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Literature Reviews on Loan Default's Impact on Ecobank Finances

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Abstract:
Defaulting on a loan is the failure of a borrower to pay the principal or interest on security or loan. The consequences of defaulting on a loan depend on whether the loan is unsecured (student loans, credit cards, or personal loans) or secured (car loans or mortgages). In either case, it is suggested that consumers opt for debt consolidation plans as a means of satisfying creditors in order to avoid the repercussions of loan default. This study reviews related literature on the effects of loan default on the financial performance of Ecobank. Personal loans are regarded as high-cost, high-risk unsecured loans. Defaulting on one can cause your credit score to plunge. As your credit score drops interest rates on your adjustable-rate loans, such as credit cards, increase significantly. Loan default is the inability to repay the loan by either failing to complete the loan as per the loan agreement or neglecting to service the loan. The types of loan default review adopted for this study as they fall within the purview of this study are; technical default and debt services default. The provisions for loan defaults reduce the total loan portfolio of banks and as such affects interest earnings on such assets. This constitutes a huge cost to banks. A study of the financial statement of banks indicates that unsecured loans have a direct effect on the profitability of banks. This is because the charge for bad debts is treated as expenses on the profit and loss account and as such impact negatively on the profit position of banks. Despite the above research-related evidence on the effect of bad loans on banks, it is realized that the general contribution to the academic debate on the subject is weak.

Keywords: *Loan default, banking, loans, interest rate, financial statement, Ecobank.*

Introduction

This study reviews related literature on the effects of loan default on the financial performance of Ecobank. The literature was analysed in terms of theoretical, conceptual, and empirical research. The theoretical portion examines the theory that underpins this research. The conceptual framework emphasizes concepts related to the study's important variables, giving a framework for the researcher to comprehend the study's focus. The empirical review evaluates and considers other studies conducted by other researchers that are relevant to the current investigation. The objective of the empirical review is to compare the findings of this study with those of previous relevant studies in order to corroborate or refute early researchers' conclusions.
This study is guided by three relevant theories in the field of loan management including Asymmetry and Agency theories.

Asymmetry Theory

The theory of asymmetry information states that it may be difficult to distinguish between good borrowers and bad ones which may result into adverse selection and moral hazard problems. The moral hazard problem implies that a borrower has the incentive to default unless there are consequences for his future application for credit. This result from the difficulty lenders has in assessing the level of wealth borrowers will have accumulated by the date on which debt must be

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repaid. This theory explains that in the market, the party that possess more information on the specific item to be transacted is in a position to negotiate optimal terms for the transaction than the other party. The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction Averse selection and moral hazards have led to significant accumulation of NPLs in commercial banks (Muriithi, 2020).

Agency Theory

The study is also underpinned by the Agency Theory (AT) which supports the opportunistic behaviour of individuals. In relation, Jensen and Payne (2006) explain that customers and investors alike would expect their bankers to respond favourably to their objectives for joining them in business. Banks as agents of their customers and investors try to put in place mechanisms that seek to align the interest of the agent and the principal. All parties in their own self-interest are at the same time motivated to maximize organizational values (Francis, 2009). Mechanisms used to address agency problems as far as banks profitability is concerned to include effective loan portfolio management to minimize the incidence of bad loans and thereby to maximize profitability which in essence safeguards the worth of stakeholders (Jensen & Payne, 2006).

The Concepts of Loans

A loan is usually available on a fixed and spot basis and can be secured or unsecured. Loans are offered for specify amounts for specified periods. Mabvure et al. (2021) described loans in general are part of or major component of the total assets of every bank. The lender cannot seek repayment prior to expiry of the period unless there has been some default. In a legal sense, a loan facility is a contractual promise between a lender and a borrower where the lender usually bank consent to the granting of an amount to a borrower, who intend undertakes to resettle same to the lender either in bulk or in installments within a specified period of time.

Concept of Loan Default

According to Araka et al. (2018), default occurs when a debtor has not met her/his legal obligations according to debt contract. Loan default can be defined as the failure of a borrower to pay his/her loan as at when due (Balogun & Alimi, 1988). Loan default is the inability to repay the loan by either failing to complete the loan as per the loan agreement or neglect to service the loan (Otoo, Takyi Appiah & Wiah, 2015). In finance, default to occurs when a debtor has not made his or her legal obligations according to the debt contract (Murray, 2001). According to Pearson and Greeff (2006), loan defaults a risk that hold that describes the point in the borrower's repayment this tory where he or she missed at least three (3) instalments within a twenty-four (24) month period.

