, and the study used purposive and random sampling techniques as sampling techniques. Questionnaire survey and interview guides were used for data collection, while both quantitative and qualitative data analysis was used. It was found that individuals from all the surveyed monetary institutions' staff generally agree that factors such as fund redirection, over or underneath funding, undermined integrity, credit operators' capacity limitations, firm failures, deliberate default, poor portfolio diversification, and changing policy environments contribute to the occurring of nonperforming loans were the specific financial institution determinants causing the occurrence of non-performing loans. On the determinants of nonperforming loans on financial institutions, the majority of the respondents (138, 98.6%) revealed that financial institutions provide loans to customers, while only 2(1.4%) revealed that they don't provide loans. On ways of credit assessment and loan default, it was found that the majority (69.3%) of respondents firmly concur ($M =$ 1.33, $SD =$ 0.516) that experiencing a know your customer policy in force results in a high loan quality, 32.8% agreed with easily admitted borrowers usually default ($M =$ 2.791, $SD =$ 1.090), 65.4% of the respondents agreed with poor risk assessment would lead to loan default ($M =$ 1.4, $SD =$ 0.682), and only 19.5% mentioned that good loan underwriting ensures loan performance was one of the ways of credit assessment and loan default (M = 2.25, SD = 0.957). There was a weakly positive association (r=0.501, p<0.05) between

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loan evaluation and the performance of financial institutions. There is a need for financial institutions to develop a flexible credit method that offers sufficient user choices, in-depth credit analysis, a genuine approval process, proactive monitoring, and obvious recovery strategies for subpar loans.

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INTRODUCTION

Nonperforming loans (NPLs) are loans that are in default or are close to being in default, meaning that the borrower has failed to make payments on the loan for a specified period of time, typically 90 days or more. In other words, these are loans that the borrower has stopped paying back and has fallen behind on their payments. On the other hand, the performance of financial institutions refers to how well institutions are able to achieve their financial goals and objectives, as well as meet the needs of their customers and stakeholders. Financial institutions include banks, credit unions, insurance companies, investment firms, and other organizations that provide financial services to individuals, businesses, and governments. Hence, the performance of financial institutions is crucial for maintaining a stable and efficient financial system that supports economic growth and development.

Nonperforming loans (NPLs) in Middle and South-Eastern Europe were 4% in 2002 and over 15% in 2014, whereas NPLs in the Organisation for Economic and Development Cooperation and Development (OECD) were 3% in 2002 and increased to 8% in 2014 (Čolak, 2022). Financial institutions were required to examine every aspect of their lending practices including the assessment of credit risk for potential future borrowers. Financial decisions made with regard to credit standards and restrictions, the collection of accounts receivable and the monitoring of poor credit, the monitoring of creditor behaviour and the handling of internal evaluation whilst also carrying the threat of standard or toxic debt, and the payment of invested capital in receivables (Van Thiel & Van Raaij, 2019).

According to Achieng (2021), the commercial banking problem of nonperforming loans has persisted and continued to grow, rising from about 4.9% in the year 2012 to 6.3% in 2015. Achieng (2021) also demonstrated how a rapid build-up of nonperforming debts occurred in African nations in the 1990s. The rapid build-up of nonperforming debts in African nations in the 1990s was a complex issue that was driven by a combination of internal

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and external factors. It had a significant impact on the economies of many African nations, and the effects of this crisis are still being felt in some countries today and little attention has been made. Financial institutions in Ghana are thought to have performed admirably in their efforts to serve the majority of the people in a nation where banking is not a common practice.

However, according to data from the World Bank, Ghana's average value between 2008 and 2018 was 14.94%, with a low of 7.68% in 2008 and a high of 21.59% in 2017. Inflation is one of the primary drivers of interest rates in Ghana. High inflation rates lead to higher interest rates as lenders try to compensate for the loss of purchasing power over time hence, contributing to the high-interest rates. The highest percentage from 2018 is 18.19%, and the world average for 2018, which is reliant on 121 economies, is 6.88% (Bismark, 2021).

