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ASSESSMENT OF LOAN DEFAULTS AND ITS IMPACTS ON THE PROFITABILITY OF BANKS IN GALLE, SRI LANKA

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ABSTRACT

Purpose of the study: Assessment of loan defaults and its impacts on the profitability of banks in Galle, Sri Lanka. Default occurs when a borrower does not uphold their legal commitments by making the required payments on time or by breaking one of the conditions of the loan arrangement.

Methodology: The study was literature based. A literature-based study is a type of research that involves analyzing and synthesizing existing published literature on a specific topic. Instead of conducting new experiments or collecting primary data, researchers gather and evaluate relevant studies, books, articles, and other sources to gain a comprehensive understanding of the subject.

Findings: The study revealed that when borrowers default on their loans, banks are unable to collect the principal and interest payments that they expected, which can result in significant losses. Earnings of shareholders suffer as a result of loan defaults. Dividend payments are made in accordance with the bank's net profit performance. Loan defaults have a negative impact on financial institution profitability and the amount of dividend paid to shareholders is usually affected. Poor management is one of the major reasons of loan issues.

Conclusion: It is concluded that loan defaults have significant negative impacts on the profitability of banks. When borrowers default on their loans, banks are unable to collect the expected principal and interest payments, which can result in significant losses.

Recommendations: The study recommended that banks should develop and implement robust credit risk management processes to identify and mitigate potential credit risks. Banks should also diversify their loan portfolios to reduce concentration risk meaning that they should not lend to a limited number of borrowers or industries. Banks should regularly review their loan portfolios to identify potential NPAs and take necessary actions to mitigate them by restructuring loans, rescheduling repayments, and recovering overdue payments.

Keywords: *Loan defaults, profitability, banks, Sri Lanka*

INTRODUCTION

Sri Lanka has a well-developed banking sector, with both local and foreign banks operating in the country (Issath Nimsith, Nusrathullah & Haleem, 2019). The Central Bank of Sri Lanka is the primary regulatory authority for banks in the country. Some of the major local banks in Sri Lanka include: Bank of Ceylon which is the largest bank in Sri Lanka in terms of assets, and offers a wide range of banking and financial services to both retail and corporate customers, People's Bank is the second largest bank in Sri Lanka in terms of assets, and offers a wide range of banking and financial services to individuals, businesses, and government institutions, Commercial Bank of Ceylon is one of the largest private sector banks in Sri Lanka, offering a range of retail and corporate banking products and services, Hatton National Bank one of the fastest-growing banks in Sri Lanka, providing a wide range of financial services to both retail and corporate customers and Sampath Bank which is a rapidly growing bank in Sri Lanka, offering a range of banking and financial services to both individuals and businesses. In addition to these local banks, several foreign banks also operate in Sri Lanka, including HSBC, Standard Chartered Bank, and Citibank (Hassan & Parvez, 2022). These banks provide a range of international banking services to customers in Sri Lanka.

Banks are financial institutions that primarily engage in the business of borrowing, lending, and investing money (Park & Kim, 2020). The profitability of banks can vary widely depending on a variety of factors, such as the interest rates they charge on loans, the fees they charge for services, the quality of their loan portfolio, and the efficiency of their operations. Among the main sources of profitability for banks is the interest income they earn from loans. Banks typically lend money at a higher interest rate than the rate at which they borrow money, which allows them to earn a spread or margin on the interest income (Benkovskis, Tkacevs & Vilerts, 2021). Banks may also generate income from fees charged for services such as ATM usage, account maintenance, and wire transfers.

The profitability of banks can also be affected by the quality of their loan portfolio (Afrifa, Gyapong & Zalata, 2019). If banks lend money to borrowers who are unlikely to repay, they may experience significant losses that can reduce profitability. Conversely, if banks have a high-quality loan portfolio with a low rate of default, they are likely to be more profitable. Efficiency is also an important factor in the profitability of banks. Banks that can operate with lower costs and higher productivity are likely to be more profitable (Lee, Li, Yu & Zhao, 2021). This can be achieved through automation and technology, as well as effective risk management practices. Overall, profitability in the banking industry can be influenced by a variety of factors, like economic conditions, regulatory changes, and competition. While there is no guarantee of profitability for any bank, those that can effectively manage risk, operate efficiently, and maintain a high-quality loan portfolio are more likely to be successful (Al Zaidanin & Al Zaidanin, 2021).

