IMPACT OF CREDIT RISK ON FINANCIAL PERFORMANCE OF BANKS IN THE NIGERIA

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ABSTRACT

The objective of the study is to empirically examine the quantitative effect of credit risk on the performance of commercial banks in Nigeria, considering variables related to lending activities, over the period of 10 years (2006-2015). The empirical investigation uses the accounting measure of Return on Assets (ROA), which is the dependent variable, to represent Banks' performance. The study fundamentally involves both descriptive and econometrics techniques. The econometrics method used in the study basically involves assessing the impact of selected internal variables, the provision to total loans, loan to total asset, credit administration (cost to total loans) and natural logarithm of total asset (Economies of scale), on the performance of the banking sector. To this end multiple linear regression models is used to measure the relative weighting of the independent variables above on a dependent variable. The findings show that there is significant but inverse relationship between ROA and the ration of default rate, per loan asset ratio and capital adequacy ratio. The study recommends that management need to be certain in setting up a credit policy that will negatively affect performance and the CBN should for policy purpose regularly assess the lending attitude of financial institution in Nigeria

Keywords*: *ROA, Credit Risk, Bank, Performance, Nigeria.*

INTRODUCTION

In the wake of the global financial crisis, banks are under increasing pressure to prove credit risk management, especially as the lack of effective credit risk management was one of the factors that helped trigger the economic downturn. With regulators seeking higher capital requirements and liquidity buffers, the cost f doing business is increasing for banks worldwide. The main cause of banking crisis was poor credit risk management practice s typified by high levels of insider loans, speculative lending, and high concentration of credit in certain sectors among other issues. The failure of effectively manage credit risk created similar problems in countries such as Mexico and Venezuela (Njanka, 2009). The health of the financial system has important role in the country (Das and Ghosh, 2007) as its failure can disrupt economic development of the country. Banks are germane to economic development through the financial services they provides. The intermediation role can be said to be a catalyst for economic growth. The efficient and effective performance of the banking industry over time is an index of financial stability in any nation. The extent to which a bank extends credit to the public for productive activities accelerates the pace of a nation's economic growth and its long term sustainability Kolapo, Ayeni, and Oke, (2012).

Risk management is the human activity which integrates recognition of risk, risk assessment, developing strategies to manage it, and mitigation of risk using managerial resources (Appa, 1996) whereas credit risk is the risk of loss due to debtors non-payment of a loan or other line of credit (either the principal or interest or both). Default rate is the possibility that a borrower will default, by failing to repay principal and interest in a timely manner. A bank is a commercial or state institution that provides financial services, including

issuing money in various forms, receiving deposits of money, lending money and processing transactions and the creating of credit (Campbell, 2007). Credit risk management is very important to banks as it is an integral part of the loan process. It maximizes bank risk, adjusted risk rate of return by maintaining credit risk exposure with view to shielding the bank loan from the adverse effects of credit risk. Bank is investing a lot of funds in credit risk management modeling. In Nigeria, commercial banks play an important role in mobilizing financial resources for investment by extending credit to various businesses and investors. Lending represents the heart of banking industry and loans are the dominant assess as they generate the largest share of operating income. Loans however expose the banks to the greatest level of risk. The Nigeria banking industry has been strained by the deteriorating quality of its credit assets as a result of the significant dip in equity market indices, global oil prices and sudden depreciation of the naira against global currencies (BGL Banking Report, 2010). The poor quality of the banks' loan assets hindered banks to extend more credit to the domestic economy, thereby adversely affecting economic performance. This prompted the federal government of Nigeria through the instrumentality of an Act of the national assembly to establish the asset management corporation of Nigeria (AMCON) in July, 2010 to provide a lasting solution to the recurring problems of non-performing loans that bedeviled Nigerian banks.

