



Credit Management Spur Higher Profitability? Evidence from Nigerian Banking Sector

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Abstract

The rising non-performing credit portfolios have significantly contributed to financial distress in the banking sector. Banks collect deposits and lends to customers but when customers fail to meet their obligations problems such as non-performing loans arise. This study evaluates the impact of credit risk management on bank profitability of some selected commercial banks in Nigeria using econometric analysis method on annual time series data of ten banks over the period of 2006 to 2012. The results from Levin, Lin & Chu unit root test shows that all the variables were non-stationary at level. The results from Panel Least Square (PLS) estimate found that that credit risk management has a significant impact on the profitability of Nigeria banks. Therefore, management need to be cautious in setting up a credit policy that might not negatively affects profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits. This conclusion has important policy implications for emerging countries like Nigeria as it suggests that capitalisation and total assets of the bank should be periodically evaluated. The regulatory authorities will therefore need to put in place appropriate machinery that will address issues of bank liquidity and shore assets quality in the industry.

Keywords

Credit Risk; Profitability; Non-Performance Loan; Loan & Advances

Introduction

Financial institutions are exposed to a variety of risks among them; interest rate risk, foreign exchange risk,

political risk, market risk, liquidity risk, operational risk and credit risk [17]. In some instances, commercial banks and other financial institutions have approved decisions that are not vetted, there has been cases of loan defaults and nonperforming loans, massive extension of credit and directed lending. Policies to minimize on the negative effects have focused on mergers in banks and NBFIs, better banking practices but stringent lending, review of laws to be in line with the global standards, well capitalized banks which are expected to be profitable, liquid banks that are able to meet the demands of their depositors, and maintenance of required cash levels with the central bank which means less cash is available for lending [15]. This has led to reduced interest income for the commercial banks and other financial institutions and by extension reduction in profits ([20]; [22]; [39]).

Credit risk is the possibility that the actual return on an investment or loan extended will deviate from that, which was expected ([16];[18]) defines credit risk as losses from the refusal or inability of credit customers to pay what is owed in full and on time. The main sources of credit risk include, limited institutional capacity, inappropriate credit policies, volatile interest rates, poor management, inappropriate laws, low capital and liquidity levels, directed lending, massive licensing of banks, poor loan underwriting, reckless lending, poor credit assessment., no non-executive directors, poor loan underwriting, laxity in credit assessment, poor lending practices, government interference and inadequate supervision by the central bank. To minimize these risks, it is necessary for the financial system to have; well-capitalized banks,

service to a wide range of customers, sharing of information about borrowers, stabilization of interest rates, reduction in non-performing loans, increased bank deposits and increased credit extended to borrowers. Loan defaults and nonperforming loans need to be reduced ([29]; [37]).

Definition of Terms

The ability of the banking industry in granting credit facilities has played a predominant role in the Nigerian economic environment. The probability of incurring losses resulting from non-payment of loans or other forms of credit by debtors known as credit risks are mostly encountered in the financial sector particularly by institutions such as banks. The biggest credit risk facing banking and financial intermediaries is the risk of customers or counter party default. During the 1990s, as the number of players in banking sector increased substantially in the Nigerian economy and banks witnessed rising non-performing credit portfolios. This significantly contributed to financial distress in the banking sector. Also identified was the existence of predatory debtor in the banking system whose modus operandi involve the abandonment of their debt obligations in some banks only to contract new debts in other banks. Credit creation is the main income generating activity for the banks. But this activity involves huge risks to both the lender and the borrower. The risk of a trading partner not fulfilling his or her obligation as per the contract on due date or anytime thereafter can greatly jeopardize the smooth functioning of bank's business. On the other hand, a bank with high credit risk has high bankruptcy risk that puts the depositors in jeopardy. In a bid to survive and maintain adequate profit level in this highly competitive environment, banks have tended to take excessive risks. But then the increasing tendency for greater risk taking has resulted in insolvency and failure of a large number of the banks.

Banking problems majorly are caused of serious by low credit standards for borrowers and counterparties, poor portfolio management, and lack of attention to changes in economic or other circumstances that can lead to deterioration in the credit standing of bank's counter parties. And it is clear that banks use high leverage to generate an acceptable level of profit. Credit risk management comes to maximize a bank's risk adjusted rate of return by maintaining credit risk

exposure within acceptable limit in order to provide a framework of the understanding the impact of credit risk management on banks profitability.