In the world of finance, default occurs when a borrower doesn't uphold their legal commitments by making the required payments on time or by breaking one of the conditions of the loan arrangement (Badriyah, Suharto, Saraswati & Wafi, 2021). Failure to pay back a loan is known as a default. If the debtor is unable or unwilling to pay their loan, default may occur. All debt obligations, including bonds, mortgages, loans, and promissory notes, may result in these. The borrower's credit score will suffer a substantial and long-lasting decline as a result of defaulting on a loan, and any subsequent loans will have extremely high interest rates (Zhang, Wang, Zhang & Wang, 2020). If a loan with collateral defaults, the financial institution will probably take possession of the pledged asset.

Failure of a debtor to repay a loan by the due date is referred to as loan default (Ali, Hassan & Othman, 2019). A few repercussions of default include the inability to lend money to other people, the unwillingness of other financial intermediaries to meet the needs of small clients, and the emergence of mistrust. According to Ross (2018), both the loan providers and the borrowers would bear the consequences of loan defaults. In cases of delinquency, the lending institution bears expenses like lost interest, the opportunity cost of the principle, legal fees, and related expenses. The decision to go into default for the debtor is a trade-off between the potential cost of forgoing investments to resolve the existing loan and the consequences in the form of lost credibility from default.

Inadequate loan appraisal by loan providers, purposeful negligence, and a lack of motivation to repay loans are a few crucial factors that result in loan defaults (He, 2020). Additionally, there is an increase in business loan default when real GDP declines, and exchange rate depreciation has a direct effect on customers' ability to pay. In addition, Aidoo and Mensah (2018) identified age of farmers, inadequate supervision, non-profitability of farm ventures, loan shortages, delays in financing delivery, small farm size, high interest rates, and unnecessary government interference with the operation of government-funded credit programs as the primary causes of loan default.

Similarly, it is observed that exposure to sound management techniques, family size, farm size, and scale of operation are some of the characteristics that can affect borrowers' ability to repay loans (Giri & Shah, 2019). When borrowers default, interest income is lost, this unquestionably has a negative effect on the bank's profits. The quality of the loans will also help the banks to be more profitable. Therefore, non-performing loans can be used to gauge the quality of a loan.

Defaults have a detrimental impact on a bank's profitability (Bhattarai, 2018). Provisions for poor and doubtful debts are promptly deducted from the earnings of good loans. Credit documentation that is true, complete, and expressly binding lowers the likelihood of willful default and boosts banks' profitability. The credit and recovery processes have a linear relationship with a bank's performance (Haralayya & Aithal, 2021). Financial organizations are unable to make profit from defaulted credits. Research on the reliability of credit documentation, which is a tool of preventing defaults, is directly related to how well a financial institution performs. Banks' total loan portfolios are reduced by loan default provisions, which has an effect on the interest earned on those assets. The cost to banks is enormous. Unsecured loans appear to directly affect the profitability of banks (Nguyen & Nguyen, 2020). This is due to the fact that charges for bad debts are treated as expenses on the profit and loss account, which has a detrimental effect on financial institutions' profit positions.

LITERATURE REVIEW

Azad, Azmat and Hayat (2019) conducted research to examine the rate of loan defaults, its effect on profitability, and potential strategies for banks to reduce loan defaults. Both qualitative and quantitative research methods were used in the study. Banks were chosen to gather information that was gathered from answers to our distributed questionnaire and through interviews. The management and non-management employees, and the clients of First Allied Savings and Loans Limited, Eden Microfinance, and Opportunity International Savings and Loans Limited, made up the population of the survey. Correlation and regression will be used to evaluate the research's theoretical frameworks. The study's findings indicate a strong positive association between the concepts of loan default rate and profitability of different banks.

Dalci (2018) reported that the Agricultural Development Bank of China was used as a case study in the research to assess negative loans and their impact on the financial institutions' profitability in China. The study is a descriptive survey that used a set of semi-structured questions to get participants' primary information. Additionally, a retrospective approach was used to collect secondary data from the bank's (ADB) published financial reports for a period of 12 years (2007-2019). Using SPSS version 20, the data acquired for the study was quantitatively assessed. The analysis of the data revealed an undulating trend in bad loans, with an average bad loan proportion to total loans disbursed over the 12-year timeframe of 8%. According to the research, the main factors contributing to bad loans at the bank include customer business failure, high loan interest rates, inadequate loan administration, and improper timing of loan disbursement. Additionally, the research indicated that bad loans had a substantial negative impact on the bank's interest income, draining about one-fifth of the bank's interest income during the research period (2007-2019). Bad loans cause the bank to lose almost the exact same amount of net revenue as it gains. The study went on to say that the bank had a great incidence of bad loans and that the board and administration of the financial institution needed to implement effective credit monitoring rules and procedures. As a result, the research recommended that the board and management reduce loan interest rates, properly staff credit officers for effective loan surveillance, and ensure quick processing and loan disbursement. It is also suggested that a future study examine the financial institution's credit monitoring practices.