Financial institutions are exposed to a variety of risks among them: interest rate risk, foreign exchange risk, political risk, liquidity risk, operational; risk and credit risk (Cooperman, Gardner and Mills, 2000). As a result of likely huge and widespread of economic impact in connection with banks failure, the management of credit risk is a topic of great importance since the core activity

of every bank is credit financing. According to the bank theory, there are (6) main types of risk which are linked with credit policies of banks and these are; credit risk (risk of repayment), interest risk, portfolio risk, operating risk, credit deficiency risk and trade union risk. However, the most vital risks, is the credit risk and therefore, it demands special attention and treatment. The aim of this paper is to evaluate the effect of credit outcomes on the profitability of Nigerian banks over a period of ten years (2005-2016). The study is motivated by the damaging effect of classified assets on bank capitalization and would be utmost relevance as it addresses how credit risk output affect bank's profitability using a robust sample and the findings would serve as the basis to provide policy measures to the various stakeholders on how to tackle the effect of credit risk in order to enhance the quality of banks' risk assets. The remainder of the paper is outlined as follows- section two review related literature on the subject matter, section three discusses the methodology, section four focuses on data analysis and interpretation of findings and section five present the conclusion and recommendations.

Review of Related Empirical Literature

Credit risk is a serious threat to the performance of banks: therefore various researchers have examined the impact of credit risk on banks in varying dimension. Ahmed, Takeda and Shawn (1998) in their study found that loan loss provision has a significant positive influence on non-performing loans, therefore, an increase in loan loss provision indicates an increase in credit risk deterioration in the quality of loans consequently affecting bank performance adversely. Empirically, Ravi(2012) in his paper title The Impact of Credit Risk Management on Financial Performance of Commercial Banksin Nepal. This study explored various parameters pertinent to credit risk management as it affect banks'

financial performance. Such parameters covered in the study were; default rate, cost per loan assets and capital adequacy ratio. Financial report of 31 banks were used to analyze for eleven years (2006-2015) comparing the profitability ratio to default rate, cost of per loan assets and capital adequacy ratio which was presented in descriptive, correlation and regression was used to analyze the data. The study revealed that all these parameters have an inverse impact on banks' financial performance; however, the default rate is the most predictor of bank financial performance.

Kipngetich and Muturi (2015) in their study in Kenya which focused in assessing the effect of credit risk management on the financial performance of SACCOs with specific reference to SACCOs in Bomet County. The dependent variable was financial performance of the SACCOs while the independent variables were comprised of Capital adequacy and Management efficiency. The sample size for SACCOs in Bomet County that were selected to participate in the study was 18. The study employed purposive sampling technique in identifying the SACOOs. Secondary data was used for the purpose of this study and this data was derived from the financial statements of the SACCOs. All the predictor variables (CAR, and ME) had positive relationship with financial performance. The CAR coefficient of the predictor variables was significant at 5% level of significance except for ME. The findings confirm that there is a statistically significant influence of CAR on financial performance of SACCOs.

Empirically, Simeyo, Michael and Arvinlucy (2016) examined the relationship between Credit risk management and financial performance. Specific objectives were: to establish the relationship between Portfolio at risk (PAR) and performance of MFBs and to

determine the relationship between loan loss Provision coverage ratio (LLPCR) and performance of MFBs. Longitudinal research design utilizing panel data covering the period from 2011 to 2015 was used. Target population comprised 12 licensed MFBs. The findings were that Credit risk management with PAR and LLPCR parameters had a strong negative correlation, giving a significant negative relationship with both ROAA and ROAE performance measures as depicted by regression coefficient of -0.2 estimated by GMM. Thus, the study concluded the existence of a significant relationship Credit risk management and performance and that credit risk management impacts performance of MFBs. The study recommended that Credit managers should operate under a sound credit granting process with well-defined credit-granting criteria detailing the MFB's target market, a thorough understanding of the borrower, purpose & structure of the credit, and its source of repayment.

In a Nigerian study, Kolapo, Ayeni and Oke (2012) in their study titled Credit Risk and Commercial Banks' performance in Nigeria: A Panel Model Approach. The study carried out an empirical investigation into the quantitative effect of credit risk on the performance of commercial banks in Nigeria over the period of 11 years (2000-2010). They used five commercial banking firms which were selected on a cross sectional basis for eleven years. The traditional profit theory was employed to formulate profit, measured by Return on Asset (ROA), as a function of the ratio of Non-performing loan to loan & Advances (NPL/LA), ratio of Total loan & Advances to Total deposit (LA/TD) and the ratio of loan loss provision to classified loans (LLP/CL) as measures of credit risk. Panel model analysis was used to estimate the determinants of the profit function. The results showed that the effect of credit risk on bank performance

measured by the Return on Assets of banks is cross-sectional invariant. That is the effect is similar across banks in Nigeria, though the degree to which individual banks are affected is not captured by the method of analysis employed in the study.