Types of Loan Default

Zablon, Sambiri, and Otieno (2015) reviewed various types of loan defaults. Their review is adopted for this study as it falls within the purview of the study. Zablon, et al (2015) indicated that default can be of two classes. These are technical default and debts services default. Debt service (servicing) default is where the debtor has not made a scheduled payment of interest or principal. Technical default occurs when an affirmative or a negative covenant is violated (Zablon, et, al, 2015). Zablon, et al (2015) explained that affirmative covenants are loan contracts clauses that require the borrower to achieve and sustain some accounting ratios performances over a period normally the loan period. Some of these accounting ratios include net worth, liquidity, and debt

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service coverage. However, some of these restrictions are frequently violated (Zablon, et al, 2015). On the other hand, negative covenants are those clauses that proscribe certain actions by the borrower that can impair the creditor's position such as unable to retrieves lend amount through sale of secured asset. Some of the negative covenants include the prohibition on mortgaged asset disposal, and restrictions on dividend payments. Negative covenants are not frequently violated as affirmative clauses (Zablon, et al, 2015). This situation may be due to the fact that affirmative clauses relate to financial ratios performance which is difficult to predict and maintain given the turbulent economic and business frontiers. Most lenders include a clause that makes total outstanding debts becoming immediately payable on the first instance of payment default (Zablon, et al, 2015). Defaults can be classified into five main groups. These are sovereign, orderly, strategic, sovereign strategic, and consumer defaults (Zablon, et al, 2015).

Causes of Loan Default

Default occurs when a debtor has not met her/his legal obligations according to debt contract. The causes of loan default include; the types of loan offered, term of the loan, interests rate on the loan, poor credit history, borrowers' income and transaction cost of the loans. High interest rates on the loans by the Microfinance institutions have been discovered to be the reason behind the alarming loan default. Most of the default arose from poor management procedures, loan diversion and unwillingness to repay loans among others because of this the lenders must give various institutional methods that aim to reduce the risk of loan default (CBK, 2016). Korankye (2014) stated that the causes and control of loan default or delinquency in Microfinance Institutions in Ghana include: high interest rate, inadequate loan sizes, poor appraisal, lack of monitoring of the borrowers and improper client selection.

Another cause is the illness of the borrower: Under certain circumstances, the borrower instead of repaying the loan he/she uses the funds for medical expenses instead of the intended purpose. This can be seen in the illness or such diseases such as HIV and AIDs, cancer which can be very expensive to treat. Due to illness, such borrowers will find it difficult to honor their loan obligations. In many cases where the borrower is terminally ill or dies, the borrower may end up not repaying the loan in good time or not repay it at all. This kind of problem could be more pronounced in cases where the borrower is either an individual or a principal partner of a company. The general health of the borrower should be taken into consideration and health of a close relative (Nyaliet, 2017).

Financial Performance

Organisations pursue different goals to achieve their performance objectives (Greve, 2003; Hauser & Katz, 1998). The financial performance concept originates from organisational performance, strategic management and financial accounting studies, and measures firms' performance. The European Central Bank report (2021) defined bank performance as its capacity to generate sustainable profitability. It stated, subsequent to the spectacular losses in the financial crisis and the substantial government intervention, there is little public support for banks returning return on equity (RoE) ratios of well above 20%, as these have mostly proved to be unsustainable (European Central Bank, 2021).

Financial performance is also a measure of how well a firm can use assets from its primary mode of business and generate revenues. This term is also used as a general measure of a firm's

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overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. There are many different ways to measure financial performance, but all measures should be taken in aggregation. Line items such as revenue from operations, operating income or cash flow from operations can be used, as well as total unit sales (Business Dictionary, 2011).

