NON-PERFORMING LOANS AND PERFORMANCE OF FINANCIAL INSTITUTIONS IN KABALE DISTRICT

BY

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DECLARATION

I, Semusu Alex, hereby declare that this research dissertation is my own work and has never been submitted to any University for examination.

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APPROVAL

This is to certify that this research dissertation by Semusu Alex has been done with our guidance and supervision.

Signed………………………..   Date……………………

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First, I acknowledge the help of our heavenly father who has given me life and strength up to date.

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LIST OF ABBREVIATIONS

BIS	Bank for international settlements
BOU	Bank of Uganda
CVI	Content Validity Index
GCC	Gulf Cooperation Council
GDP	Gross Domestic Product
KYC	Know Your Customer
MENA	Middle East and North Africa countries
NPLs	Non-Performing Loans
OECD	Organization for Economic Co-operation and Development
ROA	Return on Assets
ROE	Return on Expenditure
%	Percent
SA	strongly agree
A	agree
N	neutral
SD	strongly disagree
D	disagree

ABSTRACT

This study was undertaken to assess the impact of non-performing loans on the performance of financial institutions in Kabale district. The study was guided by the following research objectives: to assess the determinants of non-performing loans on financial institutions: to assess credit monitoring and recovery strategies adopted by financial institutions; and to determine the relationship between non-performing loans and performance of financial institutions. The study adopted a descriptive survey design. The population of the study included 10 financial institutions (commercial banks as the unit of analysis). A sample size of 140 respondents was used as determined by Krejcie and Morgan (1970) table, and the study used purposive and random sampling techniques. Questionnaire Survey and interview guides were used for data collection while both quantitative and qualitative data analyses were used.

The study concludes that non-performing loans among financial institutions in Kabale district are as a result of poor credit assessment, failed loan monitoring, underdeveloped credit culture, lenient credit terms and conditions, aggressive lending, compromised integrity, weak institutional capacity, unfair competition among financial institutions, willful default by borrowers and their knowledge limitation, fund diversion for unintended purpose, over/under financing by financial institutions. However, the study recommends that financial institutions should put in place a vibrant credit process that ensures proper customer selection, robust credit analysis, authentic sanctioning process, proactive monitoring and clear recovery strategies for sick loans; formulate a clear policy framework that addresses issues of conflict of interest, ethical standard and check and balance in credit process; organizational capacity enhancement of financial institutions, deliberate effort to develop culture of the public towards credit and its management by financial institutions and ensuring prudent policies that govern loans.

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CHAPTER ONE

INTRODUCTION

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1.0 Introduction

This chapter presents the background to the study, the problem statement, objectives of the study, scope of the study, significance of the study and organization of the study.

1.1 Background of the study

1.1.1 Historical perspective

Non-Performing Loans (NPLs) in Central and South-eastern Europe were at 4% in 2002 and reached almost 15% in 2014 while for Organization for Economic Co-operation and Development (OECD) they were 3% in 2002 and increased to 8% in 2014 (Kjosevski and Mihail, 2017). Financial institutions were obliged to review their lending policies like potential borrower's credit risk assessment, making the credit granting decision with credit terms and limits, collecting receivables and dealing with defaulters, monitoring borrower's behaviour and compiling management reports while bearing the risk of default or bad debt and financing the investment in receivables.

Financial institutions of Indonesia asked microfinance institution to list their stock exchange between the first quarter of 2005 to fourth quarter of 2014, to analyse the impact of macroeconomic factors and the institutions' specific factors toward non-performing loans (Bloem and Gorter, 2017). While using dynamic panel data system method, the authors found that in the previous period of non-performing loans, change of gross domestic product and inflation rate had a significantly negative impact on NPLs. Bloem and Gorter (2017) further found operations expenses to operations income to have a positive relationship with NPLs. More so, Ofori et al. (2016) revealed that non-performing loans are caused by the fact that many have middle to long-term period loans, where interest rate would be a significant factor to loan defaulting. In sub-Saharan Africa (Fofack, 2016), commercial banking crisis on non-performing loans has remained high and continued to show an upward trend, ranging from 4.9% in 2012 to 6.3% in 2015. Fofack further showed that African countries in the 1990s were also accompanied by a rapid accumulation of non-performing loans. In Ghana, financial institutions are believed to have performed creditably in the quest to provide service to the majority of the population in the country where banking is not part of the culture (Obuobi and Polio, 2018). However, the World

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Bank provides data for Ghana from 2008 to 2018 that the average value during that period was 14.94 % with a minimum of 7.68 % in 2008 and maximum of 21.59% in 2017. The largest value from 2018 was 18.19% for comparison, the world average in 2018 based on 121 countries was 6.88% (Obuobi and Polio, 2018). Edet (2013) also documented Non-performing loans in West Africa and the East African region. In Kenya, a study on microfinance loans default revealed that most of the small loans were defaulted due to non-supervision of the borrowers from the lending institutions, inadequate training of borrowers and spending of received loans in projects other than agreed (Bichanga, 2013). Edet (2013) further showed that poor credit risk management practices also influence the credit default risks for rural financial institutions in Tanzania. Edet added that poor portfolio management also influences the profitability of financial institutions negatively. Crabb and Keller (2016) revealed thatother factors which influence non-performing loans include management strategies, staff competences, choice of lending methodology and management information system (Crabb and Keller, 2016).

More so, Warue (2013) investigated the link between NPLs and macroeconomic factors between the period 2009-2015. While employing Panel econometrics approach, the study found evidence that financial institutions' specific factors contribute to NPLs performance at higher magnitude compared with macroeconomic factors. Specifically, return on assets (ROA) was negative and significantly related to NPL levels in financial institutions but insignificant in small and medium institutions (Central Bank of Kenya, 2015). However, it was found that no evidence that financial institutions asset size was related to NPL levels across all institutions in Kenya (Central Bank of Kenya, 2015). In Uganda, the Bank of Uganda reported that Non-performing loans as a percentage of total gross loans in financial institutions increased from 2.75% in 2006 to 4.23% in 2012 and later increased to 10.47% by the end of 2016 (BOU, 2017). NPLs show a steeper trend from 2011 to 2013 and 2015 to 2016 and this affects the performance of financial institutions across the country. In Kabale district, the issue of non-performing loans in financial institutions is becoming a serious problem that impedes the sustainability of the various financial institutions (BOU, 2016). This assertion is supported by Mombo (2017) who also revealed that the deterioration of non-performing loans has been at the pivotal point of affairs of causing financial institutions' distress as well as economic crises. In view of this, different financial institutions were used to assess its loaning schemes to develop the means of checking the conduct and behaviour of borrowers that are obliged to review their lending policies.

1.1.2 Theoretical perspective

The study adopts two theories, that is to say Credit Rationing Theory and the Financial Accelerator Theory:

The Credit Rationing Theory

Credit rationing theory suggests that lenders are based on prevailing interest rates and available collateral or substitutes for collaterals to control the amount of credit that financial institutions give out to borrowers (Fried & Howitt, 1980). The kind of surety the borrowers present to the financial institutions makes lenders to make decisions to either lend or not to lend. To avoid a risk investment and the chances of the borrowers not fulfilling his/her credit obligations, lenders give out loans at low interest rates. The provision of loans based on other alternatives to collateral provides borrowers with an avenue of defaulting in repaying their loans since their relationship with the lender is not as strong when collateral is involved. Furthermore, the credit rationing theory suggests that interest rate is very significant in determining the amount a financial institution was willing to lend and determine the ability of the borrower to repay the loan (Fried & Howitt, 1980).

The Financial Accelerator Theory

This theory seeks to explain how lending and borrowing activities of organizations are largely affected by small economic tremors. This theory depends on the interaction between the external finance premium that arises due to unequal flow of information between borrowers and lenders and economic agents' net worth. Economic agents' net worth can be defined as: the sum of liquid assets plus collateral value of illiquid assets minus outstanding obligations; and the external finance premium can be defined as: the difference between the cost of funds raised externally and opportunity costs internal to the firm (Bernanke et al., 2009). The theory reported that for debt financing, borrowers are motivated to take projects that are riskier. These projects are those that have a high propensity to generate large return, then projects offering low returns. These projects are preferred from borrowers since the firm's losses in case the projects' return is low and is limited to zero by legal regulation. These projects are unfavourable from the lender's point of view since they bear all, or most of, the costs in the case of low project returns. The theory also designates that due to economic tremors, the borrowers may not have the aptitude to borrow and the probability of them avoiding the repayment of their loans or external finance.

1.1.3 Conceptual perspective

The study was conceptualized on two variables that is non-performing loans as the independent variable and performance of financial institutions as the dependent variable. A bank loan is considered non-performing when more than 90 days pass without the borrower paying the agreed instalments or interest (Kiyai, 2012). Non-performing loans are also called "bad debt". A performing loan will provide a bank with the interest income it needs to make a profit and extend new loans (Kiyai, 2012). When customers do not meet their agreed repayment arrangements for 90 days or more, the bank must set aside more capital on the assumption that the loan will not be paid back. This reduces its capacity to provide new loans.

Non-performing loans are defined as those financial assets from which financial institutions no longer receive interest and/or instalment payments as initially or beforehand booked. They are referred to as non-performing because the loan ceases to generate income for the bank. According to Choudhury et al. (2012), non-performing loan is not a multiclass concept. This is mainly because non-performing loans can be classified into different varieties usually based on the duration it has been overdue. Non-performing loans are viewed as a typical by-product of a financial crisis: they are not a main product of the lending function but rather an accidental occurrence of the lending process, one that has enormous potential to deepen the severity and duration of a financial crisis and to complicate macro-economic management (Bichanga, 2013). A non-performing loan, or NPL, is one that is in or close to default (Bichanga, 2013). This typically happens when principal and interest payments on the loan are overdue by 90 days or more. Non-performing loans are generally considered bad debt because the chances of them getting paid back are minimal. The more non-performing loans a bank has on its books, the more its stock price is likely to be affected. According to IMF (2012), a loan is non-performing when payments of interest and principal are past due by 90 days or more, or at least 90 days of interest payment have been capitalized, or payments are less than 90 days overdue, but there are other good reasons to doubt that payment was made in full. The Bank for International Settlements (BIS) considers a default to have occurred with regard to a particular obligor when the obligor is past due more than 90 days on any material credit obligation to the financial institution

(Kijjambu, 2015). The default often happens when a borrower faces unexpected financial difficulties, for example when an individual loses his/her job and therefore cannot repay his/her mortgage as agreed, or when a company experiences financial difficulties, among other reasons. This study, therefore, conceptualized non-performing loans by looking at loan appraisals, credit policies, loan recovery procedures and interest rates of financial institutions in Kabale district. Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues (Bofondi & Gobbi, 2013). The term is also used as a general measure of a firm's overall financial health over a given period. There are many ways to measure financial performance, but all measures should be taken in aggregate. Line items, such as revenue from operations, operating income, or cash flow from operations can be used, as well as total unit sales. Furthermore, the analyst or investor may wish to look deeper into financial statements and seek out margin growth rates or any declining debt (Bofondi & Gobbi, 2013). Financial institutions, otherwise known as banking institutions, are corporations that provide services as intermediaries of financial markets (Choudhury & Ahmed, 2012). Broadly speaking, there are three major types of financial institutions: Depository institutions – deposit-taking institutions that accept and manage deposits and make loans, including building societies, credit unions, trust companies, and mortgage loan companies. However, this study conceptualized performance of financial institutions by looking at profitability, working capital, current ratios, debt to equity and inventory turnover.

1.1.4 Contextual perspective

Over the past decade, non-performing loans in Kabale and Uganda's commercial banking industry at large have continued to show a positive trend (Kijjambu, 2015). The continued increase in NPLs has not only affected credit growth, but has also resulted in the collapse and closure of some financial institutions such as Crane Bank in 2017 and Global Trust Bank in 2014 (Kijjambu, 2015). It is against this background that the study examined the causes of NPLs in Uganda's commercial banking industry. The Banking sector has remained important for provision of financial intermediary services such as savings mobilization, risk management, projects evaluation, and diversification of risks (Choudhury, 2012).

Through provision of short-term, medium-term and long-term loans, the banking sector has also been crucial in promoting investments in areas of construction, agriculture and manufacturing.

The sector has also been important in facilitating trade through the provision of services such as bank drafts, cheques, bills of exchange and credit cards. Implementation of government monetary policy has also been aided by the banking sector. One of the major activities of financial institutions is to give out various types of loans ranging from mortgages, auto loans, business loans, personal loans, and agricultural loans, among others. In fact, there has been a move by the central bank to encourage lending by financial institutions. This has been manifested by the continued reduction of the central bank rate from 23.0 in December 2011 to 12.0 by December 2012 then to 11.0 by December 2014 and falling further to 9.5 by December 2017. This has seen total gross loans increase from Ush.1.09 trillion in the first quarter of 2005 to Ush.6.89 trillion by the second quarter of 2011 and then later increasing to Ush.11.57 trillion by the fourth quarter of 2016.

In the business of lending, financial institutions in Kabale district and Uganda at large are faced with the risk of default whereby some individuals and companies are unable to meet their debt payment obligations on time (BOU, 2016). Some individuals /companies are unable to pay completely while others are only able to pay a fraction of the loan, which has resulted into accumulation of non-performing loans (Mutebile, 2017).

1.2 Statement of the Problem

Despite the various reforms such as restructuring of the banking sector, introduction of Credit Reference Bureaus, and prudential regulations, non-performing loans have remained high and continued to increase in the commercial banking industry in Kabale district (Warue, 2013). As a ratio of total gross loans, NPLs increased from 2.32% in 2005 to 4.20% in 2009, which then increased to 5.63% by the end of 2013, before shooting to a record figure of 10.47% in 2016 (BOU, 2017). The continued increase in NPLs has adversely affected the profitability and the lending behaviours of the financial institutions in Kabale district. For instance, between June 2015 and June 2016 when NPLs increased from 4.0% to 8.3%, annual after-tax profits for financial institutions reduced by 44.2% and, in the same year, credit growth reduced from 19.7% to 3.7%. The trend exhibited by these NPL therefore puts the banking sector at a risk of systemic instability which in turn can harm the whole economy and thus retard economic growth (Mwangi, 2012). Given the above, it is therefore imperative to control NPLs. However, in order to control non-performing loans, it is necessary to understand the factors responsible for the

increase in NPLs. It is in the light of this that the study examined the impact of non-performing loans on the performance of financial institutions in Kabale district.