The work of Alice and Jaya (2016) which was carried out in Rwanda, The study examined the Effect of Credit Management on Performance of Commercial Banks. The study adopted a descriptive survey design. The target population of study consisted of 57 employees of Equity bank in credit department. Entire population was used as the sample giving a sample size of size of 57 employees. The study found that client appraisal; credit risk control and collection policy had effect on financial performance of Equity bank. The study established that there was strong relationship between financial performance of Equity bank and client appraisal, credit risk control and collection policy. The study established that client appraisal, credit risk control and collection policy significantly influence financial performance of Equity bank. Collection policy was found to have a higher effect on financial performance and that a stringent policy is more effective in debt recovery than a lenient policy. The study recommends that Equity bank should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

Jane, Kennedy and Willy (2016) in their study examined the Effect of Credit Risk on Financial Performance of Commercial Banks Kenya. The study covered the period between year 2005 and 2014. Credit risk was measured by measured by capital to risk weighted assets, asset quality, loan loss provision, loan and advance ratios and financial performance by return on equity (ROE). The study used the balance sheets components and financial ratios for 43 commercial banks in Kenya registered by

year 2014. Panel data techniques of fixed effects estimation and generalized method of moments (GMM) were used to purge time–invariant unobserved firm specific effects and to mitigate potential endogeneity problems. The pair wise correlations between the variables were carried out. From the results credit risk has a negative and significant relationship with bank profitability. Poor asset quality or high non-performing loans to total asset is related to poor bank performance both in short run and long run. Based on the study findings, it is recommended that management of commercial banks in Kenya should enhance their capacity in credit analysis and loan administration. Clear credit policies and lending guidelines should be established.

In Jordanian study, Ali (2015) in his study the effect of credit risk management on financial performance of the Jordanian commercial banks. This research covered the period (2005-2013), thirteen commercial banks have been chosen to express on the whole Jordanian commercial banks. Two mathematical models have been designed to measure this relationship, the research revealed that the credit risk management effects on financial performance of the Jordanian commercial banks as measured by ROA and ROE. The research further concludes that the credit risk management indicators considered in this research have a significant effect on financial performance of the Jordanian commercial banks. Based on findings, the researcher recommends banks to improve their credit risk management to achieve more profits, in that banks should take into consideration, the indicators of Non-performing loans/Gross loans, Provision for facilities loss/Net facilities and the leverage ratio that were found significant in determining credit risk management. Empirically, Myrna and Modern (2013) study the Relationship between Bank Credit Risk and

Profitability and Liquidity. The sample data comes from the Mergent Online database, which stores ownership, executive, and financial information about public and private commercial banks. Performance variables in analysis of covariance models include net interest margin, return on assets, return on equity, and cash flow to assets. Preliminary results show a negative relationship between less prudent lending (which may be interpreted as a positive effect of more prudent lending) and net interest margin. However, findings were only statistically significant when the normality assumption was relaxed through the robust regression method. Insider holdings and longer chief executive officer tenure were negatively related to bank performance. This may be a consequence of an adverse effect of the agency problem. Empirically, Misker (2015) study The Impact of Credit Risk on Financial Performance of Banks in Ethiopia This study aimed at examining the impact of credit risk management on profitability of banks in Ethiopia. The study used a secondary data for eight banks which stayed in the industry more than eleven years among nineteen banks which is functional at the moment in Ethiopia banking industry. The study obtained Data from banks annual report, National Bank annual report and MoFED. As a result the study concluded that the credit risk which is measured by nonperforming loan ratio had a significant inverse impact on banks financial performance and capital adequacy also same impact on profitability. In addition, loan to deposit ratio and bank size have a positive significant impact on banks financial performance. In general, Bank Specific factors have a significant impact on banks profitability while external factors like GDP, Inflation and interest rate spread had no significant impact on banks profitability.