According to Palečková (2014), the financial performance of banks guides to analyses the outcomes of a firm's policies, performance, efficiency and effectiveness in monetary terms. These results reflect in the firms return on investment, return on assets and profit earning. It also emphasizes on how a bank is effectively utilizing its financial and other resources to earn profit. Hawaldar et. al. (2016) argue that financial performance evaluation is a subjective measure to assess firm's usage of assets from its primary mode of business and generation of revenues. It also includes net operating income (NPI), earnings before interest and taxes (EBIT), profit after taxes (PAT) and net asset value (NAV). This also measure of how efficiently a bank uses its assets and other resources to generate revenues, which intern firm's overall financial condition for a given period, and can be used to compare industries with each other's. Finance and its function play a very significant role in determining the profitability and stability of the business (Hawaldar et. al., (2016).

Measuring Financial Performance

The 'financial performance' domain examines indicators such as sales growth, profitability, ROI, ROA, ROE and Earnings Per Share (EPS), which reflect directly on the firm's economic objectives. Arguably, this comprises the quantitative elements usually found in strategy research. This research accepts the financial performance framework as it reflects similar measurement indicators in other studies (Keisidou et al., 2020; Chi & Gursoy, 2009). There are two broad approaches used to measure bank performance, the accounting approach, which makes use of financial ratios. Traditionally accounting methods primarily based on the use of financial ratios have been employed for assessing bank performance (Ncube, 2009). In his contribution to profitability ratios, Thachappilly (2009) stated in his article the Financial Ratio Analysis for Performance evaluation that profitability ratios help to evaluate the performance of a company, so that investors can decide whether to invest in that company. This study measured performance using financial ratios as the indicators. Specifically, the study was limited to ratios such as Returns on Asset (RoA), Returns on Equity (RoE), and Returns on Capital Employed (RoCE).

Effects of Loan Default

At large, the main effect of bad loans on banks is the fact that increasing bad loans limit the financial growth of banks (Karim, Chan & Hassan, 2021; Kuo et al., 2021). This consequence is as a result of the fact that bad loans deprive banks of the needed liquidity and limit their capability to fund other potentially viable businesses and make credit facilities available to individuals. Karim et al. (2021) argues that there are a lot of other viable businesses that the bank cannot explore as a result of the fact that its funds are caught up in bad loans. In the face of these consequences, the bank experiences a shortfall in generated revenues (Ghana Banking Survey, 2020), and this translates into reduced financial performance (Karim et al., 2021; Nawaz et al. 2021; Ghana Banking Survey, 2020).

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Another basic effect of bad loans on the bank is a reduction in the bank's lending potential (Karim et al., 2021). Though this has been acknowledged earlier, it is important to discuss it as a primary independent effect. Banks make a greater part of their revenues and profit from lending activities (Karim et al., 2021; Nguta & Huka, 2020). As a result, when banks lose much of their lending capital to bad loans, it is likely that a greater part of their revenue is lost. Once revenue is lost in one financial year, the capability of the bank to provide access to credit facilities to other businesses and individuals would practically fall in the following financial years. This means that the bank would fail to lend, or it would reduce its amount allocated to lending in the next financial year. In this study, the amount located to lending is referred to as annual "loan size".

Research studies have shown that the effect of bad loans on the bank in terms of net financial performance (i.e. return on investment/net profit) and lending potential (i.e. annual loan size) is practical and realistic. These studies would be identified from the perspectives of foreign countries and Ghana. The studies of Karim et al. (2021), Obamuyi, (2007), Nguta & Huka, (2020), Nawaz et al., (2021), Fidrmuc & Hainz (2009), Chelagat (2021) and Aballey (2009) provide such evidence in a foreign country context. Apart from the report in Ghana Banking Survey (2020), a few other studies (Appiah, 2011; Awunyo-Vitor, 2021) have shown that bad loans negatively influence banks in terms of financial performance and lending potential in Ghana.

The performance of a bank has linear relationship with the credit and recovery process (Asari et al, 2011). Asari et al. (2011) rightly argued that banks are unable to profit from credits in default. The study relating to validity of credit documentation (a medium to abstain defaults) has direct relevance to the performance of a bank. The provisions for loan defaults reduce total loan portfolio of banks and as such affects interest earnings on such assets. This constitutes huge cost to banks. Study of the financial statement of banks indicates that unsecured loans have a direct effect on profitability of banks. This is because charge for bad debts is treated as expenses on the profit and loss account and as such impact negatively on the profit position of banks (Price Water-House Coopers, 2009).