Furthermore, Munangi and Bongani (2020) provided evidence of how financial failure prospects for Tanzania's remote financial institutions are impacted by poor credit risk management practices as well as bad portfolio management which affects financial institutions' profits negatively. The financial failure of remote financial institutions can lead to economic instability. The institutions may be unable to provide credit to businesses and individuals, which can slow down economic growth and lead to unemployment. To mitigate these effects, it is important for remote financial institutions to improve their credit risk management practices and portfolio management. This can help to minimize the risk of financial failure and ensure the sustainability of these institutions. It is also important for the government to provide adequate support and regulation to these institutions to ensure their stability and resilience.

Nonperforming loans are thought to be a usual conclusion of a financial crisis, but they are actually an unanticipated effect of the lending process that has the potential to dramatically worsen the scope and degree of both the financial meltdown and make macroeconomic administration more challenging (Žunić, Kozarić & Dželihodžić, 2021).

According to Kitonyi (2019), a loan that is in failure or on the verge of default is considered non-performing. When a loan's principal and debt payments are 90 months or more past due, this typically happens. This typically happens when a loan's debt and principal payments are 90 months or older past due. Since there is little chance they will be returned, nonperforming loans are frequently categorized as bad debt. The more nonperforming loans a bank has, the more likely it is that its stock price will be affected. As a result, this study examined the loan evaluations, credit policies, mortgage recovery processes, and borrowing costs of banking firms in the Kabale area to conceptualize nonperforming loans.

A company's financial performance serves as a barometer for how efficiently it can employ the resources in its core business to generate revenue (Bhalla, Kaur & Sharma, 2022). The expression is frequently used as a general gauge of an organization's long-term financial health. There are numerous ways to assess financial success, but they ought to be taken into account simultaneously. Line items like operating earnings, working capital through businesses, and revenue from enterprises can be employed in addition to total unit sales. Further analysis of the financial statements may be warranted by the analyst or buyer in order to spot any signs of declining debt or margin rate of growth (Kairys, 2023).

Financial institutions, often known as banking firms, are companies that act as middlemen in the financial markets (Moșteanu, 2019). The following three groups of financial institutions can be found: Depository institutions, or deposit-taking institutions that accept, handle, and lend money, include building countries, credit labour groups, trust companies, and home mortgage businesses. Nonetheless, profitability was used in this study to assess how well financial institutions did.

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Theoretical review

The study was guided by Credit Rationing Theory (CRT). According to this theory, lenders should limit the amount of credit they extend to borrowers depending on current rates of interest and obtainable security or substitutes for collaterals. The type of guarantee that borrowers show to the lenders influences their decision to lend or choose not to lend. Lenders offer loans with low-interest rates in order to prevent riskier investments and the possibility that borrowers won't meet their credit commitments (Bernanke et al., 2009). Since the bond between the borrower and the lender is weaker without collateral, loans based on different alternatives to collateral give borrowers a way out of repaying their debts. This theory was important for this study because the interest rate has a substantial impact on both how much a financial institution is willing to lend and whether or not the borrower will be able to repay the financial obligation.

MATERIALS AND METHODS

A descriptive survey design in line with Turyasingura et al. (2022) that aimed at exploring the impact of nonperforming loans on the performance of financial institutions was used. The research depended on primary data acquired from banking institutions in the Kabale district and was both quantitative as well as qualitative in nature in line with the study conducted by Benson and Ayiga (2022). Accordingly, staff members from various financial organizations were questioned. The emphasis of the qualitative data was primarily on the opinions of financial institution officials regarding not performing loans in the Kabale district's loans department, from lending regulations to the supply chain process.

This study considered an individual of 10 financial institutions (commercial banking institutions as the unit of analysis), including Absa, Baroda, Brac, Centenary, Dfcu, equity, Platinum, which is Post bank, Pride microfinance, and Stanbic in Kabale district. These organizations had a combined workforce of 178 employees and were operational from 2014 to 2020 (Ekong & Ikpe Michael, 2022). This time frame was deemed long enough to collect enough data to help identify trends in nonperforming credit and the efficiency of financial institutions. In order to include a majority of recent data and produce results that mirror the present trend, this time frame was selected. The sample size of the study was 149 from 178 target population as it is determined by Krejcie and Morgan's (1970) table which is attached. (See *Table 1*) and these were as in the table below.

Table 1: Study population, sample size and sampling technique

Institution	Population	Sample size	Sampling techniques
Branch managers	14	10	Purposive sampling
Loans officers	04	04	Purposive sampling
Human source managers	14	10	Random sampling
Cahiers	43	36	Random sampling
Credit officers	23	19	Random sampling
Secretaries	16	14	Random sampling
Security offices	09	09	Random sampling
Auditors	18	14	Random sampling
Relations officers	20	19	Random sampling
Drivers	17	14	Random sampling
Total	178	149	Respondents

Source: Primary data 2022.