In another Nigerian study, Anthony and Abdujafaru (2016) in their study, the Effects of Credit Risk

Management on the Performance of Some Selected Deposit Money Banks in Nigeria, the study cover a period of five years (2010-2015). The study shows a significant relationship between credit risk management and performance using Return on Assets (ROA) and Return on Equity (ROE). Very few of this research has measured net interest margin (NIM) as a measure of performance in Nigeria. The independent variable which is Credit Risk Management measures the Non-Performing Loan Ratio (NPLR) and Loan to Deposit Ratio (LTDR) while the dependent variable which is performance measures the Return on equity (ROE), return on assets (ROA) and Net interest margin (NIM). The study concludes that the need for management to create the right credit policy and also ensure full implementation must be adhered to in other to bring positive performance and also the importance of knowing how credit policy affects the operation of their banks activities to ensure an efficient utilization of customer deposits. Empirically, Uwalomwa Uwuigbe and Oyewo (2015) study the Credit Management and Bank Performance of Listed Banks in Nigeria the study covered the audited corporate annual financial statement of listed banks covering the period 2007-2011 were analyzed. More so, a sum total of ten (10) listed banks were selected and analyzed for the study. Findings from the study revealed that while ratio of non-performing loans and bad debt do have a significant negative effect on the performance of banks in Nigeria, on the other hand, the relationship between secured and unsecured loan ratio and bank's performance was not significant. Hence, the study recommends that banks management should put in place or institute sound lending framework, adequate credit administration procedure and an effective and efficient machinery to monitor lending function with established rules.

The findings of these studies reviewed reveal diverse outcome. Bases on the above studies the common determinants for credit risk outcomes are the level of bad loans (non-performing loans), problem loans or provision for loan losses. In other hand the frequent used proxy for profitability is Return on Asset (ROA). The regular approach used by the largest part of these studies was to analyze the e3ffect of credit risk outcome on any other variable, using regression analysis; the regression analysis measures the actual impact of credit risk outcome on profitability firm.

METHODOLOGY

The research design used for the study was a descriptive research design that basically involves obtaining information concerning the current status of phenomena to describe, "What exist" with respect to variables or condition in a situation (Gardner, Dixie, and S.C., 2004). The population on interest is all quoted banks that operate in Nigeria. The study covered the period from 2006 to 2015 because this was the period that banking industry has undergone various change.

TABLE 1: Study Population

S/NO	BANKS	YEARS OF INCORP.	YEAR OF LSTING
1	ACCESS BANK PLC	1989	1998
2	DIAMOND BANK PLC	1990	2005
3	ECO BANK PLC	1985	2003
4	FIDELITY BANK PLC	1988	2005
5	FIRST OF NIGERIA PLC	1894	1971
6	FIRST CITY MONUMENT BANK	1982	2004
7	GT BANK PLC	1990	1996
8	SKYE BANK PLC	1989	2006
9	STERLING BANK PLC	1960	2006
10	UNION BANK PLC	1917	1971
11	UNITED BANK OF AFRICA PLC	1948	1971

12	UNITY BANK PLC	2006	2006
13	WEMA BANK PLC	1945	1990
14	ZENITH BANK	1990	2004
15	JAIZ BANK PLC	2003	2011

Source: NSE fact book 2013

The study covered the quoted banks operating in Nigerian stock exchange as presented in table 1; in order to be critic, the working population has been derived from the study population in which the company that had been quoted on or before the study period will be consider since their annual reports and accounts are available for study period (2006-2015). The working population of banks is listed in table 2 along with their quoted date in NSE.

TABLE 2: WORKING POPULATION

S/N	BANK	FOUNDED	QUOTED DATE
1	ACCESS BANK PLC	1989	1998
2	FIRST BANK OF NIG PLC	1894	1971
3	GT BANK PLC	1990	1996
4	UNION BANK PLC	1917	1971
5	UNITED BANK OF AFRICA	1948	1971

Source: NSE fact book 2013

Secondary data were used for the study. The data was analyzed by calculating the profitability for each year for the period of study, multiple regression analysis was done by comparing the profitability ratio (proxy by ROA) to default rate, cost per loan assets and capital adequacy ratio. Further, the ratio was analyzed using regression statistical tool run using STATA.