Bank Banks of Ghana

Bank banks are entity banks which belong and directed by people living in the community. These banks are recorded under the company code and are accredited by the Bank of Ghana to participate in banking business. Per the company code, these are not allowed opening branches throughout the country but are allowed to open agencies within their areas of operations. The key functions of these banks are saving mobilization and provision of credit facilities to reliable clients within their catchment areas. The aim reason why the Bank of Ghana licensed these bank banks is to serves a way of developing the bank areas within the country.

According to Abledu, Akuffo, Adade and Kwofie (2016), Ghana's Bank scheme was initiated in 1976, under the auspices of the Bank of Ghana (the country's central bank). The purpose of this program was to serve small borrowers and savers in bank areas, who at the time had essentially no access to institutional savings and credit facilities. RFM specialists would recognize in this program many elements of the Directed Credit Approach. For its time, however, the Bank project was relatively well thought out. Many features of this program, indeed, foreshadowed the yet-to-be developed Financial Systems Approach to RFM intervention. During its first decade of operations, the Bank program proved, in general, to be a success. By the late 1980s, however, many individual

Bank Banks were floundering. The government attempted to reinvigorate the programmme via a macroeconomic Financial Liberalization effort initiated in 1988 and a comprehensive Bank restructuring exercise begun in 1991.

Empirical Review

The impact of loan defaults on banks have received various researches (Asantey and Tengey, 2014; Addae-Korankye, 2014; and Ntiamoah, Oteng, Opoku, and Siaw, 2014). However, the results have been mixed. A study by Abaidoo (2015) to examine the determinants of loan default and its effects on financial performance of commercial banks in Ghana by using Fidelity Bank Limited as a case study. The study employed quantitative and qualitative research techniques as the research design. In achieving the research objectives primary and secondary data was used. The primary data was collected through a well-structured questionnaire. Simple random technique was used to select 120 loan clients and a purposive sampling was used to select a credit staff. The data was collected from four branches of Fidelity Bank in the Bono Region of Ghana. It was realized that the delays in loan approval, poor management, poor credit appraisal and diversion of loans are the main determinants of loan default in Fidelity bank. The study also found that SME clients (49.5%) defaults more than Agric, personal and salary loan clients. The major cause of loan default according to the findings of this study was decrease in demand of goods and service (16.1%) sold by the loan clients. Again, it was realized that loan default has a negative impact on profitability.

Another study by Nsobilla (2015) investigated the effect of non-performing loans on financial performance and trend of incidence of non-performing loans. Secondary data with reference period of 2004-2020 were collected from six selected bank Banks in both the Ashanti and Western Regions of Ghana between. The Ordinary Least Square Regression (OLS) was employed to estimate the effect of non-performing loans on financial performance. The polynomial function was employed to determine the trend of the incidence of non-performing loans. The results of the OLS revealed that nonperforming loans, cost-income ratio, loan recovered and total revenue were all statistically significant at 1% significance levels respectively. The liquidity risk was not statistically significant. The non-performing loans and cost-income ratio had a negative influence on financial performance whereas total revenue and loan recovered had a positive effect on financial performance.

Ntiamoah, Oteng and Opoku (2014), examined Loan default rate and its impact on profitability in financial institutions. Their study adopted both qualitative (case study) and quantitative methods respectively. Financial institutions were selected to gather data, which was acquired from answers obtained from our administered questionnaire and through interviews. Hypothesis of the study was analysed using correlation and regression: Results of the study show that there is high positive correlation between the constructs of loan default rate and profitability of the various micro-finance institution. The statistical finding showed significantly that proper management of loans given to client will yield more profit for the firm.

According to a study by Asantey and Tengey (2014), there is a high negative correlation between bad loans and lending potentials, return on investment and net profit. According to them bad loans accounts for 67.9% of the variation in lending potential while it accounts for 84.1% of the variation in net profit. A study by Awo and Akotey (2021) on Naara Bank Bank also testified to the negative relationship between NPLs and financial performance. The authors discovered that a one

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(1) percent increase in NPL of Naara Bank (NRB) reduces the bank's profitability by about two (2) percent. The author further added that NPL erodes NRB's financial performance at a faster rate than additions made to it by the loans and advances made within the studied period. This explains why the loans portfolio NRB increases its profit level marginally by just 0.003 percent.