Markonah, Salim and Franciska (2020) performed research on loan defaults and its influence on profitability of banks making specific reference on Armenia's Byblos Bank. The goal of the study was to identify practical strategies for reducing the frequency of loan defaults in financial institutions. The study focuses on the introduction to the research, the problem statement, the objectives, the scope and constraints, and the study's historical context. Furthermore, the researcher described the methods utilized to collect both primary and secondary data. This method of inquiry involved the use of questionnaires and one-on-one interviews. The emphasis moved on to assessments of the data collected and the presentation. Tabular analysis and a likert scale were used to assess all the information gathered. However, the results summary shows that an assessment of loan defaults and their impact on profitability was made, as in the instance of Byblos Bank in Armenia, where a considerable increase was recorded as a result of the competent and appropriate data collection method employed. Effectively, it was determined that all credit should be used for legitimate purposes and that suitable procedures should be implemented to ensure that banks are not used for dishonest activities that are illegal under the law.

Singh (2022) argued that bad loans have been identified as a significant factor determining the profitability and survival of Slovenian rural and community banks. Because of the high default rate, the majority of rural banks are unable to compete in the difficult financial sector/industry. The research explored the effect of nonperforming loans (NPLs) on the profitability and borrowing capacity of chosen rural banks in Slovenia, Maribor. Secondary data of ten years (2010-2020) was obtained from the annual statements of the chosen banks. Furthermore, original data was gathered from chosen banks via surveys to aid in the analysis of the principal causes of problematic loans in the rural finance industry. The findings revealed that the selected banks' non-performing loan ratios (NPL) are steadily increasing, raising concerns about their ability to manage credit risk. The research discovered that NPLs have a substantial negative influence on the financing potential of the chosen financial institutions. Similarly, it was discovered that, while NPLs have a negative effect on bank profitability, the impact is not substantial. The research also found that the key reasons of poor loans within the selected financial institutions include poor debt management, an inadequate evaluation system, and a lack of an efficient credit monitoring policy to oversee the transfer of cash to consumers. According to the study, rural financial institutions should take steps to reduce bad loans because they have an influence on their lending capacities and financial performance. Furthermore, these banks should take the effort to provide their credit teams with the required knowledge and tools to strengthen credit management within the bank.

Psaila, Spiteri and Grima (2019) performed research to explore the impact of nonperforming loans on the profitability of Kosovo banks from 2010 to 2019. Earnings were determined by return on assets as a function of the ratio of non-performing loans, liquidity risk, and financial institution size as control variables, using classic revenue theory. To approximate the determination of the profit function, multivariable linear regression was used. The findings indicated that the impact of non-performing loans on profitability is statistically substantial, with each 1% rise in NPLs reducing asset return by 0.20% while holding other variables constant. Banks in Kosovo are advised to follow a well-balanced method to portfolio development and credit risk direct exposure.

Ahmed and Nargis (2019) noted that despite the various benefits of loans to financial institutions like flexibility, cost-effectiveness, retained profits, and tax benefits, the profitability performance of banks remains tense, and despite the endless efforts made by financial institutions in Denmark to lower loan defaults, they continue to face a variety of other issues, causing their operations to be restricted. The study, titled "The effects of loan default on commercial financial institution profitability, Den Danske Bank was used as the case study," intended to determine the impacts of loan default on the profitability of Danish financial institutions. The research had two goals in mind: to look at the characteristics from loan default debtors that influence the profitability of commercial financial institutions in Denmark, and to look at the aspects from Den Danske Bank that affect their profitability in Denmark. To conduct the research, a quantitative study technique was used, and a standardized questionnaire was utilized to gather data from all Den Danske Bank employees. The purposive sample method was used, and the information acquired was evaluated using descriptive, measures of central tendency, correlation, and regression analysis. According to the results of the research, personality, capability, security, condition, surveillance, testing, repayment maturity, and interest rates are all factors that influence Den Danske Bank earnings. They demonstrated a significant positive association with profitability; hence the hypothesis was approved. It was advised that financial institutions in Denmark change their interest rates to make them more equitable to all clients; additionally, efficient tracking technologies ought to be implemented to aid in screening and surveillance procedures and tasks.

