CAUSES OF LOAN DEFAULTS IN PAKISTANI BANKS: A CASE STUDY OF DISTRICT D.G. KHAN

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ABSTRACT- *This study investigates the causes of loan default, and its impact on the profitability of the Pakistani banking sector. To find the answers of the questionnaires 100 respondents were selected through purposive sampling. The results of the study show that major causes of client's loan default are Lack of business management knowledge, ineffective monitoring, delayed loan approvals, poor weather conditions, poor credit appraisals, and unwillingness of clients to repay the loans. These loan defaults negatively affect the profitability and interest income of Pakistani commercial banks. The study also identifies that the major categories of clients who normally defaulted are traders and farmers. The study suggests that effective borrower's screening, preparation of simple project appraisal reports, providing business advisory services to customers, reduction of interest rates can be helpful to mitigate the loan defaults in Pakistani commercial banks.*

Key words: Loans defaults, management, knowledge, ineffective monitoring, credit appraisals.

1. INTRODUCTION

Financial institutions play an important role in the economic growth of the country. They help to increase the national wealth of the economy through the optimal allocation of resources. Efficient allocation of capital in an economy would support economic growth. No one can deny the importance of financial institutions in any developed or developing country, these financial institutions not only float the credit flow in the economy but also enhance the productivity by invigorating the investment. Economic growth in any country is not possible without a sound financial sector. Like every country of the world, the banking sector is also playing an important role in Pakistan economy. The major function of the banks is to accept deposits and award loans to the customers. The bank charges a higher interest rate on loans as compared to the interest rate that banks pay on deposits. This variation of interest rate is actually profit received by the banks. [1].

Loans and advances for financing to customers by banks vary in size, which range from micro to macro financing. Banks provide personal and institutional loans to their customers. In both personal and institutional loans, there is a failure rate regarding to repay. This does not mean that all lending on the part of banks have been bad. Before awarding the loans to their customers financial institutions make their credit assessment, which is very important for their survival. Borrower's default risk is one of the major concerns for the financial institutions and as such accurately assessing all the relevant risks which are associated with loans will surely enhance the market efficiency of the banks [2].

Loan default is a problem that every bank is facing now a day all over the world. A loan default not only affects the profitability of banks, but also affects the economic condition of the country. Banking sector in underdeveloped countries is facing a lot of problems; similar is the case in Pakistan. The most destructive problem faced by the Pakistani banking sector is a huge amount of non-performing loans which not only harming the banking industry in Pakistan but also hampering the economic condition of Pakistan [3].

Loan default is the common practice in Pakistan because most of loans are given on political basis. Political interference in the affairs of banks should be removed through legislation [4]. Consumer financing is very complicated process and it need in-depth loan appraisal procedures. An awareness must be created regarding timely payment of loans. Awan and Ameen mentioned that industrial projects are not thoroughly evaluated before financing them and loans are lent on personal relations. This is one of the main causes of loans default [5].

The decade of 1990s was very difficult period for banking sectors because most of investment banks, leasing and investment companies were become bankrupt during this period while big commercial banks resorted retrenchment of employees and closure of loss-making branches to reduce their losses, which were mostly occurred due to non-performing loans. In spite of recovering defaulted loans, the Central Bank allowed commercial banks to write off billions of rupees loans [6],[7].

The study on microfinance loans default in Kenya shows that most of the small loans were defaulted due to non-supervision of the borrowers from MFIs, inadequate training of borrowers before they receive loans and spending of received loans by borrowers in projects other than agreed ones. [8].

A study was conducted to determine the probability of agriculture loans by a French Bank. The findings of the study showed that length of time for loan, liquidity, profitability and leverage were important determinants of agricultural loan defaults. The study also suggested that it would be very beneficial to banks and financial institutions to develop a specific model for each type of collateral [9].

The results of a study to determine the factors affecting loan repayments of agricultural credits in District Kasur of Punjab province. It was concluded that miss-utilization of agricultural loans, sloppy supervision of the bank officers, change of business and residual place from borrowers, and high interest rates were major causes of delay in payments on agricultural loans in District Kasur [10].

