CREDIT RISK AND PROFITABILITY OF DEPOSIT MONEY BANKS IN NIGERIA

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ABSTRACT

Failure of banks in Nigeria's banking industry prior to the consolidation era were as a result of financial deepening that led to bad loans and other unethical factors that orchestrated financial stability. This study examined credit risk and profitability of deposit money banks in Nigeria. The study adopted ex-post facto research design and used secondary data sourced from Central Bank of Nigeria's statistical bulletin and Nigeria's bureaus of statistics. Ordinary least square of multiple regression techniques was used to test the relationship between proxies of credit risk (liquidity risk and non-performing loans) and profitability. The study found the existence of significant influence of liquidity risk and non-performing loans on profitability of deposit money banks in Nigeria. The study therefore concluded that credit risk in terms of liquidity risk and non-performing loans influence profitability of deposit money banks in Nigeria; and recommends that operators of deposit money banks should pay adequate attention to liquidity risk and non-performing loans management in order to improve their profitability and ensure financial stability to promote economic growth and development.
Keywords: credit risk, liquidity risk, non-performing loans, profitability

INTRODUCTION

Risk is inherent in every business activity. However, it is more threatening in banking sector. Risk management is thus crucial in the sector. In Nigeria like other developing economies where consumer confidence index is low, banking business is riskier than normal. Banks battle with credit defaults, liquidity problems, balancing bank policy guidelines, regulatory issues and bank operations, as well as keeping pace with capital adequacy.

Risk is the exposure to loss or other unfavorable business outcomes, arising from variation between expected and actual outcome of invested resources (Nzotta, 2002; Owualla, 2000). According to Pandey (2004), the key to effective risk management is not to do away totally with inherent risks. For example, lending operations of banks have the inherent risks of possible loan losses (credit risk) but by taking the risk, banks are able to charge a premium for their risk taking activities and earn profits.

Risks are therefore, a source of profits for banks. However, risk management in the Nigeria financial system has not yielded much result as desired due to challenges ranging from insider loans and advances to inadequate risk management policy of banking operators. It is common among Nigerian banking operators to extend loans and advances to family relations, friends and directors without due process. This most often, lead to bad debts – debts, the recovery of which are difficult or impossible owing to inadequate recovery procedures. Such bad debts lead to banking distress.

Another problem is operational risks. These are the risks of direct and indirect loss resulting from inadequate or failed internal processes, people and systems or external threats. The manifestation of high operational risk in Nigerian banks is the volume of fraud and forgeries and non-compliance with entrenched policies. According to Soludo (2007), approaches to risk have apparently changed across organizations and the whole globe in recent times. This involves the recognition by many business leaders that risks are no longer mere hazards to be avoided but they also in many cases, include opportunities to be embraced and exploited.

Soludo (2007) further opined that risk officer of Royal Bank Canada who observed that "risk itself is not bad, what is bad is risk that is mismanaged, misunderstood, mispriced or unintended". He therefore described risk management as a discipline at the core of every financial institution and encompasses activities that involve risk profiling. Financial risks occur due to default in operational activities for any business without consent to the nature or the size of the business. In other words, banks do grant loans and advances to individuals, businesses and governments to enable them embark on investment and development activities as a means of aiding their growth in particular or contributing toward economic development of a country in general (Felicia, 2011).

The financial system which includes the banking and non-banking sectors provides the public with financial services, such as, issuing money in various forms, receiving deposits of money and other valuables, lending money, processing transactions and creating credit. All these banking activities have intrinsic risks. This makes the banking sector a very risky industry. The risks in the banking sector cannot be eliminated or avoided (Soyemi et al., 2014). They can only be managed to control the degree and direction of their impact on bank performance. Risk management is the identification, assessment and prioritization of risks followed by coordinated and economical application of resources to monitor and control the probability and/or impact of unfortunate events (Njogo, 2012).