1.3 Purpose of the study

The purpose of the study was to assess the impact of non-performing loans on the performance of financial institutions in Kabale district.

1.4 Specific Research objectives

i. To determine the causes of non-performing loans on financial institutions in Kabale district;

ii. To assess credit monitoring and recovery strategies adopted by financial institutions in Kabale district;

iii. To determine the relationship between non-performing loans and performance of financial institutions in Kabale district.

1.5 Research questions

i. What are the causes of non-performing loans of financial institutions in Kabale district?

ii. What are the credit monitoring and recovery strategies adopted by financial institutions in Kabale district?

iii. What is the relationship between non-performing loans and performance of financial institutions in Kabale district?

1.6 Scope of the study

The scope of the study was looked at in three perspectives that is content, geographical and time scope.

1.6.1 Content scope

The study considered non-performing loans (Loan appraisal, credit policy, loan recovery procedure and Interest rate) as the independent variable while performance of financial institutions in terms of (profitability, working capital, current ratios, debt to equity and inventory turnover) were the dependent variable.

1.6.2 Geographical scope

The study was carried out from selected financial institutions in Kabale district, western Uganda.

1.6.3 Time scope

The study considered the period of 10 years from 2011 to 2020. In this period, the study compared the related information available and the trend of performance of financial institutions in relation to non-performing loans.

1.7 Significance of the study

The study may be beneficial to the following groups:

Creditors

To assess the credit-worthiness of financial institutions based on both financial loss and operational loss reports without ignoring the latter as it equally affects profitability.

Investors

The study will make the investors recognize that the overall level of non-performing loans equally affects their return on investment and hence not ignore the NPLs element when making investment decisions.

Financial institution Managers

The study will make the financial institution managers appreciate the need to monitor and control Non-performing loans as they equally affect the profitability though provisions made by the financial institutions.

Financial institution Employees

The staff involved in the day-to-day operating activities will draw inference to the study in appreciating the need for controlling operational losses as they affect profitability and their future benefits in the bank.

Management Consultants

With this study the management consultants can advise on the best investment decisions based on not only the financial losses position but equally considering the inherent non-performing loans as they also impact on the profitability of financial institutions.

Academicians

The academicians will find the study useful as it highlights areas for further research and contributes to new knowledge.

The study also gives insight into how the operational losses affect various stakeholders in the banking sector. The academicians being charged with dissemination of knowledge to various stakeholders will hence find this study useful when doing further studies.

1.8 Operational definition of key terms

A loan is money, property, or other material goods given to another party in exchange for future of the loan value or principal amount along with interest or financial charges. A non-performing loan is the one that is in or close to default. This typically happens when payments of interests and principal are past due by 90 days or more, or at least 90 days of interest payment have been capitalized, or payments are less than 90 days overdue, but there are other good reasons to doubt that payment was made in full.

Credit Policy refers to guidelines that are followed in managing credit in the business. They include credit standards, credit terms and collection effort.

1.9 Conceptual framework

The diagrammatic representation of conceptual framework shows how the variables are related.

Independent variable   **Dependent variable**

Non-performing loans	**Performance of financial institutions**
• Loan appraisal	• Profitability
• Credit policy	• Working capital
• Loan recovery procedure	• Current ratios
• Interest rate	• Debt to equity
	• Inventory turnover
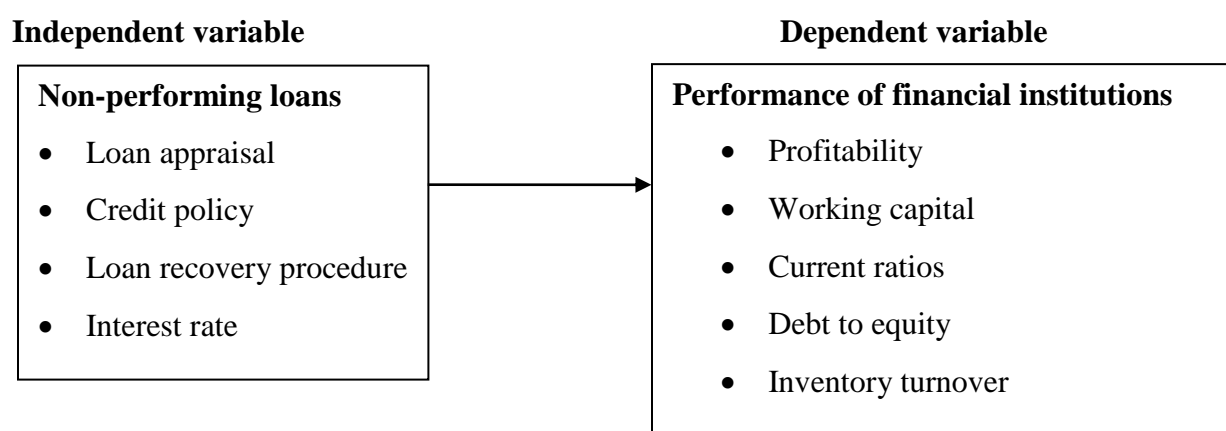
Figure I: Conceptual framework

The study considered Non-performing loans as the independent variable (loan appraisal, credit policy, loan recovery procedure and interest rate) while performance of financial institutions were the dependent variable (profitability, working capital, current ratios, debt to equity and inventory turnover).

Loan appraisals

Preliminary loan appraisals determine whether a loan was defaulted or not (Buchholz, 2014). The default mostly arises when customers use false information or means to acquire loans from the lending institutions. These might also include accepting or giving securities whose values have been impaired and overstated. Some borrowers who might have falsified their past business performance records in order to obtain loans would not be able to repay easily later. It can be ascertained that initial loan appraisal includes the core five ingredients of loan appraisal. These comprise tests on accuracy, collaterals, honesty, capacity and cash flow to determine loan's credit worthiness and the probability of loans default.

Loan recovery procedures

The loan recovery procedures employed by various financial institutions can contribute to loans default to the greatest extent. Poor loan recovery procedures, for example, create a huge portfolio of debt uncollected and thus lead to loan default and vice versa.

Credit policies

At the same time, the nature of credit policies including loaning conditions and terms as well as loaning procedures had the long-term effect on loan default (Stiglitz and Weiss, 2011). The basic requirements a member was required to meet to qualify for a loan in the institution determined whether or not that member would honour the loan repayment in future. Liberal, stringent and lenient credit policies had long-term consequences on the loan default. For instance, it is highly likely that lenient and liberal policies would almost automatically create a huge portfolio of loan default. More so, under credit policy the issue of knowing the customer, customarily known as KYC (Know Your Customer) is so vital before proceeding to details. Financial institutions use various means to obtain such information about the existing or potential customer. Use of financial statement, credit report from credit bureau, customers' history if not new is the potential sources of information (Ross et al., 2011).According to Gehrig and Stenbacka (2017) a credit report is the organized presentation of information about an individual's and/or company's credit record that a credit bureau communicates to those who request information about the credit history of an individual's and/or company's experiences with credit, leases, non-credit-related bills, collection agency actions, monetary-related public records, and inquiries about the individual's credit history. Financial institutions use credit information to conduct credit risk analysis of prospective borrowers in order to mitigate credit risk. Further, Gehrig and Stenbacka,

(2017) highlight that credit information sharing reduces adverse selection problems and thereby promotes financial stability; it serves as a borrower disciplining device and it reduces the informational rents that financial institutions can extract within the framework of their established customer relationships. In addition, Gehrig and Stenbacka (2017) show that information exchange will assist in minimizing lending corruption in banks by reducing information asymmetry between consumers and lenders, improving the bribery control methods and reducing informational rent, and hence the bargaining power of lenders. The exchange of consumer credit information disciplines borrowers to repay loans because borrowers do not want to damage the good report which can make it difficult for them to get credit (Gehrig and Stenbacka, 2017).

Interest rate

A financial institution is exposed to interest rate risk when the maturities of its assets and liabilities are mismatched (Saunders & Cornett, 2013). Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. If interest rates rise and a mismatch occurs in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities. Also known as asset and liability management risk, interest rate risk is a critical treasury function, in which financial institutions match the maturity schedules and risk profiles of their funding sources (liabilities) to the terms of the loans they are funding (assets). Bessis (2012) states that interest rate risk could result in economic losses, insolvency and non-performing loans.

Profitability of financial institution

Loans and advances constitute the primary source of income by banks. As any business establishment, financial institutions also seek to maximize their profits. Since loans and advances are more profitable than any other assets, financial institutions are willing to lend as much of their funds as possible. But they have to be careful about the safety of such advances (Radha et al, 2018). Bankers naturally try to balance the issue of maximizing profit by lending and at the same time manage risk of loan default as it would impair profit and thereby the very capital. Thus, financial institutions need to be cautious in advancing loans as there is a greater risk which follows it in a situation where the loan is defaulted. The performance of financial institutions as

the dependent variable was determined by the profits made in the loans section. Bonin and Huang (2011) indicate that the profitability of banking increases if financial risk is eliminated quickly. If financial crises are not eliminated, it does not only lower living standards but can also eliminate many of the achievements of economic reforms overnight. The study therefore considered intervening variables like Concrete payment plan, Sensitization of customers on loan repayment and Constructive structural change.

Working capital

Non-Performing Loans of financial institutions are as result of losing their ability to generate optimum working capital from their principal activities. With the increase of non-performing loans, the operating income from credit provision is very small because the interest that the institution should receive from the debtor is not fully accepted. To minimize the risk of credit problems, the financial institution should provide funds for business development purposes and accommodates the risk of loss of funds caused by bank operations (Ali, 2014). Working capital serves to accommodate the risk of losses that may be faced by financial institutions (Barus and Eric, 2016). The higher the working capital, the greater the ability of the financial institution to minimize the credit risk that occurs, meaning that the financial institution is able to cover the credit risk that occurs with the number of fund reserves obtained from the comparison of capital and Risk Weighted Assets (ATMR).

Current ratios

The current ratio is a liquidity ratio that measures whether a financial institution has enough resources to meet its short-term obligations. It compares the institution's current assets to its current liabilities and is expressed as follows.

Current ratio =   <u>Current assets</u>

                   Current liabilities

The current ratio is an indication of the financial institutions' liquidity (Elliot, 2015). Acceptable current ratios vary from institution to institution. In many cases, a creditor would consider a high current ratio to be better than a low current ratio, because when there are more non-performing loans, financial institutions experience a low current ratio which indicates that the financial institution is more likely to fail to pay back the creditors. Ndii (2010) argues that non-performing

loans lead to low current ratio which is a direct sign of high risk of bankruptcy which impacts the profits adversely.

Debt to equity

The debt to equity ratio is a simple formula to show how capital has been raised to run a business. It is considered an important financial metric because it indicates the stability of a company and its ability to raise additional capital to grow Kjosevski and Mihail, (2017). For debt-equity conversions, this includes converting debt only of viable firms in the context of operational restructuring for the firms (which may include changing management), at fair value, and with financial institutions holding the equity for a limited period only (Kjosevski & Mihail, 2017). For NPL securitization, this includes securitizing a diversified pool of NPLs, banks keeping some residual financial interest ("skin in the game"), and creating the legal and operational framework that will allow owners of distressed assets to force operational restructuring of firms and obtain best value from those assets. For these techniques to help address the systemic problem of excessive corporate debt and impaired bank loans more generally, they need to be nested within a comprehensive, system-wide plan that should involve: Assessing the viability of distressed firms and restructuring the viable and liquidating the nonviable; requiring financial institutions to proactively recognize and work out NPLs (Elliot, 2015). Debt-equity conversions can play a role in addressing the problems of excessive corporate debt and impaired bank loans. They reduce NPLs and the debt overhang of corporates, as well as provide a means to restructure/resolve the indebted firm by changing ownership and incentives. More so, Debt-equity conversions help weak/nonviable financial institutions to keep going as conversions reduce their debts and borrowing costs and financial institutions that may not have the incentives to pro-actively restructure themselves more especially those with minority shareholders or state-owned.

Inventory turnover

Inventory turnover is a measure of the number of times inventory is sold or used in a time period such as a year (Kijjambu, 2015). It is calculated to see if a business has an excessive inventory in comparison to its sales level. Inventory turnover is also known as inventory turns, merchandise turnover, stock turn, stock turns, turns, and stock turnover. Inventory turnover is a ratio that measures the number of times inventory is sold or consumed in a given time period. The

inventory turnover formula is calculated by dividing the cost of goods sold (COGS) by average inventory.

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

This chapter presents the views of different scholars in relation to the study objectives that is: to determine the causes of non-performing loans of financial institutions; to assess credit monitoring and recovery strategies adopted by financial institutions; and, to determine the relationship between non-performing loans and performance of financial institutions.

2.1 Theoretical review

Several theories have been promulgated to explain financial performance. Nevertheless, the theories that explain non-performing loans are scanty. This study discussed two theories that seek to explain the two concepts.

2.1.1 Credit Rationing Theory

This theory suggests that lenders base on prevailing interest rates and available collateral or substitutes for collaterals to control the amount of credit they give out to borrowers. Decision making by lenders to either lend or not to lend is conditional on the kind of surety the borrowers present to them. To avoid riskier investment and the chances of the borrowers not fulfilling their credit obligations, lenders give out loans at low interest rates (Bernanke et al., 2009). The provision of loans based on other alternatives to collateral provides borrowers with an avenue of defaulting from repaying their loans since their relationship with the lender is not as strong when collateral is involved. The credit rationing theory suggests that interest rate is very significant in determining the amount a financial institution will be willing to lend and determine the ability of the borrower to repay the loan (Bernanke et al., 2009).