According to [11] the determinants of loan defaults different financial ratios such as current ratio, liquidity ratio, leverage ratio, profitability ratio and ratio of loan to total assets were found very helpful. The chances of loan default decreases if the size of the firm getting larger and chances of loan defaults increased if the size of the loan increased relative to those SMEs.

The economic impact of non-performing loans is very serious. The interest rate, Inflation, Unemployment, Energy crises, and Exchange rate have a significant positive relationship with NPLs, and GDP has a significant negative relationship with NPLs in Pakistani banking sector [12].

In Pakistan different studies have been conducted to observe the economic determinants of non-performing loans in which impact of interest rates, energy crises, unemployment, inflation, GDP and exchange rate were focused. Similarly, factors affecting the loan repayment in agriculture sector and SMEs loans defaults have also been studied. Keeping in view the above perspective, the author has focused on to determine the major causes of loans defaults from the banker's and borrower's point of view by giving these causes ranks according to their importance and their impact on the profitability of Pakistani banks.

Banks in Pakistan are also playing a key role to strengthen Pakistan economy. The major source of profitability of these banks is advancing loans that involve risk of defaults. So these institutions should be keen in order to determine the causes of defaults and make policies to overcome such problems.

Research Objectives

- To identify and examine the causes of loan defaults in the Pakistani banking sector and its impact on the profitability of Pakistani banks.
- To identify the different ways through which loan defaults in Pakistani banks can be minimized.
- To identify the categories of clients who normally defaults.

2. METHODOLOGY

Population

The population of the study consists of the entire staff and credit department of entire Pakistani industry who have rich experience in loan activities so they can better respond to questions. It also encompasses the borrowers who enjoyed the loan facilities from these banks during 2008-2012. The researcher chooses these borrowers by the lists provided by these banks.

Sample and Sampling Procedure for Data Collection

The 100 respondents were selected, which comprises of 60 loan borrowers and 40 bank officers. The bank officers were selected from HBL, UBL, ABL, MCB, and NBP because these banks are working in Pakistan from last 35 years and have a major share in the Pakistani banking industry. Purposive sampling was used for the selection of bank officers and defaulters. As researcher knows the local language of DG. Khan very well, so he felt no difficulty to understand the viewpoints of clients even they could not read and write to the response of a questionnaire.

Research Instruments

The questionnaire is adapted from a similar study conducted in Ghana. But some changes have been made according to Pakistani culture [13]. The Questionnaire consisted of the questions that reflect the characteristics of the respondents like gender, marital status, age, education and their family size. Both Structured and dichotomous questions used to get the response of the borrowers and bank's staff. Specific questions with a fixed range of answers were used in the instrument. The Ranking scale was used to ask the respondents to give rank for different questions according to their priority. The questionnaires distributed to bank staff who involved in any loan activities from 2008-2012 and to the clients were selected with consultation of the bank officers. The researcher visited the clients personally and gets their response through questionnaires. The borrowers were also assured that they're providing information will be used only for research purpose and will be confidential. The researcher also used secondary sources as different loans default thesis, articles, magazines, internet and financial reports of the banks to provide support the study.

Data Collection

The data were collected from the bank's staff of five banks which are included in study by taking appointment so they shall be relaxed and provide correct information. The researcher also used personal contacts for meetings with some bank officers. The researcher also selected the clients with the bank officers' consultation and personally visited the borrowers for getting their responses related to the questions.

Statistical Package for Social Sciences (SPSS) and Microsoft Excel were used to analyze the data. Analysis of data is effectively descriptive. Statistical techniques such as frequencies, percentages, means, and standard deviation used to analyze the data and inferential statistics were also applied. Minimum score, maximum score, sum of scores, mean scores, and standard deviations were calculated for each cause of loan defaults. Tables and graphs also used for the presentation of results. Groups are made on the basis of different variables means. Different variables are tabulated in the same groups on the basis of their mean scores, which lies in specific ranges. For example, variables whose mean score lies in the range of (1- 1.99, 2- 2.99, 3- 3.99, 4- 4.99, 5- 5.99, 6- 6.99, 7- 7.99, 8- 8.99, 9- 9.99, 10- 11) are kept in the same group. After grouping these variables Wilcoxon signed rank test is also applied to observe the difference between these groups.