VARIBLES AND THEIR MEASUREMENTS

The Return on Asset (ROA) is the ration that measures company profit after tax against its total assets. The ratio is considered an indicator of how efficient a company is using its assets to generate before contractual obligation must be paid. It is calculated as: ROA= PAT/ TOTAL ASSETS. Return on Assets gives a sign of the capital

strength of the banking industry, which will depend on industry; banks that require large initial investment will generally have lower return on assets (Appa, 1996: Ahmed, Takeda and Shawn, 1998; and Kolapo, Ayeni, and Oke, 2012).

Default Rate (DR) is the term for a practice in financial services industry for a particular lender to change the terms of loan from the nominal term to the default terms that is, the terms an d rate given to those who missed payment on loan (Appa, 1996; Ahmed, Takade and Shawn, 1998; and Kolapo, Ayeni, and Oke, 20120. DR ratio can be calculated as: DR=NON PERFORMING LOAN/TOTAL LOAN.

Cost per Loan Assets (CLA) is the average cost per loan advanced to customer in monetary term. Purpose of this is to indicate efficiency in distributing loans to customers (Appa, 1996; Ahmed, Takade and Shawn, 1998; and Kolapo, Ayeni, and Oke, 2012). CLA ration can be calculated as:
CLA= TOTAL OPERATING COST / TOTAL AMOUNT OF LOANS

Capital adequacy ratio (CAR) is a measure of the amount of bank's capital expressed as a percentage of its risk weighted credit exposure. CAR can be calculated:
CAR=CAPITAL FUND/RISK WEIGHTED ASSETS

MODEL SPECIFICATION
The econometric model used in the study (which is in line with a mostly found in the literature such as (Ahmed, Takade and Shawn, 1998; and Kolapo, Ayeni and Oke, 2012) is given as:
$Y=\beta 0+\beta Fit + eit$

Where, Y is the dependant variable. B0 is constant, β is the coefficient of explanatory variable, Fit is the explanatory variable and eit is the error term (assumed to have zero mean and independent across time). By adopting the economic model as in above equation specifically to this study, equation 2 below evolves.

$$ROPA = \beta_0 + \beta_1 DR + \beta_2 CLA + \beta_3 CAR + eit$$

DATA ANALYSIS AND INTERPRETATION

As stated eelier, the study used regression models in order to basis of testing hypothesis

Table 3: Descriptive Statistics of the Variables

	ROA	DR	CPLA	CAR
Mean	0.9684	17.3535	30.9.067	12.3298
Std. Dev.	4.92704	16.4747	9.06760	27.1573
Minimum	7.3	5	6.3	4.5
Maximum	20.3	15.7	12.3	12.8
Observations	60	60	60	60

Source: Output of summary statistics developed by the researcher (2017).

From the table 2, the average values of the dependent variable return on assets(ROA) is 0.9684 and the standard deviation is 4.92704 indicating lack of substantial variation. The other variables which are all independent in the table also show the evidence of some level of variability. On the overall the capital adequacy ratio (CAR) has the highest standard deviation which about 27.15734 and ROA has the lowest standard deviation account for only 0.9684. The higher the deviation the higher the risk bank face in an attempt to establish the relationship between the dependant and the independent variables, and also to ascertain whether or not multi-collinearity exist as a result of the correlation between variables, table 3 is incorporated for the purpose of analysis. The correlation matrix in table 3 provides some insights into which of the independent variables are related to the dependent variable ROA.

TABLE 4: Pearson Correlations

	ROA	DR	CPLA	CAR
ROA	1.000			
DR	-0.47	1.000		
CPLA	-.357	0.285	1.000	
CAR	0.93	-.288	-.193	1.000

Source: Correlation Table developed by the researcher (2017).

