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Does Financial Transparency and Internal Controls Affect Non-Performing Loans of Commercial Banks? Systematic Literature Review

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ABSTRACT

This research includes a comprehensive evaluation of 30 papers published in 20 peer-reviewed journals from 2015 to 2023 on the impact of transparency and internal controls on non-performing loans (NPL). There are two reasons for conducting this analysis. First, policymakers, such as the Uganda Central Bank, recognize the importance of the NPL problem and are addressing it with a number of approaches. Any policy response necessitates a thorough grasp of the underlying factors. Second, the availability of data in the NPL-sector increased, allowing scholars to do more advanced studies. I summarize the literature based on three broad, although overlapping themes: transparency, internal control, and non-performing loans. The material is meticulously evaluated in ten subcategories using an open coding process. Although the contribution of transparency to non-performing loans was not revealed in the literature and still requires further empirical research, the results show that there is a significant relationship between internal controls and non-performing loans of commercial banks.

Keywords: Internal controls, Non-performing loans, Transparency

Introduction

The literature lacks a clear definition of NPLs. Previous studies have outlined NPLs according to their specifications (Rehman et al., 2016). NPLs are loans that have not been repaid but still have a 90-day grace period remaining beyond their maturity date when complete collection of principle and interest in compliance with the loan or advances in issue is no longer possible, loans or advances are said to be NPLs (Rehman et al., 2016). There are three kinds on non-performing loans, for example, Payments that are 90 days past due are regarded as fair, those that are 180 days past due as dubious, and those that are a year past due as losses (Wood, 2018). Additionally, for MFBs (Micro Finance Banks) and commercial banks that provide consumer financing, a loan is deemed non-performing if it is not repaid within 30 days of the due date(Parvin, 2023). Loans that have not received maintenance for at least 90 days are classified as non-performing loans (NPL) (Rezina et al., 2020). It is a debt that has defaulted or is about to default, in other words(Rezina et al., 2020).

Globally, a non-performing loan is one in which interest and principal payments are more than 90 days late or more than 90 days' interest has been refinanced. The viability of banks is heavily jeopardized by loan default (Pani, 2022). These poor loans cost banks money because of the impact they have on the quality of their asset portfolio and profitability. This is in accordance with banking regulations, which compel banks to make provisions for non-performing loans and charge for bad loans, both of which lower their income and loan portfolio(Rezina et al., 2020). Non-performing loans as a percentage of total loans are 24.6% for Ireland, 31.3% for Greece, 9.5% for Egypt, 6% for Russia, 3.6% for South Africa, 3.2% for the USA, 2.9% for Brazil, and 1% for China (Constraints, 2015). The concept of governance has been applied in both economics and law for centuries and it has been understood to mean enforcement of contracts, protection of property rights and collective action (Slaev, 2020). In fact, governance is associated with people operating within organizations. Organizations allow for achieving outcomes beyond the reach of a single person (Slaev, 2020). Nevertheless, organizations must be governed properly in order for them to achieve their objectives.

Akter and Hossain (2021) investigated whether certain characteristics of the audit committees of Bangladesh's publicly traded banks might be used to explain the amount of non-performing loans (NPLs). A panel data set containing 250 bank-year observations for the years 2013 to 2017 was used in this study, and it included all 30 listed banks. The impact of various audit committee characteristics on NPLs was investigated using the random-effects GLS regression model with cluster robust standard error and AR (1) disruption. The study discovered that frequent audit committee meetings and a larger proportion of independent members in the audit committee help to minimize NPLs. Findings, however, provide no conclusive proof that the other audit committee characteristics evaluated (audit committee size, financial experience and financial literacy of the audit committee members, and professional credentials of the audit committee Chairman) had an impact on the reduction of NPLs. Their study was done on banks in Bangladesh and used random-

effects GLS regression model and this raises contextual and methodological gap in a sense that the current study will be carried out on Ugandan banks and will use multiple regression to determine the effect of internal auditing on non-performing loans

