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## NONPERFORMING LOANS PORTFOLIO AND ITS EFFECT ON BANK PROFITABILITY IN NIGERIA

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### ABSTRACT

*Huge nonperforming loans portfolio erodes the ability of banks to make profits. In the 1990s and beyond many Nigerian banks became weak and highly unprofitable due to excessive nonperforming loans portfolio accumulated by bank promoters and management that led to their demise. Insider dealing was the major cause of large nonperforming loan portfolio in Nigeria, involving over-extension of loans to promoters, directors and significant others that became bad and irrecoverable. To clean up the mess in the banking sector and return the banks to the paths of sound management and profitability, the CBN had to inject about N700bn in a bailout exercise while purging the system of bad and irresponsible management teams. The exploratory research design was adopted. Data generated were organized and coded before they were classified. To achieve the objective of the study data analyses were done through descriptive and regression analyses using the statistical package for the social sciences for the regression. With the regression result of  $Y = 78.353 - 4.04x$  it was found that nonperforming loans portfolio has negative effect on bank profitability.*

**Keywords:** Shareholders funds; Self dealing; Nonperforming loans portfolio; Bank profitability



## 1. INTRODUCTION

Nonperforming loans are those risk assets not generating income. As a first step, loans are often considered to be nonperforming when principal or interest on them is due and left unpaid for 90 days or more. Loan classification and provisioning entails much more than simply looking at amounts overdue.

The borrowers' cash-flow and overall ability to repay amounts owing are significantly more important than whether the loan is overdue or not. For financial reporting purposes, the principal balance outstanding rather than delinquent payments is used to identify a nonperforming loan portfolio.

The nonperforming loan portfolio is an indication of the quality of the total portfolio and ultimately that of a bank's lending decisions. There can be a number of reasons to explain deterioration in loan portfolio quality. It is unavoidable that banks make mistakes in judgment. However, for most failed banks, the real problems are systemic in nature and rooted in a bank's credit culture and management style.

According to Greuning and Bratanovic (2003) credit risk is the most common cause of nonperforming loans and bank failures, causing virtually all regulatory authorities to prescribe minimum standards for credit risk management. They opine that the basis of sound credit risk management is the identification of the existing and potential risks inherent in lending activities.

Measures to counteract these risks normally comprise clearly defined policies that express the bank's credit risk management philosophy and the parameters within which credit risk is to be controlled. Specific credit risk management measures typically include three kinds of policies. One set of policies includes those aimed to limit or reduce credit risk, such as policies on concentration and large exposures, adequate diversification, lending to connected parties or over-exposures.

The second set includes policies of asset classification. These mandate periodic evaluation of the collectability of the portfolio of loans and other credit instruments, including any accrued and unpaid interest which exposes a bank to credit risk. The third set includes policies of loss provisioning or the making of allowances at a level adequate enough to absorb anticipated loss not only on the loan portfolio, but also on all other assets that are subject to losses.



Profitability in the form of retained earnings is typically one of the key sources of capital generation. A sound banking system is built on profitable and adequately capitalized banks. Profitability is a revealing indicator of a bank's competitive position in banking markets and of the quality of its management. It allows a bank to maintain a certain risk profile and provides a cushion against short-term problems.

Interest income is a major source of bank profitability and is dependent on performing loans. Interest income originates from loans and all advances extended by a bank such as working capital overdrafts, among others. It also includes interest received on bank's deposits kept with other financial institutions. Interest income is often eroded when a bank accumulates a large stock of nonperforming loans that do not yield income.

There is a growing body of empirical evidence to suggest that nonperforming loans (NPLs) have adverse effects on bank profitability that often lead to bank failures. Profitability is an indicator of a bank's capacity to carry risks and / or to increase its capital. The capital adequacy of a bank is generally gauged by the extent to which owners' funds provide cover for depositors in the event of loans and advances becoming nonperforming.

It is often the practice to measure capital adequacy by the extent to which the prescribed ratio is realized. Also, it is common to examine the extent to which shareholders' funds cover nonperforming loans. For example, during the Nigerian banking crisis in the 1990s, while the total loans and advances in 1990s was about N30bn, about N12bn, representing about 44 percent of the total was nonperforming.

The level of deterioration in loan quality contributed to low profitability and bank distress (NDIC, 1991). As the distress syndrome became wide-spread, the distressed banks' total nonperforming loans and leases stood at N40.33 billion which represented about 55.69 percent of the total nonperforming loans and leases of the banking industry in December 1996 compared to N35.20 billion or about 60.82 percent of the industry total as at the end of December 1995.

The distressed banks ratio of nonperforming loans and leases to total loans and leases increased from 68.87 percent to about 79.77 percent while the industry ratio stood at about 33.90 percent in 1996. These represent empirical indicators of declining profitability and potential bank failures (NDIC, 1996). Because the loans



portfolio usually represents the largest risk asset of a bank, bank regulation always undertakes an appraisal of the lending culture of banks.