2.1.2 The Financial Accelerator Theory

This theory seeks to explain how lending and borrowing activities of organizations are largely affected by small economic tremors. This theory depends on the interaction between the external finance premium that arises due to unequal flow of information between borrowers and lenders and economic agents' net worth. Economic agents' net worth can be defined as: the sum of liquid assets plus collateral value of illiquid assets minus outstanding obligations; and the external finance premium can be defined as: the difference between the cost of funds raised

externally and opportunity costs internal to the firm (Bernanke et al., 2009). The theory reported that for debt financing, borrowers are motivated to take projects that are riskier. These projects are the ones that have a high propensity to generate large return, then projects offering low returns. These projects are preferred from borrowers since the firm's losses in the case when the project's return is low and are limited to zero by legal regulation. These projects are unfavourable from the lender's point of view since they bear all, or most of, the costs in the case of low project returns. The theory also designates that due to economic tremors, the borrowers may not have the aptitude to borrow and the probability of them avoiding the repayment of their loans or external finance.

2.2 Objective I: Causes of non-performing loans from financial institutions

Credit policy

Poor and unprofessional Credit evaluation with the due respect to lending decisions made in the past by the financial sector, a lot of emphasis has been put on security than other similar important considerations (Bonin, & Huang, 2011). There are instances in the past when it was easier to get a loan from financial institutions as long as the borrower had security to be charged than the ability to service the loan. Cash flow projections, viability of the projects, character of the borrowers, previous loans completion and ability to repay were not considered as important. This way a number of financial institutions ended up with many non-performing loans due to incomplete, poor and unprofessional credit risk assessment and evaluation. Credit sanctioning that has not duly considered the credit terms would potentially lead to occurrence of poor loan performance. Bernanke et al. (2009) in their study conducted on the Spanish banking sector from 1984 to 2003 evidence that NPLs are determined by lenient credit terms. The cause for the lenience is attributed to disaster myopia, herd behaviour, moral hazard and agency problems that may entice bank managers to take risk and lend excessively during boom periods as per this study. Ross et al. (2011), who studied the Indian commercial banks, also found out that terms of credit determines occurrence of Non-performing loans.

Ross et al. (2011) hypothesizes that bank managers have short-term decision horizons because their reputations are strongly influenced by public perceptions of their performance, as evidenced by short-term earnings. Managers' reputations suffer if they fail to expand credit when the economy is expanding and bank earnings are improving. This herd behaviour will result in some

loans going to customers with higher default risk than would occur otherwise. Dash & Kabra (2010) also suggest that bank managers adjust lending standards as market conditions change, seeking to smooth overall lending risk. The dominant reason for bank failure in the early 1980s was poor bank management, which encompasses factors like economic, legislative, managerial, and regulatory led to the banking crises. Besides the study by Dash & Kabra (2010) indicates lack of proper skill amongst loan officials, speedy process of evaluating loans mainly due to external pressure, are among the factors that lead to huge concentration of non-performing loans. Financial institutions experienced an increase in competition in the United States during 1980 and early 1990. This resulted in a change in lending practices. Due to the competition and the pressure to deliver increasing returns, financial institutions increased the granting of credit facilities to marginal borrowers. These facilities were aggressively priced to compensate for the increase in risk. Although the strategy delivered short-term results, credit losses followed and, in many cases, caused banks to fail (Dash & Kabra, 2010).The failure of financial institutions can, therefore, not only be linked to unfavourable economic environments, but also to the nature of the credit policies they employ.

Loan recovery procedure

Regular monitoring of loan quality, possibly with an early warning system capable of alerting regulatory authorities of potential bank stress, is essential to ensure a sound financial system and prevent systemic crises (Sinkey, 2012). The need to give due attention to borrower thus need not be overemphasized in order to ensure loan performance. There is a tendency by borrowers to give better attention to their loans when they perceive they got better attention. Some of the loan's defaults ascribe to lower level of attention given to borrowers. It is advised that banks keep up with their loans timely. Financial institutions lose money because they do not monitor their borrowers' property, and fail to recognize warning signs early enough (Mucheke, 2011). When banks fail to give due attention to the borrowers and what they are doing with the money, then they will fail to see the risk of loss. The objective of supervising a loan is to verify whether the basis on which the lending decision was taken continues to hold good and to ascertain the loan funds are being properly utilized for the purpose they were granted. In order to meet these objectives financial institutions need to see whether the character of the borrower, its capacity to repay the loan, capital contribution, prevailing market conditions and the value of the collateral that was taken during loan approval time remains the same (Mucheke, 2011). Follow-up of the

financial stability of a borrower can be done by periodically scrutinizing the operations of the accounts, examining the stock statements and ascertaining the value of security. Visiting the borrower periodically to understand the progress of the borrower's business activity and thereby give advice as necessary is also among the methods banks adopt to follow up their loans.

It is clear that effective credit monitoring involves looking into various operations of the borrower including operations of the loan, checking whether the borrower is properly managed, and the environment in which the borrower is carrying out its business is satisfactory. Constant monitoring increases the chance that the borrower will respond to a financial institution's concern and provide information more willingly. A financial institution which always closely follows the borrowers standing can often point out danger or opportunities to the lender as well as quick agreement to request for credit. It thus establishes that monitoring is basically constructive, and not a panic reaction and carries more weight when it expresses concern (Strischek, 2010). Financial institutions should have clearly defined continuous procedures for identifying potential bad and doubtful loans (Sinkey, 2012). These procedures should include regular independent reviews of the loan portfolio. Within this system, there should be formal procedures for the continuous review of all large loans and all areas of lending concentration. These reviews should place particular emphasis upon the borrower's continuing ability to service the loan. Failure to do these continuous reviews and monitoring will lead to loss to banks or increase the risk of such losses (Sinkey, 2012).

Loan appraisals

Bindra (2012) argues that the true underlying cause of non-performing loans is entirely of our own making: poor risk management. This is a situation whereby the bank credit officials do not properly access the suitability of advancing credit to their customers; they do not adhere to the good lending principles. Practically all affected institutions display similar symptoms: insider lending; poor monitoring of loan accounts, under-qualified staff, little or no cash flow appraisal of loan projects. He concludes that loan losses can be minimized through professional management of the lending function. This requires careful appraisal of loan requests, continuous monitoring of customer conditions and proper followup on how the loan has been utilized as there is a possibility that the loan may not be utilized for the intended purpose, leading to project failures. Dash and Kabra (2010) showed that operating efficiency helped explain NPLs, i.e.

financial institutions that incur big cost for loan follow-up would have a comparatively lower non-performing loan. The unavailability of donor funds both from IMF, World Bank and the European Union has further aggravated the problem of declining growth of the economy. With this situation, little activity goes on in the banking sector, as most people cannot afford credit.

The findings of the study suggest that non-performing loans increase with increase in lending rates, real effective exchange rate and unemployment rate (Mutie, 2016). Whereas increase in returns on assets and GDP growth are associated with a decreasing effect on non-performing loans, based on the findings, the study recommends that financial institutions should consider the international competitiveness of the domestic economy before extending loans so as to minimize the effect of real exchange rate appreciation. Efforts to lower lending rates, for example, by reducing operating costs of the financial institutions and increasing their liquidity are of paramount importance in this regard. Furthermore, there is need to promote GDP growth for example, by creating a conducive business atmosphere and promoting high productivity industries. Elliot (2015) showed that there is also need to reduce unemployment rate by developing labour market information system and supporting labour-intensive industries. Promoting stock markets would also enable financial institutions diversify their portfolio and therefore spread their risk. Generally, in developing and underdeveloped countries, the reasons for default have a multidimensional aspect. Various researchers have concluded various reasons for loan default like default culture is not a new dimension in the arena of investment. Rather in the present economic structure, it is an established culture. The redundancy of unusual happening becomes so frequent that it seems people prefer to be declared as defaulters (Awoyemi , 2014).

Interest rates

High interest rates reduce the borrower's net worth which has a negative impact on investment and financial intermediation, leading to rising non-performing loans and bank failures. In these circumstances, it is high-return, high-risk projects that are financed suggesting instances of adverse selection and moral hazard. Ndii (2010) argues that high interest rates contribute to high default rates and the decline in interest margins implies bad borrowers may be able to resume servicing their facilities. It also means a shift in strategy among financial institutions with emphasis on margins from volumes and diversification to non-interest income streams. This scenario persisted for much of the last decade and while the Government had managed to control

inflation by 1994, real interest rates remained high, indicating a continued high cost of investment. Mucheke (2011) also cites interest rates as one of the contributory factors to non-performing loans. Abid et al. (2014), while studying financial institutions' specific causes of non-performing loans in Tunisia, summarized that macroeconomics factors such as Gross Domestic Product (GDP) had negative impact on NPL. This was in support of the findings by Beck, Jakubik and Piloui (2013). The study also found inflation rate and interest rate to have a positive impact on NPLs. Banking-specific factors such as solvency ratio and returns on equity had negative and significant impacts, while operations inefficiency was found to have a positive impact on NPLs. Given the positive relationship between NPLs and size of the bank, the study therefore finds support for the notion of "too-big-to-fail" discussed by Louzis, Vouldis and Metaxas (2011). Anyanzwa (2014) attributed the increased provisioning for bad loans by commercial banks in the difficult national economic environment has adversely affected the financial performance of customers. He said that any further delay in resumption of donor support is likely to put upward pressure on interest rates, ultimately impacting negatively on the already sluggish economic growth. Muthuma (2011) argues that the poor fiscal policy had resulted to high inflation rates and that this could be one of the contributors of non-performing loans. Inflationary expectation is a factor that is embedded in the interest rate. Interest will remain high if investors believe that the government will introduce inflation in the future by adding money in circulation through extended credit from the Central Bank. He was however perplexed on how we would justify a case as that of leading foreign financial institutions, Barclays Bank and Standard Chartered who continue to reap huge profits while recording a decline in their level of non-performing loans and yet operate in the same economy as other institutions. The choice of GDP, unemployment and interest rate as the primary causes of NPLs may also be justified from the theoretical literature of life-cycle consumption models. Dash and Kabra (2010) examine such a model and introduce explicitly the probability of default explained earlier. The model implies that borrowers with low incomes have higher rates of default. This is explained by their increased risk of facing unemployment and being unable to pay. Additionally, in equilibrium, banks charge higher interest rates to riskier clients.

2.3 Objective II: Assessing Credit Monitoring and Recovery Strategies adopted by financial institutions

According to Dash and Kabra (2010), credit analysis is the first step in the process credit monitoring and recovery strategies adopted by financial institutions. The assessment starts with an understanding of the customer's needs and capacities to ensure there is a good fit in terms of the financing solution. Credit assessment is the most important safeguard to ensure the underlying quality of the credit being granted and is considered an essential element of credit risk management. A credit analysis is used by the credit official to evaluate a borrower's character, capital, capacity, collateral and the cyclical aspect of the economy, or generally referred to as the five Cs (Strischek, 2010). Detailed discussion of this model, also referred as the five C's follows below.

2.3.1 The Five Cs of Credit

The credit analysis process, traditionally employed by the first banks, does not differ fundamentally from the processes used today (Ross et al., 2011). The five Cs are considered the fundamentals of successful lending and have been around for approximately 50 years. Initially, only character, capacity and capital were considered. However, over the years collateral and conditions were added. These provided an even more comprehensive view and clearer understanding of the underlying risk and resulting lending decision (Ross et al., 2011). According to Dash and Kabra (2010), these principles should be the cornerstone of every lending decision. The five Cs are discussed as follows:

Character:

Character refers to the borrower's reputation and the borrower's willingness to settle debt obligations. In evaluating character, the borrower's honesty, integrity and trustworthiness are assessed. The borrower's credit history and the commitment of the owners are also evaluated (Ross et al., 2011). Financial institutions' reputation, referring specifically to credit, is based on past performance. A borrower has built up a good reputation or credit record if past commitments were promptly met (observed behaviour) and repaid timely (Ross et al., 2011). Character is considered the most important and yet the most difficult to assess (Ross et al., 2011).

Capacity:

Analysis of the financial capacity of the customers should also be carried out in order to determine a borrower's ability to meet financial obligations in a timely fashion (Ross et al., 2011). Its ability to pay may be much more important. It is critical to understand the difference. Watching customer payment habits over time is an excellent indication of cash flow. Also, checking bank and trade references, as well as any pending litigation or contingent liabilities are pivotal. Further checking for a parent institution relationship is important as a parent financial institution's guarantee may be available. Interbank loans might affect financial solvency. Agency ratings that predict slow payment or default should be carried out before completion of investigating capacity of a borrower.

Capital:

Capital refers to the owner's level of investment in the business (Sinkey, 2012). Financial institutions prefer owners to take a proportionate share of the risk. Although there are no hard and fast rules, a debt/equity ratio of 50:50 would be sufficient to mitigate the financial institution's risk where funding (unsecured) is based on the business's cash flow to service the funding (Strischek, 2010). Lenders prefer significant equity (own contribution), as it demonstrates an owner's commitment and confidence in the business venture.

Conditions:

Conditions are external circumstances that could affect the borrower's ability to repay the amount financed. Lenders consider the overall economic and industry trends, regulatory, legal and liability issues before a decision is made (Sinkey, 2012). Once finance is approved, it is normally subject to terms and covenants and conditions, which are specifically related to the compliance of the approved facility (Strischek, 2010). Financial institutions normally include covenants along with conditions when credit facilities are granted to protect the bank's interest. The primary role of covenants is to serve as an early warning system (Obiero, 2012). Covenants can either be negative or positive (Sinkey, 2012).