Table 1: Frequency distribution of causes of bad loans (bankers view)

Data Analysis

	N	Minimum	Maximum	Sum	Mean	Std. Deviation	Ranking
a	40	1.00	9.00	194.00	4.85	2.74	2nd
b	40	1.00	10.00	194.00	4.85	3.39	2nd
c	40	5.00	11.00	378.00	9.45	1.79	8th
c	40	4.00	10.00	270.00	6.75	2.65	7th
e	40	1.00	10.00	224.00	5.60	2.80	5th
f	40	7.00	11.00	386.00	9.65	1.42	9th
g	40	1.00	7.00	134.00	3.35	1.84	1st
h	40	1.00	11.00	194.00	4.85	3.23	2nd
i	40	2.00	11.00	248.00	6.20	3.15	6th
J	40	2.00	9.00	216.00	5.40	2.16	4th
k	40	1.00	9.00	202.00	5.05	2.82	3rd

3. RESULTS AND DISCUSSION

Statistical Package for Social Sciences (SPSS) was used to analyze the data and different causes of loans defaults were ranked according to their mean score. The respondents were asked to select from 1 to 11 with 1 being most important and 11 being the least important cause of loan defaults. The table 1 shows the causes of bad loans, according to the banker, s view.

The results of the study identified that ineffective monitoring of credit officers ranked 1st with the lowest average of 3.35, with getting a maximum score of 1, minimum score of 7 and total score of 134. Monitoring of loans is a very important function of management. Negligence in this important issue hurts the performance of banks in the form of loan defaults. Poor credit appraisal,

delayed loan approval and lack of business management knowledge were ranked 2nd. All these factors got similar average value of 4.85. Unwillingness of clients to repay the loans got rank 3rd with 1 and 9 as maximum and minimum values respectively and average score of 5.05. Terms of the loan was ranked by 4th among the major causes of loan defaults with a mean value of 5.40 and with maximum and minimum values of 2 and 9 respectively. Poor weather conditions ranked as a 5th major cause of loans defaults with 1 and 10 as maximum and minimum values and average score of 9.65 followed by non-compliance with credit policy, under financing, diversion of loans and marketing problems as ranked 6th, 7th, 8th and 9th respectively. The frequency tables identified the mean scores given by the bank officers for each cause of bad loans. The results of the research showed that the major cause of loan default was the ineffective monitoring of the credit officers followed by delayed approval of loans, poor credit appraisal, and lack of business management knowledge as the other important factors that led to loans default. These results can be seen with the help of graph as given below:-

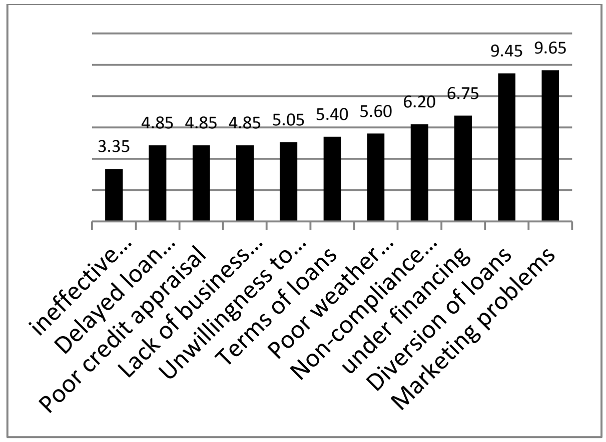


Figure 1: Causes of Loan Default

The result identified that with the lowest average score of 1.95 proper monitoring was ranked 1st, with getting maximum rank of first and lowest rank of fifth and total score of 78. Timely loan approval ranked 2nd, with the maximum rank of first and minimum rank of four and with the average score of 2. The reduction in interest rate ranked 3rd with an average score of 3.20. Providing training to credit officers was ranked 4th with a mean score of 3.65 followed by extension, of loan repayment period, which was ranked 5th with highest mean value of 2. These results through graph can be shown as:-