Banks must thoroughly evaluate potential borrowers' ability to repay the loan; otherwise, there is a risk of extending credit to possible defaulters (Balagobei 2019). Similar to this, if banks extend credit unethically, such as by providing an unjustified favor to further their own interests or accepting bribes from borrowers, there is a high likelihood that the amount of NPLs will rise, creating agency issues that will harm the interests of shareholders (Mees and Smith 2019). According to Khan and Ahmad (2020), an independent audit committee keeps an eye on a bank's financial reporting, internal controls, and risks to lessen agency issues with dishonestly issuing credit and anticipating a negative association between an independent audit committee and NPLs. By performing an empirical analysis on 86 banks listed on the stock markets in Pakistan, India, and Bangladesh during the years 2006–2016, Ali (2018) confirmed theoretical relationships. Al Zobi, Mo'taz Kamel; Shubita, Mohammad Fawzi; Alomari, Mazen; Almatarneh, Zeyad Soliman; and Alrawashdeh (2019) found a similar correlation between audit committee independence and credit risks in 13 Jordanian commercial banks for the years 2009 to 2016. However, their study only focused on commercial banks from Asia and this raises a contectual gap since the current study is focusing on commercial banks in Uganda and also they only focused on independence of audit committee and this study will look at internal audit as a whole and this also raises conceptual gap

The growing trend of non-performing loans (NPLs) in Bangladesh's banking industry exemplifies a widespread issue of loan default that mostly results from borrowers' propensity to fail on their debts, who are often members of the socially constituted upper class(Jahan & Shahidullah Tasfiq, 2022). An adequate governance and control architecture, together with the culture of loan default, may successfully manage this rising NPL trend. Sen, Ghosh, and Population (2022) examined the effects of audit committee independence, director ownership, external audit quality, CEO authority, and bank size on the management of non-performing loans (NPLs) in light of this context. The results highlight the significance of audit committee independence, director ownership, and external audit quality in controlling NPLs after identifying two endogenous variables in a system of linear equations and applying the system generalized method of moment (GMM) approach of regression analysis. This study, however, discovers no discernible effect of CEO power on reducing NPLs. NPLs are not linearly affected by Bank Size, assessed in a relative sense. This study raise methodological and conceptual gaps as the current study will use multiple regression and relate transparency and internal control to non-performing loans of commercial banks.

Statovci, Ahmeti, and Aliu (2021) determine how internal banking controls affect the amount of non-performing loans in Kosovo banks as mediation factors, linear regression model and mediation analysis are the research technique employed in this work and findings show that lending interest rates have a considerable impact on non-performing loans, whereas the three mediator variables such as detective work, preventative measures, and corrective action have an impact on lowering non-performing loans. Preventive control serves as a mediator and has the greatest indirect impact on lowering NPLs. By incorporating the recommendations of Circular No. 2011-06 released on 20 May 2011 by the Tunisian Central Bank, Saada (2015) intended to investigate the extent to which the control quality effects non-performing loans (NPLs) of Tunisian listed banks. Design, technique, and strategy the presence of foreign directors on the board of Tunisian banks is shown to increase credit risk using regressions utilizing panel data that are applied to a sample of 11 listed banks between 2010 and 2015. These administrators have greater authority than institutional administrators or state officials because of their knowledge, independence, and access to new technologies. The risk committee outperforms the audit and credit committees in terms of lowering non-performing loans, and by incorporating the Central Bank's guidelines, it is possible to empirically test the effect of control quality on NPL and identify effective ways to improve banking governance practices.

Since the year 2000, Good Corporate Governance (GCG) has been implemented in Indonesia. One of the foundational elements of the economic market system is good corporate governance (Pani, 2022). The GCG application offers a chance to develop and establish a favorable environment for business development and investment(Jahan & Shahidullah Tasfiq, 2022). This way of thinking makes the GCG implementation by Indonesian banks a crucial problem for achieving economic success. Naji and Syed Shabib – Ul - Hassan (2023) carried out study aimed at collecting empirical data on GCG characteristics, as well as other regulatory-driven factors such bank size, capital adequacy ratios, and non-performing loans (NPLs), Secondary data from 30 banks that are registered with BEI for the years 2011 to 2015 is the source of the data. The findings indicate that the Capital Adequacy Ratio, Managerial Ownership, and Bank Size then influence positively and significantly on financial performance while other variables NPL have a negligible impact and Committee Audit have a positive but negligible impact on banking financial performance, according to the research. Their study did not look at the influence of interest rates on corporate governance practices and non-performing loans and this raises conceptual gap and also the study only considered banks in Indonesia which raises contextual gap since the current study will focus on commercial banks in Uganda.