Security:

Security is the assets that the borrower pledges to the bank to mitigate the bank's risk in event of default (Elliot, 2015). It is something valuable which is pledged to the bank by the borrower to support the borrower's intention to repay the money advanced. Security is taken to mitigate the bank's risk in the event of default and is considered a secondary source of repayment (Kjosevski

and Mihail, 2017).Supporting of the aforementioned, Ross, Westerfield and Jaffe (2011) define secured lending in financial institutions as the business where the secured loans have a pledge of some of the borrower's property (such as home or vehicles) behind them as collateral that may have to be sold if the borrower defaults and has no other way to repay the lender. The purpose of security is to reduce the risk of giving credit by increasing the chances of the lender recovering the amounts that become due to the borrower. Security increases the availability of credit and improves the terms on which credit is available. The offer of security influences the lender's decision whether or not to lend, and it also changes the terms on which he is prepared to lend, typically by increasing the amount of the loan, by extending the period for which the loan is granted and by lowering the interest rate (Elliot, 2015).

Debt recovery is the process of pursuing loans which have not been repaid and managing to recover them by convincing the loanees to make attempts to repay their outstanding loans (Kjosevski and Mihail, 2017). Normally, this role of recovering loans is not an easy task as clients will go out of their way to prove inaccessible to the lender (bank). The banking industry in most cases has a debt recovery unit which is in charge of following loans before they become delinquent and make attempts to recover them (Garber, 2017; Phillips & Reichart, 2010). Debt recovery is a very important component of banking as it plays a key role in ensuring that the main objective of the bank (to issue loans) results into the desired outcome of making a margin out of the loans advanced. It is evident that the presence of debt recovery puts pressure on the loanees to pay up lest they get the dreaded calls from the banking staff through the debt recovery unit. Debt recovery unit is involved in the day-to-day role of ensuring that the loans issued to the bank's customers are repaid as per the schedule of contract signed by the customer and bank. Phillips and Reichart (2010) conducted on the Spanish banking sector from 1984 to 2003 and availed evidence that NPLs are determined by poor measures on debt recovery.

The task of debt recovery entails compiling a list of overdue loans and proactively managing the loans by calling up customers who are defaulting. This unit is equally charged with the role of liaising with lawyers to draft demand letters to the loan defaulters and sending the same to the customers who are defaulting. There are various credit monitoring and recovery strategies that have been adopted by many financial institutions. Many of the agonies and frustrations of slow and distresses credits can be avoided by good loan supervision (Obiero, 2012). Supervision helps

keeping a good loan good. It may be visiting the borrowers' premises to investigate the general state of affairs and maintenance of plant and equipment (Obiero, 2012). Inadequate maintenance is often an early sign of financial distress. Also, to be observed is the state of employee morale and the physical stock of materials and finished goods. The general business policy and advice is considered. If a bank is sanitizing to business development, it can revise its own credit and loan polices and advise its customers (Elliot, 2015). Again, keeping track of deposits and balances gives clue to the affairs of the borrowers.

Debt rescheduling signifies a change in the existing terms of a loan. A financial institution should consider rescheduling a debt when it has determined that the rescheduling is in the government's interests and that recovery of all or a portion of the debt is reasonably assured (Maphartia, 2014). As with instalment payments, before rescheduling a debt, the agency should reassess the debtor's financial position and ability to repay the debt if rescheduled. The agency should also determine if it should require the debtor to use pre-authorized debit to make payment. In regard to any repayment arrangement, the terms and conditions of the rescheduling, including the acceleration clause, must be in writing and signed by the debtor. The bank should discourage informal workout arrangements with debtors. Each bank should establish uniform policies, procedures and criteria for rescheduling and other types of workouts for each programme area. Its policies and procedures should provide for the recognition of gains and losses on rescheduled accounts in accordance with the provisions of credit management standards (Maphartia, 2014). Repossession of security is aimed at recovery of dues and not to deprive the borrower of the property.

The recovery process through repossession of security involves repossession, valuation of security and realization of security through appropriate means. All these would be carried out in a fair and transparent manner. Repossession is done only after issuing the notice as detailed above. Due process of law is followed while taking repossession of the property. The bank will take all reasonable care for ensuring the safety and security of the property after taking custody, in the ordinary course of the business (Epure & Lafuente 2017). In its efforts to recover a delinquent debt, a bank may use the services of private collection agencies (Mutie, 2016). Private collection agencies charge fees, which are paid out of amounts collected. The creditor agency retains the final authority to resolve disputes, compromise debts, suspend or terminate collection

action, and refer accounts to Credit Reference Bureau. The credit reference agency ought therefore to supplement and inter-pose between the lending institution/creditor and the borrower/debtor. The other point to be taken up is about levels of intervention between the creditor, debtor and the lawyer. Lending institutions simply require to seek advisory and other services if credit activity will not be paralyzed by the phenomenon of bad debts (Elliot 2015). These services will take the shape of credit brokerage, debt adjusting, collecting, counselling, and factoring services and ultimately recovery action.

Credit scoring systems can be used by financial institutions as a credit recovery strategy. A credit score is a number that is based on a statistical analysis of a borrower's credit report, and is used to represent the creditworthiness of that person. A credit score is primarily based on credit report information. Lenders, use credit scores to evaluate the potential risk posed by giving loans to consumers and to mitigate losses due to bad debt. Using credit scores, financial institutions determine who are the most qualified for a loan, at what rate of interest, and to what credit limits (Dash & Kabra, 2010). While written communication, telephonic reminders or visits by the bank's representatives to the borrowers' place or residence are used as loan followup measures, the bank will not initiate any legal or other recovery measures including repossession of the security without giving due notice in writing (Wangai, Bosire and Gathogo, 2012).

The bank will follow all such procedures as required under the law for recovery / repossession of security. Ross, Westerfield and Jaffe (2011) highlight that information sharing is useful both at the origination stage and after credit has been extended. Especially at the origination phase, information sharing reduces the problems of adverse selection. In fact, the exchange of credit information improves non-performing loan ratios, leads to fewer losses through write-offs and decreases interest rates for good credit risks. Obiero (2012) further supports that sharing credit information between lenders intensifies competition and increases access to finance. Dash and Kabra (2010) indicate that credit information sharing results in improved financial institutions' knowledge of an applicant's character, easing adverse selection and reduce the informational rents that financial institutions could otherwise extract from their customers. Credit information also acts as a borrower disciplining device, by cutting insolvent debtors off from credit and eliminates or reduces the borrower's incentive to become over-indebted by drawing credit simultaneously from many financial institutions without any of them realizing it.

2.4 Objective III: The relationship between non-performing loans and performance of financial institutions

Historically, the occurrence of banking crises has often been associated with a massive accumulation of non-performing loans which can account for a sizable share of total assets of insolvent banks and financial institutions, especially during episodes of systemic crises. Deterioration in banks' loan quality is one of the major causes of financial fragility. Past experience shows that a rapid buildup of bad loans plays a crucial role in banking crises (Kargi, 2011). It is widely accepted that the quantity or percentage of non-performing loans (NPLs) is often associated with bank failures and financial crises in both developing and developed countries. In fact, there is abundant evidence that the financial/banking crises in East Asia and Sub-Saharan African countries were preceded by high non-performing loans. The current global financial crisis, which originated in the US, was also attributed to the rapid default of sub-prime loans/mortgages. In view of this reality, it is therefore understandable why much emphasis is placed on non-performing loans when examining financial vulnerabilities (Mutie, 2016).

The concept of non-performing loans has been defined in different types of literature. According to Kjosevski and Mihail (2017), non-performing loans are defined as defaulted loans which banks are unable to profit from. They are loans which cannot be recovered within stipulated time that is governed by the laws of a country. According to the International Monetary Fund (IMF, 2009), a non-performing loan is any loan in which interest and principal payments are more than 90 days overdue; or more than 90 days' worth of interest has been refinanced, non-performing loans generally refer to loans which for a relatively long period of time do not generate income; that is the principal and/or interest on these loans has been left unpaid for at least 90 days (Mutie, 2016).

Non-performing loans are further defined as loans whose cash flows stream is so uncertain that the bank does not recognize income until cash is received, and those loans whose interest rate has been lowered on the maturity increase because of a problem with the borrower (Machiraju, Undated). Machiraju expresses non-performing loans as a leading indicator of credit quality. Kargi (2011) says non-performing loans (NPL) or bad loans arise in respect of the loans and advances which are given by banks to the whole range of different projects including but not exclusively retail or wholesale, personal or corporate or short, medium- or long-term projects.

NPLs are a very sensitive element of a bank's operations. According to Chen and Pan (2012) the losses bad loans (NPLs) cause a reduction of the capital resource of the bank; and affect its ability to grow and develop its business (Dash & Kabra (2010). Disclosure of the extent of these losses in its financial statements may lead to a loss of confidence in the bank's management and a reduction in its credit ratings. This will in turn   increase the bank's cost of borrowing in the wholesale market and make it more expensive or more difficult to raise capital. In extreme cases, it can lead to a loss of deposits, the withdrawal of the bank's authorization and ultimately insolvency (Garber, 2017). Thus NPL is one of the concrete embodiments of credit risk which banks take. They have greater implication on the function of banks as well as the overall financial sector development. A study by Talata (2011) examined the effect of non-performing loans on financial performance. The finding showed that NPLs, loan recovered, cost-income ratio, and total revenue were statistically significant at one per cent (1%) level of significance respectively. However, liquidity risk was not statistically significant. The NPLs and cost to income ratio had a negative effect on financial performance while total revenue and loan recovered had a positive influence on financial performance. A study by Wangai, Bosire and Gathogo (2012) investigated the effect of non-performing loans on financial performance of financial institutions in Kenya. The research was carried out in Nakuru town, Kenya. The results showed that credit risk had significant effect on financial performance of financial institutions in Nakuru town.

Research by Muasya (2011) carried a comparative study to find out extent to which commercial banking institutions in Kenya and Europe were affected by problem of poor risk assessment on loan quality during the global financial crisis period 2008/2009. The study results showed that Kenyan financial institutions made less losses as compared to financial institutions in the US and Europe in same period due to the negative effect of Non-Performing Loans. A study by Kargi (2011) examined the effect of NPLs on the financial performance of financial institutions in Nigeria. The study employed financial ratios as proxies for performance of banks. Data on credit risk was extracted from the financial reports of sampled financial institutions covering five years from 2007 to 2011.The data was analysed using the descriptive and inferential statistics, that is pare-wise correlation and regression techniques analysis. The results revealed that credit risk management had a statistically significant effect on the financial performance, measured as profits (Awoyemi, 2014). The study held those profits negatively affected by volume of loans

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and advances, NPLs and deposits, hence exposing financial institutions to great liquidity risk and financial distress. A study by Epure and Lafuente (2017) studied bank financial performance in the banking industry in the presence of risk in Costa-Rica during the 2008 to 2017 period. The finding revealed that improvement in performance followed changes in regulations and that risk explains differences in financial institutions. NPLs were found to negatively affect efficiency and ROA while the capital adequacy ratio had a significant and positive effect on the net interest cover margin. A study by Kithinji (2010) examined the impact of credit risk management practices on the profits of commercial banking institutions operating in Kenya. Chen and Pan (2012) assessed the credit risk efficiency of 34 financial institutions in Taiwanese for a period of four years (2010-2011). Chen and Pan used financial ratio as proxy for credit risk. Data was analysed using DEA.

The parameters of credit risk were credit risk allocative efficiency, credit risk cost efficiency and credit risk technical efficiency. The findings revealed that only one bank was efficient in all types of efficiencies over the study period evaluated. A study by Felix and Claudine (2015) assessed the association between financial institutions' performance and credit risk management practices. Findings showed that ROA and ROE, both measuring profitability of financial institutions, were negatively related to the ratio of NPLs to total loan of financial institutions, hence leading to a decline in profitability. Ahmad and Ariff (2017) in a comparative study also analysed how credit risk of financial institutions emerge in developed economy banking systems. The results revealed that regulation is an important determinant for banking systems that offer many products; and, quality of management was critical in the cases of loan-dominant institutions in emerging economies. An increase in loan loss provision is also considered a significant factor affecting credit risk.

Another study was carried out by Al-Khouri (2011) in India assessing the effect of credit orientation on loan default in financial institutions. The study further assessed specific risks and the overall banking environment on the financial performance of 43 financial institutions operating in six of the Gulf Cooperation Council (GCC) countries over the period between 1998 and 2008. The study employed fixed effect regression model for analysis. The findings revealed that credit risk, capital risk and liquidity risk are the key financial institutions' specific risks that

affect bank performance (ROA) while only Liquidity risk affects profitability when measured by ROE.

A study by Ben-Naceur and Omran (2013) examined the influence of financial institutional development, regulations and concentration on financial institutions' margin and profitability in the Middle East and North Africa countries (MENA) from 1989-2005.The study revealed that capitalization of the bank and credit risk had a significant and positive impact on financial institutions' cost efficiency, net interest margin and profitability. According to Kjosevski and Mihail (2017) there is a significant negative contemporaneous effect of GDP growth on the NPL ratio and infer a quick transmission of macroeconomic developments to the ability of economic agents to service their loans. The other macroeconomic variables, aside from GDP growth, such as unemployment and interest rates, have got an impact on household and firms that they have a relation with NPL ratio. More specifically, an increase in the unemployment rate should influence negatively the cash flow streams of households and increase the debt burden. With regard to firms, increases in unemployment may signal a decrease in production as a consequence of a drop in effective demand. This may lead to a decrease in revenues and a fragile debt condition.

Obiero (2012) indicated that commercial banks with greater risk appetite tend to record higher losses. This also leads to leniency. Salas and Saurina (2002) attribute the leniency to disaster myopia, herd behaviour and agency problems that may entice bank managers to lend excessively during boom periods of economic expansion. Radha and Vasudevan (2018) also indicated that there is significant positive relationship between the loan-loss rate and internal factors such as high interest rates, excessive lending, and volatile funds. Keeton (1999) also indicated a strong relationship between credit growth and impaired assets. Specifically, Chen and Pan (2012) show that rapid credit growth, which was associated with lower credit standards. Chen and Pan (2012) reveal that rapid credit expansion, bank size, capital ratio and market power explain variation in NPLs. Meanwhile, Wangai, Bosire and Gathogo (2012) indicated that favourable macroeconomic conditions (measured by GDP growth) and financial factors such as maturity, cost and terms of credit, bank size, and credit orientation impact significantly on the NPLs of commercial banks in India.