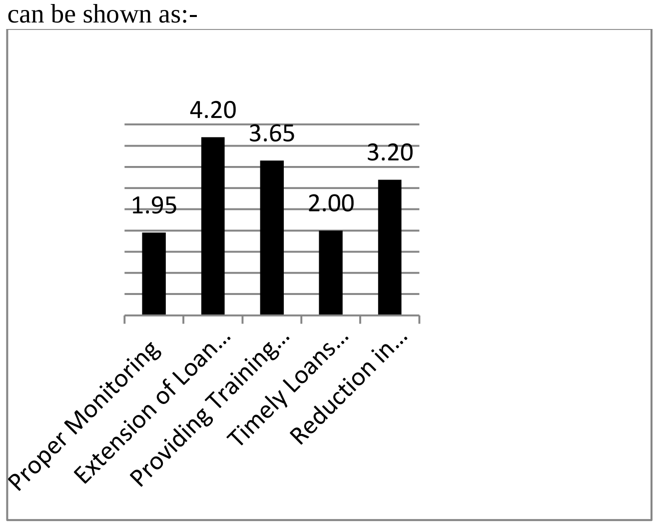


Figure 2. Measures to reduce loan defaults

A Wilcoxon signed rank test applied to the data collected for the groups (a and d) confirms the difference between these two groups is non-significant (z =-. 211, p =. 833). This test also identified that difference between groups (d and ce) is significant (z = -3.029 , p = .002) whereas the difference between groups (ce and b) is marginally significant (z = -2.005 , p = .045).

Reasons of loans default (Customer' view)

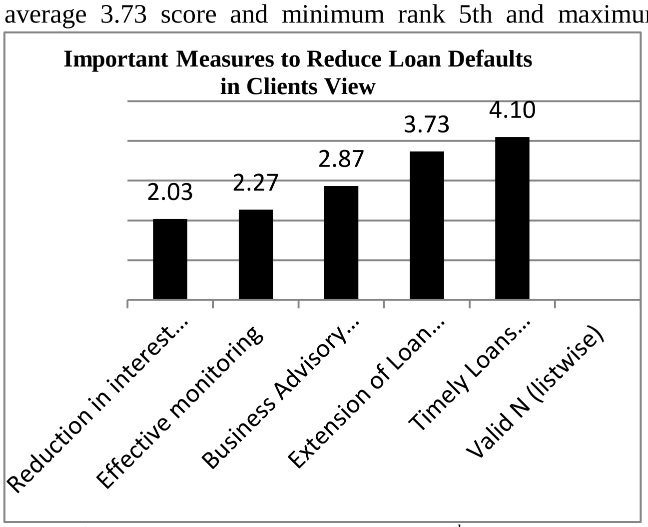
The analysis of the data provided by the borrowers show that 10 borrower (16.7 %) were defaulted because of delayed approval of their loans and they could not utilize their loans properly well-in-time. Four borrowers (6.7%) borrowers defaulted because of poor credit appraisal, equally borrowers defaulted because of diversion of loans. The data show that 14 borrowers (23.3 %) were defaulted because of poor weather conditions. Six (10%) of the loan defaults occurred because of poor monitoring by the credit officers. 14 (23.3%) borrowers defaulted because of lack of business management knowledge with their respective fields and 6 (10%) did not return loans in time because of their unwillingness to repay the loans. Therefore, the results of the study categorically identified that the majority of the loan defaults occurred because of poor weather conditions and lack of business management knowledge (see table 3).

Reduction in interest rate ranked 1st with an average score of 2.03 with a minimum rank of 5th and maximum rank of 1st respectively. Effective monitoring was ranked 2nd with a mean score of 2.27 with getting a minimum rank 5th and

Figure 3 How to reduce loan default (Customers' view)

maximum rank 1st. A business advisory service was ranked 3rd with getting minimum rank 5th and maximum rank 1st with average score 2.86.