The excessively high level of non-performing loans in the banks can also be attributed to poor corporate governance practices, lax credit administration processes and the absence or non-adherence to credit risk management practices. The question is; how low should credit risks in banking be? Or put in different words; is there a level of credit risks at which the relationship between credit risks and bank specific factors (such as non-performing loans ratio; loan & advances; and operating efficiency) becomes positive? The hypothesis is that; at some low level of credit risks, the relationship between the two variables is non-existent, or perhaps even positive, but at higher rates it becomes negative. Are these the same for Nigerian banks? The last twenty years have been marked by substantial financial deregulation which is accompanied by methodologies and technologies for managing credit risks. The art of managing credit risk is more challenging than ever. Hence, the question is what is the impact of credit risk management on the profitability of Nigerian banks? How does Loan and advances affect banks profitability? What is the relationship between non-performing loans and profitability in Nigerian banks?

This study therefore seeks to examine the impact of credit risk management on Nigerian banking profitability and identifies the relationships between the non-performing loans; loan and advances and banks profitability. To achieve the study's objectives it is hypothesized that there is no significance between non-performing loan, loan and advances and banks profitability.

Review of relevant literature

Credit risk is the current and prospective risk to earnings or capital arising from an obligor's failure to meet the terms of any contract with the bank or otherwise to perform as agreed. Credit risk is found in all activities in which success depends on counterparty, issuers, or borrower performance. It arises any time bank funds are extended, committed, invested, or otherwise exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet. Thus risk is determined by factor extraneous to the bank such as general unemployment

levels, changing socio-economic conditions, debtors' attitudes and political issues.

Credit risk according to Basel Committee of Banking Supervision [7] and [24] is the possibility of losing the outstanding loan partially or totally, due to credit events (default risk). Credit events usually include events such as bankruptcy, failure to pay a due obligation, repudiation/moratorium or credit rating change and restructure. Basel Committee on Banking Supervision- ([29] & [37]) defined credit risk as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. [29] observe that credit risk as the risk that an asset or a loan becomes irrecoverable in the case of outright default, or the risk of delay in the servicing of the loan. In either case, the present value of the asset declines, thereby undermining the solvency of a bank. Credit risk is critical since the default of a small number of important customers can generate large losses, which can lead to insolvency [10].

[6] & [9] observed that banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transaction. [2] asserts that credit risk arises from non-performance by a borrower. It may arise from either an inability or an unwillingness to perform in the pre-committed contracted manner. [14] claimed that the single biggest contributor to the bad loans of many of the failed local banks was insider lending. He further observed that the second major factor contributing to bank failure were the high interest rates charged to borrowers operating in the high-risk. The most profound impact of high non-performing loans in banks portfolio is reduction in the bank profitability especially when it comes to disposals.

[5] stated that lending involves a number of risks. In addition to risk related to the creditworthiness of the borrower, there are others including funding risk, interest rate risk, clearing risk and foreign exchange risk. International lending also involves country risk. [8] observed that historical experience shows that concentration of credit risk in asset portfolios has been one of the major causes of bank distress. This is true

both for individual institutions as well as banking systems at large.

[36] state that the most obvious characteristics of failed banks is not poor operating efficiency, however, but an increased volume of non-performing loans. Non-performing loans in failed banks have typically been associated with regional macroeconomic problems. [21] observed that the US Office of the Comptroller of the Currency found the difference between the failed banks and those that remained healthy or recovered from problems was the caliber of management. Superior managers not only run their banks in a cost efficient fashion, and thus generate large profits relative to their peers, but also impose better loan underwriting and monitoring standards than their peers which result to better credit quality.

[28], [27] and [3], suggest that bank risk taking has pervasive effects on bank profits and safety. [11] asserts that the profitability of a bank depends on its ability to foresee, avoid and monitor risks, possible to cover losses brought about by risk arisen. This has the net effect of increasing the ratio of substandard credits in the bank's credit portfolio and decreasing the bank's profitability [30]. The banks supervisors are well aware of this problem, it is however very difficult to persuade bank managers to follow more prudent credit policies during an economic upturn, especially in a highly competitive environment. They claim that even conservative managers might find market pressure for higher profits very difficult to overcome.