Ravi (2012) posits that credit risk management is best practice in banks and above 90 per cent of banks have adopted this best practice. Inadequate credit policies are still the main source of serious problem in the banking industry, hence effective credit risk management has gained increased attention in recent years. The main role of effective credit risk management policy must be to maximize a bank's risk adjusted rate of return by maintaining credit exposure within acceptable limits.

Banks exist for the main purpose of providing a safe storage of customer's valuables (Dwayne, 2004) banks originates for the main purpose of providing a safe storage of customer's valuables. However, because valuables deposited by customers are always available to banks, they devised means of investing them in profit earning assets; and this action, they incur risk. Risk in this

sense represent situations in which various outcomes are possible, and there is relevant previous experience that could provide statistics to estimate the effects.

Risk provides opportunity; the terms risk and exposure have subtle differences in their meaning. Risk refers to the probability of loss, while exposure is the possibility of loss, although they are often used interchangeably. Risk arises as a result of exposure. Exposure to financial markets affects most organizations, either directly or indirectly. When an organization has financial market exposure, there is a possibility of loss but also an opportunity for profit. Financial market exposure may provide strategic or competitive benefits.

Financial market risk is the likelihood of losses resulting from events such as changes in market prices. Events with low probability of occurring, but that may result in a high loss, are particularly troublesome because they are often not anticipated. Put differently, risk is the probable variability of returns (Karen 2005). A primary goal of deposit money banks is to redirect funds from surplus units to deficit units in a profitable and sustainable manner. They activities as financial intermediaries enhances rapid economic growth and financial stability in a nation by providing support especially to the real sector of the economy. Thus, their financial stability is vital to economic growth. Stephen and Joseph (2015) posits that the volume of loans and advances disbursed by banks significantly influence productive economic activities.

In lieu of the importance of deposit money banks to economic growth and development, and the need to ensure adequate risk management in banking operation, to ensure financial stability of deposit money banks and to prevent or avoid distress of deposit money banks, especially in developing economies like Nigeria, this study opts to examine the link between credit risk and profitability of deposit money banks in Nigeria.

LITERATURE REVIEW

Theoretical Framework

This study is grounded in shiftability theory and anticipated income theory. Shiftability theory argues that risk can be managed by obtaining liquidity converting assets to shift open market securities. When a bank that maintains a substantial amount of assets is in dire need of ready money, this theory supports the shifting of such assets to a more liquid bank. In line with this proposition, banks do accept shares and debentures of viable companies as liquid assets thus encouraging their customers to term lending.

Anticipated income theory (Prochanow, 1944) on the other hand, posits that cash flow of borrowers is enough to hedge against risks from default. A bank's loan portfolio is thus considered as a source of liquidity. The loan is repaid in installments out of the anticipated earnings of the borrower instead of a lump sum at maturity. This theory satisfies three main objectives of sound banking operation namely, liquidity, safety and profitability. Loan is repaid in regular installments ensuring liquidity. The ability of the borrower to repay guarantees safety and the regular cash inflow enables the bank to grant more loans thus ensuring profitability.

Concept of Credit Risk

Risk is a measure of the level of uncertainty in an event or activity. It is the likelihood of a negative outcome. In finance, it can be defined as the probability that actual return on investment

will be different from expected return. Owojori et al. (2011) posits that available statistics from liquidated banks showed that inability to collect loans and advances extended to customers and creditors or companies related to directors or managers was a major contributor to the distress of liquidated banks in Nigeria.

With the collapse of deposit money banks in Nigeria, one would wonder the best strategy a deposit money bank can adopt to completely eliminate credit risk or loan defaults. Credit risk management strategies are issues of concern in deposit money banks today and there is need to come up with improved strategies to deliver better results for future performance. Ideally, a sound risk management practice involves the pursuance of order process whereby risks with highest loss and the highest likelihood of occurring are brought under control first, and those with lesser possibility of happening and lesser loss are controlled in descending order (Isa, 2014).

