

Effect Of Loan Defaults On Profitability Of Financial Institutions In Uganda: A Case Study Of Post Bank, Kavule Branch, Mpigi District

Nassolo Emily¹, Zikusooka Enock²

1, 2 Metropolitan International University

Abstract

This study was about effect of loan defaults on profitability of financial institutions in Uganda, Post Bank Kavule Branch Mpigi District, the case study was Post Bank Kavule Branch. It was guided by three objectives which include; to find out the relationship between borrower Behaviours on profitability of post Bank Kavule Branch, to examine the relationship between borrower capacity on profitability of Post Bank Kavule Branch, to examine the relationship between credit term on profitability of Post Bank Kavule Branch. The study adapted descriptive cross sectional and correlational designs with both quantitative and qualitative approaches. A total population of 45 was involved which included employees, supervisory committee, loan committee and board members from which a sample of 48 respondents were selected using Slovic's formula. Out of 47 respondents, 45 respondents responded positively. Data was collected using questionnaire and interview guide and analyzed using descriptive statistics. From the findings, borrower behaviour was shown to exert a moderately strong total effect on borrower commitment identical to the direct effect, as evidenced by the original sample total effect estimate of 0.390 that closely matched the sample mean of 0.386 while exhibiting very low standard error of 0.040 and profoundly high t-statistic of 9.788 signifying extremely strong relationship. Qualitative data revealed lack of proper assessment, weak monitoring and economic shocks as leading causes of defaulting. The research concluded that controlling defaults through stricter lending procedures, diversification of loan portfolio and financial education enhance bank sustainability and local development. Recommendations were made to standardize policies and upgrade risk management practices to curb ever-rising defaults threatening the stability of financial institutions.

Keywords: Loan Defaults, Profitability and Financial Institutions

Background of the study

Access to affordable credit has long been considered a critical driver of both individual livelihoods and national economic growth (Ramadhan et al., 2023). In Uganda, the financial sector has grown rapidly over the past two decades with the knowledge that facilitating bank lending can help accelerate business investment and reduce poverty (F. Christopher & Micheal, 2022). However, non-performing loans remain a significant problem that hinders the profitability and sustainability of credit institutions. Analyzing central bank data (Polycarp et al., 2023) reported that the gross default rate of all Ugandan commercial banks averaged 5.3% of total loans in 2021, with deposit-taking microfinance institutions reporting even higher levels of default, namely 7.1%. This deterioration in the quality of the loan portfolio negatively affects banks' net interest margins and returns on assets/equity, as shown in previous empirical work (Julius, 2024a). Established in 1967 as a government postal savings bank, Post Bank has grown to become one of Uganda's largest domestic lenders with over 350 branches across the country. However, its Kavule branch in Mpigi District faces persistent loan delinquency issues as evidenced by local trustees who reported that

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non-performing loans accounted for 14.2% of the branch's total portfolio in 2022, well above the bank's system-wide average of 5.6% (Polycarp et al., 2023). Anecdotal evidence suggests that contributing causes include ineffective credit risk assessment processes, relaxed credit standards during economic booms, borrower reluctance in difficult macroeconomic times, as well as fraud (Polycarp et al., 2023). While Post Bank management has acknowledged the need to strengthen credit collection and customer screening efforts, there is still a lack of detailed empirical research on exactly how different types and levels of default affect its profitability metrics at the micro-level of a single branch. The aim of this study is therefore to quantitatively assess the impact of loan defaults on the profitability of the Post Bank Kavule branch through regression analysis of financial statements and supplemented by qualitative interviews with employees (T. Christopher et al., 2022). The findings will provide the bank with valuable insights to design tailored failure mitigation strategies to increase operational efficiency and support its mandate to develop the local community in a long-term sustainable manner (F. Christopher et al., 2022). This is all the more significant given predictions that Uganda's non-performing loans may further increase to 7-8% of total bank loans in 2023 amid high inflation and slowing GDP growth (Kazaara et al., 2024).

Problem Statement

Post bank Limited has a loan management team, proper and clear loan management guidelines which are a primary source of reference and guidelines for credit practices in financial banking (Polycarp et al., 2023). The goal of the team is to support the objectives of postbank limited by providing information and guidance to enable the implementation and maintenance of an effective loan portfolio and to identify, analyze and mitigate loan defaults that threaten the achievement of the financial institution's objectives of profitability and sales growth (Julius, 2024a).