The deregulation of the financial system in Nigeria embarked upon from 1986 allowed the influx of banks into the banking industry. As a result of alternative interest rate on deposits and loans, credits were given out indiscriminately without proper credit appraisal [35]. The resultant effects were that many of these loans turn out to be bad. It is therefore not surprising to find banks to have non-performing loans that exceed 50 per cent of the bank's loan portfolio. The increased number of banks over-stretched their existing human resources capacity which resulted into many problems such as poor credit appraisal system, financial crimes, accumulation of poor asset quality among others [38]. The consequence was increased in the number of distressed banks. However, bank management, adverse ownership influences and other forms of insider abuses coupled with political considerations and prolonged court process especially as regards

debts recovery created difficulties to reducing distress in the financial system [38]. Since the banking crisis started, the Central Bank of Nigeria (CBN) has had to revoke the licenses of many distressed bank particularly in the 1990's and recently some banks has to be bailout. This calls for efficient management of risk involving loan and other advances to prevent reoccurrences.

[34] highlighted that available statistics from the liquidated banks clearly showed that inability to collect loans and advances extended to customers and directors or companies related to directors/managers was a major contributor to the distress of the liquidated banks. At the height of the distress in 1995, when 60 out of the 115 operating banks were distressed, the ratio of the distressed banks' non-performing loans and leases to their total loans and leases was 67%. The ratio deteriorated to 79% in 1996; to 82% in 1997; and by December 2002, the licences of 35 of the distressed banks had been revoked. In 2003, only one bank (Peak Merchant Bank) was closed. No bank was closed in the year 2004. Therefore, the number of banking licences revoked by the CBN since 1994 remained at 36 until January 2006, when licences of 14 more banks were revoked, following their failure to meet the minimum re-capitalization directive of the CBN. At the time, the banking licences were revoked, some of the banks had ratios of performing credits that were less than 10% of loan portfolios. In 2000 for instance, the ratio of non-performing loans to total loans of the industry had improved to 21.5% and as at the end of 2001, the ratio stood at 16.9%. In 2002, it deteriorated to 21.27%, 21.59% in 2003, and in 2004, the ratio was 23.08% ([32] & [33]).

The role of bank remains central in financing economic activity and its effectiveness could exert positive impact on overall economy as a sound and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system [3]. Therefore, the determinants of bank performance have attracted the interest of academic research as well as of bank management. Studies dealing with internal determinants employ variables such as size, capital, credit risk management and expenses management. The need for risk management in the banking sector is inherent in the nature of the banking business. Poor asset quality and low levels of liquidity are the two major causes of bank failures and represented as the key risk sources in terms of credit

and liquidity risk and attracted great attention from researchers to examine the their impact on bank profitability.

Credit risk is by far the most significant risk faced by banks and the success of their business depends on accurate measurement and efficient management of this risk to a greater extent than any other risk [5]. Increases in credit risk will raise the marginal cost of debt and equity, which in turn increases the cost of funds for the bank [9]. To measure credit risk, there are a number of ratios employed by researchers. The ratio of Loan Loss Reserves to Gross Loans (LOSRES) is a measure of bank's asset quality that indicates how much of the total portfolio has been provided for but not charged off. Indicator shows that the higher the ratio the poorer the quality and therefore the higher the risk of the loan portfolio will be. In addition, Loan loss provisioning as a share of net interest income (LOSRENI) is another measure of credit quality, which indicates high credit quality by showing low figures. In the studies of cross countries analysis, it also could reflect the difference in provisioning regulations [19].

Assessing the impact of loan activities on bank risk, [13] uses the ratio of bank loans to assets (LOTA). The reason to do so is because bank loans are relatively illiquid and subject to higher default risk than other bank assets, implying a positive relationship between LTA and the risk measures. In contrast, relative improvements in credit risk management strategies might suggest that LTA is negatively related to bank risk measures [1]. [12] reports the effect of credit risk on profitability appears clearly negative This result may be explained by taking into account the fact that the more financial institutions are exposed to high risk loans, the higher is the accumulation of unpaid loans, implying that these loan losses have produced lower returns to many commercial banks [31]. The findings of Felix and [23] also shows that return on equity ROE and return on asset ROA all indicating profitability were negatively related to the ratio of non-performing loan to total loan NPL/TL of financial institutions therefore decreases profitability.

