Available online at www.elixirpublishers.com (Elixir International Journal)

Finance Management

ISSN: 2229-712X

Elixir Fin. Mgmt. 70 (2014) 24090-24091

Non-Performing Loans and Growth & profitability of Pakistani banking sector

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ARTICLE INFO

Article history:

Received: 1 December 2013;
Received in revised form:
25 April 2014;
Accepted: 5 May 2014;

Keywords

Non-Performing Loans (NPL),
Return on Assets (ROA),
Return on Equity (ROE) and Total Assets (TA).

ABSTRACT

This paper examined the impact of non-performing loans on the profitability of the banking industry of Pakistan. We have taken the Return on Assets (ROA), Return on Equity (ROE) as Total Assets (TA) as profitability measure for the time span of 1998-2010. We have taken the data of Non-Performing Loans from the central bank of Pakistan. By applying the regression analysis, we have concluded that Non-Performing Loans have significant negative impact on the profitability and growth of the Banking sector of Pakistan.

Introduction

Banking sector plays a vital role in the development of any economy. All over the world, banking industry has gone through several changes over the period of last two decades. Especially in the perspective of Pakistan, banking reforms were introduced and most of were banks privatized thereby.

The growth of banking industry in any economy is the hope for the economic development. Banks are the only medium through which funds transfer from saver's to the investors. Banks collect surplus funds from the people in the form of savings and transfer these funds to investor in the form of loans. So if banks collect more funds, lend these funds as loans to the investors, who invest these loans in the economy in the form of new businesses, it can help boost economic growth. The establishment of new businesses is likely to result in more job opportunities, increase in production, which may lead to people having more choices thereby directing the economy on the track of development.

However banks are confronted with many problems and the exotic one is non-performing loans. This problem has a material effect on the health of banking sector.

Merely due to the problem of non-performing loans, considering alone, Pakistani banking sector faces problem in growth and in profitability as well. In the long- run the economy of Pakistan will suffer, as banks are not willing to lend, and job opportunities will diminish causing overall economic growth to be low. Over the period of time, the increasing trend in the Non-performing Loans is alarming for the banking growth and profitability.

Review of Literature

Nelson M. Waweru (2009) examined the Commercial Banking Crises in Kenya: Causes and Remedies. To complete this study he took the data by through questionnaire which includes the items regarding the causes of the non-performing loans, steps taking in this regard and the success of these changes. The sample studied includes middle level managers, credit mangers and credit analysts. By using Cronbach's alpha he concluded that the failure to disclose vital information during the loan application and lack of an aggressive debt collection policy are the main causes for non-Performing loans.

Muhammad Farhan Akhtar et al. (2011) examined Factors Influencing the Profitability of Conventional Banks of Pakistan to complete this study they collected the data for the period of 2006 to 2009. They defined Return on Assets (ROA) and Return on Equity (ROE) as dependent variables on Bank size, Gearing Ratio, NPL's ratio, Asset Management, Operating efficiency and Capital adequacy as independent variables. By applying the multi- variant regression model they concluded that Gearing ratio, NPL's ratio and Asset management ratio are the significantly affected the profitability of the banks.

Tobias and Themba(2011) studied the Effects of Banking Sectoral Factors on The Profitability of Commercial Banks in Kenya. They included all the licensed commercial banks and used the secondary data for the period of 2002 to 2008. They defined the ROA as profitability measure of banks as dependent variable on Capital adequacy of banks (CAP) Asset quality of banks (ASQ) Liquidity of banks (LIQ) Operational cost efficiency of banks(CIR) Income diversification of banks (RDI) Market foreign ownership structure (FGN) Market Concentration (MKT).By applying the multiple linear regression model, they concluded that all these variables have significant impact on the profitability of the banking sector and broadly speaking managerial decisions and market factors are main drivers which affect the profitability of the banks.

Grigori and Novikov (2011) examined the Comparative Analysis of Credit Risk Determinants In the Banking Sector of the Baltic States. They took the quarterly data for the period of July 1997 to December 2009. By applying the VEC model, they concluded that the most significant change in the non-performing loans due to change in the GDP. Non- performing loans - its causes, consequences and some learning was observed by the Islam et al (2005). They took the data of non-performing loans from the secondary sources and conducted a detailed interview of 87 managers of 26 branches of 9 different banks along with 12 borrowers. By applying the descriptive statistics they concluded that the funds in fact unutilized and

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mostly flow out of the economy which ultimately in short runs losses to the institutions and society, and in long run resulted in economy stagnated. Yoonhee(2006) examined the role of Non-Performing Loans (NPL's) and capital adequacy in banking structure and competition. He took the data of 28 banks and by applying the Vector regression analysis they concluded that overall banking industry does not confirm to standard convergence theory in concentration with a given sunk cost. Zhixiong (2003) examined the Asymmetric Growth, Non-Performing Loans and banking Crisis. He concluded that if the economy's productivity growth increased then the friction of non-performing loans also increased. Hippolyte (2005) examined the Nonperforming Loans in Sub-Saharan Africa: Causal Analysis and Macroeconomic Implications. He concluded that the rise of nonperforming loans led to a deterioration of bank assets and erosion of their capital.

Methodology

In this paper we have explored the effect of Non-Performing Loans and the growth of Banking industry and their profitability. We used the Secondary data for the period of 1998 to 2010. We use the Return on Assets and Return on Equity (ROE) as the profitability measure for banks and increase in the total assets as the growth of banks. By applying the flowing models:

$ROA=\alpha_1 + \beta_1 NPL + \epsilon_1$-- i

$ROE=\alpha_2 + \beta_2 NPL + \epsilon_2$-- ii

$TA=\alpha_3 + \beta_3 NPL + \epsilon_3$--- iii

Where, NPL is independent variable and ROA, ROE and TA are dependent variables in above models.

Assuming the above models follows certain assumptions of classical linear regression models and ϵ_I follows the normal distribution with mean zero and constant variance.

Our findings are as follows

ROA= 1.044 - 0.13 NPL---i

S.E	(0.24)	(0.03)
T-test	(4.30)	(-3.32)
P-Value	(0.00)	(0.00)

The model is highly significant at 5% level and 10% significant at 10% level.

ROE= 3.90 - 0.49 NPL---ii

S.E	(1.02)	(0.16)
T-test	(3.78)	(-2.97)
P-Value	(0.30)	(0.01)

The overall model is significant at 5% level and 10% level.

TA= 47.01 - 5.79 NPL---iii

S.E	(10.15)	(1.63)
T-test	(4.63)	(-3.53)
P-Value	(0.00)	(0.00)

Overall model is highly significant at 5% and 10% level.

Discussion on Results

Form the findings, we can say that non performing loan is very important factor which affect the profitability of the banking sector. But from last two decades, there are certain changes occurred in Pakistani banking industry like the privatization of the public banks. Due to this the political influence in the Pakistani banking industry decreased, which results in low level of non- performing loans in the coming years.

From our first model we found that there is negative relationship between the Return on Assets (ROA) and the Non performing loans, which is theoretically true. Our results support the literature and show the significant impact of non- performing loans on the ROA. In the second model, again we found the negative relation between the Return on Equity (ROE) and the non-performing loans. In the final model we found the inverse relationship between the Total assets and the non-performing loans. In nutshell we concluded that a non performing loan is the big hurdle in the growth and profitability of the banking sector of Pakistan.

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