

THE RISING INCIDENCE OF NON -PERFORMING LOANS AND THE NEXUS OF ECONOMIC PERFORMANCE IN NIGERIA: AN INVESTIGATION.

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ABSTRACT: Since the introduction of Structural Adjustment Programme (SAP) in Nigeria in the 1980's, the financial system has witnessed excessive liberalization. Community Banks which were the main stay of the financial system have transformed to Microfinance Banks (MFB) resulting from the uncontrolled collapsed of these institutions. The Central Bank of Nigeria (CBN) very recently introduced reforms meant to curb the high incidence of bank failures in the country that required the introduction of minimum capital requirement for the establishment of commercial Banks and MFBs. After some years of experiments, it was obvious that the reforms put in place were not adequate to stem the tide of bank failures. It was as a result of this that the Apex Bank (Central Bank of Nigeria) increase the minimum capital requirement for commercial banks to N25b (\$160,000). Many Banks could not meet this new capital requirement and were faced with the option of been merged with other stronger banks or allowed themselves to be completely taken over by other banks. From researches done on the performance of banks, it has been proven that banks tend to do very well when the economy is also doing very well. It is on this basis that this work has been undertaken to confirm this assertion or otherwise confirm that non- performing loans tend to increase when the economy slacks into a recession. The study found that increase in non-performing loans impacted negatively on the Gross Domestic Product in Nigeria and that increase in lending rate and inflation rate cause non-performing loans to increase. The implication of this study is that Central bank should introduce policies that can have moderating effects on inflation and lending rates. Government should pay their loans on time and insider abuse should be eliminated from the financial system. Above all, banks should know their customers before granting loans to them, infact adhering strictly to the 5C's of credit in modern banking practice.

KEYWORDS: Non-Performing Loans, Interest Rate, Inflation Rate, Collateral, Reforms/Government Policies, Economy.

INTRODUCTION

The issues of non-performing loans (NPLs) have gained increasing attention in the last two decades. In spite of the 1952 Banking Ordinance, the Nigerian banking sector has experienced a

number of bank failures; with non-performing loans becoming the precursor to eventual bank failures in Nigeria. Non-performing loans are those loan facilities which borrowers often have difficulties repaying. Many researchers explained NPLs as bad debts whose recovery is highly doubtful because they are not being serviced as required. In the banking system, the bad loan problems consist of a stock component (old debt) that is not performing and a flow component (new lending) that may become non-performing. Loans are not necessarily annual events but happen at different periods of the year and are often affected by seasonal performance of economy but importantly by short term inflation, lending rates, level of risk where the economy is not doing well. The health of a bank is not reflected by the size of its balance sheet but by the return of its assets; thus earning power is an important indicator of bank performance.

Kassim (2002) suggested that some causes of Non-performing Loans (NPLs) include:

- Poor management,
- Lack of sound credit policy,
- Inadequate credit analysis,
- Errors in documentation,
- Undue emphasis on profitability at the expense of loan quality,
- Fraudulent practices,
- Political instability / economic depression,
- Abnormal competition,
- Policy and regulatory inconsistencies,
- Weak real sector,
- Political and social influence on bank operators etc.

Also, banks should not be left out of the blame because banks in Nigeria charge high interest rates on loans. When loans are granted to customers, banks charge numerous interests as determined by them. The accumulation of these interests is often higher than the initial amount borrowed. This usually increases the loan portfolio as well as the volume of bad loans. Again, management after granting loans to customers accept certain percentage as gratification, which may result in insufficient funds to execute the intended business and at the end of the day, management may not have moral standing to ask for the full refund of the money borrowed. Directors of banks often grant “ghost loans” to themselves to enrich their businesses without any intention to pay the loan. Hence, Okpara G. C. (2009) observes that directors tend to misuse their privileged positions to obtain unsecured loans which, in some cases are in excess of their banks’ statutory lending limits and this is in violation of the provisions of the lending policy of banks. Furthermore they approve loans for their friends and relatives in situations of insufficient information, thus increasing the potential of non-performing loans. In addition, some banks grant interest waivers on non-performing insider-credits without obtaining approval from the CBN. Some researchers maintained that non-performing loans led to the deterioration of bank assets, capital as well as their profitability. Again, that adverse economic and market factors ranging from recessionary conditions, regulatory changes and resource shortages of efficient management and strained labour relations, have impacted on the health of businesses and driven them to default on their loan repayments. NPLs are a credit risk to commercial banks and it is the risk of loss resulting from failure of borrowers to meet their payments obligation. These loans have tended to caused financial instability in the larger economy and have a times resulted in the

outright failure of state projects. This study wishes to determine the relationship between NPLs and Economy, and the ability of the later to predict the direction and intensity of the economy.