Like the use of collateral in obtaining credit, proper management and control (Julius, 2024b). Due to effective credit management, Post Bank has experienced a low loan default rate as the loan portfolio is one of the best performing in the microfinance industry in Uganda (District et al., 2023).

However, despite all the above-mentioned measures that the postal bank has undertaken to mitigate loan defaults, it is unfortunate that the financial institution continues to have some bad debts and a declining level of profitability (Ivan et al., 2023). Poorly planned loan products and partnerships were common – a situation associated with a poorly managed loan default system at the micro-deposit-taking institution (Edgar & Moses, 2023). The increase in net loss and bad debt losses had an adverse effect on the reduction of loan defaults on the profitability of the financial institution (Chijoriga, 2017). It is on this premise that this study was adopted to examine the impact of loan defaults on the profitability of financial institutions in Uganda using a postal bank as a case study.

Specific Objectives

1. To examine the relationship between borrower behaviour on profitability in post bank limited Kavule branch, Mpigi District.
2. To establish the relationship between borrowers' capacity on profitability of the post bank limited, Kavule branch, Mpigi District

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3. To investigate the relationships between credit terms on profitability in post bank limited Kavule branch, Mpigi District

Methodology

Research design is a plan showing how the problem under investigation that was studied. This study employs descriptive survey design by use of questionnaires (Olanrewaju & Abiodun, 2021). The study was at collecting information from the respondents in relation to the determinants of loan defaults (Rasheed et al., 2022). The purpose of descriptive research was adopted (Mugenda and Mugenda 2019). According to (Olanrewaju et al., 2021b) the major purpose of descriptive research is description of the state of affairs as it exists at present. According to Kothari (2018) a questionnaire is the most popular method of data collection since it can be posted to the targeted people no matter how far they are and has minimal or no cases of interviewer bias as the respondents use their own words (Olanrewaju et al., 2021a). The research included the use of both quantitative and qualitative methods of data collection with the use of a descriptive and correlation survey involving an ex-post facto design consisting of the use of interviews, questionnaires which were distributed to various individuals. The target population was 48 and the chosen sample was 45 respondents (Nafiu et al., 2013).

Self-Administered Questionnaires (SAQ) was employed to gather data from the study elements in a structured manner (Nafiu, 2012). SAQs with one open ended question per section was designed for SME employees to give additional or express their mind while the rest was close-ended aimed at testing perception using a five-point likert scale measuring from Strongly Disagree as response 1, Disagree as response 2, Not sure as response 3 Agree as response 4 and Strongly Agree as response 5 for easy measurements of variables (Nafiu, 2012). An interview refers to a data collection technique that involved face-to-face, telephone or focus group discussions between the researcher and the interviewee(s) (Nafiu, 2012). The guide involved unstructured and generally open-ended questions that would allow probing for in-depth information from participants. This guide enabled the gathering of facts from the bank, and other top management officers in these enterprises since these people have in-depth information concerning taxation policies and the performance of bank (Hussein et al., 2024).

This is the process of bringing order, structure, and meaning to the mass of raw information gathered for purposes of getting a feel for reliability and testing the research questions (Tasha et al., 2023). Initially, data was entered into MS Excel computer program for cleaning. The data was also imported to SPSS version 23 statistical software for investigation. Quantitative data analysis entailed descriptive statistics and inferential statistics (Nelson et al., 2022). Descriptive statistics involved analysis using frequencies, percentages, mean, charts, and standard deviation. The Analysis of central tendency and dispersion based on; a 5-point Likert scale ranging from strong agree to strong disagree. Similarly, inferential statistics was done based on the Pearson's correlation coefficient and linear regression analysis.

Quantitative data was analyzed by reporting of summary results in numerical terms and was presented using a percentage distribution technique but maintaining a specified degree of confidence (Aslam et al., 2022). While Qualitative data was analyzed in the form of texts and themes, yet impressions was examined and presented using descriptive methods for in depth analysis to be generated from views of the respondents and to allow the reader to make their opinions freely (Maiga et al., 2021). In addition, qualitative data is flexible, needs more checking and auditing at all steps of the analysis as well as careful archiving

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of each step of the analysis for later checking. Conversely, qualitative research offered an overall approach that provides the backbone for the analysis (Nafiu & Ph, 2012). Closed-ended questions was recorded and then the answers to each question was checked by the respondent as deemed suitable.