With regard to raising savings, reducing the risk of moral hazard and adverse selection, allocating resources to the most fruitful projects, and risk diversification, the banking sector is crucial for a number of macroeconomic and microeconomic variables(Akter & Hossain, 2021). Therefore, the banking system must operate efficiently, especially in growing and developing nations (Statovci et al., 2021). With the use of the system GMM dynamic panel data estimator, Bayar (2019) investigates the macroeconomic, institutional, and bank-specific variables that contribute to nonperforming banking loans as a measure of the health of the banking system in emerging market nations between 2000 and 2013. According to the results of the dynamic panel regression analysis, nonperforming loans were negatively impacted by economic growth, inflation, institutional development, return on equity and assets, regulatory capital to risk-weighted assets, and noninterest income to total income, whereas they were positively impacted by unemployment, public debt, credit growth, lagged values of nonperforming loans, cost to income ratio, and financial crises. The connected literature mentioned above demonstrates that despite much effort on the part of researchers to link internal controls, transparency, and non-performing commercial bank loans, contextual and conceptual gaps still remain. No study was conducted inside the Ugandan setting, contextually speaking. The concept of transparency being a corporate governance guideline was neglected in all research. These discrepancies necessitate the need for this study, which will focus on Uganda, to establish the link between internal controls, transparency, and non-performing commercial bank loans.

Methodology

The researcher employed two complementary search strategies: (a) a systematic database search of scholarly and gray literature and (b) a backward literature search of the references of each study included in our review. For documents that were not available in full text in the database or repository searched, the research team e-mailed document authors and associated organizations and/or requested the item via two different universities to exhaust all potential avenues for locating full-text documents identified in searches.

In each database and repository, I used the following search terms with all possible combinations: (a) transparency and internal controls AND (b) non-performing loans OR. Our database searches yielded 20,000 potentially relevant documents. After removing duplicates, we were left with 2000 documents for title review. Documents had to (a) be written in English; (b) be a peer-reviewed journal article, dissertation, or government/nongovernmental report published during or before December 2015; (c) analyze data (i.e., empirical studies); and (d) assess the reliability, validity, and/or feasibility of the use of the most current, full-length version of at least one publicly available IPV/IPH risk assessment instrument. Upon title review, one reviewer pared down the remaining reports to 800 documents. After abstract review, this same team member reduced this number to 200 reports for more extensive text review. This reviewer then scanned the full text of each remaining article to determine whether the article used a tool pertinent to our review, which left 85 documents for full-text review. The researcher completed full-text review of these documents, which identified 45 articles that fully met our inclusion criteria. The reviewer systematically extracted data from all included studies and stored the information in a spreadsheet created prior to data extraction. Any discrepancies that arose between reviewer and supervisors were resolved

Results and Discussion

The findings also indicates that most of the studies like looked Saseela Balagobei (2020) at corporate governance and non-performing loans, though he did not look at transparency and internal controls and this raises conceptual gap, Arifa et.al (2021) looked at audit committee and non-performing loans, using random-effects regression model with cluster robust standard error and AR (1)GLS, they found out that - holding audit committee meetings frequently and a higher number of independent members in the audit committee facilitate to reduce NPLs. However, their study was carried out in Asia and this raises contextual gap. Ifran 2018 also looked at corporate governance practices and non-performing loans, using panel data analysis technique, revealed that there is a significant relationship between corporate governance and non-performing loan. Kumar et.al (2022) using generalized method of moment (GMM) approach of regression analysis found out that he significance of audit committee independence, director ownership, and external audit quality in controlling NPLs. However, this paper finds no significant impact of CEO power on lowering NPLs. Bujar et.al, (2021) using linear regression model and mediation analysis, reaveled that lending interest rate has significant effect on NPLs, whereas all three mediation variables detective, preventive and corrective control, have effect on reducing the NPLs. The highest indirect effect on reducing NPLs comes from preventive control as mediation variable. Moufida (2017) using Regressions using panel data are applied on a sample of 11 listed banks during the period from 2010 to 2015 indicated that the presence of foreign directors on the Tunisian bank board affects credit risk. These administrators, with knowledge, independence and technology transfer, exercise more control than institutional administrators or state representatives. Nisrul et.al (2019) using tools of analysis Eviews revealed Capital Adequacy Ratio, Managerial Ownership and bank Size influence positive significantly on financial performance while other variable NPL has a insignificant negative effect and Committee Audit influence positive but insignificant on banking financial performance

Conclusion

From the results obtained, there arises methodological, conceptual and contextual gap since most of the studies were done outside Uganda and fewer studies considered transparency and internal controls as a measure of corporate governance. Methodologically all studies did not consider structural equation modelling as a tool for analyzing the effect transparency and internal controls on non-performing loans of commercial banks. All these give a justification to carry out a study to investigate the how transparency and internal control affect the non-performing loans of commercial banks in Uganda

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