

# **Determinants of Non-Performing Loan Facility in Commercial Bank Industry, Batticaloa District- Sri Lanka**

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## **Abstract**

The banking sector is an inevitable financial service sector to support the development of the nation through channelizing funds for productive purpose, intermediating flow of funds from surplus to deficit units and supporting financial and economic policies of the government. The Sri Lankan commercial banking sector accounts a major portion of financial intermediation and acknowledged as main tool of monetary policy, credit channel and facilitator for payment systems. Maintaining asset quality and profitability are critical for banks survival and growth. A major threat to the banking sector is a prevalence of Non-Performing Loans (NPLs). The NPLs are the cursor for poor regional and economic development. Recent records motions that the trend of NPLs in Sri Lanka swings upward, especially the double effect in 2012. This study questions why the commercial banks are far behind in managing the NPLs. As a result, this research aims to understand and explain employing qualitative methodology to identify the determinants of the NPLs in commercial banks in Batticaloa District of Sri Lanka. Findings reveal that there are several banking specific factors, customer related specific factors and macro environment factors influenced the NPLs.

**Keywords:** Licensed Commercial Banks, Non-Performing Loans, Batticaloa District

## **Introduction**

The financial system is one of the most significant components in the economic system of the country and it is considered as the main player in the economic model. A strong financial system helps for industrial development, creation of direct or indirect employment, enhancing the gross domestic product. Finally, it leads to the country's prosperity and economic development (Babihuga, 2007). In general, the financial system consists of the regulatory authorities, financial institutions, markets, instruments, a payment and settlement system, a legal framework and regulations (CBSL).

The banking industry is a core unit in the financial institutions and plays a dominant role in the financial system. As bank is one of the players in the economic models, it channels funds from surplus unit (those who have excess) as deposits to deficit unit (who need it for their investment) as loans or advance. These functions perform through the effective intermediation role. This intermediation role links the householders, private

sectors and government sectors of the economic models for their respective needs accomplishments (Bossone B, 2009).

Lending is the core function in the intermediation process, which plays a significant contribution in generating income to the bank and it revitalizes investment in the industrial development. It is one of the units in economic models and their channels funds from surplus unit of household, private sector and government sectors to deficit unit of household, private sector and government sector for development purpose. Though the strong banking performance is not only given the stability to the bank, it contributes country's stability as well. Mac Donald and Koch(2006) state loans are the dominant asset and represent 50-75 percent of the total amount at most banks, generate the largest share of operating income and represent the banks greater risk exposure. Moreover, its contribution to the growth of any country is huge in that they are the main intermediaries between depositors and those in need of fund for their viable projects (creditors) thereby ensure that the money available in the economy is always put to good use. Therefore, managing loan in a proper way not only has a positive effect on the bank's performance, but also on the borrower firms and a country as a whole. Failure to manage loans, which make up the largest share of bank assets, would likely lead to the episode of the high level of non - performing loans. 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 .On the other hand the Basel Committee1(2001) puts non-performing loans as loans left unpaid for a period of 90 days.

The causes for loan default vary in different countries and have a multidimensional aspect, both in developing and developed nations. Theoretically, there are so many reasons as to why loans fail to perform. Some of these include depressed economic conditions, high real interest rate, inflation, lenient terms of credit, credit orientation, high credit growth and risk appetite, and poor monitoring among others. Bercoff et al. (2002) categorizes causes of nonperforming loans to Bank specific and Macroeconomic conditions.

Increasing levels of non-performing loans in the Sri Lankan banking industry has been a hindrance to economic stability. According to Central Bank of Sri Lanka, status of the Non-Performing Loan during last seven years is fluctuating. Though there seem to be some improvements during recent quarters, the ratio still remains higher. It is evidenced by CBSL that the Non-performing Loan ratio in 2012 has been doubled from 2011 and the NPLs ratio in 2014 is recorded 6.2%. It is in above the standard and alarming the financial institution and regulatory institutions vigilant on this aspect.

The aftermath of the post war period, banking services has been extended to the island wide, especially in the North and eastern provinces for the regional growth. There are ample of the credit facilities extended by the financial institutions to promote and develop small medium business in the North and eastern region.

