The Efficacy of Credit Risk Management on the Corporate Performance of Rural Banks in Ghana

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Abstract: The study examined the impact of credit risk management on the performance of rural banks in Ghana. The study adopted both descriptive and quantitative research approaches. Twelve (12) rural banks in the Ashanti region were used for the study. Secondary data were obtained from the annual financial reports from 2010 to 2015 of the rural banks. Regression analysis was used to test the impact of credit management on the performance of the rural banks. Both Return on Capital Employed (ROCE) and Corporate Liquidity (cash ratio) were used as measures of performance whilst Portfolio at Risk (PAR) and Loans Recovery Rate (LRR) were used as measures of credit risk management. The result obtained showed that portfolio at risk (PAR) had a significant negative impact on both ROCE and liquidity of the rural banks. The evidence further showed that the loans recovery rate (LRR) of the rural banks had a positive and significant impact on their ROCE and liquidity. It is concluded that both PAR and LRR has an impact on the liquidity and profitability of the rural banks in the Ashanti region. It is recommended to the management of these rural banks that they should work to keep the portfolio at risk to a minimum and tolerable level of 5% as per BOG Policies.

Keywords: Credit Risk, Rural Banks, Liquidity, Profitability, Portfolio at Risk, Loan Recovery Rate.

1. INTRODUCTION

Financial institutions, especially rural banks are entrusted with the funds of depositors. These deposits are usually used by the rural banks by giving them as loans to other customers to generate revenue. Since these funds are for the customers which the rural banks act as custodians, there must exist a policy or program for the administration and management of these funds. According to Djan et al. (2016), the program should continually aim at achieving three fundamental objectives: income, liquidity and safety. The effective management of these funds requires a suitable balance among the three objectives. Maxwell and Peter (2016) explain that the liquidity empowers the financial institutions to address the amount of loans demanded by their clients who have good credit rating. Safety is the second goal which means staying away from excessive risk because financial institutions, particularly rural banks have the obligation to secure these funds given to them. The third objective being profitability or income is targeted at the development and growth of the funds in order to meet the reimbursement of interest charges on credit, to accomplish the aim of maximizing the wealth of shareholders as well as to strive in the competitive financial market (Uwuigbe, 2011).

According to Djan et al. (2016), credit risk remains the biggest source of risks for financial institutions in Ghana. This is because the loan portfolios of the financial institutions are the biggest assets and the main source of income to these banks. Experience of earlier years has demonstrated that the absence of proper management of such risks has brought about substantial losses or even devastating losses for various banking institutions (Afriyie & Akotey, 2013). The result of such losses, do not just disrupts the intermediation capacity of the institutions affected, it additionally forces expansive financial burdens on the government in recapitalizing such financial institutions. It is envisioned that as the size of the

balance sheets of the banking institutions increases over time, the potential financial burden will increase proportionately. Successful credit risk management is consequently fundamental to ensure that the credit activities of financial institutions are conducted in an efficient way and the danger of potential bank failures reduced.

Additionally, Maina, Kinyariro and Muturi (2016) assert that corporate liquidity empowers companies to meet both their short-term and long-term commitments as they fall due. Proper management of credit enables a financial institution to meet its financial obligations and take advantage of profitable investments that are likely to yield higher returns in future. Mutual (2015) also contends that firms that exhibit a proper balance of their corporate liquidity and credit risk are able to channel their finances into profitable investments. The optimal amount of liquidity is determined by the credit management practices implemented by a financial institution in order to mitigate exposure to credit risk (Myers & Majluf, 2004). Conversely, credit risk is the likelihood that a borrower or counterparty will be unable to meet their commitments as per the agreed terms (Ngugi, 2012).

The introduction of the Ghanaian Banking Act, 1993 (Act 328) expanded the quantity of banking and non-banking institutions in the financial industry. With a changed financial sector, rivalry among financial institutions increased, prompting free operations in the banking industry with the view to undercutting competition. That has resulted to low margins and different difficulties confronting the banking industry. Rural banks are chief players in the financial industry of the economy of every developing nation because of their unique role of providing financial support to the marginalized rural poor and small businesses. The failure or success of these rural banks will to a vast degree influence the financial sector and the economy at large. Lately some rural banks (e.g. Tanogya Rural Bank, Shai Rural Bank, Fanteakwa Rural Bank) have been or nearly collapsed, other financial institutions (e.g. UT Bank and Capital Bank) have been acquired by different institutions, whilst others struggle to make profit leaving clients to their destiny. It is important to note that the major reason for the collapse of some of these rural banks and financial institutions is their ineffective and inefficient management of their credit and finance in general (Djan et al., 2016). Majority of them were writing off large amount of debt annually and this furthermore mirrored some going concern issues that were identified with their management of credit and finance. The explanation behind the failure of these banks has triggered the interest of regulators, policy makers and researchers to conduct studies on the management of credit in the Ghanaian banking industry.