Fofack (2015) also indicated that the real interest rate, net interest margins, and inter-bank loans are significant causes of NPLs. More recently, Kjosevski and Mihail (2017) analysed the relationship between NPLs and ownership structure of commercial banks and found that banks with higher government ownership recorded lower non-performing loans. Generally, robustness and prudence of the credit process largely contribute to loan qualities banks maintain. In this regard, appropriateness of customer selection process, quality and depth of credit assessment, thoroughness of the sanctioning process, and mechanisms of post-disbursement followup will have a significant role in determining where a specific financial institution stands when it comes to loan performance. In other words, the credit risk management frameworks banks set and live by are very crucial in keeping loan default to minimum level. Thus, failing in any one of the issues discussed under section 2.4 will likely lead to occurrences of NPL.

2.5 Summary of the literature and research gap

Chen and Pan (2012) on the basis of the reviewed literature, NPLs were looked at as loan appraisal, credit policy, loan recovery procedure and interest rate on the financial institutions' specific factors that have been found to impact on loan performance. On the other hand, profitability, working capital, current ratios, debt to equity and inventory turnover are some of the macroeconomic factors that have been found to impact on the performance of institutions. However, there are mixed findings with regard to the impact of different variables due to the variation in the environment and data used in different studies. There are also different methodological approaches regardless of whether it is cross-country or individual country studies. Panel data techniques are the most dominant especially in cases where bank level (disaggregated) data is used. Another study conducted by Morakinyo and Sibanda (2016) looked at bank-specific factors affecting loan performance using a case study of Nigeria Development Bank Limited. However, this study was qualitative in nature, mainly focusing on staff involved in credit management, credit policy and management information system software used, ignoring quantitative factors such as returns on assets, lending rate and many more, which have been found to impact significantly on loan performance by various studies. Both studies therefore leave a gap as to what factors are important in explaining NPLs across financial institutions in Uganda (Nanteza, 2015). Moreover, to the best of my knowledge, no study has looked at loan appraisal, credit policy, loan recovery procedure and interest rate on the performance of financial institutions in terms of profitability, working capital, current ratios, debt to equity and inventory

turnover. Therefore, this study was intended to close this gap by looking at causes of non-performing loans, credit monitoring and loan recovery strategies on the performance of financial institutions from both qualitative and quantitative perspectives.

CHAPTER THREE
METHODOLOGY

3.0 Introduction

This chapter is a description of the methodology used in the study to find answers to the research questions. In this chapter, the research methodology is presented in the order of research design, target population, sample size, sampling procedure, data collection methods, instruments of data collection and data analysis.

3.1 Research Design

The research design is a conceptual structure in which research is conducted and finally concluded. It lays down rules for the selection of the data, collection of data and treatment of the findings. The choice of research design depends on the nature of the problem on which the study is being undertaken and the scope of the study (Creswell & Plano Clark, 2007). This study, therefore, adopted a descriptive survey design that aimed at exploring the impact of non-performing loans on the performance of financial institutions. Descriptive designs result in a description of the data, either in words, pictures, charts, or tables, and indicate whether the data analysis shows statistical relationships or is merely descriptive. Census survey based on the financial institutions in Kabale district was used to produce results that are broad, credible and conclusive. The research was both quantitative and qualitative in nature and relied on primary data obtained from financial institutions in Kabale district. Both quantitative and qualitative data were collected. Several financial institutions staff were interviewed accordingly. The qualitative data were basically focused on the financial institution officials' views about non-performing loans in the loans department of financial institutions in Kabale district right from policies to the value chain process of lending. Quantitative methods applied to the numerical aspects of the study such as loan appraisal, credit policy, loan recovery procedure and interest rate.

3.2 Population of the Study

The population is defined as a large group of people from which a number of individuals are selected for the study (Mugenda, 2008). It is also a group where the researcher sampled from and was interested to generalize to (Manfreda, 2008). It is therefore essential to identify the population precisely and accurately because inferences have to be made about the elements in the population. According to the Uganda Bankers Association, Kabale district has 10 financial institutions (commercial banks as the unit of analysis) that is Absa, Baroda, Brac, Centenary, Dfcu, Equity, Platinum, Post Bank, Pride Microfinance and Stanbic in Kabale district with a total population of 220 employees that have been in existence from 2014 to 2020 (Uganda Bankers Association Report, 2019). This period was considered long enough to provide sufficient variables to assist in determining the causes of non-performing loans and the performance of financial institutions. This period was chosen in order to capture the most recent data and to give results that reflect the current trend.

3.3 Sample size and Sampling technique

The sample size of the study was 140 as determined by Krejcie and Morgan (1970) Table which is attached (see Appendix V) and the sampled categories are specified in Table 1 below.

Table 1: Sample size and Sampling technique

Institution	Population	Sample size	Sampling techniques
Branch managers	15	14	Purposive sampling
Loans officers	15	14	Purposive sampling
Human source managers	30	28	Random sampling
Cashiers	40	36	Random sampling
Credit officers	25	24	Random sampling
Secretaries	25	24	Random sampling
Receptionists	20	10	Random sampling
Auditors	20	10	Random sampling
Relations officers	15	14	Random sampling
Recovery / monitoring officers	15	14	Random sampling
Total	**220**	**140**	

According to Maree (2006), sampling refers to the process of selecting a population for the study. Manfreda (2008) defines sampling technique as a description of strategies which the researcher uses to select representative respondents from the target population. Sampling is the

process of selecting elements from a population in such a way that the sample elements selected represent the target population. Selecting a sample is a very important step in conducting research, particularly for quantitative research. This study used purposive and random sampling techniques only. According to Manfreda, (2008), purposive sampling gives the researcher prior judgement about the samples. Kathuri (2007) adds that purposive sampling means a sampling technique in which a researcher uses his or her own knowledge of the population and selects the knowledgeable sample for the research study. Therefore, purposive sampling in this study was used to select the branch managers and loans officers of financial institutions since they had the main role of financial performance of their branches and they were the main implementers of the loan practices.

Random sampling technique was used to select other employees like human resource, 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 had direct contacts with the loan customers.

3.4 Data Collection methods and instruments
The study used both questionnaires and interview guides for data collection.

3.4.1 Questionnaires
A questionnaire is a research instrument of a set of standardized printed or written questions with a choice of answers, devised for purposes of a survey or statistical study (Trochim, 2007). He further defines structured questionnaire as a document that consists of a set of standardized questions with a fixed scheme, which specifies the exact wording and order of the questions for gathering information from respondents. The researcher used a structured questionnaire as a primary data collection instrument. The questionnaire was considered appropriate because it is more convenient to administer and to collect data to enable the achievement of the objective of the study. The primary data collected in the study included data on non-performing loans and performance of financial institutions. The questionnaire contained closed-ended questions and open-ended questions and had various sections. The first part contained questions on the bio data of the respondent and the other sections contained questions on the specific objectives of the study. A "drop-and-pick later" approach was employed in administering the questionnaire and helping the researcher in assisting the respondents in case of any issues in filling the

questionnaires and to ensure maximum or high response rates. The questionnaires targeted the employees. The questionnaires underwent a test run to ensure effective data capture and reliability before the official rollout. The closed-ended items were on a 5-point Likert scale due to its simplicity and ease in answering, coding and analysis. The response modes were: 1-Strongly agree, 2-Agree, 3-Neutral, 4-Disagree, 5- Strongly disagree.

3.4.2 Interview guide

According to Kahn and Connell (1957), in Marshall (1995), interviews are a conversation with purpose and therefore data is collected easily. Interviews also have greater flexibility and opportunity to restructure questions (Kothari, 2004). An interview guide was prepared to assist the researcher to collect data through face-to-face interviews that were conducted with the administrators of the selected financial institutions in Kabale municipality. The purpose of the interviews was to solicit views concerning non-performing loans and performance of financial institutions. Interview guides were used because they assist the interviewer to remain focused during probing time for deeper information.

3.5 Data Quality Control

The validity and reliability of instruments was tested as below.

3.5.1 Validity

After constructing the questionnaire, the researcher contacted five people to test whether the questions were valid. The validity of the questionnaire was established using expert judgement method. The questionnaire tool was given to five people to examine whether the questions were related to the study variables and the objectives of the study. The researcher then used the following formula to establish the Content Validity of Instrument (CVI):

$$C.V.I = n/N \quad \text{Where: C.V.I = Content Validity of Instruments,}$$

$$n = \text{Number of items indicated relevant and}$$

$$N = \text{Total number of items in the questionnaire.}$$

Table 2: Content Validity Index results

Research instruments	Total No of items in the instruments	Number of instruments rated as valid	Content Validity Index (CVI)
Questionnaire	18	16	0.888
Interview guide	11	8	0.889

After performing the calculation, the research instruments were considered valid since the average rate of the questionnaire was found to be above 0.7 as recommended by Amin (2005). The elicited response is presented in Table 2 above. The CVI of questionnaires was 0.827 and the interview guide was 0.889 of each instrument which was above 0.7. It was, therefore, concluded that all instruments used to collect the data for this study were valid.

3.5.2 Reliability

Reliability of research instruments refers to the consistency of respondents in answering the items in the questionnaire. Accordingly, the reliability of the questionnaire and interview guide was tested using the CRONBACH method of internal consistency given by the following formula:

$$\alpha = \frac{K}{K-1}\left(\frac{1 - \Sigma SD_i^2}{SD_t^2}\right)$$

Where: α = alpha coefficient,

K   = the number of items in the instrument

Σ   = summation of the values

SD_i^2 = variance of individual items

SD_t^2 = variance of all items in the instrument

The Cronbach alpha coefficients were judged in relation to the 0.5 which when above shows that the instruments are reliable (Amin, 2005).The elicited results are presented in Table 3 below.

Table 3: Reliability coefficient results

Alpha	Variable	No. of items
0.81	Loan appraisal	6
0.83	Credit policy	7
0.85	Loan recovery procedure	8
0.86	Interest rate	8
0.87	Performance of financial institutions	9

Table 3 shows that Cronbach's coefficient Alpha (α) of Loan appraisal was 0.81, Credit policy was 0.83, Loan recovery procedure was 0.85, Interest rate was 0.86, and performance of financial institutions was 0.87. Since the results were above 0.7, it was concluded that the instruments this study used to collect data were reliable.

3.6 Data analysis

Descriptive statistics comprising frequencies and percentages were presented for categorical demographic characteristics, status of non-performing loans and performance of financial institutions in tables.

3.6.1 Qualitative analysis

This study used content analysis to analyse qualitative data into meaningful shorter sentences. This type of analysis was preferred when qualitative data has been collected in textual format such as data collected using face-to-face interview, as suggested by Sekaran (2009). A thematic approach was used to analyse qualitative data where themes, categories and patterns was identified. The recurrent themes that emerged in relation to each guiding objective from the interviews, were presented in the results, with selected best quotes that emerged from participants.

3.6.2 Quantitative analysis

Quantitative data was coded and later entered into SPSS for analysis. The relationship between: non-performing loans and performance of financial institutions was established using the Pearson correlation co-efficient. Correlation coefficient and the level of significance at 5% was reported.

3.7 Ethical Considerations

The participation of respondents was voluntary. All respondents were required to sign an informed consent form to show that their participation were voluntary and had not been forced to participate in the study. This study ensured that respondents were not asked to reveal information that would embarrass them or endanger their home life, friendships or jobs. Since the participants were required to fill in the questionnaire, it was expected that they would not be exposed to physical harm.

3.8 Limitations to the study

The research, among other things, was confronted with the COVID-19 situation whereby officials were reluctant to give out information.

Another area of limitation to this study came from the inability of respondents to complete and submit questionnaire on time for data to be analysed.

The research was limited by financial constraints due to the extent of the scope of the study and the period of investigation.

CHAPTER FOUR

DATA ANALYSIS, PRESENTATION AND INTERPRETATION

4.1 Introduction

This chapter presents the findings obtained from primary data. The findings are as a result of application of several statistical tools and techniques among which include: frequencies summarized in form of tables and graphs, factor analysis, correlation and regression used to analyse the general information as well as study variables.

4.2 Response rate

Table 4.1: Response rate

Response rate		Frequency	%
Valid	Responses	137	97.8
	Non-responses	03	2.2
	Total	140	100

Source: Field data 2021

The findings in Table 4.1 indicate a response rate of 97.8% and non-response was 2.2%. According to Mugenda and Mugenda (2009), response rate of 97.8% was a good response rate since it was above 70.0%.

4.3 Respondents bio data

4.3.1 Sex

Table 4.2: Respondents sex

Sex	Frequency	%
Male	72	52.6
Female	65	47.4
Total	137	100

Source: Field data 2021

Findings in Table 4.2 indicate that the majority of the respondents 72(52.6%) were males and 65(47.4%) were females. Considering both males and females helped the study to obtain gender balanced information, however, despite the government effort of gender equality in my view males have been dominantly employed as seen in the Table with 72 able to answer our questionnaires.

4.3.2 Respondent age

Table 4.3: Showing respondents' age bracket

Age	Frequency	%
below 25 years	18	13.1
25-35	49	35.8
36-45	28	20.4
46-55	29	21.2
56 and above	13	9.5
Total	**137**	**100**

Source: Field data 2021

Findings revealed that the majority of the financial institutions' employees 49 (35.8%) were between the age group of 25-35. Others, 29 (21.2%), were between the 46-55 age range, 28 (20%) were between the range of 36-45 years, 18 (13.1%) were below 25 years and these were mostly fresh graduates from the university. The minority 13 (9.5%) were 56 years and above; however, this category of respondents had more experience on work than other respondents since they had experience in the banking system. However, looking at the age distribution above, it can be concluded that the sample was representative enough to represent the population since all the age categories found in the population were captured in the sample.