This research attempts to explore determinants of nonperforming loans in Batticaloa District, Sri Lanka with the following objectives:

- To identify levels of Non-Performing Loans ratio in Batticaloa District.
- To identify the factors contributing to the Non-Performing Loan facility in the Batticaloa District.
- To identify the strategies to reduce the Non Performing of the banking Industry in Batticaloa District.

## Literature Review

### Definition of Non-Performing Loan

It is observed that there is no standard definition of NPLs and definition of NPLs vary across the country. As per the Basel Committee on banking supervision, NPLs defined as a default occurs when the bank considers that an obligor is unlikely to repay its credit obligations to the banking group in full, without recourse by the bank to actions such as realizing security (if held); or the obligor is past due for more than 90 days on any material credit obligation to the banking group.

A Non-performing Loan/ Asset is a credit facility in respect of which, the interest and or principal amount has remained past due for a specific period of time. According to Alton and Hazen (2001) non-performing loans are those loans which are ninety days or more past due or no longer accruing interest. Hennie (2003) agrees arguing that non-performing loans are those loans which are not generating income. This is further supported by Caprio and Klingebiel (1996), cited in Fofack (2005), who define non-performing loans as those loans which for a relatively long period of time do not generate income that is, the principal and or interest on these loans have been left unpaid for at least ninety days. Non- performing loans are also commonly described as loans in arrears for at least ninety days (Guy, 2011). According to this paper, nonperforming/Assets/ loans are loans that are ninety or more days delinquent in payments of interest and/or principal (Bexley and Nenninger, 2012).

### Impact of Non-Performing Loan

Michael et al (2006) emphasized that NPL in the loan portfolio affect operational efficiency, which in turn affects profitability, liquidity and solvency position of banks. Batra, S (2003) noted that in addition to the influence on profitability, liquidity and competitive functioning, NPL also affect the psychology of bankers in respect of their disposition of funds towards credit delivery and credit expansion. NPL generate a vicious effect on banking survival and growth, and if not managed properly lead to banking failures.

### Factors Contributing to the Non-Performing Loan

The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers (Auronen, 2003), In Richard (2011), which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender) (Auronen, 2003) in Richard (2011). The party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of non-performing loans in banks (Bester, 1994; Bofondi and Gobbi, 2003).

In scholar studies, problem loans are often used as an exogenous variable to explain other banking outcomes such as bank performance, failures, and bank crises (Boudriga et al., 2009). However, some studies investigate problem loans as an endogenous variable (Sinkey and Greenwalt, 1991; Kwan and Eisenbeis, 1997; Salas and Saurina, 2002) in (Boudriga et al., 2009). GDP growth, inflation and interest rates are common macro-economic factors, while size and lending policy are micro-economic variables (Greenidge and Grosvenor, 2010). These variables are by no means exhaustive, but they provide a useful framework for monitoring the development of non- performing loans. Countries

and emergent economies (Hauer and Peiris, 2005; Matthews et al., 2007), as cited by (Maggi and Guida, 2009). Bercoff et al (2002) examine the fragility of the Argentinean Banking system over the 1993-1996 period; they argue that non-performing loans are affected by both bank specific factors and macroeconomic factors. To separate the impact of bank specific and macroeconomic factors, the authors employ survival analysis. Using a dynamic model and a panel dataset covering the period 1985-1997 to investigate the determinants of problem loans of Spanish commercial and saving banks, Salas and Saurina (2002) reveal that real growth in GDP, rapid credit expansion, bank size, capital ratio and market power to explain variation in non-performing loans. Furthermore, Jimenez and Saurina (2005) examine the Spanish banking sector from 1984 to 2003; they provide evidence that non-performing loans are determined by GDP growth, high real interest rates and lenient credit terms. This study attributes the latter to disaster myopia, herd behavior and agency problems that may entice bank managers to lend excessively during boom periods. Meanwhile, Rajiv and Dhal (2003) utilise panel regression analysis to report that favourable macroeconomic conditions and financial factors such as maturity, cost and terms of credit, banks size, and credit orientation impact significantly on the non-performing loans of commercial banks in India. Babihuga (2007), in an IMF working paper, explores the relationship between several macroeconomic variables and financial soundness indicators (capital adequacy, profitability, and asset quality) based on country aggregate data. She explained the cross-country heterogeneity by differences in interest rates, inflation, and other macroeconomic factors. However, the study does not consider the impact of industry specific drivers of problem loans. Most empirical studies examine the influence of the macroeconomic environment on non-performing loans (Louzis et al, 2011). Rinaldi and Sanchis-Arellano (2006) analyze household non-performing loans for a panel of European countries and provide empirical evidence that disposable income, unemployment and monetary conditions have a strong impact on non-performing loans. Berge and Boye (2007) find that problem loans are highly sensitive to the real interest rates and unemployment for the Nordic banking system over the period 1993–2005. Lawrence (1995) examines the theoretical literature of life-cycle consumption model and introduces explicitly the probability of default. This model implies that borrowers with low incomes have higher rates of default due to increased risk of facing unemployment and being unable to settle their obligation. Additionally, in equilibrium, banks charge higher interest rates to riskier clients. Rinaldi and Sanchis-Arellano (2006) extend Lawrence's model by assuming that agents borrow in order to invest in real or financial assets. They argue that the probability of default depends on current income and the unemployment rate, which is linked to the uncertainty regarding future income and the lending rates.