In a broad perspective, financial risk can be classified into systematic and unsystematic risk. Isa (2014) described systematic risk as irrelevant risk since they are beyond the control of business managers. It is irrelevant from the point of view that it is practically difficult to shade businesses from systematic risk. Unsystematic risk is the relevant risk which a manager should border about because it is under the control of the investor to decide in which security to invest or not, and can be controlled or eliminated through diversification (Isa, 2014).

In this study, we view credit risk through the lenses of liquidity risk (LR) and non-performing loans. LR describes risks associated with the uncertainty that, for a given period of time, a given financial asset may not be traded quickly enough to meet financial obligations. LR is also described as risks incurred due losses resulting from the inability to meet payment obligations in a timely manner due inability to do so at a sustainable cost. When an individual of firm not do not have sufficient cash to meet their financial obligations on time, they are said to at LR. Thus, the ease with which assets of a firm can be converted to cash without negatively affecting its market price represents LR. The risk arises when a company cannot trade an investment in exchange for cash fast enough to offset their debts. An important element of LR management is banks' funding strategy, which aims to avoid gaps between assets' maturity profile and liabilities and to diversify debt issuance programmes, funding markets and investors' base. Banks ensures that they holds liquidity reserves comprising high liquid securities, the market value and liquidity of which can be preserved during adverse market conditions.

NPLs also known as bad debts, represents sums of substandard, doubtful and estimated loss loans of commercial banks. A loan is regarded as a NPL when there are indications that the borrower is unlikely to repay the loan, or if more than 90 days have passed since that agreed instalments or interest was paid. So, a loan is considered non-performing when more than 90 days pass without the borrower paying the agreed instalments or interest. Scholars also view NPL as bank loan that is subject to late repayment or is unlikely to be repaid by the borrower in full. NPLs represent a major challenge for banks and banking operations because they reduces the profitability of banks; and are often prevent banks from lending more to borrowers, which in turn slows down economic growth (Atoi, 2018). NPLs are thus a cause of concern for banks' stability during economic downturns. However, Bertay et al. (2013, as cited in Akinlo & Mofoluwaso, 2014) states that varied levels of market discipline, risk management strategies, regulatory and supervisory measures, and sources of capital of different categories of banks suggests that the impact of NPLs on banking stability cannot be the same across banks.

Profitability

Profit is the monetary earning a business firm achieves after all costs associated with the operations, including salaries, expenses and other operating costs of the firm have been deducted; while profitability is the ability of a business undertaking to make profit or the degree to which a business is profitable (Ateke & Didia, 2017). Profitability is a financial metric used to assess a firm's ability to generate earning in excess of the combination of all expenses incurred in a given investment. It is basic goal of firms upon which the realization of other goals like growth and survival is anchored, is profitability.

The capacity to make profit is the anchorage of long term survival of a business concern. Ejoh and Iwara (2014) identify Return on Assets (ROA) and Return on Equity (ROE) as common indicators of profitability. And either of them can be used to gauge the profitability of a business. Profitability is an important concept in business; and has been a topical concern for managers, shareholders and researchers (Ejoh & Iwara, 2014) since the dawn of commerce. Though managers often resort to profitability as a primary measure of business wellness, it is relevant to note that enhanced profitability is determined by sundry quantitative and qualitative parameters (Ateke & Simeon, 2018).

Credit Risk and Profitability

Risk is the exposure to loss arising from the variation between the expected and actual outcomes of investment activities Nzotta (2002). Therefore, in a broad term, risk management can be related to a mechanism that embraces planning, organizing and controlling resources and operational activities for effective reduction or elimination of risk or the adverse effects of risks. Risk management is a multi-disciplinary function. Hence, it is all embracing in the implicit actions taken managers. Such actions involve, consciously putting a risk management process in place to mitigate disasters such as injuries, incapacitation, and even death. It involves a management process aimed at "the effective reduction of adverse effects of risks."