One of the principal objectives of such appraisal is to verify the quality of the credit portfolio and make a quantitative assessment on potential nonperforming loans or possible losses, and recommending remedial actions so as to ensure that the banks remain profitable. This is against the backdrop that profit is the bottom line performance result showing the net effects of bank policies and activities in a financial year, and nonperforming loans portfolio is not usually an indicator of bank profitability (ADHIKARI, 2007; MATYSZAK, 2007; ALLI, 2011; BARLTROP; MCNAUGHTON, 1997).

### **1.1 Statement of the Problem**

Banks are susceptible to many risks including credit risk that usually brings about nonperforming loans. Credit crystallizes when loans and other advances become nonperforming and almost irrecoverable.

During the financial crises of the late 1980s, 1990s and beyond, many banks collapsed mainly due to huge nonperforming, loans indicating that nonperforming loans portfolio is rather a sign of pending bank failure than a pointer to bank profitability.

For example, in 1993 insolvent banks accounted for about 20 percent of banking system assets and about 22 percent of deposits. In 1995 almost half of the banks reported being in financial distress, during which about 25 banks were liquidated as a result of nonperforming loans portfolio.

Moving into 2000s technically distressed banks in Nigeria had accumulated nonperforming loans in excess of the shareholders' funds that led to the injection of about N700bn by the Central Bank of Nigeria and the formation of the Asset Management Company of Nigeria (AMCON) to participate in a bazaar of nonperforming loans (NPLs) as strategies to reviving the sick banks.

Qualitative data provide empirical evidence to suggest that bank executives and top managers in some of the failed banks in Nigeria were involved in insider illicit loan deals in excess of N125bn. Empirical evidence from other Sub-Saharan African



countries prove that nonperforming loans portfolio was responsible for bank failures in many countries.

For example, in 1988-90, in Benin, all three commercial banks collapsed, 80 percent of banks loans portfolio were nonperforming, and in Cameroon, nonperforming loans portfolio reached 60-70 percent in 1993 and five commercial banks were closed and three others were restructured.

Also in 1998 in Cameroon, nonperforming loans accounted for 30 percent of total loans. Three banks were restructured and two were liquidated. In Sao Tome and Principe, 90 percent of the nonbank's loans were nonperforming in 1992, and nonperforming loans of the largest bank in Mali reached 75 percent in 1989. (UGOANI, 2013A, 2013B; CAPRIO; KLINGEBIEL, 2002).

The issues of nonperforming loans portfolio and negative bank profit can be traced to insider abuse, compromise of sound credit risk procedures, overtrading, incompetence, complacency, inadequate supervision, among other shortcomings of corporate governance.

## **1.2 Objective of the study**

The study was designed to explore the effect of NPL portfolio on bank profitability.

## **1.3 Delimitation of study**

The study was delimited to commercial banks as financial intermediaries.

## **1.4 Limitations of the study**

The study was constrained by lack of research grant and dearth of current literature. However, these limitations did not dilute the academic quality of the study.

## **1.5 Hypothesis**

Based on the objective of the study, two hypotheses were formulated and tested at 0.05 level of significance to check the assumptions.

- Ho: Nonperforming loans portfolio has no negative effect on bank profitability
- Hi: Nonperforming loans portfolio has negative effect on bank profitability



## 2. LITERATURE REVIEW

Although banks are susceptible to credit risk the high incidence of nonperforming loans portfolio is exacerbated by poor risk appetite. According to Greuning and Bratanovic (2003), this tendency typically involves the extension of loans which initially send financial risk to a level beyond the reasonable payment capacity of the borrower.

Poor selection of risks also involves loans based on the expectation of successful completion of a business transaction, rather than on the borrower's credit worthiness, and loans made for the speculative purchase of securities or goods like the case in Nigeria where huge loans were dished out by most of the failed banks on questionable and speculative basis, and most of which became nonperforming (NWAZE, 2006).

Self-dealing, and loans predicted on collateral of problematic liquidation value or loans that lack adequate security margins are sources of high nonperforming loans and bank profit. For example, some former directors and chief executive officers of failed banks in Nigeria are on trail for creating huge nonperforming loans. (JIBUEZE, 2011).

During the banking sector crisis in Nigeria in the 1990s and 2000s, promoters and executives of some of the failed banks were known to have been engaged in lending to themselves for the acquisition of their bank shares contrary to the law. Such loans became nonperforming and now subject to legal tussles. For example, shareholders of failed banks such as Afribank, Oceanic, Intercontinental, etc, that had high NPLs portfolio sought the help of the court on how to sale the sick banks. (JIBUEZE, 2014).

According to McNaughton & Dietz (1997) the collapse of citibank's credit culture led to asset deterioration in one of the most well managed institutions in the world. According to them, pressure to make high profits led to a tendency to overlook well-documented credit standards during the 1980s.