The benefits of diversification in the form of reduced risk, for the US banking system, since non-interest income growth was highly correlated with net interest income during the 1990s. The moral hazard of too-big-to-fail banks represents another channel relating bank-specific features with non-performing loans (Louzis et al, 2011). A policy concern is that too-big-to-fail banks may resort to excessive risk taking since market discipline is not imposed by its creditors, who expect government protection in case of a bank's failure (Stern and Feldman, 2004). Consequently, large banks may increase their leverage too much and extend loans to lower quality borrowers (Louzis et al, 2011).

Boyd and Gertler (1994) argue that in the 1980s the tendency of US large banks towards riskier portfolios was encouraged by the US government's too-big-to-fail policy. On the other hand, Ennis and Malek (2005) examine US banks' performance across size classes over the period 1983–2003 and conclude that the evidence for the too-big-to-fail

distortions is in no way definite. Hu et al (2006) also show that bank size is negatively related to non-performing loans. In a seminal study, Berle and Means (1933) in Louzis et al. (2011) argue that dispersed ownership of corporate equity may lead to a poorer performance of the firm as the incentive of shareholders to monitor the management weakens. An opposing view is that an efficient capital market imposes discipline on firm's management and therefore dispersed ownership should not have an effect on firm's performance (Fama, 1980) as cited in (Louzis et al., 2011). A strand in the empirical literature tests these contrasting views using loan quality as an indicator of riskiness but evidence is inconclusive (Louzis et al, 2011). Iannotta et al. (2007) find a link between higher ownership concentrations and loan quality using a sample of 181 large banks over the period 1999–2004, thus lending support to the Berle and Means view.

On the other hand, Laeven and Levine (2009) employ data on 279 banks and find a positive association between greater cash flow rights of a large owner and risk taking. Furthermore, Shehzad et al. (2010) present empirical evidence, from a data set comprising 500 banks from 2005 to 2007, that ownership proxied by three levels of shareholding (10%, 20% and 50%) has a positive impact on the non-performing loans ratio when the level of ownership concentration is defined at 10% but a negative impact when the level of level of ownership concentration is defined at 50%. Therefore, they suggest that sharing of control may have adverse effects on the quality of loans extended up to a level, but in cases of a strong controlling owner, bank's management becomes more efficient leading to lower non-performing loans. Azofra and Santamaria (2011) find that high levels of ownership concentration benefit both the bank's profitability and efficiency for a sample of Spanish commercial banks.

Empirically, Novaes and Werlang (1995) report lower performance for state controlled banks in Brazil and Argentina due the high proportion of problem loans given to government. Micco et al. (2004), analyze 50,000 financial institutions with different ownership types covering 119 countries. They conclude that non-performing loans tend to be higher for banks with state ownership than for other groups. Hu et al. (2004) use a panel of Taiwanese banks and find a positive correlation between capital share owned by the state and the level of non-performing loans. Garcia-Marco and Robles-Fernandez (2007) investigate the relationship between risk taking and ownership structure. They document that commercial banks (mainly private owned) are more exposed to risk than deposit banks (mainly state owned).

More recently Hu et al (2006) analyzed the relationship between non-performing loans and ownership structure of commercial banks in Taiwan with a panel dataset covering the period 1996-1999. The study shows that banks with higher government ownership recorded lower non-performing loans. Using a pseudo panel-based model for several Sub-Saharan African countries, Fofack (2005) finds evidence that economic growth, real exchange rate appreciation, the real interest rate, net interest margins, and inter-bank loans are significant determinants of non-performing loans in these countries. The author attributes the strong association between the macroeconomic factors and non-performing loans to the undiversified nature of some African economies.