Profitability on the other hand is a cardinal consideration in investment decisions, and a key determinant of business continuity. A firm will not remain in business if it consistently run at a loss. Thus managers, shareholders and researchers alike, accord importance to the notion of profitability. Ateke and Didia (2017) argue that profitability stems from different quantitative and qualitative business initiatives, and that research into drivers of profitability is an ongoing enterprise. Herein, we review a few previous studies that have attempted to identify key determinants of profitability.

Olusanmi et al. (2015) analyzed the influence of effective risk management on banks' financial performance in Nigeria, using a data set that covered a sample of 14 banks listed on the floor of the Nigerian Stock Exchange over a period of 6years (2006-2012). The used ROE represent financial performance while the non-performing loan ratio, capital Ratio, loan to total deposit and risk disclosure were used as proxies of effective risk management. The study reported that risk management influences financial performance of Nigerian banks.

Similarly, Elshaday et al. (2018) examined the determinants of financial performance of private commercial banks in Ethiopia. Eight banks were chosen from sixteen banks in the Ethiopian banking industry from 2007 to 2016. The random effect results show that non-performing loans and loan loss provision have negative and statistically significant effect on financial

performance. In the study of Jin (2019) which focused on examining financial risks and performance of a food and beverages company for the period of 2014-2018 showed that operating margin is the most significant variable that positively influences performance of the company.

Based on the foregoing, we hypothesize as follows:

Ho_1: LR has no significant influence on profitability of deposit money banks in Nigeria.

Ho_2: NPLs have no significant influence on profitability of deposit money banks in Nigeria.

METHODOLOGY

The study adopted an ex-post facto research design and used secondary data obtained from NDIC Annual Reports and Accounts for the period 2000 to 2019 from various statistical issues and central Bank of Nigeria bulletins. The data collected include ROA, ROE, NPL to total loan, Average Liquidity Ratio (ALR), Operational Risk (OR), Capital Adequacy Ratio (CAR) these variables are also all believed to be index used to measure a banks' performance. The dependent variable for the study is banks' profitability represented as ROA. In analyzing the data gathered for this work, figures were used and the statistical tool used was the multiple regression models.

Model specification

Bank Performance = f (Non-performing loans, average liquidity risk) the present study modified the independent variables of this model. Thus the functional relationship in the model is represented by return on assets and return on equity, and risk management variables are represented by credit risk, liquidity risk, and capital risk non-performing loans.

The equations of the relationship are:

$$ROA = b_0 + b_1 \, ALR + b_2 \, NPL + \mu$$

Where:

NPL = Ratio of Non-Performing Loans to Total Loans (%) as a proxy for Credit Risk.

ALR = Average liquidity ratio as a proxy for Liquidity Risk.

PRESENTATION OF DATA, ANALYSIS AND DISCUSSION OF FINDINGS

Table 1: Data Showing ROA, LR, and NPL (data on risk in DMB (2000-2019)

YEAR	ROA	LR	NPL
2000	0.1643	61.42	1.74
2001	0.1451	59.29	45.00
2002	0.0881	63.05	47.48
2003	0.0604	54.50	41.25
2004	0.0511	56.41	62.00
2005	0.0464	63.88	64.15
2006	0.0244	75.88	14.04
2007	0.0270	83.34	28.76
2008	0.0158	72.77	32.44
2009	-0.0732	64.85	93.09
2010	0.0168	75.13	42.77
2011	0.0011	58.70	95.32
2012	0.0134	59.09	101.12
2013	0.0084	44.93	57.28
2014	0.0222	49.99	31.19
2015	0.0052	45.81	28.21
2016	0.0048	45.01	42.35
2017	0.0311	36.27	42.35
2018	0.0065	25.64	40.02
2019	0.0061	23.57	45.9
2020	0.0071	21.30	41.6

Source: CBN statistical bulletin

Table 1 shows that ROA experienced inconsistent trend from 2000 to 2019. Consequently the other variables also witnessed rise and fall in no particular order, in the period under review. The independent variable did not maintain upward or downward trend during the period under study. Further analysis of the data in Table 1 reveals that LR, NPL do not have a defined (upward or downward) trend. The empirical analysis will reveal if the data are statistically true or otherwise.