A study by Otoo, Takyi-appiah and Wiah (2015) which sought to determine the trend and forecast loan default at Minescho Credit Union, Tarkwa. A secondary data from the Credit Union was analyzed using Regression Analysis and the Box-Jenkins method of Time Series. From the Regression Analysis, there was a moderately strong relationship between the amount of loan default and time. Also, the amount of loan default had an increasing trend. The two years forecast of the amount of loan default oscillated initially and remained constant from 2016 onwards.

Research Gap

Despite the above research-related evidences on the effect of bad loans on banks, it is realized that the general contribution to academic debate on the subject is weak. This is because studies on the subject are generally few, and most of them provided their evidences based on meta-analysis and literature reviews. The same gap is identified with studies conducted in a Ghanaian context. However, a lack of related studies in a Ghanaian context is direr. The special interest of the researcher in this study is to provide related evidence using secondary data and empirical analysis, which provides a more valid and verifiable estimation of the effect of bad loans on banks.

Conceptual Framework of the Study

The research model of this paper was shaped from two comprehensive variables including loan default and bank's performance. Based on theoretical background and review of the previous literature, a conceptual model is developed to examine the impact of loan default on bank's performance. Figure 1 presents the research model.

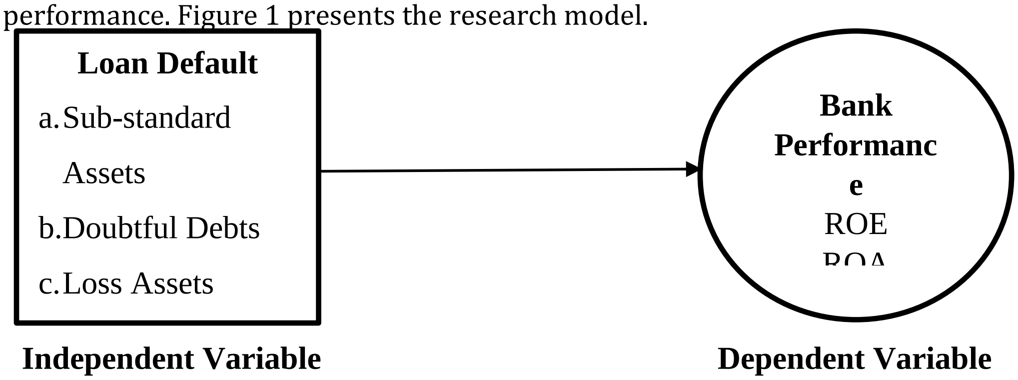

Figure 1: Conceptual framework
Source: Author's construct (2021)

Explanation of the Framework

Research studies have shown that the effect of bad loans on the bank in terms of net financial performance (i.e., return on investment/net profit) and lending potential (i.e. annual loan size) is practical and realistic. The studies of Karim et al. (2021), Obamuyi, (2007), Nguta & Huka, (2020), Nawaz et al., (2021), Fidrmuc & Hainz (2009), Chelagat (2021) and Aballey (2009) provide

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such evidence in a foreign country context. And in the Ghanaian context, the Ghana Banking Survey (2020); Appiah, 2011; Awunyo-Vitor, 2021, have shown that bad loans negatively influence banks in terms of financial performance and lending potential in Ghana.

The first component of the framework talks about the independent variable considered in this study is seen as the loan default which are measured using Sub-standard Assets, Doubtful Debts and Loss Assets.

This research accepts the financial performance framework as it reflects similar measurement indicators in other studies (Keisidou et al., 2020; Chi & Gursoy, 2009). Therefore, in this study the performance or success of the bank bank is assessed by using the three performance measures; the market measures (ROE), and financial measures (ROA). This decision is also aligned with Rahman (2001) which cited that a combined measure using revenue, profit and other variables would be appropriate to assess performance.

Conclusion

This review discussed three relevant theories in the field of loan management including Asymmetry and Agency theories were discussed. The next chapter describes the research methodology that was used for the study. Broad concepts were reviewed including loans, loan default, financial performance and indicators or measures of financial performance. A review of related studies constituting the empirical review have been done and gaps identified for which the study have been situated. A conceptual framework has been designed to reflect the various variables that the study hinges on, thus, loan default as the independent variable and financial performance as the dependent variable. The next chapter, chapter four presents the research methods for the study.

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