This paper has five sections. Section 1 is the introduction. Section 2.deals on the review of related literature. Section 3 is research methodology and model specification, section 4 deals with the results of the analyses, while section 5 discusses the results and concludes appropriately with some recommendations.

Hypotheses

1. Non-performing of loans have no significant relationships with the Gross Domestic Product of Nigeria.
2. There is no significant relationship between the Levels of non-performing loans and some important economic indicators such as : (i) lending rate. (ii) levels of inflation etc.

REVIEW OF RELATED LITERATURE

Non-Performing Loans And The Banking System In Nigeria

NPLs can be defined as default loans, which banks are unable to profit from. Non-performing loans are loans that have not expired, but it is uncertain whether the borrowers would be often to repay their debts. Customers of banks in Nigeria consist of business people, civil servants, contractors, petty traders, government at large. Each in one way or another contributes to the poor performance of loans in the banking system. Goldstein and Turner (1996) stated “ the accumulation of NPLs is generally attributable to a number of factors, including economic downturn, macroeconomic volatility, high interest rate, excessive reliance on overly high-priced inter-bank borrowings, insider borrowing and moral hazard. Civil servants who borrowed facilities from banks, when their salaries are delayed or denied for a specific period, their loans will stop performing and the consequence is rising non-performing loans. The issue of periodic strike actions in Nigeria undertaken by the Academic Staff Union of Universities (ASUU) and no payment of staff salaries resulting there from have tended to add to the volume of existing non-performing loans. Most of the retirees have borrowed from our banks when they were in active service and hoping to complete the payment of the loan from their gratuities or monthly pensions. The non-payment of such gratuity and due pensions has frequently resulted in bad debts and non- performing loans. Many contractors borrowed from the banks to execute their projects, some of these projects are often abandoned due to none or poor mobilizations from the government or individual who own the projects; the loans borrowed have also been classified as non- performing loans adding to the existing bad loans. Government who also borrowed from banks for some projects but due to the poor priority of projects, most of these projects are often abandoned and repayment of such borrowed amount often became difficult.

In a published report, the RBI attribute the rise in NPL of both public and private sectors to the diversion of funds away from the original purpose for which they were granted, as well as the misappropriation of funds by borrowers (Venkatav, 2009).Non-performing loans can also be caused by the harshness of the economy of the nation, not only in Nigeria, because the Central Bank of Ghana Kwesi Amissah said that harsh economic environment affect some small and medium scale enterprises in Ghana.

According to the annual report of the Japanese economy, the persistent increase in non-performing loans is due to the deterioration of business confidence, erosion of profitability and an increase in costs of doing business in most countries.

The Institutional investor (May 2009), observed that Russian, corporate and retail non-performing loans (NPLs) are steadily growing, with some banks recording NPLs at over 10% of the balance sheet in 2009. This results from the unfavorable macroeconomic policies in the country. Credit culture is another factor which has been identified by some research findings as the plausible cause of NPLs. Sometimes borrowers decide to apply for loans without thinking enough about the future, borrowers take out large loans not because it is financially wise to do so but because they see others do it. Again, some borrowers use short term loans to finance long term projects. The direct consequence of such loan misapplication can be disastrous and devastating.

Diawan and Rodrik (1992), for instance, suggested that high NPLs increase the uncertainty regarding the capital position of the banks and therefore tend to limit their access to financing. This in turn increases the banks' lending rates and thus contributes to lower credit growth. In some banks, governments have large amounts of non-performing loans and some Commercial banks tend to finance government fiscal deficits and sustain some unprofitable government ventures with large borrowings from banks. These actions increase the prospects of generating NPLs.