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Purposive sampling was used to select the branch managers and loan officers of financial institutions since they have the main role in the financial performance of their branches and they are the main implementers of the loan practices. This technique was justified for this study because it helped to get respondents believed to have detailed knowledge about the study.

According to Turyasingura et al. (2022), a simple random sampling technique was used to select other employees like human resources, cashiers, receptionists, auditors, relations officers, drivers and secretaries since it gives all participants equal opportunities to be selected for the study. This was used to select other employees from the loans section who were interviewed since they have direct contact with the loan customers. A simple random sampling tactic is warranted for the study, corresponding towards Benson and Ayiga (2022), because it is a fair type of sampling that when done properly, helps to remove any bias in comparison to other sampling methods. Data gathering for the research included either a questionnaire or interview guides. SPSS edition 28 was employed in order to evaluate the data.

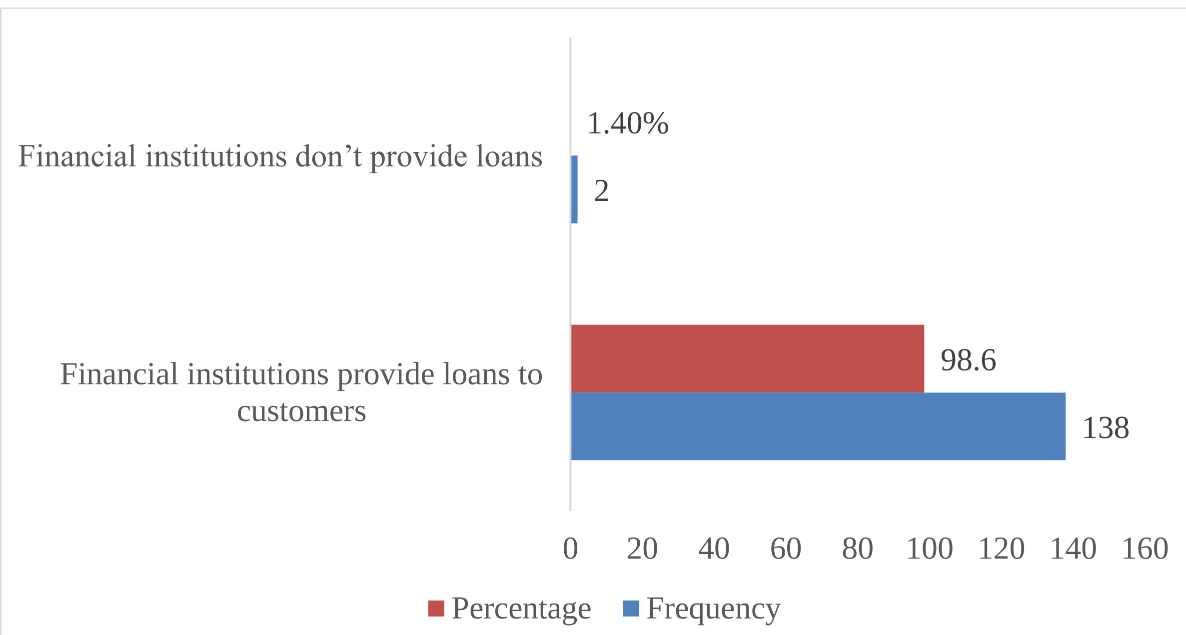
RESULTS

The Determinants of Nonperforming Loans on Financial Institutions

Provision of Loans by Financial Institutions

During the field research, those surveyed were asked to give information regarding whether financial intuitions offer loans to customers. Hence, Figure 1 shows the response rate on the issuance of loans to customers as indicated below.

Figure 1: Responses to whether financial institutions provide loans



Source: Field data 2022

Based on *Figure 1* above, the majority of the respondents (138, 98.6%) revealed that financial institutions provide loans to customers, while only 2(1.4%) revealed that they don’t provide loans. More so, respondents were asked to reveal how financial institutions evaluate customers for loans and responses were presented in (*Table 2*) below.