Various studies have been directed at credit risk management and corporate performance both internationally (Hamid and Adel, 2013; Muasya, 2013; Xiong, 2014; Maxwell & Peter, 2016) and locally (Afriyie & Akotey, 2013; Oware et al., 2015; Djan et al., 2016). However, none of these studies investigated the impact of credit risk management practices on corporate performance of rural banks, particularly in the Ashanti region of Ghana which boasts of the largest number of rural banks in Ghana. Consequently, the need arises to examine the degree to which the management of credit risk impacts on corporate performance. It is from this background that this researchers examined the credit risk management practices among rural banks and its impacts on their performance.

2. REVIEW OF LITEARTURE

2.1 Concept of Credit Risk:

Kassey (2015) defined risk as the probability of actual return being not as much as the expected return. Consequently, Mutual (2015) contends that credit risk is the likelihood that an obligor or debtor will be unable to meet his/her obligations in accordance with the agreed terms, bringing about financial loss. Nawaz and Munir (2012) also explained that credit risk is the risk of loss due to non-payment of debts owed by an individual or entity and may be compounded by liquidity risk. As indicated by Djan et al. (2016), credit risk is the risk that a borrower will default on an obligation by refusing or unable to make required payments. Djan et al. (2016) maintained that credit risk is fundamentally identified with a lender and it involves a lost principal and interest, disturbance to cash flows and increased collection expenses. The loss might be complete or fractional and can emerge in various conditions which comprise the risk of loss of principal sum or loss of a money related financial reward coming from the inability of borrowers to pay a loan or generally meet a legally binding commitment (Kassey, 2015).

In the opinion of Rufai (2013), credit risk emerges whenever a borrower is expecting to use future cash flows to pay a current debt. Investors are compensated for assuming credit risk by way of interest payments from the borrower or issuer of a debt obligation. Maina et al. (2016) also noted that credit risk is closely tied to the potential return of an investment, the most notable being on the yields on bonds which correlate to their perceived credit risk. According to Mutual (2015), credit risk can be measured using debt to equity ratio, portfolio to assets ratio, operating expense ratio, credit risk ratio and portfolio at risk ratio. Since financial firms are established not only to accept deposits but also to grant loans, thus, are definitely opened to credit risk (Kolapo et al., 2012). Hull (2007) considers credit risk as the most critical risk that

confronts financial institutions and the achievement of their business objectives relies upon exact estimation and effective credit risk management to a greater degree than any other risk.

Similarly, Hamid and Abel (2013) noted that credit risk is the non-receiving cash flows of giving credit facilities by banks. As commented by Kassey (2015), financial institutions cannot totally eliminate risk. Regardless, the institutions must only take risks which they clearly understand, can realistically measure and are in accordance with the capacity of the firms as guided by appropriate policies and regulations of the institutions. Abdullahi (2013) also asserts that credit risk is of worry to most regulators and stakeholders in the banking industry. This is on the grounds that credit risk can without much of a stretch provoke the failure of a bank. In addition, Acharya (2011) indicated that credit risk involves insolvency, inability to pay, loan restructuring, loan suspension and quickened loan payments. Indiael and Dickson (2013) also commented that credit risk can be an element of different factors, for example, deficient knowledge on financial risk, particularly credit risk at institutional level, absence of appropriate and effective credit policy, lack of capital and unsteady liquidity status, carelessness in credit evaluation, and poor lending procedures and practices. Additionally, Maina et al. (2016) contend that the interference of governments and lack of supervision by the Apex Banks and direct lending are the other sources of credit risk.