In Nigeria banking system, the issue of computerization has its effect; people rely much on the information generated by the computer without considering the capacity and carefulness of the persons whose responsibility it is to "feed" the computer with information. Poor documentation and carelessness have often impacted much on the validity of information in the system. Banks may not have the full names, addresses, occupations of their customers or even the amount borrowed. How can such banks recover the loan borrowed by these type of customers? Correct information is therefore a "sine qua non" for reducing the incidence of NPLs. A decline of the net worth, which is a managerial buffer for banks, reduces banks' ability to take risks, such as acquiring new customers and investing in growth fields. Non-performing loans hinders banks' intermediary function thereby affecting productivity and performance of the economy in a very negative way.

Mohd et al, (2010), maintain that the management of non-performing loans are often associated with high operational costs leading to dwindling capital growths in the affected banks. Non-Performing Loans (NPLs) reduces the liquidity of banks, distorts credit expansion, and slows down the growth of the real sector with direct consequences for the performance of banks. Somoye, (2010) said that NPLs also bring down investors' confidence in the banking system, thereby discouraging them from making reasonable investments. As far as the Nigeria banking sector is concern, something has to be done seriously and urgently to bring back the confidence of bank customers in the sector. Confidence is one of the things banks must offer in order to get the patronage of customers.

Financial Sector Reform

Reforms by different Governments and the Central Bank of Nigeria have tended to liberalize the economy and the Babangida Administration for example, enhanced the structural adjustment programme (SAP) in 1986. This programme relied heavily on market forces and the private sector to move the economy forward. Though the deregulation reforms in Nigeria started in 1986 with the setting up of a foreign exchange market, the reforms pertaining to the banking industry did not commence until January 1987. (Ikhide and Alawode 2001 & Asogwa 2005).

The issue of reform in the banking sector started with the deregulation of the rate of interest in both loans and deposits. Again, government set out new rules for the establishment of banks and issuing of banks licenses. The new rules made the entry into the banking system much easier than previously. The immediate effects of these policy changes were the marked increase in banks – from 56 (Merchant and Commercial bank) in 1986 to 109 by 1990 and 120 by 1992 (Adegbite. O.E, 2005). Community Banks, finance companies and Leasing companies were established between 1989 and 1990 in order to meet the needs of the people in the rural areas. In 1990 the equity capital of commercial banks were raised from N20 million to N50 million, while that of Merchant banks rose from N12 million to N40 million. The 1990 Prudential Guidelines directed banks to make adequate provisions for bad and doubtful debts. Banks were required to stop accruing interest on non-performing loans, while interest that had already accrued on such accounts should not be recognized as income.

During universal banking era, government introduced a new capital of N1000 million or N1 billion for each category of banks, and raised it by the year 2002 to N2 billion. By 2004 July the CBN announced a new capital base for banks, and this is N25 billion. The frequency of the reforms rest squarely on the poor performance of economy (taken from CBN bulletin). Investors preferred to be on the defensive instead of jumping into a business, thereby denying the economy of the vital financial impetus for sustainable economic performance.

RESEARCH METHODOLOGY

The study employed secondary data, obtained from claimed publications of the Central Bank of Nigeria, (CBN), and from International Financial Statistics (an IMF Publication) covering the period of 29 years, 1984 – 2012.

Model Specification

The functional relationships between the dependent and independent variables in our study were established as follows;

$LNPLs = F(LDR)$

$LNPLs = F(INFR)$

$LNPLs = F(LGDP)$

Where: LNPLs = Level of Non-performing Loans.