## **Methodology**

This study is explorative in nature and this method is generally used when the researcher wants to identify key issues and key variables (Chris, 2013). Multistage sampling methodology has been adopted, at the first stage; the convenience sampling adhered to select banks' branches of Bank of Ceylon, Peoples Bank, Hatton National Bank, Seylan

Bank, DFCC Vadhana Bank, NDB,NTB,Union Bank, MCB bank, Sampath Bank, and Pan Asia Bank to be researched. At second level, since the study is significant at management level and the expert perception has to be incorporated in the study in order to generate a valid output, the judgmental sampling technique is employed to select Regional Managers, Branch managers, Credit analysts and recovery officer.

The primary data for this research was collected using a questionnaire and interviews of senior managers involved in lending activities. Structured questionnaires were administered. An additional method of data collection was personal interviews with executives and senior management in selected commercial bank. 70 open ended questionnaire questionnaires have been issued to the targeted respondent. Further, six interviews have been made, and excels and SPSS were used for data analysis.

## Data Analysis

### Respondent Analysis

Out of the seventy questionnaires issued to the Branch managers, Credit officers and Recovery officers of the 23 selected commercial banks' branches in the Batticaloa District in Sri Lanka, fifty two usable responses were collected. The response rate is 74% and six interviews were conducted out of target 10 interviews. Despite this, the target population was fairly represented considering that key senior managers who are relevant to the study were interviewed. The results are shown in table 1 below.

**Table 1.** Details of the respondents

	Intended	Successful	Response rate
Interviews	10	6	60%
Questionnaire	70	51	74%
Total	80		

Source: Compiled data

### Profile of respondents

Most of the questionnaire respondents were credit Officers representing 44% of the total respondents. Branch Managers and Recovery Officers represent 35% and 15% respectively of the total respondents, while regional managers represented 6%.

**Table 2.** Position of the Respondent

Position of the Respondent	Frequency	Percent
Regional Managers	3	6%
Branch Managers	18	35%
Credit Officers	23	44%
Recovery Officers	8	15%
Total	52	100%

Source: Compiled data

Their working experience indicates in table 3 below, 30% of the respondents' working experience in banking industry belongs to the range between 5 years to 10 years. 28% of the respondents' experience just less than five years. 26% of the bankers' experience lies in the range from 15 years to 20 years.

**Table 3.** Experience of the respondents

Experience of the Respondents	Frequency	Percent
Under 5 years	15	28%
Between 5 and 10 years	16	30%
Between 15 and 20 years	14	26%
More than 20 years	8	15%
	53	100%

Source: Complied Data

### **Level of Non-Performing Loan**

The below table 4 shows the position of NPL of the licensed commercial Banks in Batticaloa District, NPLs of the majority of bank is in the range of 3%-5%. 26% of the bank's NPLs are above 10%. Only 13 % of the banks are below the 3%.

**Table 4.** Level of Non-Performing Loan in Batticaloa District

NPLs Ratio in Percentage	No.of Bank	Percent
1%- 3%	3.0	13%
3%-5%	8.0	35%
5%-8%	2.0	9%
8%-10%	4.0	17%
Above 10%	6.0	26%
Total	23.0	100%

### **Specific Factors contributing to the Non-Performing –Overall view based on variables**

As per the below table, above 80% of the respondent agreed that the borrowers' poor business knowledge and management skills for the main reason for the NPLs of the area. Nearly 77% of the respondent agreed that the difficult to obtain proper data from customer poor record maintenance by customer (Accounting) is a one of the causes for the NPLs. Over/under financing for the project by banks, Lack of tight credit monitoring, Willful defaulter are the factors which have been agreed by more than 50% of the respondents.