[6] & [9] asserts that loans are the largest and most obvious source of credit risk, while others are found on the various activities that the bank involved itself with. Therefore, it is a requirement for every bank worldwide to be aware of the need to identify measure, monitor and control credit risk while also determining

how credit risks could be lowered. This means that a bank should hold adequate capital against these risks and that they are adequately compensated for risks incurred. This is stipulated in Basel II, which regulates banks about how much capital they need to put aside to guide against these types of financial and operational risks they face. In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems. Also, it is in the realization of the consequence of deteriorating loan quality on profitability of the banking sector and the economy at larger that this research work is motivated.

Methodology

The study is both historical and descriptive as it seeks to describe the pattern of credit risk of Nigerian banks in the past. The sampling technique that will be use is panel data technique. For example, total of five deposits money banks in Nigeria from 2006-2012 as used in this study. These include:

- First Bank of Nigeria Plc
- Access Bank
- Zenith Bank Plc
- Guaranty Trust Bank Plc
- United Bank of Nigeria

Model Specification

This study examines the relationship between credit risk management and bank profitability of some selected commercial banks in Nigeria using econometric analysis method for the period 2006- 2012. Data for the study are obtained from secondary sources such as various editions of annual reports and account of the selected commercial banks listed in Nigeria Stock Exchange, as well as review of existing literatures. The problem of stationarity has been solved through the use of Levin, Lin & Chu unit root test unit root test. The pooled data was analysed using multiple regression models which adopt Panel Least Square (PLS), method in estimating the parameter of the model, which is specified thus:

Model:

$$\text{Profitability} = f(\text{Credit Risk}) \quad (i)$$

$$\text{Prof} = f(\text{Total Credit} / \text{Total Asset}; \text{NPL} / \text{Total Loan}) \quad (ii)$$

$$\text{ROA}_{it} = \alpha_0 + \beta_1 \text{LA2TA}_{it} + \beta_2 \text{NP2TL}_{it} + \mu \quad (iii)$$

Where:

α_0 = Autonomous incomes

β_1 , and β_2 are parameters

ROA = Return on Assets - Ratio of Profit after tax to total assets. (Proxy for Profitability)

LA2TA = Loan & advances to Total Asset

NP2TL = Non Performing Loan to Total Loan

μ = Error Term

Regression was employed in the study to forecast relationship between variables and estimate the influence of each explanatory variable to the dependent variable.

Results and Discussion

Levin, Lin & Chu Unit Root Test

The study employs E-view package to carry out unit root tests (Levin, Lin & Chu) in order to determine the stationarity of the variables used. All the variables were stationary at level.

TABLE 1 LEVIN, LIN & CHU UNIT ROOT TEST RESULT

Variables	LLC	Order of Integration	Probability
ROA	4.0633	I(0)	0.0008
LA2TA	-13.3896	I(0)	0.0000
NP2TL	2669.64	I(0)	0.0000

Note: The null Hypothesis is the presence of Unit root above in ROA, LA2TA and NP2TL. Levin, Lin & Chu test includes a constant; Akaike Information Criterion was used to select lags automatically.

The unit root test is conducted on the variables used in this study in other to avoid a spurious regression. From the above results, it shows that the data are all stationary at level. Moreover, considering the low probability value and critical values that are significant at 1%, 5% and 10% when compare to the Levin, Lin & Chu test statistics. The above result show that ROA, LA2TA and NP2TL are stationary series at level form but became an I(0) series. This implies that the above Levin, Lin & Chu test suggest that, ROA, LA2TA and NP2TL are of the same order of integration.

Descriptive Statistics

Table 2 shows the descriptive statistics of all variables used in the research.

TABLE 2 SUMMARY STATISTICS OF VARIABLES USED IN THE MODEL

	ROA	NP2TL	LA2TA
Mean	0.021220	0.335017	0.42857
Std. Dev	0.011639	0.134755	13.36496
Skewness	-0.071953	-2.099630	0.951022
Kurtosis	4.067129	10.32870	4.278915
Probability	0.429364	0.000000	0.021697
No of Obs	35	35	35

As can be observed from Table 2 the lowest mean value is Return on Asset (ROA) as 0.021220 and the highest mean value of Loan and Advances to Total Asset is 0.42857. Whereas the mean value of Non Performing Loan to Total Loan is 0.0335017. The mean of the data are ROA (0.021220), NP2TL (0.335017) and LA2TA (0.42857) while the standard deviations of the data are ROA (0.011639), NP2TL (0.134755) and LA2TA (13.36496). It is also observed that ROA and NP2TL are negatively skewed while LA2TA is positively skewed.

