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AN EMPIRICAL STUDY ON THE EFFECT OF BAD LOANS ON BANKS' LENDING POTENTIAL AND FINANCIAL PERFORMANCE: THE CASE OF SMES LENDING IN GHANA

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ABSTRACT

This paper assesses the effect of bad loans on the lending potential and financial performance of banks. Secondary data that span a period of 5 years (2008-2013) is used. This data is sourced from the annual reports of four banks listed on Ghana Stock Exchange. Pearson's correlation test and ordinary leas squares regression are used to analyse data. A high negative correlation between bad loans and lending potential (i.e. amount allocated each year by banks for lending to SMEs) is found at 5% level of significance, r (20) = -.824, p = .000. Also, bad loans make a high negative correlation with return on investment or net profit at 5% significance level, (20) = -.917, p < .05. Bad loans significantly predict lending potential at 5% significance level (t = -6.174, p < .000), where bad loans account for 67.9% of the variation in in this respect. Moreover, bad loans significantly predict net profit at 5% significance level (t = -9.77, p < .000), with 84.1% of the variation in net profit accounted for by it. It is therefore evident that banks would have to hedge against the realisation of bad loans to maximise their financial performance, and to improve access to credit facilities to creditworthy SMEs and other borrowers.

KEYWORDS: Lending, Bad Loans, Loan Default, Commercial Banks, Smes, Smes Lending, Lending Potential