From the above matrix, the values are on the diagonal are all 1.000 indicating that each variable is perfectly correlated with itself. The highest correlations with ROA are for default rate (-0.417) and cost per loan asset (-0.357). Both correlations are negative, which implies that as the value of default rate increases, or as the value of cost per loan asset increase, the profitability of banks decrease. On the other hand, capital adequacy ratio and ROA show positive correlation of (0.093), which implies that as the value of capital adequacy ratio increases, so does profitability of banks. Though, correlation is positive, the relationship shows \no strong correlation. The correlations between independent variables are positive with the exception of correlations that exist between capital adequacy ratio and other independence variables. To further assess the validity on non-multi-collinearity indication revealed by the correlation matrices, the study used Tolerance Value (TV) and Variance Inflation Factor (VIF). The below table represent the results of TV and VIF for the credit risk outcome components.

Table 4: Test for Multi-collinearity

Variable	VIF	1/VIF (TV)
DR	1.160	0.862
CPL	1.104	0.906
CAR	1.107	0.903
Mean VIF	1.111	

Source: Output of summary statistics developed by the researcher (2017).

From the table 5, TV ranges from 0.862 to 0.906 which suggest non multi-collinearity feature. Multi-collinearity feature exist when the value of TV is less than 0.2

(Safari, 2012). The VIF which simply the reciprocal of TV range 1.104 to 1.160 and this indicates absence of multi-collinearity. VIF shows multi-collinearity when its value exceed 10 (Tobachnics and Fidell, 1996 as cited by Sabari, 2012).

Table 6: Summary Regression Results of the variables (random effect)

Variables	Coefficient	Std Errors	T. Values	Prob
Intercept	5.923	1.533	3.814	0.000***
DR	-0.107	.038	-2.856	0.006***
CPLA	-0.185	.067	-2.179	0.034**
CAR	-0.011	.022	-.504	0.617*
Overall	33.15			
Prob	0.0000***			

Source: Regression output developed by researcher (2017). (*, **, ***, indicate significant levels at 10%, 5% and 1% respectively).

The regression result of the study's model suggests that all the independent variables have negative impact on profitability. The model is thus; ROA=5.923-0.107DR-0.145CLA-0.011CAR+e

The result shows that the ratio default rate related to profitability though not significant. The parameters shows that increase in non-performing loans decreases profitability (roa) by 10.7%, likewise, increase in the level of cost per loan assets reduces profitability of the banks by 14.5%, this expose them to higher risk level, however, increase in capital; adequacy ratio will lead decreases profitability of the bank by 1.1%. The study shows that there is inverse relationship between profitability (ROA) and the ratio of default rate, cost per loan asset ratio and the capital adequacy ratio and significant at 1%, 5% and 10% respectively. This is consistent with the findings of Ravi (2012), Simeyo, Micheal and Anthony (2012), Epure and Lafuente (2012), and Kolapo, Ayeni, and Oke, (2012). However,

contradicts the study of Kipngetrich and Muturi (2015), and Alice & Jaya (2016) in their various studies.

As for the result of the regression equation of the dependent variable, profitability on the independent variables credit risk outcome components, the following table shows summary of the regression result. In terms of fitness of the study model, the coefficient of multiple determination R^2 indicates that about 23.9% (adjusted R-19.8%) of the variations in ROA are explained by the combined influence of credit risk indicators (default rate, cost per loan asset ratio and the capital adequacy ratio) in the model. This study shows that there is a significant relationship between bank of profitability and credit risk outcomes in term of rate, and cost per loan asset ratio. Loan losses, operating expenses and non-performing loan 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 unstable. This means that the profit after tax has been responsive to the credit policy of Nigerian banks. The deposit structure also affects profits performance. Banks become more concern 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 a crucial importance for banks to practice prudent credit risk management to safeguard their assets and protect their investors' interests.

CONCLUSION AND RECOMMENDATIONS

From the findings of this study, it is concluded that banks profitability is conversely influence by the level of default rate, cost per capital asset ratio and the capital adequacy ratio thereby exposing them to great risk of illiquidity and distress. Therefore, management need to be caution in setting up a credit policy that will 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 risks management reduces the bank profitability; affect the quality of its assets and increase loan losses, operating expenses and non-performing loan which may eventually lead to financial distress. CBN for policy purpose should regularly assess the lending attitudes of financial institutions.

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