RESULTS

Table 1: composite reliability

Latent variable	Original sample (o)	Sample mean(M)	Standard Error (STEER)	T-statistics	P-value
Borrower behaviour	0.894	0.894	0.015	59.236	0.000
Borrower commitment	1.000	1.000	0.000		
Credit administration	0.928	0.928	0.010	97.350	0.000
Credit repayment performance	0.903	0.903	0.017	53.351	0.000

Source: primary data

The composite reliability analysis findings reported in the table reveal that all four latent constructs met the recommended threshold value of 0.70, with borrower behaviour recording an extremely high original composite reliability of 0.894 which was also equal to its sample mean of 0.894 and a relatively small standard error of 0.015, thus demonstrating impressive internal consistency among its measures, while borrower commitment presented a perfect composite reliability of 1.000 as expected since it was measured using a single-item format, credit administration exhibited the next strongest composite reliability of 0.928 which was very close to its sample mean of 0.928 and a standard error of just 0.010, and lastly credit repayment performance also showed very good composite reliability of 0.903 that was consistent with its sample mean of 0.903 albeit with a slightly higher standard error of 0.017, with all constructs' t-statistics values far exceeding the critical t-value showing very strong convergent validity at extremely low p-values proving that each item pattern converged well and measured its respective construct as intended based on the output.

Table 2: average variance

Latent variable	Original sample (o)	Sample mean (M)	Standard Error (STEER)	T-statistics
Borrower behaviour	0.740	0.741	0.030	24.450
Borrower commitment	1.000	1.000	0.000	
Credit administration	0.813	0.814	0.021	38.349
Credit repayment performance	0.757	0.785	0.035	21.751

Source: primary data

The average variance extracted values presented in the table serve to assess the amount of variance that is captured by a construct in relation to the amount of variance due to measurement error, with any value exceeding the prerequisite threshold of 0.50 considered adequate to establish convergent validity, accordingly the results indicate that borrower behaviour captured an excellent original average variance of 0.740 which closely matched its sample mean of 0.741 while maintaining a reasonably small standard error of 0.030, with a highly significant t-statistic of 24.450, credit administration also attained strong convergent validity evidenced by its original average variance of 0.813 being very close to the sample mean of 0.814 alongside a minimal standard error of 0.021 and outstandingly high t-value of 38.349, borrower commitment unsurprisingly achieved perfect convergent validity as implied by its fixation at 1.000 given it was single-item measured, and credit repayment performance marginally surpassed the 0.50 threshold at 0.757 for original average variance versus the sample mean of 0.785 along with a moderate standard error of 0.035 and a still notably large t-statistic of 21.751, suggesting all constructs passed the convergent validity assessment as the majority of variance was due to the respective constructs not error.

Table 3: path coefficient

Latent variable	Original sample (o)	Sample mean (M)	Standard Error (STEER)	T-statistics
Borrower behaviour Borrower commitment	0.390	0.386	0.040	9.788
Borrower behaviour Credit repayment performance	0.604	0.608	0.042	14.243

Borrower commitment Credit repayment performance	0.236	0.237	0.041	5.809
Credit administration Borrower commitment	0.487	0.491	0.026	18.961
Credit administration Credit repayment performance	0.144	0.140	0.056	2.584

Source: primary data

The path coefficients generated through the multivariate regression analysis and presented in the table provide important insights into the strength and significance of relationships between the latent constructs, specifically, the findings show that borrower behaviour had a moderately strong positive impact on borrower commitment as evidenced by the original path coefficient of 0.390 which closely aligned with its sample mean of 0.386 while exhibiting a standard error of 0.040 and a highly significant t-value of 9.788, borrower behaviour also wielded a strong positive influence on credit repayment performance as demonstrated by the original path coefficient of 0.604 that was virtually equal to its sample mean of 0.608 coupled with a standard error of just 0.042 and outstandingly large t-statistic of 14.243, borrower commitment in turn had a moderately positive effect on credit repayment performance with an original path coefficient of 0.236 that slightly underestimated the sample mean of 0.237 but maintained a negligible standard error of 0.041 and a still substantially high t-value of 5.809, credit administration was found to moderately positively impact borrower commitment as shown through its original path coefficient of 0.487 approximating the sample mean of 0.491 despite a marginal standard error of 0.026 and immense t-value of 18.961, while its effect on credit repayment performance was low yet significant as the smallest original path coefficient of 0.144 nearly matched the sample mean of 0.140 even with the highest standard error of 0.056 and a considerable t-statistic of 2.584, signifying all hypothesized relationships were substantiated.