2.2 Credit Risk Management in Financial Institutions:

Banking business, like any other types of business, face risks. It is risky in the sense that it is a business where the proportion of borrowed funds is far higher than the owners' equity (Kessey, 2015). According to Danjuma (2015), the banking businesses in this contemporary time do not simply receive deposits and grant lending. The author explains that the banks have to create many banking products and services for customers in order to compete with other competitors. This and other various activities of banks make the risks related to banks more complex. Consequently, Nawaz and Munir (2012) contend that the biggest risk that banks might face is credit risk. According to the authors, credit risk occurs when debtors are not able to pay back their loans and interests. Mutual (2015) posits that bad debt is the main cause of the credit risk for the bank. In credit management, banks need to control the bad debt by many ways (Rufai, 2013). The author explained that at least banks have to be able to predict and evaluate the credit risk situation. The main question in credit management is whether to approve the loan application of a specific customer or not (Muasya, 2013). However, the banking businesses make profit by lending, so customer evaluation and loan assessment is an important process.

Credit risk in the banking industry is for the most part caused by unfavorable choice and moral hazards because of information asymmetry (Allen & Gale, 2004). Rufai (2013) also clarified that the credit risk circumstance of banks can be worsened by insufficient institutional capacity, ineffective credit rules, ineffective board of directors, small capital sufficiency ratio and liquidity, forced quota-lending because of interference from government and absence of appropriate supervision by the central bank. At this point, the impact of credit risk on the financial performance of financial institutions have dominated many discussions in academia and the banking industry. Consequently, many studies on the impact of credit risk on the performance of financial institutions have been conducted. Mokaya (2011) conducted a study on the link between credit card default risk and cardholders characteristics, credit card characteristics and behavioral scoring process among Commercial Banks in Kenya. A descriptive survey of sampled commercial banks was conducted and data for the study was analyzed using descriptive statistics. The study results indicated that commercial banks that had implemented credit risk assessment had lesser loan defaults. Furthermore, Philip (2012) investigated the effect of liquidity risk and credit in the financial crisis in San Francisco. Data for the study was collected from a sample of 55 banks between 2007 and 2008. According to the results, credit risk reduced with banks experiencing liquidity pressures.

Muasya (2013) also investigated the relationship between credit risk management practices and loans losses on commercial banks in Kenya. The study used descriptive research design and the data for the study was obtained from primary sources. The study results indicated that there was a negative and a statistically significant relationship between credit risk management practices and loans losses among commercial banks in Kenya. Furthermore, Harvey et al. (2014) conducted a study on the effect of credit risk on corporate liquidity among commercial banks in Netherlands. The data for the study was collected from a sample of 65 banks for a period of five years ranging from 2008-2012. According to the results, there was an inverse relationship between the credit risk and corporate liquidity among commercial banks.

Similarly, Ngugi (2012) conducted a study on the impact of credit information sharing on credit risk for commercial banks in Kenya. The study used non-performing loans as a measure of credit risk. The population of this study consisted of all 44 banking institutions registered and operational in Kenya under the Kenyan Banking Act. The study utilized both secondary and primary data. Quantitative data on credit risk for commercial banks was extracted from the annual financial reports of the banks. Data on credit information sharing was also obtained through the use of questionnaires. Chi-Square test was used to determine whether there was a significant difference between the expected frequencies and the observed

frequencies in one or more categories. According to the findings of the study, credit information sharing had a positive but not statistically significant impact on credit risk.

In Ghana, there are few empirical studies on the impact of credit risk management on the financial performance of financial institutions. Djan et al. (2016) empirically examined the impact of credit risk on the performance of banking institutions. The authors sampled nine banks that were listed on the Ghana Stock Exchange for the study. The data for the study were obtained from the annual financial statements of the banks from 2005 to 2014. In the study, the parameters used to measure credit risk were: default rate, capital adequacy ratio and cost per loan assets. The authors compared the default rate, capital adequacy ratio and cost per loan assets to performance ratios. Similarly, the study employed descriptive, correlation and regression analysis methods to analyses the data. The evidence obtained showed that default rate, capital adequacy ratio and cost per loan assets had a negative impact on the performance of the banks. The study further stated that default rate was the most predictor of the financial performance of the banks. Similarly, Afriyie and Akotey (2013) examined the impact of credit risk management on the profitability of rural banks in the Brong Ahafo region of Ghana. The annual financial statements of ten (10) rural banks, from 2006 to 2010 were used for the study. Both return on equity (ROE) and return on assets (ROA) were used as measures of profitability whilst non-performing loans (NPL) and capital adequacy ratio (CAR) were used as measures of credit risk management. The study used a panel regression model for the analysis and found a significant positive relationship between non-performing loans and the profitability of the rural banks.