LDR = Level of lending rate

LINFR= Level of Inflation rate

LGDP= Level of Gross Domestic Product

Dependent Variable: NPL					
Method: Least Squares					
Date: 02/13/14 Time: 14:19					
Sample: 1984 2012					
Included observations: 29					
Variable	Coefficient	Std. Error	t-Statistic	Prob.	
C	-24.43649	39.21530	-0.623137	0.5388	
GDP	1.84E-05	8.06E-07	22.86820	0.0000	
INFL	0.253401	0.551293	0.459647	0.6497	
LDR	0.883409	1.775551	0.497541	0.6232	
R-squared	0.959592	Mean dependent var		180.0427	
Adjusted R-squared	0.954743	S.D. dependent var		226.0733	
S.E. of regression	48.09403	Akaike info criterion		10.71164	
Sum squared resid	57825.90	Schwarz criterion		10.90023	
Log likelihood	-151.3187	F-statistic		197.8971	
Durbin-Watson stat	1.982559	Prob(F-statistic)		0.000000	

DATA ANALYSES

TABLE 1

$NPL = f(GDP, INFL, LDR)$

Source: E-view Software package: computer print out

The table indicates that variables are appropriately signed with, (R^2) at 0.9595 and the adjusted R^2

at 0.9547, with the t-value of the independent variable at 22.86, confirming significant relationship at 5% level of confidence. The F-test at 197.9 also confirms the significance of the multiple regression equation.

R^2 indicates that at least 95.47% of the variation in the dependent variable (NPL) was explained.

TABLE 2

GDP =f(NPL)

Dependent Variable: GDP Method: Least Squares Date: 01/21/14 Time: 09:40 Sample: 1984 2012 Included observations: 29				
Variable	Coefficient	Std. Error	t-Statistic	Prob
C	330928.0	598905.7	0.552554	0.5851
NPL	52362.88	2094.510	25.00007	0.0000
R-squared	0.958589	Mean dependent var		9758482.
Adjusted R-squared	0.957055	S.D. dependent var		12090841
S.E. of regression	2505594.	Akaike info criterion		32.37242
Sum squared resid	1.70E+14	Schwarz criterion		32.46672
Log likelihood	-467.4001	F-statistic		625.0033
Durbin-Watson stat	1.896644	Prob(F-statistic)		0.000000

Source: E-view Software package: computer print out

This indicates the short run relationship between the variables GDP and NPL and that the data is stationary at level. The fundamentals are significant and point to the existence of strong relationship between the GDP and NPLs.

TABLE 3

Date: 01/21/14 Time: 09.31 Sample: 1984 2012				
	GDP	INFL	LDR	NPL
Mean	9758482.	21.21379	21.81341	180.0427
Median	4189250.	12.90000	21.33750	75.00000
Maximum	40544100	72.80000	36.09000	879.7800
Minimum	116272.2	5.400000	11.75000	1.753000
Std. Dev.	12090841	18.18659	5.304338	226.0733
Skewness	1.301408	1.402528	0.456146	1.531655
Kurtosis	3.515993	3.865024	3.863479	4.687107
Jarque-Bera	8.507758	10.41174	1.906598	14.77816
Probability	0.014209	0.005484	0.385467	0.000618
Observations	29	29	29	29

Source: E-view Software package: computer print out

Analyses of the Mean, Median and Standard Deviation of the variables in focus, GDP, INFL, LDR & NPL

TABLE 4
Correlation Matrix of variables used in Analyses

	GDP	INFL	LDR	NPL
GDP	1.000000	-0.343671	0.023799	0.979076
INFL	-0.343671	1.000000	0.236922	-0.313423
LDR	0.023799	0.236922	1.000000	0.049013
NPL	0.979076	-0.313423	0.049013	1.000000

Source: E-view software package: computer print out

$$NPL = F(GDP) \quad R = 0.979076, R^2 = 1.958152$$

$$NPL = F(INFL) \quad R = -0.313423, R^2 = 0.626846$$

$$NPL = F(LDR) \quad R = 0.049013, R^2 = 0.098026$$

TABLE 5: Directional Relationships between the variance.

