# Chapter 5
# Corruption, Credit Risk, and Bank Profitability:
## Evidence of Angolan Banks

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## ABSTRACT

*The economies of African countries are generally characterized by inefficient management of resources, strong heterogeneity in the rate of economic growth, as well as high levels of corruption and embezzlement of public funds, clearly highlighting the need to consider the role of government in the performance of the economic environment. Corruption is characterized by three key behaviors—bribery, embezzlement, and nepotism—characteristics that can influence the performance of any financial system. The objective is to examine the effect of corruption on credit risk in Angola. The result of the feasible generalized least squares (FGLS) estimation suggests that corruption increases non-performing loans in the Angolan economy; additionally, the authors find that the larger the bank's assets (bank size), the more averse to credit risk they become, and the smaller the state's stake in the banking system, the lower the non-performing loans.*

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## INTRODUCTION

The economies of African countries are generally characterized by inefficient resource management, strong heterogeneity in the rate of economic growth, as well as, high levels of corruption and embezzlement of public funds (Igharo et al., 2020; Kunieda, 2014; Sector et al., 2021). Corruption is defined as the use of public office for private gain (Bai et al., 2013; Jalles, 2016; Kunieda, 2014; Sector et al., 2021). Corruption is a problem that affects all economies, however, it is higher in poor countries, regardless of how it is calculated (Kunieda, 2014; Setor et al., 2021), therefore, Angola does not escape this reality.

Corruption causes negative effects on the financial performance of any organization (Van Vu et al., 2018). In the study conducted by Kunieda (2014) aiming to investigate the effect of capital account liberalization on corruption, the author found that more corrupt countries impose higher tax rates and thus, increase the negative impacts on economic growth. In parallel to this, Trabelsi and Trabelsi (2020) evidenced that both high levels of corruption and low levels of corruption can decrease economic growth.

Due to the poor access to credit in emerging countries, bribing banks or turning to relatives and friends to obtain financing has been the alternative solution found by entrepreneurs. Thus, corruption proves to be a strong barrier to entrepreneurship in emerging countries, mainly due to its ability to increase the cost of doing business (Hanoteau et al., 2021).

The economic reality of developing countries forces them to reconsider the role of governments in explaining economic performance (Jalles, 2016), since the personal interests of policymakers in the financial system cause distortions in the market, driving the inefficient allocation of resources. These include, for example, allocation of public resources to meet political needs or even personal interests (Huggard et al, 1993; Jalles, 2016), granting bank loans only to clients who belong to the party in power, appointing bank managers or financial institutions individuals because they belong to political affiliation and overlapping political objectives with the objectives of banking institutions.

Corruption is characterized by three key behaviors, bribery, embezzlement, and nepotism (Bai et al., 2013; Hewa Wellalage et al., 2020). However, these three characteristics can influence the performance of any financial system, since the financial system is very sensitive to any non-transparent behavior, i.e., in an environment where high levels of corruption prevail, financial systems are more fragile and unstable, in addition to the excessive number of defaulting credit risk and the strong inability of banks to intermediate financial resources and stimulate entrepreneurial activity (Jenkins et al., 2021; Mohamad & Jenkins, 2020). Therefore, the quality of access to formal credit, weak institutions, and mainly led by bureaucrats willing to extort, are strong factors for increased corruption and failure of entrepreneurial activity (Hanoteau et al., 2021). Among the various risks existing in the banking sector, credit risk is the main risk that banks face, being the main source of bank failures, able to indicate the beginning of a banking crisis, with the ability to infect all sectors of the economy (Mpofu & Nikolaidou, 2018).

Adequate capitalization, low leverage, excess liquidity, and weak dependence on external funding were the key factors for the non-aggravation of the 2008 global financial crisis in the banking system of Sub-Saharan African countries. Contrary to this, the banking systems of African countries were affected by the financial crisis through trade integrations and sharp exchange rate depreciation, which aggravated the financial problems of borrowers. Consequently, there was an increase in defaulted loans (Nikolaidou & Vogiazas, 2017). The theoretical and empirical literature points to macroeconomic factors and institutional or bank-specific factors as the main determinants for explaining defaulted loans. Regarding macroeconomic factors it is justified by the increase in real GDP and improvement in the country's economic conditions, which can increase the ability of borrowers to meet their credit obligations, on the

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