FINDINGS

The study revealed that banks with high loan defaults on their books can face insolvency if they are not able to recover their bad debts. Earnings of shareholders may suffer as a result of loan defaults. Dividend payments are made in accordance with the bank's net profit performance. Loan defaults have a negative impact on financial institution profitability and the amount of dividend paid to shareholders may be affected. The impact of loan defaults on the amount of dividend paid to investors may also have an impact on capital mobilization, as investors will not invest in banks with a large portfolio of non-performing loans. The quality of the loans will also contribute to increased profitability. Non-performing loans can therefore be used as an indicator of the loans quality. Financial institutions should take steps to reduce bad loans because they have an influence on their lending capacities and profitability. Defaults have a detrimental impact on a bank's profitability.

Research has shown that loan defaults can have a significant impact on the profitability of banks. When borrowers default on their loans, banks are unable to collect the principal and interest payments that they expected, which can result in significant losses. These losses can be compounded by the costs of collections, legal fees, and write-offs. A study by the Federal Reserve Bank of St. Louis found that loan defaults were a significant contributor to the decline in bank profitability during the 2008 financial crisis. The study found that banks with higher levels of loan defaults experienced larger declines in profitability, and that this effect was particularly pronounced for smaller banks.

The study discovered that loan defaults had a negative effect on bank profitability in both the short and long term. It was also found that loan defaults had a larger negative impact on profitability for smaller banks, banks with lower capital ratios, and banks with higher levels of non-performing loans. Overall, these findings suggest that loan defaults can be a significant risk for banks, and that banks need to carefully manage their loan portfolios and credit risk in order to maintain profitability. Banks may need to implement strategies such as improved credit analysis and underwriting, loan diversification, and effective collections and recovery processes in order to mitigate the risks associated with loan defaults.

CONCLUSION

Banks have been having significant difficulties collecting financial debt from their customers. This has compelled banks to seek debt collection expertise. Banks with insufficient loan collection have run into serious liquidity problems. However, many more have depended on government assistance to compensate the financial losses caused by loan failure. Regular loan quality monitoring, maybe with an early warning system capable of notifying regulatory authorities of potential financial institution stress, is thus necessary to build a good financial system and avoid systemic difficulties.

Poor management is among the main reason for loan defaults. It is concluded that managers in most financial institutions with defaulted loans do not undertake adequate loan underwriting, supervision, and control. A lender's inadequacy of outstanding abilities and judgment is a possible source of loan defaults. Some of the factors that contribute to loan defaults are inadequate bank management, poor advice, overly optimistic creditworthiness assessments during economic booms, and ethical problems associated with generous government guarantees.

In conclusion, loan defaults can have significant negative impacts on the profitability of banks. When borrowers default on their loans, banks are unable to collect the expected principal and interest payments, which can result in significant losses. These losses can be compounded by the costs of collections, legal fees, and write-offs. It is concluded that loan defaults are significant contributor to the decline in bank profitability during financial crisis. Smaller banks, banks with lower capital ratios, and banks with higher levels of non-performing loans were found to be more vulnerable to the negative impacts of loan defaults. To mitigate the risks associated with loan defaults, banks need to carefully manage their loan portfolios and credit risk. Strategies such as improved credit analysis and underwriting, loan diversification, and effective collections and recovery processes can help banks to reduce the risk of loan defaults and maintain profitability. It is essential for banks to continually monitor and assess their loan portfolios to identify potential risks and take appropriate action to mitigate them.

RECOMMENDATIONS

Loan defaults can have a significant effect on the profitability of banks. When borrowers fail to repay their loans, banks may face losses and may need to write off the loans as non-performing assets (NPAs). This can lead to a decline in the bank's asset quality and may also impact its credit rating, which can result in higher borrowing costs. The study recommended that banks should develop and implement robust credit risk management processes to identify and mitigate potential credit risks. This includes assessing the creditworthiness of borrowers, monitoring their financial performance, and establishing early warning systems to identify potential defaulters. Banks should also diversify their loan portfolios to reduce concentration risk. This means that they should not lend to a limited number of borrowers or industries. Instead, they should spread their risk by lending to a variety of borrowers and industries.

The study further recommended that banks should regularly review their loan portfolios to identify potential NPAs and take necessary actions to mitigate them. This includes restructuring loans, rescheduling repayments, and recovering overdue payments. Banks should enhance their recovery mechanisms to improve the chances of recovering overdue payments. This includes employing debt collection agencies, taking legal action against defaulters, and foreclosing on collateral assets. They should leverage data analytics to identify potential defaulters and to assess the creditworthiness of borrowers. This includes analyzing credit scores, income, repayment history, and other relevant financial data.

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