Table 4: total effects of loan default

Latent variable	Original sample (O)	Sample mean (M)	Standard Error (STEER)	T- statistics
Borrower behaviour Borrower commitment	0.390	0.386	0.040	9.788
Borrower behaviour Credit repayment performance	0.697	0.700	0.033	21.158

Credit administration Borrower commitment	0.236	0.237	0.041	5.809
Credit administration Credit repayment performance	0.259	0.256	0.053	4.860

Source: primary data

The total effects analysis findings comprehensively captured both the direct and indirect impacts between the latent constructs, specifically, borrower behaviour was shown to exert a moderately strong total effect on borrower commitment identical to the direct effect, as evidenced by the original sample total effect estimate of 0.390 that closely matched the sample mean of 0.386 while exhibiting very low standard error of 0.040 and profoundly high t-statistic of 9.788 signifying extremely strong relationship, meanwhile borrower behaviour wielded an even stronger total impact on credit repayment performance well above the combined direct effects, as demonstrated by the sizable original total effect of 0.697 accurately approximating the sample mean of 0.700 alongside minuscule standard error of 0.033 and exceptionally large t-value of 21.158, in addition credit administration maintained its moderately positive total influence on borrower commitment akin to the direct effect, as implied by the original total effect of 0.236 being consistent with the sample mean of 0.237 and small standard error of 0.041 coupled with strongly significant t-statistic of 5.809, and similarly its total impact on credit repayment performance remained marginally positive, as reflected in the original total effect size of 0.259 closely resembling the sample mean of 0.256 despite a slightly elevated standard error of 0.053 and still substantially high t-value of 4.860, signifying all hypothesized relationships were strongly substantiated in the total effects model (Nelson et al., 2023). Finally, credit administration and credit repayment performance with 0.259, with a sample mean of 0.256

Conclusions

Following the study findings as indicated in chapter four of this paper, the researcher made the following conclusions; Borrowers' behaviour is rarely the result of a single motive.

Common behaviour results mainly from an individual's interactions with the external environment, however, the personality of the borrowers always play an instrumental role.

Borrowers usually have a behavior of avoid defaulting on loans because they believe that this may spoil their reputation. Borrowers are

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usually more determined to use loan money effectively for income generating activities in fear for failure to repay back the loan if they do not effectively plan for the loan.

Loan defaults and repayment depend highly on customer commitment to repay back the loan. The total commitment that borrowers put in to clear their dates as per repayment schedules highly influences the credit repayment performance. Lack of commitment of the borrowers negatively affects the loan repayment performance. Credit repayment performance requires frequent monitoring of the borrowers. This involves identifying the bad debtors, assessing the performance of their loans that is to say, whether the loan was effectively used for the intended. The rate at which the borrowers meet their loan repayment schedules is directly proportional to loan repayment performance in that the higher the commitment, the better the loan repayment performance and the lower the commitment, the poor the repayment performance.

Recommendations

To Post bank Kavule, It is the role of the bank to effectively evaluate, assess and examine the borrowers' ability and willingness to repay the requested loan before they are offered those loans. This would enable the bank to reduce bad debts and improve on the loan repayment performance. More so, Post bank Kavule should ensure that their interests on the loan are not too high for the borrower in a way that the interest rate should not take much of the borrowers' money which may lead to repayment avoidance.

To Borrowers, the borrowers should first plan for the loan before they borrow to avoid diverting the borrowed money for other motives other than the intended. This will help them in meeting the loan repayment schedules and avoid bad debts. More so, as a borrower, you should first understand the loaning rates, the burden and the opportunity cost of repayment of the loan, how much they will pay as interest during loan repayment as well as evaluating the performance of the business before the loan. This will act as a basis for decision making on whether to borrow or not.

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