**Table 5.** Specific Factors for NPLs

CRSF : Customer Related Specific Factor

Categories	Specific Factors	Frequency of	Percentage	Rank
CRSF	Poor business knowledge and management	42	81%	1
CRSF	Poor record maintenance by the customer	40	77%	2
BRSF	Over/under financing for the project by bank	34	65%	3
BRSF	Lack of tight credit monitoring	34	65%	3
CRSF	Willful defaulter	29	56%	5
CRSF	Fund diversion by the customer for	29	56%	5
EERSF	Delays in payment for construction company	24	46%	7
EERSF	Unforeseen Business risks	24	46%	7
BRSF	Improper selection of customers due to the	23	44%	9
EERSF	Natural disaster affecting agriculture	17	33%	10
BRSF	Poor credit evaluations by credit analysts due	17	33%	10
BRSF	Inexperience of managers and other delegates	12	23%	12
BRSF	Poor portfolio diversification	12	23%	12
EERSF	Macroeconomic policies	11	21%	14
BRSF	Improper collateral selection	9		
EE	International pressure	8	15%	15
BRF	Inadequacy of credit policies	6	12%	16
EERSF	Government interference in sanctioning loan	4	8%	17
CRSF	Compromised integrity of bank staff	4	8%	17

BRSF : Bank Related specific Factors

EERSF : External Environment related specific Factors

In addition to that, delays in payment for construction company from government, Unforeseen Business risks, Improper selection of customers due to the competition among banks, Natural disaster affecting agriculture, Poor credit evaluations by credit analysts due to the lack of knowledge and inexperience of credit staff, Inexperience of managers and other delegates about the market ,Poor portfolio diversification , Macroeconomic policies, Improper collateral selection, International pressure, Inadequacy of credit policies, Government interference in sanctioning loan, and Compromised integrity of bank staff. Below 50% of the respondents have agreed the above factor to cause the Non-Performing loan.

## Discussions

The study shows the NPLs ratio of the each branch of the selected banks in Batticaloa District. CBSL standard says that a healthier bank should maintain NPLs ratio below the industry average in Sri Lanka. The study shows above 50% of the branch banks' NPLs is above the 5%. It is apparently revealed, the newly opened banks in the area find difficulty in managing NPLs. The senior managers pinpointed that new branches face several difficulties in capturing market share in the area and in order to meet their annual target,



they have to concentrate aggressive lending to meet their given targets. Comparatively the existing established bank branches records low NPLs mainly due to their effective management of credit.

The study analyzed each factor that has an impact on occurrences of nonperforming loans. There are several factors contributes to the NPLs in the Licensed Commercial bank in the Batticaloa district. Generally, we can categorize these factors into bank specific factors, Customer specific factors and external environment related factors. (Bercoff et al 2002).

In respect of the factors affecting NPL, the subjective question in the survey and in-depth interviews identified factors such as borrowers' poor business knowledge and management skills, difficulties in obtaining proper data from customer as poor record maintenance by customer (Accounting), Over/under financing for the project by the bank, lack of tight credit monitoring, willful defaulter, fund diversion by the customer for unprofitable source ascribe to the causes of NPLs.

81% of the bankers responded that the poor business knowledge and management skills of borrowers are the main reason for NPLs. In depth interview reveals that lack of entrepreneurial culture for unsustainable business efforts are the main reasons that the entrepreneurs fail to ensure the success of the business. Further, though the young entrepreneurs have entrepreneurial culture, they struggle to position their business. It is observed in the district that the most of the entrepreneurs frequently switching from existing business to new business for rapid income earnings without doing proper market analysis. The unstable business decision may hit the entire investment of the young entrepreneurship and it may impact the loan given by the banks. This is a big challenge for the bank to provide loan facilities for young entrepreneurs.

The above analysis shows that the 77% of the respondents agreed that the poor record maintenance of the customer is a main reason for the poor credit evaluation of the credit analyst. In this area, most of the customers do not have a proper record to reveal a real status of financial and accounting, operational, marketing performance. This leads to the asymmetric information to the bankers about the customer.

It is observed 65% of the respondents agreed that over financing or under financing towards client's projects by the bank is a major concern. The most of the projects have been financed without considering the feasibility study, marketing analysis, and technical feasibility. Even banks, they fail to identify the real debt and equity ratio of the particular project of customer. It is mainly due to the inexperienced credit officers and managers in the field.

Another most important reason for NPLs is lack of tight credit monitoring. The delegated monitoring theory says, the bank plays an intermediation role to invest the depositors' funds to financial claims of the corporation or individual. As part of the intermediation role bank has to be monitored the investment on behalf of depositors (Saunders and Cornett, 2003). Agresti 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 study also indicates 65% of the respondent agreed. There is also a tendency by borrowers to give more attention to repaying loans if they are properly given attention by banks. 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. Bercoff, Giovanni and Grimard (2002) showed that operating efficiency helped explain NPLs. i.e. banks that incur big cost for loan follow-up would have a comparatively lower nonperforming loan. Respondents had a neutral view to the statement that banks 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 magnitude of budget allocated.