Extension of loan repayment period ranked 4th with an average 3.73 score and minimum rank 5th and maximum



rank 1st.Timely loan disbursement got 5th rank with a total score 246 and maximum rank of 2nd and minimum rank of 5th. This fact has been highlighted in the Figure 3.

A Wilcoxon signed rank test applied to the collected data for groups (d and abc) shows that the difference between these two groups is strongly significant ($z = -3.367$, $p = .001$) whereas the difference between groups (c and d) is also significant ($z = -1.160$, $p = 0.246$).

Findings

The specific objective of the study was to determine the causes of loan defaults and their impact on the profitability of Pakistani banks. The findings of the study identified the major determinants of loan defaults which include Lack of business management knowledge, ineffective monitoring, delayed loan approvals, poor weather conditions, poor credit appraisals, and unwillingness of clients to repay the loans. The study revealed that NPLs provisions strongly reduced the interest income of the commercial banks of Pakistan. However, their most negative effect on the interest income of the banks seen in 2009 when the provisions for bad loans reduced the interest income of ABL, UBL, and MCB around 16.91%, 29.43% and 16.22% respectively. Provisions for NPLs also declined the interest income of HBL and NBP around 19.86% and 29.48% correspondingly. The findings also showed the strong negative effect of the bad loans on the profitability of commercial banks of Pakistan; however, its most horrible impact on the profitability of the banks can be seen during the same period of 2009 when they reduced the operating profits of ABL to 42.9% and MCB to 33.39%. In the same year NPLs reduced the operating profits of HBL to 73.86% and NBP to 107.67%. During this period bad loan provisions hammered the profitability of UBL by reducing its operating profit to 218.15%. All these results are identified

Table 3 Measures to reduce loan defaults (Customer's View)

		a	b	c	d	e
N	Valid	60	60	60	60	60
	Missing	0	0	0	0	0
Mean		2.27	2.03	4.10	3.73	2.86
Std. Dev.		1.17	1.22	.84	1.34	1.27
Minimum		1.00	1.00	2.00	1.00	1.00
Maximum		5.00	5.00	5.00	5.00	5.00
Sum		136	122	246	224	172
Ranking		2nd	1st	5th	4th	3rd

that management must take important measures to mitigate these loan defaults in order to strength their financial position. It is also important to note that majority of the borrowers who defaulted were engaged in agriculture and business/trading activities.

4. CONCLUSIONS

We conclude from the above discussion that very little attention is paid on the monitoring of loans utilization and this is the main reason that the loans amount is miss-utilized and consequently default is occurred. Non-performing loans (NPLs) do not only reduce interest income and profitability of the banks but also create liquidity problems for them**.** The bankers will have to bear other unnecessary cost like wastage of stationary, courier charges, and payment of legal counsel for corresponding and initiating legal proceeding against the willful defaulters. Similarly, a lot of human efforts are wasted during recovery campaign of defaulted loans.

The following recommendations are made to decrease the ratio of loan defaults.

- An effective mechanism for the borrower's screening must be insured, because information Asymmetry always remains a major cause for loans default.
- The banks must get information about the previous repayment behavior of borrowers before sanctioning of loans.
- The banks should give loans on the basis of entrepreneurial skills and credit worthiness of borrowers rather than fixing debt to equity ratio.
- The credit officers should visit project sites properly in order to make sure that borrowers are utilizing their loans in agreed purposes.
- The banks should arrange continuous training programs for credit officers in order to enhance their credit skills like preparation of excellent project appraisal reports,

monitoring of loan activities and overcoming the delayed loan approval problems.

- Beside another important way to reduce loan defaults the banks should provide business advisory services to their customers, because most of the loan defaults occur due to lack of business management knowledge of borrowers. Because lack of business management knowledge the borrowers went for a loss and could not return the borrowed amount on time.
- Banks should provide facilities to their credit officers for proper monitoring of loan activities like vehicles, required relevant staff, and logistics that can be helpful in proper monitoring of loans.
- As agriculture and business loans resulted huge amounts of loan defaults so banks should look at other types of loans like overdraft and salary loans.
- Most of the borrowers were anxious for high interest rate charged by the banks, therefore banks should reduce interest rates in order to reduce loan defaults.

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