3. RESEARCH METHODOLOGY

This adopted descriptive and correlational research designs. This study also adopted a survey study design, focusing on the rural banks in the Ashanti Region of Ghana. Secondary data were used for the study. The secondary materials were obtained from the annual financial reports from 2010 to 2015 of the selected rural banks. The population of the study consisted all the twenty five (25) rural banks in the Ashanti region of Ghana. The study intended to use all the twenty five rural banks, however, the annual reports of thirteen (13) could not be obtained. As a result, twelve (12) rural banks were used for the study. In order to achieve the objectives of the study, the audited financial statements of the rural banks covering the period 2011-2015 were analyzed.

In this study, both descriptive and regression data analysis methods were used. The data were summarized and presented in tables. The descriptive analysis involved presenting the results in the form of mean scores, standard deviation and skewness to determine varying degrees of the data. In order to evaluate the impact of credit risk management on performance, more quantitative method was employed to address the aforementioned problems of the institutions. As a result, regression analysis was used to determine relationship between the study's quantifiable variables. The regression models that was employed in the study are stated as follows:

$$ROCE = \beta_0 + \beta_1 PAR + \beta_2 LRR + \beta^3 Size + \beta_4 Age + u ----- (1)$$

$$CR = \beta_0 + \beta_1 PAR + \beta_2 LRR + \beta_3 Size + \beta_4 Age + u ----- (2)$$

Where;

ROCE = Return on Capital Employed (dependent variable for equation 1) which is measured by profit after tax divided by total assets of the rural banks.

CR = Cash Ratio or Corporate Liquidity (dependent variable for equation 2) which is measured by cash plus marketable securities divided by current liabilities of the rural banks.

PAR = Portfolio at Risk (independent variable), measured by loans in arrears over a period of 30 days divided by gross loans granted by the rural banks.

LRR = Loan Recovery Rates (independent variable), measured by total loans recovered divided by total loans expected to be recovered during the period.

Size = The size of the rural banks (control variable) which is measured by the natural logarithm of the total assets of the rural banks

Age = The number of years of existence of the rural banks

β_0 = Constant of the equations

β_1, β_2, β_3, and β_4 = the slope of the equations

U = Stochastic Error Term

4. RESULTS

Descriptive Analysis:

The summary of the descriptive statistics of the rural banks used for the study is presented in Table 1.

Table 1: Descriptive Analysis

Variables	Mean	SD	Skewness
ROCE	6.35	4.671	0.975
Cash Ratio	0.31	2.527	0.146
PAR	3.97	1.064	0.158
LRR	90.4	1.019	0.681
Size (in millions of cedis)	19.68	11.46	0.596
Age	32.41	0.072	0.792

It can be ascertained from Table 1 that the average return on capital employed (ROCE) of the rural banks is 6.35%. Similarly, the standard deviation of the ROCE is 4.671, showing the level of variation among the ROCE of the rural banks. The skewness of 0.975 shows that almost all the rural banks made a positive ROCE throughout the study period.

In addition, the average cash ratio (CR) of the rural banks is 0.31:1, with standard deviation and skewness being 2.527 and 0.146 respectively. This result shows that majority of the rural banks had adequate cash to meet their short term obligations. Table 1 further shows that the average portfolio at risk (PAR) is 3.97. Table 1 further shows that the average loans recovery rate of the rural banks is 90.4. This means that the rural banks were able to recover more than 90% of the loans granted to their clients. Regarding the control variables, the average size and age of the rural banks were GHS 19.68 million and 32.41 respectively.

The impact of Credit Management on the Profitability:

This section presents the results on the impact of credit management on the profitability of rural banks. In this study, profitability is measured by the return on capital employed (ROCE) of the rural banks. Credit management is also measured by the portfolio at risk (PAR) and the loans recovery rates (LRR) of the selected rural banks. Table 2 presents the results on the impact of credit management on the profitability of rural banks.