According to the Reserve Bank of India, willful default occurs when a loan isn't repaid even though the cash is available, or when money lent for a particular purpose is used for something else. In the Batticaloa district, especially in the government sector, some customers have intentionally escaped from their obligations. Further, it is noted some NPLs cause of diverting the loan funds to unprofitable investment, it has been observed in the area that the customers are very keen to invest their borrowed money from banks to various unprofitable activities such as: building up luxury house, land, this causes the bankruptcy of the main business of the customer.

Improper selection of the customer by banks is another reason for the NPLs, aftermath of post war, the government extended their support to open up new bank branches in order to enhance the regional development of the district. The bank's branch has opened in the area, as the supply of bank branches radically increased the area, people have the opportunity to cater their financial this leads to the intensified competition among the financial institutions in the District. Unfair industry competition among banks-endangering banks not select good customers. Sometimes non-performing loans of other banks are bought from other banks. Salas and Saurina (2002) who studied Spanish banks found out that credit growth is associated with non-performing loans.

Especially for the agriculture industry in the area heavily affected by vulnerability of the climate conditions in the area. The farmers who obtained financial assistance from the banks were not in the position to repay their obligations on timely manner as their production/ crops have been hit by the flood or drought, this caused for the loss of production and most of the customers have not claimed from the insurance company because of the asymmetric deals with customers and insurance companies.

Further, the respondent says that the most of the rice millers were affected by the control price of rice and imported rice from India. This sudden implementation severely affects the business performance of the rice millers in the region. It is indirectly affected the banks through nonpayment of the loan facility.

Lack of experience of the credit officers is the main reason for the NPLs. Since most of the bank's branches newly opened branches in the district, most of the banks have worked with fresh employees who are newly recruited to the banking industry. Experience in the industry very low compared to well-established branch banks.

As the knowledge and experience is limited to the customer, the banks fail to scrutinize the customer business position and the real requirements of the customer in a proper manner. In some case, the managers and credit officers fail to identify it.

As most of the lending in the district is based on collateral rather than cash flow based lending. As such obtaining good collateral is most important to minimize credit risk as a secondary source of payment (Koch & MacDonald, 2003). In some instances the selection/ identification of good collateral is a questionable in the area. Most of the NPLs loan backed by the residential property for commercial purpose. Some properties are overvalued by valuers. As such at the time of liquidation of the collateral, the bank has faced legal problem and social problem.

## **Conclusion**

According to the study, there are several factors identify for NPLs of the licensed commercial banks – Batticaloa District. Most of the instances the banks related factors influence the NPLs in the region those are: Over or under financing projects, Lack of

tight credit monitoring, poor credit evaluation, poor portfolio diversification, improper collateral selection, inadequacy of credit policy are the main factors in bankers side . However the bankers, they pointed out that there are customer related factors such as poor business knowledge, poor record maintenance, diversion of funds and willful defaulter were the main reason for the NPLs. Further, NPLs occurs in the specific sectors like Agriculture and fishing, and construction, this is mainly due to the macro environmental factors. In order minimize the NPLs, the bank may respond in following manner, Banks 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 follow up and clear recovery strategies for sick loans. Banks should put in place a clear policy framework that addresses issues of conflict of interest, ethical standards, check and balance in the decision making process for all those involved in the credit process ensure its implementation thereof. Banks 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. Banks should give due emphasis it takes to develop the competency of credit operators, information system management pertaining to credit and efficiency of the credit process.

It is apparent that banks need to seriously consider all the customer, bank and external environmental related factors carefully. The impact of environmental factors such as natural disasters and government policy should be considered seriously during the credit assessment process. The bank should slow down on issuing loans to companies in the agricultural and manufacturing sectors as they are currently not performing well. Loans in these sectors should only be granted if the borrower proves that they have the capacity to pay back loans given. Management needs to ensure that borrowed funds are being used for the intended purpose through enhanced credit monitoring. This can be achieved by adopting a relationship management approach which helps management to have a closer look at the business as well as the characters of the senior managers running the organization.

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