Pairwise Granger Causality Tests			
Date: 01/21/14 Time: 09:44			
Sample: 1981 2012			
Lags: 2			
Null Hypothesis:	Obs	F-Statistic	Probability
INFL does not Granger Cause GDP	27	0.26082	0.77277
GDP does not Granger Cause INFL		1.08173	0.35637
LDR does not Granger Cause GDP	27	0.09603	0.90881
GDP does not Granger Cause LDR		0.25391	0.77801
NPL does not Granger Cause GDP	27	3.61809	0.04380
GDP does not Granger Cause NPL		7.40187	0.00348
LDR does not Granger Cause INFL	27	2.40810	0.11331
INFL does not Granger Cause LDR		2.88824	0.07695
NPL does not Granger Cause INFL	27	1.05810	0.36413
INFL does not Granger Cause NPL		0.04224	0.95872
NPL does not Granger Cause LDR	27	0.06631	0.93603
LDR does not Granger Cause NPL		0.36306	0.69964

Source: E-view Software package: computer print out.
This indicate the directional relationship between the variables

DISCUSSION OF THE FINDINGS

In Table (4.2) , the result of level series indicate that (R^2) is 0.958589 (95.85%) while the adjusted R^2 is 0.907055(90.70%) showing that the change that occurred in the dependent variable was explained by its association with the explanatory variable. The signs and sizes are in consonance with a priori expectations. Again, the overall fit of the model is considered very good, given an F- statistic of 625.0033 and (P –value = 0.000000).

However , the D-W statistic of 1.8066 which lies between the critical value of 1 and 2 suggest the presence of some degree of auto correlation in the level series. This shows that there may be some degree of dependence in the level series which could lead to spurious regression results, suggesting the need for more rigorous analyses of the stationarity properties of the level series data. The regression analysis in table 1, shows that (R^2) is 0.959592 (95.95%) while the adjusted R^2 is 0.954743(95.47%), F- statistic of 197.8971 and (P –value = 0.000000) indicating a good result. Above all, there is improvement in D.W which is 1.982559 in the regression analysis compared with D.W statistic of 1.8066 in the level series.

Table (4.3) explained the means, median as well as standard deviation of the both dependent and independent variables. The means for GDP is 9758482, INFR is 21.21379, LDR is 21.21341 NPL is 180.0427and standard deviation for GDP is 120.90841, INFR is 18.18659, LDR is 5.304338, NPL is 22.60733. Table (4.4) shows the relationship between the variables.

The result of Pair Wise Granger causality test presented in (Table 4.5) above establish the direction of causality of Non-performing loan, Lending rate, inflation rate and Gross Domestic Product. The result shows that the causality between non-performing loans, lending rate and inflation rate is insignificant. However, non-performing loans granger cause Gross Domestic Product. The result show that F-statistic for null hypothesis of the causality test is 3.61809 from NPL to GDP and P-value is 0.04368 indicating the presence of causality at 5% significant level. It demonstrates clearly that a bi- directional relationship exists between non-performing loans and Gross Domestic Product. This means that any increase in non-performing loans will result decrease of Gross Domestic Product. The null hypothesis is therefore rejected

CONCLUSION AND RECOMMENDATIONS

Various factors contribute to the incidence of non-performing loans in Nigeria financial system. Such factors include unpredictable government policy, poor credit policy in the banking system, actions of management and Board members and the prepondence of insider abuse. Non-performing loans cripple the activities of financial system, banks would not have sufficient fund to supply to deficit sector of the economy that need the finance. This tends to hinders the efficient performance of the economy, as investment cannot be maintained.. The statistical results show that any increase in non-performing loans will adversely affect the Gross Domestic Product because non- performing loans are the deteriorating assets of the bank and negatively affect the performance of the bank in terms of liquidity and profitability. Again, we could confirm that increase in non-performing loans does not affect interest rate or inflation. Instead increase in interest rate or inflation rate do affect non-performing loans adversely. Again, when

the inflation rate is high, customers find it difficult to pay their existing loans because of the rising cost of capital.

RECOMMENDATIONS

Government actions, credit culture and management decisions are the major factors that cause non-performing loans. As a result, non-performing loan reduces banks' profitability, capital and caused stagnation of economic resources, such as labor and capital, in fields with low productivity as well as decline in confidence in the financial system. Therefore, government should invest in growth-enhancing sectors of the economy; and pay their loans on time, ensure early payments of contractors and other suppliers. Both public and private sectors of the economy should be encouraged to repay their loans to financial institutions, so that the process of financial intermediation can yield practical and positive results for the economy. The Central Bank of Nigeria should be proactive and anticipatory in policy formulations, taking global trends into consideration.

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