4.3.2 Respondents highest level

Tale 4.4: Highest Level of education

Level of education	Frequency	%
A-level	3	2.2
Diploma	14	10.2
Degree	76	55.5
Master's degree	39	28.5

Doctorate	5	3.6
Total	**137**	**100.0**

Source: Field data 2021

From the field, respondents had different level of education as illustrated in Table 4.4 above. The majority of the respondents, 76(55.5%), were degree holders, 39 (28.5%) had Master's degree, 14 (10.2%) had diploma as their highest level of education, 5 (3.6%) revealed to have attained doctorate level and the minority 3 (2.2%) revealed that they had A-level as their level of education and these were mostly messengers. Having the majority of respondents to have acquired diploma level and above helped the study to acquire relevant information since they were able to interpret the data collection instruments with the help of their education experience. Looking at the education distribution of the respondents, it was concluded that the sample was a true representation of the targeted population and gave us assurance that the information obtained from them was undoubtedly reliable and could be based on to make tangible deductions pertaining the study.

4.3.5 Positions held by employees in the financial institutions

Table 4.5: Showing respondents' position held

Position held	Frequency	%
Business development officers	12	8.7
Relations Managers	16	11.7
Credit analysts	26	19
Recovery/monitoring loans	41	30
Credit managers	27	19.7
Administrators	15	10.9
Total	**137**	**100**

Source: Field data 2021

From the field, the study considered positions held by respondents in financial institutions and the majority 41 (30%) were loan recovery and monitoring managers, 27(19.7%) were credit managers, 26 (19%) were credit analysts, 16(11.7%) were relations managers, 15(10.9%) were administrators, while the minority 12(8.7%) were business administrators. We found this empirical distribution imperative in our research as it gave us vast experience in answering our questions pertaining the variables under scrutiny because such respondents were found to be

participatory in rolling out policies and procedures governing loan assessment. This gave us confidence in our research and the information in was treated with utmost good faith in the study and this explains why the findings are unbiased, relevant to the field of accounting and finance in general.

4.3.6 Experience of service in the financial institution

Table 4.6:Experience in the financial institution

Responses	Frequency	%
Less than 5yrs	50	35.7
6-10	50	35.7
11-15	12	8.6
16-20	9	6.4
20 and above	19	13.6
Total	**137**	**100**

Source: Field data 2021

From the field, respondents had different working experience depending on the time spent working in the institution where the majority, 50 (35.7%), revealed to have spent less than 5 years and 6-10 years respectively working in the banking system. Another group of 19(13.6%) revealed to have spent 20 years and above in financial institutions and these were mostly managers and human resources. Twelve {12 (8.6%)) had spent 11-15 years while the minority 9(6.4%) had spent 16-20 years working in the financial institutions. This clearly depicts that respondents had rich experience in providing response that naturally contributed to the data quality of the survey. The analysis also led to the observation that almost all the respondents had worked for some reasonable number of years and therefore information given was taken to be reliable for the results to be valid.

4.4 Objective I: The causes of non-performing loans on financial institutions

4.4.1 Causes of the occurrence of NPLs among institutions

During the field study, respondents revealed specific causes of non-performing loans naturally vary across different financial institutions due to the uniqueness to strength or weakness on a particular aspect. A particular issue may or may not be the case in other institutions unlike the macroeconomic factors that is typical for all operators in particular geography or so. However, in

the subjective question in the survey respondents from the ten surveyed financial institutions gave various responses. Some of the responses on the cause for occurrences of NPL were all shared by some participants in all the institutions surveyed as in Table 4.7 below.

Table 4.7: Showing specific financial institution causing the occurrence of NPLs

Causes	Absa	Baroda	Brac	Centenary	Dfcu	Equity	Platinum	Post bank	Pride	Stanbic	Total
High interest rate	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
Loan appraisal	x	x	X			x	x	x	x	x	8
Willful default	x	x	X	x	X	x		x		x	8
Loan recovery procedure		x	X		X	x	x	x	x	x	8
Credit policy	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
External influence on sanctioning	x		X	x					x	x	5
Unavailability of data for analysis			X	x					x		3
Poor regulatory and supervisory frame work	x		X	x					x		4

Source: Field data 2021

Table 4.7 indicates causes like high interest, loan recovery procedure, loan appraisal, credit operators' capacity limitation, business failures, willful default, poor diversification of portfolio, credit policy are commonly shared views by respondents from all the surveyed financial institutions staff ascribing to cause occurrence of non-performing loans.

4.4.4 Ranking the causes of Non-performing loans

Respondents were also asked to rank the causes of nonperforming loans among financial institutions in order of importance (from one to eight) as illustrated in the table below.

Table 4.8: Showing ranking to the causes of Non-performing loans

Causes of non-performing loans	1st %	2nd %	3rd %	4th %	5th %	6th %	7th %	8th %
Credit policy	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
Loan appraisal	22	17	21	7	11	4	10	1
Loan recovery procedure	22	21	10	4	24	1	14	1
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 2021

The results in Table 4.8 above indicated that 22 % of respondents ranked loan appraisal and loan recovery procedures as the top-ranking factors causing occurrences of non-performing loans while credit policy was ranked the third factor by 29 % of the respondents. Thus, poor credit monitoring by banks, bank size, poor risk assessment, credit culture/orientation were the top four factors ranked to cause occurrences of non-performing loans. On the other hand, charging high interest rate and credit policies were factors that were ranked seventh and eighth.

4.4.5 Credit assessment and the occurrence of NPL in financial institutions

The respondents were asked to reveal whether credit assessment has led to the occurrence of NPL in financial institutions. Respondents were asked to indicate whether they strongly agree (SA), agree (A), neutral (N), disagree (D) and strongly disagree (SD) using the 5-point Likert scale. The analysis was done using the mean and standard deviation. A mean above 3 indicates an agreement of respondents; a mean of 3 shows undecided; and a mean of below 3 shows disagree by respondents. The standard deviation (SD) of close to 1 shows agreement, while the standard deviation of close to 0 indicates disagreement of the respondents. The analysis further grouped strongly agrees and agree to mean agree and strongly disagree and disagree to mean disagree.

Table 4.9 Showing ways of credit assessment and loan default

Responses	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
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

Source: Field data 2021

Table 4.9 above indicates the relation between credit assessment and occurrence of non-performing loans. A total 44% of the respondents agree that easily admitted borrowers usually default the average response has a mean 2.79 and standard deviation of 1.09. On the other hand, 69.3% of the respondents strongly agree (mean 1.33 and standard deviation 0.516) that having in place a know your customer policy leads to high loan quality. With regard to good loan underwriting, 69.4% of the respondents agree that it ensures loan performance. Poor risk assessment is perceived to lead to loan default by 97.8% of the respondents.

From the above result, respondents strongly agree that financial institutions that employ a robust Know Your Customer policy in recruiting their customers and also do good risk assessment would have a better loan quality. On the other hand, when the loan underwriting is poor, the loans would be prone to default. The respondents view was nearly neutral to the statement "easily admitted customers usually default". In general, the outcome indicates that poor credit risk assessment causes occurrences of non-performing loans.

4.5 Objective II: Credit monitoring and recovery strategies adopted by financial institutions

4.5.1 Assessing factors indicating credit monitoring and recovery strategies

Table 4.10: Showing factors indicating credit monitoring and loan default

Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
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 occurrence of nonperforming loans	16.3	45.2	9.6	22.2	6.7	2.58	0.194
Financial institutions with higher budget for loan monitoring have lower non-performing Loans	3.6	36.5	33.6	22.6	2.9	3.06	2.563

Source: Field data 2021

Using field data in Table 4.10 above, the study revealed that strict loan monitoring is believed to ensure loan performance by 92.7% of the respondents. On the other hand, 43.7% of the respondents (mean 1.74, standard deviation 0.74) disagree with the assertion that loan might perform well if properly monitored despite poor assessment during sanctioning. This indicates that loan follow-up can never substitute proper credit assessment. However, 61.3% of the respondents (mean 2.58, standard deviation 0.194) agree that occurrence of non-performing loan is directly related to loan follow up. On the other hand, only 40.1% of the respondents agree that financial institutions with higher budget for loan monitoring have lower non-performing loans, the average response being neutral (mean 3.06, standard deviation 2.56). From the foregoing discussion it can be concluded that credit monitoring is directly related to loan performance. Despite this, the respondents did not support the argument that loan would perform well only by

proper monitoring if proper assessment is not carried out while advancing the credit. This indicates that followup would never substitute credit analysis or assessment. On the other hand, though loan monitoring requires a budget, allocating a higher budget might not ensure loan performance as a good number of respondents are neutral to the assertion.

4.5.2 Assessing collateralizing loans and occurrence of non-performing loans

Table 4.11: Showing statements pertaining to Collateral and the occurrence of NPL

Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
Collateralized loans perform well	4.4	20.4	26.5	34.6	5.1	3.07	1.013
Collateralizing loans help protect loan default	10.9	59.9	8.8	17.5	2.9	2.42	0.997
Most of the time non-collateralized loans are defaulted	3.6	20.4	31.4	38	6.6	3.23	0.972

Source: Field data 2021

Findings in Table 4.11 above show that with regard to the relation between collateralizing loans and occurrence of non-performing loans, only 33.8% and 24% of respondents agreed with the statement that collateralizing loan protects loan default and non-collateralized loans would be defaulted respectively. However, respondents were of the view that borrowers would service their debt if they had pledged collateral, the response had mean 2.42 and standard deviation 0.997.The fact that only small portion, 24% of (mean 3.23, standard deviation 0.972) the respondents concurred with the argument that non-collateralized loans are defaulted or only 33.8% (mean 3.7, standard deviation 1.01) only agreed with the assertion that collateralizing loans helps loan performance indicates that the relation between collateralizing loans and loan default is not strong. However, the respondents were of the view that borrowers would service the loan if they had pledged collateral lest it would be foreclosed in case of default.

4.5.3 Borrowers' orientation and the occurrence of NPL in financial institutions

Table 4.12: Showing how borrower's orientation is related to the occurrence of NPL in financial institutions

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Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
Borrower's orientation/culture is related to loan performance	30.9	63.2	5.9	-	-	1.75	0.554
There is a relationship between loan default and borrower's culture	29.4	64	5.1	1.5	-	1.79	0.601
Default in some area is ascribed to the culture of the borrowers	19.7	63.5	12.4	4.4	-	2.01	0.707
Society's cultural development leads to good loan performance	31.4	54.7	10.9	2.9	-	1.85	0.723

Source: Field data 2021

With regard to the findings in Table 4.12 above, the relation between borrowers' orientation/culture and loan performance, only less than 5% of the respondents disagree with the assertion that loan performance is affected by orientation /culture of a society and its development. Thus, the result indicates strong relation between culture/orientation and occurrence of non-performing loans and all of the factors relating to culture indicate agreement.

4.6 Objective III: The relationship between non-performing loans and performance of financial institutions

4.6.1 Loan appraisal and performance of performance of financial institutions

Table 4.13: Showing loan appraisal and performance of financial institutions

Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
Aggressive lending leads to large NPL volume/ratio	20.6	58.1	11	10.3	-	2.11	0.849
Financial institutions whose credit growth is	4.4	30.7	38.7	26.3	-	1.87	0.859

rapid experience huge NPL level							
Financial institution's great risk appetite is cause for NPL	9.7	50.7	23.9	15.7	-	2.46	0.872
Compromised integrity in lending leads to loan default	26.9	56.9	9.7	6.7	-	1.96	0.799

Source: Field data 2021

From Table 4.15 above, the response on the relation between loan appraisal and occurrence of non-performing loans in financial institutions; almost 78.7% of them agreed to the assertion that aggressive lending leads to occurrence of large magnitude of NPL. Similarly, 60.4% (mean 2.46, standard deviation 0.87) of the respondents thought that ban financial institutions' greater risk appetite would be cause for occurrence of nonperforming loans. The response on the relation between compromised integrity and NPL reveals that almost 83.6% agreed. So, it can be stated that when financial institutions pursue aggressive lending strategy and thereby experience rapid credit growth they might heap up a large volume of non-performing loans. Not only this but also compromised integrity in sanctioning credit is believed to be cause for occurrence of loan default by respondents that affects performance of financial institutions.

Table 4.14: Correlation results of loan appraisal relation performance of financial institutions

		Loan appraisal	Performance of Financial Institutions
Spearman's rho loan appraisal	Correlation Coefficient	1.000	.501**
Sig. (2-tailed)		.	.003
N		137	137
Performance of FinancialSpearman's Correlation		.501**	1.000
Institutions	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 2021

Table 4.14 shows a moderate positive correlation between loan appraisal and performance of Performance of Financial Institutions (r=0.501, p<0.05). This analysis shows a unit improvement in loan appraisal, other factors held constant, is likely to increase performance (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "loan appraisal is vital for financial institutions since it tests on accuracy, collaterals, honesty, capacity and cash flow to determine lane's credit worthiness and the probability of loans default". Another respondent said that "loan appraisal assists institutions to identify borrowers who might have falsified their past business performance records in order to obtain loans would not be able to repay easily later".

4.6.2 Credit policy and performance of financial institutions

Table 4.15: Showing how credit policy influences performance of financial institutions

Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
Having 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 growth in Financial institutions size comes growth on NPL	1.5	11.7	24.8	55.5	6.6	3.54	0840

Source: Field data 2021

The survey response in Table 4.16 above showed the relation between having large number of borrowers and financial institutions' size indicates that it is not the cause for the occurrence of loan default. Responses to questions relating to financial institutions' size and occurrences on NPL are inclined towards disagreement.

Table 4.16: Correlation results of credit policy and performance

	Credit policy	Performance of Financial Institutions
Spearman's rho credit policy Correlation Coefficient Sig. (2-tailed) N	1.000 . 137	.441** .008 137
Performance of Financial Spearman's Correlation Institutions Sig. (2-tailed) N	.441** .008 137	1.000 . 137
** Correlation is Significant at the 0.01 (2-tailed) ** Correlation is significant at the 0.05 (1-tailed)		

Source: Field data 2021

Table 4.16 shows a moderate positive correlation between credit policy and performance of financial institutions (r=0.441; p<0.05). This analysis shows that a unit improvement in credit policy, other factors held constant, performance is likely to increase (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "credit policy deal with the issue of knowing the customer, customarily known as KYC (Know Your Customer) is so vital before proceeding to details. Financial institutions use various means to obtain such information about the existing or potential customer like use of financial statement, credit report from credit bureau, customers' history if not new are the potential sources of information.