Model Estimation Issues and Discussion of Results

TABLE 3 PANEL LEAST SQUARE

INDEPENDENT \ DEPENDENT	ROA	
	Coefficient	Probability
NP2TL	-0.52620	0.0128
LA2TA	-0.83607	0.0076
R ²	0.731209	
ADJUSTED R ²	0.556742	
F-STATISTIC	1.898401	0.024286
DURBIN WATSON	1.899315	

Regression Results and Discussion

The regression result of the study's model as indicated above suggests that all the independent variables have negative impact on profitability. Therefore, this research shows that all the variables used to capture capitalization that is (bank liquidity, bank deposit, bank loan, operating expenses and bank size followed the theoretical a priori expectation in relation to the profitability captured by return on asset.

The studies of credit risk management and bank profitability enables us provide answer to the soundness, safety, profitability, quality of loan

portfolio, asset, and deposit in the Nigerian banking industry. The selection of credit risk management has not been taken seriously and the performance is a function of the inputs.

The result show that the ratio Non-performing loan to Total Loan negatively relate to profitability though not significant. The parameters shows that increase in non-performing loans decreases profitability (ROA) by 53%, however, increase in the level of loan & advances to total assets significantly decrease profitability of the banks by 84%, this expose them to higher risk level. The study shows that there is a direct but negative relationship between profitability (ROA) and the ratio of non-performing loan to total loan and the ratio of loan & advances to total asset. This is consistent with the findings of [13], [12], [31], [1] and [23].

In terms of the fitness of the study model, the coefficient of multiple determinations R² indicates that about 73% (adjusted R 56%) of the variations in ROA are explained by the combined influence of credit risk indicators (NP2TL and LA2TA) in the model. The Durbin Watson statistic measures the serial correlation of the variables. The result of the Durbin Watson test shows 1.899315. Since the value is approximately 2, it is accepted that there is no autocorrelation among the successive values of the variables in the model.

The test of overall significance of regression implies testing the null hypotheses. The overall significance of the regression is tested using Fisher's statistics. In this study the calculated F* value of 1.898401 is significant at 5%. It is therefore, concluded that linear relationship exist between the dependent and the independent variables of the model. Base on this findings, the postulations which respectively state that there is no significant relationship between non-performing loan and banks profitability while loan and advances does not have a significant influence on banks profitability were rejected. The evidence established that the independent explanatory variables (credit risk indicators) have individual and combine impact on the return of asset of banks in Nigeria.

This study shows that there is a significant relationship between bank performance (in terms of profitability) and credit risk management (in terms of loan performance). Loans and advances and non performing loans are major variables in determining asset quality of a bank. These risk items are important in determining the profitability of banks in Nigeria. Where a bank does not effectively manage its risk, its

profit will be unstable. This means that the profit after tax has been responsive to the credit policy of Nigerian banks. The deposit structure also affects profit performance. Many highly profitability banks hold a large volume of core deposits. The growth of loan has been relatively fast for the past few years and which is not fully covered by the deposit base. Banks become more concerned because loans are usually among the riskiest of all assets and therefore may threatened their liquidity position and lead to distress. Better credit risk management results in better bank performance. Thus, it is of crucial importance for banks to practice prudent credit risk management to safeguard their assets and protect the investors' interests.

Conclusion and Recommendations

The study investigated the impact of credit risk on the profitability of Nigerian banks. From the findings it is concluded that banks profitability is inversely influenced by the levels of loans and advances, and non-performing loans thereby exposing them to great risk of illiquidity and distress. Therefore, management need to be cautious in setting up a credit policy that will not negatively affects profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits and maximization of profit. Improper credit risk management reduce the bank profitability, affects the quality of its assets and increase loan losses and non-performing loan which may eventually lead to financial distress. CBN for policy purposes should regularly assess the lending attitudes of financial institutions. One direct way is to assess the degree of credit crunch by isolating the impact of supply side of loan from the demand side taking into account the opinion of the firms about banks' lending attitude. Finally, strengthening the securities market will have a positive impact on the overall development of the banking sector by increasing competitiveness in the financial sector. When the range of portfolio selection is wide people can compare the return and security of their investment among the banks and the securities market operators. As a result banks remain under some pressure to improve their financial soundness.

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