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Table 2: Specific financial institution determinants causing the occurrence of non-performing loans

Determinants	Absa	Baroda	Brac	Centenary	Dfcu	Equity	Platinum	Post bank	Pride	Stanbic	Total
Fund diversion	x	x	x	x	X	x	X	X	x	x	10
Poor customer selection	x				X						2
Poor portfolio diversification	x	x		x		x		X	x	x	7
Weak governance	x		x					X	x		4
Unfair competition among banks	x							X	x		3
Unforeseen Business risks	x				X						2
Borrowers' poor business knowledge and management skill	x		x					X	x	x	5
Compromised integrity	x	x	x			x	X	X	x	x	8
Wilful default	x	x	x	x	X	x		X		x	8
Over/under financing		x	x		X	x	X	X	x	x	8
Credit operator's capacity limitation	x		x	x		x	X	X	x	x	8
Macroeconomic factors		x	x	x				X	x	x	6
Inadequacy of credit policies	x		x	x			x	X	x		6
Macroeconomic policies		x	x	x					x		4
Management problems	x		x	x		x	x		x		6
Type of business ownership		x	x	x					x		4
External influence on sanctioning	x		x	x					x	x	5
Unavailability of data for analysis			x	x					x		3
Poor regulatory and supervisory framework	x		x	x					x		4

Source: Field data 2022

Table 2 shows that individuals from all the surveyed monetary institutions' staff generally agree that factors such as fund redirection:

> *"the over or underneath funding, undermined integrity, credit operators' capacity limitations, firm failures, deliberate default, poor portfolio diversification, and changing policy environments contribute to the occurring of nonperforming loans".*

Table 3: The determinants contributing to the occurrence of Nonperforming loans

Determinants that cause the occurrence of nonperforming loans	1st %	2nd %	3rd %	4th %	5th %	6th %	7th %	8th %
Rapid Loan growth by banks	4	2	6	28	3	24	2	51
High-interest rate	2	2	11	3	1	37	5	27
Lenient credit terms	4	5	7	31	1	23	6	11
Credit culture / Orientation	14	6	29	13	5	7	12	4
Size of the Bank	22	17	21	7	11	4	10	1
Poor monitoring/follow	22	21	10	4	24	1	14	1
The ownership type of bank	15	19	5	3	29	2	17	1
Poor risk assessment	-	36	17	3	33	2	41	3

Source: Field data 2022

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According to *Table 3's* results, "the top two factors contributing to the occurrence of failing loans were bank size and insufficient monitoring and follow-up, while the third factor was credit culture and orientation, which was mentioned by 29% of respondents. Thus, inadequate credit supervision by banks, bank size, inadequate risk evaluation, and credit culture/orientation were found to be the top four factors that contributed to the frequency of nonperforming loans". On the other hand, charging a high expenditure rate and rapid loan growth were factors that combined to place seventh and eighth.

Table 4: ways of credit assessment and loan default

Responses	SA (1)	A (2)	N (3)	D (4)	SD (5)	Mean	Std Dev
Easily admitted borrowers usually default	11.2	32.8	26.9	23.9	5.2	2.79	1.090
Know Your Customer policy of banks lead to high loans quality	69.3	28.5	2.2	-	-	1.33	0.516
Good loan underwriting ensures loan performance	19.5	50.4	18	9.8	2.3	2.25	0.957
Poor risk assessment would lead to loan default	65.4	32.4	-	0.7	1.5	1.4	0.682

Key: SA: Strongly Agree (1), A = Agree (2), N = Neutral (3), D = Disagree (4), SD = Strongly Disagree (5)

Source: Field data 2022

Responses to the determinants in *Table 4* above demonstrate how credit evaluation and the occurrence of nonperforming loans are related. The average answer has a mean of 2.79 and a standard deviation of 1.09, with 44% of those polled agreeing that borrowers who are readily admitted to default frequently. However, 69.3% of respondents firmly concur ($M = 1.33$, $SD = 0.516$) that experiencing a know-your-customer policy in force results in high loan quality. According to 69.4% of the respondents, sound loan underwriting guarantees loan performance. According to 97.8% of the respondents, poor risk evaluation increases the likelihood of loan default.