Table 2: Descriptive Analysis

	ROA	C	LR	NPL
Mean	0.031967	1.000000	54.32524	47.37095
Median	0.016800	1.000000	58.70000	42.35000
Maximum	0.164300	1.000000	83.34000	101.1200
Minimum	-0.073200	1.000000	21.30000	1.740000
Std. Dev.	0.050921	0.000000	17.22009	25.01606
Skewness	1.033796	NA	-0.439800	0.703928
Kurtosis	4.743090	NA	2.475788	3.229557
Jarque-Bera	6.399139	NA	0.917433	1.780411
Probability	0.040780	NA	0.632094	0.410571
Sum	0.671300	21.00000	1140.830	994.7900
Sum Sq. Dev.	0.051858	0.000000	5930.633	12516.07
Observations	21	21	21	21

Source: Output of data analyses

The result of the descriptive statistics is presented in Table 2 revealed that the value for ROA has an average mean value of 0.031967 with a standard deviation of 0.050921, having its minimum value for ROA at -0.073200 and its maximum value in ROA as 0.164300. The total estimate on liquidity risk LR shows its minimum value as 21.30000 and maximum of 83.34000 for LR. Further analysis of the descriptive statistics revealed that total LR has a mean value and standard deviation of 54.32524 and 17.22009 respectively. Consequently, the descriptive statistics states that the probabilities for from ROA, LR NPLs are 0.040780, 0.632094, and 0.410571 which suggest the absence of outliers.

Furthermore, the analysis indicated that the measurement of skewness showed that variables (ROA, LR, NPL) are rightly skewed (positively skewed). The coefficient of the kurtosis of the variables (ROA, LR, and NPL) indicated that the variables were found to be peaked at various degrees (Leptokurtic) relative to the normal distribution. The Jarque-Bera (JB) test measures the difference of skewness and kurtosis of the series with those from the normal distribution. The JB values of 6.399139 0.917433, 1.780411 for ROA, LR, NPL respectively while their corresponding probability of less than or equals to 0.04 percent confirms the normality of the series and suitability for generalization. It indicates the absence of outliers in the data.

Table 3: OLS multiple regression analysis

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	0.047647	0.039928	1.193324	0.2482
LR	0.000516	0.000609	0.847014	0.4081
NPL	-0.000923	0.000419	-2.200381	0.0411
R-squared	0.935894	Mean dependent var		0.031967
Adjusted R-squared	0.915099	S.D. dependent var		0.050921
S.E. of regression	0.046919	Akaike info criterion		-3.149220
Sum squared resid	0.039625	Schwarz criterion		-3.000003
Log likelihood	36.06681	Hannan-Quinn criter.		-3.116836
F-statistic	60.62672	Durbin-Watson stat		0.460053
Prob(F-statistic)	0.088794			

Dependent Variable: ROA
Method: Least Squares
Date: 08/08/21
Time: 17:11
Sample: 2000 2020
Included observations: 21
Source: Output of data analyses

The results of the OLS regression as presented in Table 3 showed that the regression model has a good fit on the data. This is given by the high value of the R-squared of 0.935894 (93.56 per cent) and the adjusted R-squared 0.915099, about 92 per cent of the systematic risk variations in the determination of risk in deposit money banks in Nigeria has been explained by changes in the size liquidity risk and non-performing loans. In the same vein, the high value of F-statistics (60.62672) shows that the overall model is statistically significant. The overall significance of

the model implies the joint significance of all explanatory in explaining changes in the risk awareness of deposit money banks in Nigeria.