4.6.3 Loan recovery procedures and performance

Table 4.17: Showing loan recovery procedures and performance of financial institutions

Statement	SA (1)	A (2)	N(3)	D (4)	SD (5)	Mean	Standard

	(%)	(%)	(%)	(%)	(%)		deviation
Lenient / lax credit term cause loan default	1.8	72.6	7.4	5.2	-	2.03	.657
Borrowers default because they don't understand credit terms well	4.4	39.0	34.6	19.9	2.2	2.76	0.896
Poorly negotiated credit terms lead to loan non-performance	16.2	72.1	7.4	4.4	-	2.00	0.644

Source: Field data 2021

From Table 4.17 above, the response on the relation between loan recovery procedure and occurrence of non-performing loans in financial institutions; almost 78.7% of them agreed to the assertion that aggressive lending leads to occurrence of large magnitude of NPL. Similarly, 60.4% (mean 2.46, standard deviation 0.87) of the respondents thought that ban financial institutions' greater risk appetite would be cause for occurrence of non-performing loans. The response on the relation between compromised integrity and NPL reveals that almost 83.6% agreed. So, it can be stated that when financial institutions pursue aggressive lending strategy and thereby experience rapid credit growth they might heap up large volume of non-performing loans. Not only this, but also compromised integrity in sanctioning credit is also believed to be the cause for occurrence of loan default by respondents that affects performance of financial institutions.

Table 4.18: Correlation results of Loan recovery procedure and performance

	Loan recovery procedure	Performance of financial institutions
Spearman's rho Loan recovery Correlation Coefficient Procedure Sig. (2-tailed) N	1.000 . 137	.52** .003 137
Performance of financial Spearman's Correlation Institutions Sig. (2-tailed)	.52** .003	1.000 .

N	137	137
** Correlation is Significant at the 0.01 (2-tailed) ** Correlation is significant at the 0.05 (1-tailed)		

Source: Field data 2021

Table 4.18 shows a moderate positive correlation between loan recovery procedure and performance of financial institutions (r=0.52; p<0.05). This analysis shows a unit improvement in loan recovery procedure; other factors held constant, performance is likely to increase (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "loan recovery procedure helps in ensuring recovery of the instalments of the principal and interest in case of term loan as per the scheduled repayment program".

4.6.4 Interest rate and performance of financial institutions

Table 4.19: Showing interest rate and performance of financial institutions

Statement	SA (1) (%)	A (2) (%)	N(3) (%)	D (4) (%)	SD (5) (%)	Mean	Standard deviation
Loans with big interest rate tend to turn to NPL	0.7	22.8	33.8	39.7	2.9	3.21	0.856
Charging big interest rate leads to loan default	2.2	17.6	35.3	42.6	2.2	3.25	0.850
Loan price affects loan performance	2.3	42.9	27.1	27.1	0.8	2.81	0.889

Source: Field data 2021

From Table 4.19, only 23.5% (mean 3.21, standard deviation 0.856) of the respondents agree with the statement that loans with big interest rate tend to turn to NPL. In a like manner, only 19.9% (mean 3.25, standard deviation 0.85) of the respondents concur with the argument that charging big interest rate leads to loan default. On the other hand, about 45.1% (mean 2.81, standard deviation 0.89) of the respondents agree that loan price might affect loan performance. However, the average responses to all the factors were close to neutral.

Table 4.20: Correlation results of interest rate and performance

	Interest rate	Performance of financial institutions
Spearman's rho Interest rate Correlation Coefficient Sig. (2-tailed) N	1.000 . 137	.503** .004 137
Performance of financial institutions Spearman's Correlation Sig. (2-tailed) N	.503** .004 137	1.000 . 137
** Correlation is Significant at the 0.01 (2-tailed) ** Correlation is significant at the 0.05 (1-tailed)		

Source: Field data 2021

Table 4.20 shows a moderate positive correlation between interest rate and performance of financial institutions (r=0.503; p<0.05). This analysis shows a unit improvement in interest rate, other factors held constant, is likely to increase performance (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "interest rate is vital to financial institutions because Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. If interest rates rise and a mismatch occur in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities".

4.7 In-depth interview

In order to get deep understanding about the factors affecting non-performing loans, in-depth interviews was conducted with the financial institutions' branch managers and loans officers that had credit experience in addition to their several years of banking experience. The respondents had so many in common as to what they believed caused occurrence of non-performing loans among financial institutions in Kabale district.

Respondents views on Causes of NPL by the interviewees

Respondents indicated several causes to loan default. As per the outcome of the interview the factors were categorized as banks' internal situations, the external environment and borrowers related. The factors are organized and presented under the respective subtitles.

Banks internal factors

Causes of NPL relating to internal inefficiencies due to systems, governance, human resource issues and the related

The interview participants raised the following issues:

Bankers lack of integrity; terms and condition not being set properly; credit analysts capacity limitation; banks' aggressive lending to maximize profit; not conducting know your customers (KYC) principles properly before lending; over-trading/over-financing; not understanding and seeing critically the macroeconomic environment; excessive lending by banks on a particular sector – poor portfolio diversification; poor collateral valuation; inadequate institutional capacity in terms of risk selection; policies that failed to consider the macroeconomic environment; poor monitoring and followup; the credit approval process not being prudent and failing to comply with the existing bank policies; inadequacy of credit risk management-from identifying; measuring and monitoring; poor or no management information system (MIS) and absence check and balance-in loan processing; follow up and monitoring/ follow up.

Customer-related causes of NPL

These are the causes that emanate from borrowers and have strong bearing on occurrences of loan default. Under this aspect, the following were raised:

Fund being directed to unintended purpose; borrowers not making competitive analysis before engaging in a particular sector; business management problems- most of family-owned businesses do not have good management and they also suffer from succession; poor record keeping by businesses; intentional or willful default.

External causes of NPL

These causes were beyond the influence of banks and borrowers and these were presented as follows:

Intervention of external bodies in credit decision making; poor credit culture; macroeconomic factors like inflation; market problems; unavailability of data to conduct project analysis; inadequacy of the supervisory authorities polices- loan classification methodology adopted for both development and commercial banks were similar; and, capacity limitation of the supervisory organ.

CHAPTER FIVE

DISCUSSION, CONCLUSIONS AND RECOMMENDATIONS

5.1 Introduction

The previous chapter presented the results while this chapter is dedicated to the discussion of the research findings, conclusions and recommendations.

5.2 Discussion of the research findings

5.2.1 Objective One: The causes of non-performing loans on financial institutions

As has been stated in chapter one, the broad objective of this study was to identify the causes of non-performing loans on financial institutions. In respect of the causes affecting NPL, the subjective question in the survey and in-depth interviews identified causes such as poor credit assessment, failed loan monitoring, underdeveloped credit culture, lenient credit terms and conditions, aggressive lending, compromised integrity among financial institutions, willful default by borrowers and their knowledge limitation, fund diversion for unintended purpose, over/under-financing by Financial institutions ascribe to the causes of loan default. The study tried to investigate these factors further. In this study, 44% of the respondents agreed that easily admitted borrowers' usual default (Table 4.9). The outcomes of the in-depth interview support this view. The fact that Financial institutions pursue a loose KYC (know your customer) before admitting a new customer indulge them to recruiting a borrower with poor track record, inadequate business management, excessively risky and/or unviable venture that would eventually lead to poor credit performance. The result supports Brownbrige (1998) who stated that easily admitted customer's loan would be damaged at the early stage. The survey also indicated that 97.2% of the respondents agreed with fact that poor risk assessment greatly affects occurrences of loan default. Almost all of the bankers interviewed concurred with this view. Credit assessment deals with a thorough analysis of the five Cs, to help indicate whether to lend or not and how much, under what term and conditions, at what price to lend, to mention a few. Thus, failing to carry out proper risk assessment would lead to missing any or all of the captioned issues, which has a potential for the occurrence on NPL that affects the performance of financial institutions. Muasya (2011) indicated the impact of poor risk assessment on loan quality.

5.2.2 Objective Two: Credit monitoring and recovery strategies adopted by financial institutions

Stating the essentiality of regular monitoring of loan quality, Agrestic et al. (2008) stated that it would help ensure a sound financial system and thereby prevent systemic crises that otherwise would lead to loan default. This survey also confirmed the stated study as 92.7% of the respondents indicated agreement (Table 4.10). Lack of loan follow-up was also one of the top factors rated to contribute to the occurrences of NPL by the survey and interview participants. Naturally the objective of monitoring a loan is to verify whether the basis on which the lending decision was taken continues to hold good and to ascertain the loan funds are being properly utilized for the purpose they were granted. There is also a tendency for borrowers to give more attention to repaying loans if they are properly given attention by financial institutions. Otherwise, borrowers would be tempted to divert the fund to other purposes, as was also learnt through the in-depth interview. Thus failing to monitor loans would lead to default and poor performance. Dash and Kabra (2010) showed that operating efficiency helped explain NPLs. i.e. financial institutions that incur big cost for loan follow-up would have a comparatively lower non-performing loan. Respondents had a neutral view to the statement that financial institutions which allocate higher budget for loan monitoring would have a lower NPL. The essence seems to be having a proper system in place to proactively follow up loans than the magnitude of budget allocated. Security is taken to mitigate the financial institution's risk in the event of default and is considered a secondary source of repayment (Koch & MacDonald, 2003). According to De Lucia and Peters (1998), in the banking environment, security is required, among others, to ensure the full commitment of the borrower, to provide protection should the borrower deviate from the planned course of action outlined at the time credit is extended, and to provide insurance should the borrower default. Though 70% of the survey respondents were of the view that collateralizing loan may protect loan default lest the borrowers lose their pledged properties, the respondents were neutral with the assertion that collateralized loan perform well or non-collateralized loan are usually defaulted. So, the relation between NPL and collateral is neutral (Table 4.11) in view of the respondents.

5.2.3 Objective Three: The relationship between non-performing loans and performance of financial institutions

A study conducted by Al-Khouri (2011) in India indicated that credit orientation significantly affects loan default. Response to four of the questions posed to ascertain the relations between credit orientation and NPL in the survey indicates average agreement (Table 4.12). The in-depth interview also confirmed the outcome of the survey and earlier studies. The socio-economic underdevelopment of the country which is also associated with poor access to formal banking, as depicted by higher branch to population ratio (Awoyemi, 2014) meant that credit culture is yet to develop in Uganda. That was also why financial institutions had comparatively big NPL ratio. There is a Ugandan proverb "either a borrower or a lender might die" implying a borrower should not bother to repay loans. Thus, cultural development has got huge bearing on loan performance. The study indicated that 87.4% of the respondents agreed that lenient / lax credit terms cause loan default (Table 4.14). Limitation in capacity of credit operators is the cause for poor assessment. Shallow assessment would fail to indicate terms and conditions of loan properly, among others. This might mean loan disbursement might not be made timely; grace period may not be given properly, repayment amount set wrongly without considering the cash flow. Either of these or related would lead to poor loan performance. Thus, the failure to put appropriate terms and conditions would lead to loan default. Al-Khouri (2011) who studied the Indian commercial financial institutions also found out that terms of credit determine occurrence of non-performing loans. Jimenez and Saurina (2005) also indicated that NPLs are determined by lenient credit terms. The study by Phillips and Reichart (2010) conducted on the Spanish banking sector from 1984 to 2003 evidences that NPLs are determined by poor measures on debt recovery. This is one of the top-rated factors by respondents from six financial institutions out of the ten surveyed ones in subjective questions of the survey. Besides, 83.6% of the respondents agreed that compromised integrity would cause occurrences of NPL (Table 4.15). The same has been confirmed by interviewee participants. Bank managers at times indulge in a moral hazard that they grant loans to those who do not meet the criteria set. Such loans would hardly be repaid. A study by Mombo (2017) indicated that high interest rate charged by banks is associated with loan defaults. This study fails to support this finding in that average response to the assertion that loans with big interest rate would turn to be defaulted was neutral (Table 4.13). None of the interview participants believed that interest rate is related to occurrences of loan default in the financial institutions' context. One line of argument could be that the interest rate charged is comparatively smaller. For example, according to NBE (2011) the price index for non-energy commodity was 29% higher than a year before at the beginning of the year 2011, whereas the

average lending rate was only 12.25% for the year 2010/11. On the other hand, business might also have big profit margin that interest payment on loans could not be an issue to cause loan default (this requires a further study). Salas and Saurina (2002) who studied Spanish Financial institutions found out that credit growth is associated with non-performing loans. Of the survey participants, 38.7% had a neutral view of the idea that credit growth is related to NPL (Table 4.15). The documentary analysis also depicted that Pearson correlation at 0.05 level of significance between credit size and NPL is very weak. Nor did the in-depth interview confirm the literature in this line. Despite the fact that the survey results supported earlier studies on some factors, the subjective questions in the survey and in-depth interview conducted revealed more findings which also might provide insights for further studies. The factors thought to contribute to occurrences of NPL in this light include: fund diversion for unintended purpose, over /under-financing, unfair competition among financial institutions, compromised integrity, willful default, inadequacy institutional competence, credit operators' low level of competence, borrower's skill gap, policy environment (supervisory), among others. In fact, some of these findings might be categorized as part of result of earlier studies. For example, categorizing fund diversion, over/under-financing under poor credit assessment and categorizing others in a similar manner. However, studying each of the aforementioned factors independently would shed more light on understanding factors that determine occurrences of non-performing loans.

The research also indicated that over-financing due to poor credit assessment, compromised integrity of credit operators were the causes of incidences of NPL. In fact, cases of under financing loan requirement that meant shortage of working capital or not being able to meet planned targets were associated with defaults. In addition, the study also found out that due to underdevelopment of credit orientation /culture borrowers engaged in business which they had no deep knowledge of, diverted loans advanced for unintended purpose and at times made a willful default. The study also depicted that unfair competition among the financial institutions along with the aggressive lending pursued added to the poor customer selection made in a motive to maximize profit by the banks and/ or due to the moral hazard or compromised integrity were the other causes for the loan defaults that affect profitability.