Respondents revealed that;

> *"lenders may also verify a borrower's income and employment to assess their ability to repay the loan. This involves reviewing pay stubs, tax returns, and other financial documents."*

The novelty is that loan default occurs when a borrower fails to repay a loan as agreed. There are several reasons why a borrower may default on a loan, including job loss, illness, or financial hardship. When a borrower defaults on a loan, the lender may take legal action to recover the unpaid balance. This can include seizing collateral, reporting the default to credit bureaus, and suing the borrower for the outstanding balance. Loan default can also have a negative impact on a borrower's credit score, making it more difficult for them to obtain credit in the future.

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Table 5: factors indicating credit monitoring and loan default

Statement	SA (1)	A (2)	N (3)	D (4)	SD (5)	Mean	Std Dev
Strict monitoring ensures loan performance	38.7	54	2.2	5.1	-	1.74	0.74
Poorly assessed and advanced loans may perform well if properly monitored	4.4	27.7	24.1	32.8	10.9	3.18	0.093
Loan follow-up is directly related to the occurrence of non-performing loans	16.3	45.2	9.6	22.2	6.7	2.58	0.194
Financial institutions with higher budgets for loan monitoring have lower nonperforming loans	3.6	36.5	33.6	22.6	2.9	3.06	2.563

Key: SA: Strongly Agree (1), A = Agree (2), N = Neutral (3), D = Disagree (4), SD = Strongly Disagree (5)

Source: Field data 2022

The study found that 92.7% of the respondents believed strict loan monitoring guarantees loan performance, according to the field results in *Table 5* above. On the other hand, the claim that a loan could perform well if properly managed despite a poor evaluation during sanctioning is disputed by 43.7% of individuals (*M* = 1.74, *SD* = 0.74). This proves that appropriate credit assessment cannot be replaced by loan follow-up. But 61.3% of individuals (*M* = 2.58, *SD* = 0.194) concur that the occurrence of nonperforming loans is directly linked to loan follow-up. The average answer was neutral, with only 40.1% of respondents agreeing that banking institutions with greater budgets for loan surveillance have fewer nonperforming loans. (*M* = 3.06, *SD* = 2.56).

One of the bank branch managers said that;

> *"Late or missed payments can negatively impact a borrower's credit score and make it harder for them to secure loans in the future. Monitoring credit reports can help borrowers catch these issues before they spiral out of control."*

> *"High credit utilization, which is the percentage of available credit that a borrower is using, can also negatively impact their credit score. Monitoring credit reports can help borrowers identify if they are using too much of their available credit and take steps to reduce it,"* Loans officer said

From the interview conducted, credit officers mentioned some of the factors that indicate that a borrower can default on their loan:

> *"History of missed payments: Borrowers who have a history of missed payments are at a higher risk of defaulting on their loans. This indicates that they may not have the financial means to make their payments"* Credit officers 1-3 said

> *"High debt-to-income ratio: Borrowers with a high debt-to-income ratio are also at a higher risk of defaulting on their loans. This indicates that they may be taking on too much debt relative to their income"* Credit officers 10 and 14 said

> *"Unemployment or underemployment: Borrowers who are unemployed or underemployed may struggle to make their loan payments. They may not have a reliable source of income to make their payments on time,"* Credit Officer 22 said

> *"Lack of savings: Borrowers who have little to no savings are also at a higher risk of defaulting on their loans. They may not have a financial cushion to fall back on if they encounter unexpected expenses or a loss of income,*" Credit officers 16 and 19 said

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Table 6: How the size of financial institution influences the occurrence of NPL

Statement	SA (1)	A (2)	N (3)	D (4)	SD (5)	Mean	Std Dev
Having a large number of borrowers causes loan default	2.2	6.6	32.8	51.8	6.6	3.54	0.805
Loans default rate is directly related to financial institutions' size	2.2	5.1	24.3	58.8	9.6	3.68	0.805
With the growth in financial institutions' size comes growth in NPL	1.5	11.7	24.8	55.5	6.6	3.54	0840

Key: SA: Strongly Agree (1), A = Agree (2), N = Neutral (3), D = Disagree (4), SD = Strongly Disagree (5)

Source: Field data 2022

According to the survey answer in *Table 6* above, having a large total of borrowers and the size of financial institutions do not necessarily lead to loan defaults. Questions about the size of financial organizations and instances of NPL tend to elicit conflicting answers.