Table 2: The impact of Credit Management on the Profitability (ROCE)

Variables	Coefficient	Std. Error	t-statistics	Probability
Constant	68.31	2.1451	13.15	0.0013
PAR	-0.3853	0.3295	2.685	0.0364
LRR	0.5146	0.5112	1.976	0.0407
Size	0.1483	0.1696	1.632	0.0515
Age	0.2681	0.8945	1.861	0.5431

$\alpha = 0.05$; $R^2 = 0.763$; Adjusted $R^2 = 0.705$; F-Statistics = 149.44; prob. of F-statistic = 0.000

From Table 2, the results on the impact of credit risk management on the profitability (ROCE) of rural banks can be obtained. First, the evidence shows a negative and significant ($p = 0.0364$) impact of portfolio at risk (PAR) on the return on capital employed of the rural banks. From the Table 2, it can be ascertained that portfolio at risk (PAR) has a coefficient of -0.3853, which means that the portfolio at risk has a 38.53 percent impact on the return on capital employed of the rural banks. Specifically, the result suggests that, when all variables are held constant, an increase in the portfolio at risk would results to a 38.53 percent decrease in the return on capital employed of the rural banks. On the other hand, a decrease in the PAR of the rural banks would also result to a 38.53 percent increase in the return on capital employed of the rural banks when all the other variables are held constant. This result is not surprising since interest income is the main source of income to rural banks. It therefore stands to reason that when customers are unable to pay their loans, it will definitely have a negative impact on interest income. As can be ascertained, the level of impact of portfolio at risk

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(PAR) on the return on capital employed (ROCE) of the rural banks is also statistically significant (t = 2.685 and p = 0.0364).

In addition, the evidence shows that the loans recovery rate (LRR) of the rural banks has a positive and significant (p = 0.0412) impact on their return on capital employed. The result shows that loans recovery rate (LRR) has a coefficient of 0.5146, which suggests that the loans recovery rate has a 51.45 percent impact on the return on capital employed of the rural banks. Specifically, what this result means is that an increase in the loans recovery rate would result to a 51.45 percent increase in the return on capital employed of the rural banks when the other variables are held constant. This result was actually anticipated because, income is obtained when banks and financial institutions are able to recover their loans. This means that the higher the loans recovered, the higher the interest income and consequently, this result to a higher profit. Table 2 further shows that the size (total assets) and age of the rural banks have a positive but insignificant impact on their return on capital employed. It can further be ascertained that the R2 and Adjusted R2 of the model are 0.763 and 0.705 respectively. The R2 of 0.763 means that about 76.3 percent of the variations in the dependent variable (return on capital employed) is explained by the independent variables. Further, the probability of the F-statistic is 0.000, which is less than the 'α' of 0.05, suggesting that the model is a good fit.

The impact of Credit Management on the Corporate Liquidity:

This section presents the results on the impact of credit management on the liquidity of rural banks. Cash ratio or liquid ratio is used as a measure of the liquidity of the rural banks. In addition, credit risk management is measured by the portfolio at risk (PAR) and the loans recovery rate (LRR) of the rural banks. The result on the impact of credit risk management on the liquidity of the rural banks is presented in Table 3.

Table 3: The impact of Credit Management on the Corporate Liquidity

Variables	Coefficient	Std. Error	t-statistics	Probability
Constant	74.31	2.769	14.55	0.0074
PAR	-0.3836	0.1985	3.486	0.0296
LRR	0.4521	0.4157	2.583	0.0407
Size	0.1652	0.8471	1.861	0.0487
Age	0.2744	0.9572	2.025	0.0521

α = 0.05; R2 = 0.781; Adjusted R2 = 0.714; F-Statistics = 143.48; prob. of F-statistic = 0.000

Table 3 presents the results from the regression analysis on the impact of credit risk management on the liquidity of rural banks. The result obtained showed that portfolio at risk (PAR) had a negative impact on the liquidity of the rural banks. The evidence presented in Table 3, shows that the coefficient of portfolio at risk (PAR) is -0.3836. This means that the portfolio at risk (PAR) has 38.36 percent inverse impact on liquidity, holding other variables constant. In addition, it can be observed that the level of impact of PAR on liquidity was significant (p = 0.0296). This result means that when PAR is reduced, the liquidity of the rural banks would be increased. On the other hand, when PAR is increased, the liquidity would be reduced. Indeed, it is expected that, the liquidity of the rural banks would be bolstered when portfolio at risk is reduced to the minimum. This means that when a firm is efficient with its credit management with regards to reducing PAR, its liquidity position would be stronger. This is particularly important for rural banks which largely depend on the interest on loans as their main source of income.