Basing on findings in Table 4.14 above in chapter four, a moderate positive correlation between loan appraisal and performance of Performance of Financial Institutions (r=0.501, p<0.05). This

analysis shows a unit improvement in loan appraisal, other factors held constant, is likely to increase performance (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "loan appraisal is vital for financial institutions since it tests on accuracy, collaterals, honesty, capacity and cash flow to determine lane's credit worthiness and the probability of loans default". Another respondent said that "loan appraisal assists institutions to identify borrowers who might have falsified their past business performance records in order to obtain loans would not be able to repay easily later".Basing on table 4.16 above, a moderate positive correlation between credit policy and performance of financial institutions (r=0.441; p<0.05). This analysis shows a unit improvement in credit policy, other factors held constant, performance is likely to increase (r squared, coefficient of variation).

This analysis was also confirmed by key informants who revealed that "credit policy deal with the issue of knowing the customer, customarily known as KYC (Know Your Customer) is so vital before proceeding to details. Financial institutions use various means to obtain such information about the existing or potential customer like use of financial statement, credit report from credit bureau, customers' history if not new as the potential sources of information. From Table 4.18 in chapter four above, a moderate positive correlation exists between loan recovery procedure and performance of financial institutions (r=0.52; p<0.05). This analysis shows a unit improvement in loan recovery procedure, other factors held constant, performance is likely to increase (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "loan recovery procedure helps in ensuring recovery of the installments of the principal and interest in case of term loan as per the scheduled repayment program". From Table 4.20 in chapter four above, the study showed a moderate positive correlation between interest rate and performance of financial institutions (r=0.503; p<0.05).

This analysis shows a unit improvement in interest rate, other factors held constant, is likely to increase performance (r squared, coefficient of variation). This analysis was also confirmed by key informants who revealed that "interest rate is vital to financial institutions because Interest rate risk arises from the possibility of a change in the value of assets and liabilities in response to changes in market interest rates. If interest rates rise and a mismatch occur in maturities by holding longer-term assets than liabilities, the market value of the assets will decline by a larger amount than the liabilities".

5.3 Conclusions

The broad objective of this research was to identify the causes of non-performing loans. Based on the broad objective, a number of specific research questions were developed. To achieve this broad objective, the study used mixed research approach.

More specifically, the study used survey of employees of banks and unstructured interview of branch managers and loans officers. The results showed that, based on the respondents' views, it was evident that most likely factors that affect occurrences of nonperforming loans among financial institutions in Kabale district are presented in the paragraphs that follow.

The study indicated that poor credit assessment ascribing to capacity limitation of credit operators, institutional capacity drawbacks and setting terms and conditions that were not practical and/or not properly discussed with borrowers had been the cause for occurrences of loan default. Besides, despite the fact that credit monitoring / follow-up plays pivotal role to ensure loan collection failure to do this properly was also found to be cause for sick loans.

The research also indicated that over-financing due to poor credit assessment, interest rate banks charge, limited working capital, debt to equity, inventory turnover and compromised integrity of credit operators were the causes of incidences of NPL. In fact, cases of under-financing loan requirement that meant shortage of working capital or not being able to meet planned targets were associated with defaults.

In addition, the study also found out that due to underdevelopment of credit orientation /culture, borrowers engaged in business that they had no deep knowledge of, diverted loans advanced for unintended purpose and at times made a willful default.

The study also depicted that unfair competition among the banks along with the aggressive lending pursued added to the poor customer selection made in a motive to maximize profit by the banks and/ or due to the moral hazard or compromised integrity were the other causes for the loan defaults. In-depth interviews also indicated that underdevelopment of supervisory authority competence in formulating policies, monitoring capability also ascribe to occurrences of non-performing loans earlier.

On the other hand, the study did not support the existing literature that state occurrences of NPL is related to bank's size, and ownership type of banks.

5.4 Recommendations

After close examination and analysis of the research findings, the following recommendations are suggested:

i. As loans would contribute to the development of an economy and its default leads to the episode of huge loss of financial institutions, deliberate effort should be exerted in developing the culture of the public towards credit and its management by individual banks, Uganda Bankers Association, Uganda Public Financial Institutions Agency and others.

ii. Financial institutions should put in place a vibrant credit process that would encompass issues of proper customer selection, robust credit analysis, authentic sanctioning process, proactive monitoring and followup and clear recovery strategies for sick loans.

iii. Financial institutions should put in place a clear policy framework that addresses issues of conflict of interest, ethical standards, check and balance in decision making process for all those involved in the credit process to ensure its implementation thereof.

iv. Financial institutions should pursue a balanced approach of profit maximization and risk management lest they engage in aggressive lending and unhealthy competition that would lead to selecting borrowers that would default.

v. Financial institutions should give the due emphasis it takes to develop the competence of credit operators, information system management pertaining to credit and efficiency of the credit process.

vi. As loans would contribute to the development of an economy and their default leads to the episode of huge loss to financial institutions and the country; deliberate effort should be exerted in developing the culture of the public towards credit and its management by individual institutions.

vii. Financial institutions in Kabale should ensure aggressive sensitization of clients about the dangers of not paying their loans on time -- for example, distortion of the curb history of clients --- and also ensure that there is reduced bureaucracy in loan processing to reduce on the paranoia of clients, thus reducing NPLs in Kabale district.

5.5 Recommendations for further studies

i.   A study on the impact of employee/ customer care relationship and non-performing loans in financial institutions of Uganda

ii.   In addition, assessing the statistical relationship between employee motivation and non-performing loans in Uganda could be a future research agenda.

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Appendix I: Questionnaire employees

Dear Respondent,

I am SemusuAlex a student of Kabale University conducting a study titled "The impact of non-performing loans on the performance of financial institutions in Kabale district" in partial fulfillment for the award of Master's Degree in business administration of Kabale University.

You have been selected to participate and give your responses that will only be used for academic purposes and treated with utmost confidentiality.

Thank you for sparing your time and accept to participate in this study.

Please tick the boxes accordingly.

Section A: Bio data

1. Sex:

    i.   Male   [ ]

   ii.   Female   [ ]

2. Age:

    i.   Below 25 years   [ ]

   ii.   25 – 35 years   [ ]

  iii.   36 – 45 years   [ ]

  iv.   46 – 55 years   [ ]

   v.   56 years and above   [ ]

3. Highest Level of education:

    i.   Diploma   [ ]

   ii.   Undergraduate degree   [ ]

  iii.   Master's degree   [ ]

  iv.   Doctorate   [ ]

Other: Please specify……………………………………………………………………………….

4. What is your current position in this financial institution?

    i.   Relationship manager   [ ]

   ii.   Credit analyst   [ ]

iii.   Recovery/ monitoring officer   [ ]

iv.   Credit Manager   [ ]

v.   Administrator   [ ]

Other: Please specify………………………………………………………………………..

5. Experience of service in financial institutions?

i.   Less than 5 years   [ ]

ii.   6 – 10 years   [ ]

iii.   11 – 15 years   [ ]

iv.   16 – 20 years   [ ]

v.   Over 20 years   [ ]

Section B: The causes of non-performing loans on financial institutions

6. How do this financial institution evaluate customers for loans?

i.   Account turnover and cash flow   [ ]

ii.   Ability to service loan   [ ]

iii.   Request for collaterals   [ ]

iv.   Portfolio at risk   [ ]

v.   Profitability of the bank   [ ]

vi.   Calculating debt ratio   [ ]

Others specify …………………………………………………………..………………….

7. Please rank the factors that cause occurrence of nonperforming loans

N.B Rank the factors in order of their importance in contributing to the occurrence of Nonperforming loans from 1-8

Factor that causes occurrence of nonperforming loans	Rank 1=highest ……8=lowest
Credit policy	
High interest rate	
Loan appraisal	
Credit culture / Orientation	
Size of the Bank	
Loan recovery procedure	
Ownership type of bank	

Poor risk assessment	

Others specify …………………………………………………………………………………

8. Please indicate your degree of agreement or disagreement to the statements pertaining to credit assessment and the occurrence of NPL

Please tick in the box the option that best explains your opinion by either strongly agree 1, agree 2, undecided 3, disagree 4, strongly disagree 5

Scale	Strongly agree	Agree	Undecided	Disagree	Strongly disagree
	1	2	3	4	5

Credit assessment	1	2	3	4	5
Easily admitted borrowers usually default					
Know Your Customer policy of banks lead to high loans quality					
Good loan underwriting ensures loan performance					
Poor risk assessment would lead to loan default					

Others specify …………………………………………………………………………………

Section C: Credit monitoring and recovery strategies

11. Please indicate your degree of agreement or disagreement to the statements pertaining to credit monitoring and the occurrence of NPL

Credit monitoring	1	2	3	4	5
Strict monitoring ensures loan performance					
Poorly assessed and advanced loans may perform well if properly monitored					
Loan follow up is directly related to occurrence of nonperforming loans					

Banks with higher budget for loan monitoring have lower non-performing loans					

Others specify ……………………………………………………………………………

12. Please indicate your degree of agreement or disagreement to the statements pertaining to Collateral and the occurrence of NPL

Performance of collateral loan	1	2	3	4	5
Collateralized loans perform well					
Collateralizing loans help protect loan default					
Most of the time non-collateralized loans are defaulted					

Others specify ……………………………………………………………………………

13. Please indicate your degree of agreement or disagreement to the statements pertaining to borrower's orientation and the occurrence of NPL

Borrowers orientation	1	2	3	4	5
Borrower's orientation/culture is related to loan performance					
There is a relationship between loan default and borrower's culture					
Default in some area is ascribed to the culture of the borrowers					
Society's cultural development leads to good loan performance					

Others specify ……………………………………………………………………………

14. Please indicate your degree of agreement or disagreement to the statements pertaining to Cost of loan and loan default

	1	2	3	4	5
Loans with big interest rate tend to turn to NPL					
Charging big interest rate leads to loan default					
Loan price affects loan performance					

Others specify …………………………………………………………………………

15. Please indicate your degree of agreement or disagreement to the statements pertaining to Credit terms and loan performance

	1	2	3	4	5
Lenient / lax credit term cause loan default					
Borrowers default because they don't understand credit terms well					
Poorly negotiated credit terms lead to loan non-performance					

Others specify …………………………………………………………………………

Section D: Relationship between non-performing loans and performance of financial institutions

16. Please indicate your degree of agreement or disagreement to the statements pertaining to Credit size and the occurrence of NPL

Credit size	1	2	3	4	5
Aggressive lending leads to large NPL volume/ratio					

Financial institutions whose credit growth is rapid experience huge NPL level					
Bank's great risk appetite is cause for NPL					
Compromised integrity in lending leads to loan default					

Others specify …………………………………………………………………………

17.Please indicate your degree of agreement or disagreement to the statements pertaining to Size of financial institution and occurrence on NPL

	1	2	3	4	5
Having large number of borrowers causes loan default					
Loans default rate is directly related to financial institutions' size					
With growth in financial institutions' size comes growth on NPL					

Others specify …………………………………………………………………………

End

Appendix II: Interview Guide for administrators

Dear Respondent,

I am SemusuAlex a student of Kabale University conducting a study titled "The impact of non-performing loans on the performance of financial institutions in Kabale district" in partial fulfillment for the award of Master's Degree in business administration of Kabale University.

You have been selected to participate and give your responses that will only be used for academic purposes and treated with utmost confidentiality.

Thank you for sparing your time and accept to participate in this study.

1. What is your position in this financial institution?

....

2. How long have you been in this financial institution?

....

3. What types of credit facilities are normally applied for in your bank and how have they contributed to the loan recovery?

…………………………………………………………………………………………………

4. What is the application procedure for Loans in this financial institution?

…………………………………………………………………………………………………

5. What documents are normally requested for before a loan is acquired?

....

6. What is normally the duration of your Loans?

…………...

7. How is the loan default rate in this financial institution?

…………………………………………………………………………………………………

8. How has the loan default rate affected your financial institutions operations?

…………………………………………………………………………………………………

9. In your opinion, what are the main causes of loan defaults in this financial institution?

…………………………………………………………………………………………………

10. What are credit motoring and recovery strategies of loan recovery in this financial institution?

....

11. How often do credit policies reviewed and what effect has it had on the performance of the loan book?

…………………………………………………………………………………………………

What factors hinder effective monitoring of loans by Credit Officers?

…………………………………………………………………………………………………

12. What are the official procedures undertaken by financial institutions to recover loans in default?

…………………………………………………………………………………………………

13. What measures should management put in place to reduce on loan defaults? What strategies do your financial institution undertaking to help reduce on its NPLs?

………………………………………………………………………………………………

Thank you

Appendix III: Sample size determination table

N	S	N	S	N	S
10	10	220	140	1200	291
15	14	230	144	1300	297
20	19	240	148	1400	302
25	24	250	152	1500	306
30	28	260	155	1600	310
35	32	270	159	1700	313
40	36	280	162	1800	317
45	40	290	165	1900	320
50	44	300	169	2000	322
55	48	320	175	2200	327
60	52	340	181	2400	331
65	56	360	186	2600	335
70	59	380	191	2800	338
75	63	400	196	3000	341
80	66	420	201	3500	346
85	70	440	205	4000	351
90	73	460	210	4500	354
95	76	480	214	5000	357
100	80	500	217	6000	361
110	86	550	226	7000	364
120	92	600	234	8000	367
130	97	650	242	9000	368
140	103	700	248	10000	370
150	108	750	254	15000	375
160	113	800	260	20000	377
170	118	850	265	30000	379
180	123	900	269	40000	380
190	127	950	274	50000	381
200	132	1000	278	75000	382
210	136	1100	285	1000000	384

Note.—N is population size. S is sample size.

Source: Krejcie & Morgan, 1970