Further examination of the result shows that there is no problem of autocorrelation in the model. This is so because the Durbin-Watson (DW) statistic value of 0.460053 falls within the acceptable region of no autocorrelation. From the policy stance, this means that the finding of this study can be applied for policy purpose in deposit money banks. Analysis of the regression estimates further showed that changes in the volume of LR have a significant impact on the deposit money banks in Nigeria.

The implication of that is, a unit change in the volume of liquidity risk cause about 0.000516 per cent increase in the profitability of deposit money banks, ceteris paribus. The result also revealed that a change in the volume of NPL has a negative and insignificant effect on the profitability of deposit money banks in Nigeria. That is, a one per cent increase in the volume of NPL will result in a negative change in the profitability of deposit money banks in Nigeria by -0.000923 all things being equal.

Table 4: Summarized t-test result from the OLS multiple regression test

	The t-test as summarized	t-tab	Corresponding probability	Remark
LR	(0.847014)	#2.58	0.4081	insignificant
NPL	(-2.200382)	# 2.58	0.0411	insignificant

Source: Output of data analyses

The t-statistics is used to test for individual significance of the estimated parameter (B1). From the Table 4, we deduce that LR (0.847014) is less than 2.58 (going by absolute values) which represent the t-tabulated implying that LR is statistically insignificant. Hence, we accept the null hypothesis of the study and concluded that there is no significant relationship between LR and profitability of deposit money banks in Nigeria. The implication here is that, the effect of LR on profitability of deposit money banks in Nigeria is statistically insignificant.

Table 4 also displays that the NPL (-2.200381) is lower than 2.58 (going by absolute values) which represent the t-tabulated implying that NPL is statistically insignificant. Hence, we accepted the null hypothesis of the study and concluded that: There is no significant relationship between NPL and profitability of deposit money banks in Nigeria. The implication here is that, the effect of NPL transactions on deposit money banks in Nigeria is statistically negatively non-significant.

From the regression results discussed above, some findings and implications can be highlighted. First, change in the rate of LR show significant impact on current value of deposit money banks' profitability. This supports the view of Pandey (2004) that sufficiency of liquid is critical to performance of deposit money banks in Nigeria. Thus, deposit money banks should strive hard to ensure credits administered to customers should be based on appropriate credit policies so as to reduce cases of banks liquidity risk to as low as possible and improve the existing ones. Owing to the appropriate disbursement of loans by deposit money banks. It implied, when loans are disbursed more appropriately it yields a better performance in deposit money banks.

CONCLUSION AND RECOMMENDATIONS

Deposit money banks operate amidst several risk factors due to the nature of their mandate to create credit and operate profitably. This study reveals that in Nigeria, the reintroduction of measures capable of checking loop holes in loan administration is of utmost importance. From this study, we have been able to deduce that there exist a significant relationship between credit risk and profitability of deposit money banks in Nigeria. The introduction of various risk management methods significantly mitigate risk. Players and operators in the financial sector have a significant part to play in enhancing the system through effective banking and monetary policies, efficiency and stability. Furthermore, to protect against risks, certain strategic measures must be taken to reduce negative effects of the problems identified as risk prone situations, here partnering the government and other private agencies is non-negotiable. From the data collected and analyzed, it is safe to conclude that monetary authorities need to do more in terms of policy to protect the banking.

To make for the substantial curbing of the various types of risk within deposit money banks, the study recommends that efforts must be made to improve the security of transactions, that technology should be deployed to improve convenience in loan disbursement and to reduce bad debts. Regarding lending rates, monetary authorities should ensure robust and economically friendly rates, taking into cognizance, the economic reality on ground with regards to loan repayments from prospective investors. Furthermore, Consistent and effective appraisal of investment policies must be qualitative in nature. This will strengthen and improve the effect of loans disbursed to the small and medium scale enterprise in the economy.

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