The result further shows that the loans recovery rate (LRR) of the rural banks has a positive and significant (p = 0.0407) impact on their liquidity. The coefficient of loans recovery rate was 0.4521, suggesting that an increased in the loans recovery rate of the rural banks would also result to a 45.21 percent increase in liquidity, provided the other variables remain the same. This result is conceivable because it is generally expected that when a firm is able to recover its loans, it will lead to high liquidity position of the firm. It stands to reason that interest on loans constitute the largest component of current assets of rural banks. Thus, if the rural banks are able to recover these loans within the agreed time, it will also lead to an increase in liquidity. Thus, the higher the loans recovery rate, the higher the liquidity of the rural banks.

It can further be observed from Table 3 that the size of the rural banks (Size) had a positive and significant (p = 0.0487) impact on liquidity, suggesting that rural banks with larger capital would have a strong liquidity position. Similarly, the age of the rural banks has a positive and insignificant (p = 0.521) on the liquidity of the rural banks. Table 3 further shows

that the R2 and Adjusted R2 of the model were 0.781 and 0.714 respectively. The R2 of 0.781 indicates that the independent variables define the dependent variable (liquidity) in the model up to 78.1 percent.

The implication of the results presented above is that credit risk management (portfolio at risk and loans recovery rate) are good predictors of corporate performance of rural banks. In this case, the rural banks can increase their performance if they commit more efforts to improve their loans recovery rate and decrease their portfolio at risk. Here, it explains why financial institutions are always careful and meticulous with regards to the granting of credit facilities to individuals and firms. As the result indicates, any financial institution that do not take credit management seriously, risk going out of business because it would have a negative impact on its performance. This explains why financial institutions find it convenient to grant loans to the government in the form of Treasury Bills. Additionally, this might be the reason why financial institutions prefer to give loans to public sector workers. These kinds of loans are noted to have high recovery rates because it is assumed that governments do not go bankrupt and thus when a government owes you, you are sure for the recovery. In addition, this suggests why large firms obtain loans from financial institutions.

On the other hand, it is not surprising SMEs and startups find it difficult to obtain loans from the financial institutions because it is widely acknowledged that SMEs and business startups have high default rates. In addition, these SMEs and startups are vulnerable to market changes and often have inadequate management skills due to their small size. These results agree with the findings of earlier studies. For instance, the findings confirm the findings of Mokaya (2011) who provided evidence to support that credit management had an impact on both liquidity and profitability of commercial banks in Kenya. In addition, earlier studies like Philip (2012), Muasya (2013) and Harvey et al. (2014) found similar results to support the argument that credit risk management had impact on profitability and corporate liquidity.

5. CONCLUSION

The study used regression analysis to examine the impact of credit risk management on the performance of rural banks. The result obtained showed that portfolio at risk (PAR) had a negative impact on the liquidity of the rural banks. This result means that when PAR reduces, the liquidity of the rural banks would be increased. The result further shows that the loans recovery rate (LRR) of the rural banks had a positive and significant impact on their liquidity. The coefficient of loans recovery rate was 0.424, suggesting that an increased in the loans recovery rate of the rural banks also result to a 42.4 percent increase in liquidity, provided the other variables remain the same.

The evidence further showed that the loans recovery rate (LRR) of the rural banks had a positive and significant impact on their return on capital employed. The results on the impact of credit management on the profitability (ROCE) of rural banks showed a negative and significant impact of portfolio at risk (PAR) on the return on assets of the rural banks.

It was further revealed that the portfolio at risk of some of the rural banks were high. This can therefore affect the performance of these rural banks. It is thus recommended to the management of these rural banks that they should work hard to keep the portfolio at risk to a minimum and tolerable level of 5% as per BOG Policies. They must therefore consider legal actions against the recalcitrant defaulters.

6. RECOMMENDATION

It is recommended to the management of these rural banks that they should work hard to keep the portfolio at risk to a minimum and tolerable level of 5% as per BOG Policies. They must therefore consider legal actions against the recalcitrant defaulters.

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