Table 7: Correlation results of loan appraisal relation performance of financial institutions

		Loan appraisal	Performance of Financial Institutions
Loan appraisal	Spearman's rho Correlation Coefficient	1.000	.501**
	Sig. (2-tailed)		0.003
	N	137	137
Performance of Financial Institutions	Spearman's Correlation	.501**	1.000
	Sig. (2-tailed)	.003	
	N	137	137

** Correlation is Significant at the 0.01 (2-tailed)*
*** Correlation is significant at the 0.05 (1-tailed)*

Source: Field data 2022

Table 7 demonstrates a weakly positive association (r=0.501, $p<0.05$) between loan evaluation and the performance of financial institutions. This analysis demonstrates that, while all other variables are held constant, a unit improvement in loan appraisal is expected to boost performance (r squared, coefficient of variation). Key informants who confirmed this analysis said that "loan appraisal is vital for financial institutions since it tests on the accuracy, collaterals, honesty, capacity, and cash flow to determine lane's creditworthiness and the probability of loans default" Another responder stated that "loan appraisal assists institutions in recognizing debtors who have possibly misrepresented their past company earnings records in order that the loans would not be likely to repay easily later".

DISCUSSIONS

The Determinants of Nonperforming Loans on Financial Institutions

According to Alex's (2021) claim, the subjective questions in questionnaires and thorough interviews, factors that have an impact on nonperforming loans (NPL) are poor credit review, ineffective loan evaluation, a lack of credit culture, lenient credit terms, and, in some cases, hostile lending, compromised cash institutions' honesty and deliberate defaults by clients. Others are unawareness of limitations, fund diverting for accidental a reason, under or overpayment, and (Phiri, 2022).

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Furthermore, 44% of participants in this study concurred that it was easy to acknowledge the borrower's usual default. The outcomes of the in-depth debate support this assertion. This is in line with a study by Alex (2021) that discovered banks recruit borrowers with bad credit histories, bad business management, high risk, and/or unprofitable ventures because they adhere to a lax KYC (know who your client is) policy prior to Recognizing a new customer. The conclusion supports Alex's (2021) claim that if a customer's debt was easily acknowledged, it would be impaired early on.

Additionally, the poll found that 97.2% of respondents concur that poor chance assessment has a significant impact on the likelihood of loan default. Nearly all of the managers who were questioned shared this opinion. In order to determine whether to lend money and the manner in which much, under what terms and conditions, and at what price, among other factors, credit assessment involves a comprehensive review of the five Cs. Therefore, failing to conduct an adequate risk assessment would result in ignoring any or all of the problems mentioned in the heading, increasing the likelihood that NPL will occur and negatively impacting the behaviour of financial institutions. Poor risk assessment has a negative effect on loan quality, according to Berg (2015).

Credit Monitoring and Recovery Strategies Adopted by Financial Institutions

According to French et al. (2010), frequent loan quality monitoring is crucial because it ensures a stable financial system and averts systemic crises that might otherwise result in loan default (Alex 2021). This survey also supported the findings of the research, with 92.7% of participants agreeing. One of the top reasons given by poll and interview respondents as to why NPL occurs is a lack of loan follow-up. Naturally, the goal of overseeing lending is to ensure that the justifications used to make the lending choice remain valid and that the loan amounts are being used correctly for the intended purpose. Borrowers also have the propensity to pay more attention to loan repayment if financial institutions treat them well (Parvin et al., 2020). As was also discovered through the in-depth interview, *failing to watch loans would result in default and subpar performance because borrowers would otherwise be enticed to divert the funds to other purposes*.

CONCLUSIONS

Based on the study's findings, it was determined that poor credit evaluation, which was attributed to credit operators' capacity limitations, institutional capacity issues, and a lack of internal data for project financing, had been the root cause of loan defaults. In addition, it was discovered that failing to correctly monitor and follow up on credit accounts contributed to sick loans even though these activities are crucial for ensuring loan collection.

The study also showed that instances of NPL were caused by overfinancing due to subpar credit assessments and compromised credit operators' integrity. In reality, instances of underfinancing loan requirements, which resulted in a lack of working capital or the inability to meet set goals, were linked to defaults. The research also discovered that because credit orientation and culture had not developed, borrowers were engaging in businesses about which they knew little or nothing. These borrowers sometimes unfocused loans for unintended purposes and occasionally made wilful defaults. The study also showed that aggressive lending practices combined with poor consumer selection made in an effort to maximize bank profits and/or due to ethical risk or impaired trustworthiness were the other leads to loan defaults that affected.

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