By definition, loans to related companies are not made objectively according to banks' normal risk-acceptance criteria. For that reason, and because a high





percentage of bank failures have been caused by insider lending, bank regulators tend to restrict and monitor loans to related companies, so as to ensure good credit risk management.

According to McNaughton and Dietz (1997), although banks initially emerged as deposit takers, they soon matured into intermediators of funds, thereby assuming credit risk. Credit became “the business of banking, and the primary basis on which a bank’s quality and performance are judged.

According to them, the credit risk management process deserves special emphasis, because proper credit risk management quality influences the success or failure of financial institutions. Studies of banking crises throughout the world show that the most frequent factor in the failure of banks has been poor asset, usually loan, quality.

To this extent many bankers and regulators believe that an understanding of a bank’s credit risk management process provides a leading indicator of the quality of a bank’s loan portfolio. The asset quality, in terms of performing and nonperforming categories, directly reflects the quality of management and the ability of the bank to earn profit. Minimizing nonperforming loans and increasing bank profitability require good loan management because many good credits can become problem loans because of inadequate monitoring or supervision.

Loan supervision requires monitoring borrowers closely to detect signs that the borrower may have difficulty in repaying the loan. Such warnings are necessary to maximize the effect of corrective action and to minimize potential losses. In a study of many countries Caprio and Klingebiel (2002) find that nonperforming loans portfolio is the frequent determinant of bank failures.

They posit for example, in 1999, Indonesia closed 61 banks and nationalized 54, of a total of 240. Nonperforming loans for the banking system was estimated at about 65 – 75 percent of total loans. Also many banks were liquidated in Japan in the 1990s due to nonperforming loans portfolio put at \$1trillion.

Caprio and Klingebiel assert that due to nonperforming loans portfolio, between 1984 and 1991 more than 1400 savings and loan institutions and 1300 banks failed. In the heat of the financial crises, the Central Bank of Nigeria (CBN) revoked 28 distressed and unprofitable banks licenses in 1998. And in August 2009,





the CBN woke up one morning and dismissed the board and management of some banks that were unprofitable, technically distressed, and found to be carrying nonperforming loans in excess of N700billion (UGOANI, 2013a).

Prior to 2004 banking sector reforms in Nigeria, total nonperforming loans in the Nigerian banking system rose from N21.27bn in 2002 through N260.19bn in 2003 to N350.82bn in 2004. Nonperforming loans as a percentage of total loans declined from N59.38bn in 2002 to N21.59bn in 2003 and marginally rose to 23.08bn in 2004. Nonperforming loans as a percentage of shareholders' funds rose from 89.17bn in 2002 through N91.99bn in 2003 to N107.82bn in 2004, indicating that shareholders' interests in the banking sector were wiped off by nonperforming loans (NNAMDÍ; NWAKANMA, 2011).

In view of the dangerous situation, the CBN in 2009 injected a whopping sum of N620billion to cushion the effect of nonperforming loans of about N1.0trillion fraudulently perpetrated by bank executives (SANNI, 2010). Worried at the level of nonperforming loans portfolio, the CBN set up the Asset Management Company of Nigeria, (AMCON) in 2010 to deal with the issue of toxic assets on permanent basis in accordance with international best practices (ONOH, 2014).

The purchase of nonperforming loans of banks by Asset Management Corporation of Nigeria (AMCON) and subsequent injection of fresh capital into some of the banks led to improvement in asset quality, liquidity, capitalization, and profitability of banks. Thus, the shareholders' funds of the banking industry increased by 696.18 percent from N312.36 billion in 2010 to N2,486.95 billion in 2011.

The AMCON which commenced operation in 2010, was very visible in the Nigerian financial system in 2011 as it acquired three Deposit Money Banks (DMBs) that were established to take over the assets and assume the liabilities, of the failing banks already carrying huge nonperforming loans.

The three bridge banks acquired by AMCON by purchase and assumption transaction were: Mainstreet Bank Limited, Keystone Bank Limited and Enterprise Bank Limited (IBRAHIM, 2011).

According to Ibrahim (2012) due to the activities of AMCON total shareholders' funds in the banking industry rose by N434.24bn from N1,934 trillion in 2011 to N2369 trillion in 2012. This was attributable to the purchase of the nonperforming



loans of the DMBs by AMCON that allowed some of the banks to return to the path of profitability. In many parts of the world nonperforming loans portfolio is known to have negative effect on bank profitability.

According to Lata (2014) nonperforming loans in Bangladesh has become a problem that has significant negative impact on bank profitability. He posits that nonperforming loans is a topic of great concern in Bangladesh. He states that for the last eight years, loan default as a percentage of outstanding loans in state owned commercial banks were 50 percent or above where private commercial banks and foreign commercial banks hold maximum 5 – 10 percent of the total.

To this extent, Banks in Bangladesh have been given ultimatum to bring down their soaring nonperforming loans to below 10 percent of their respective outstanding loans. The causes of nonperforming loans are usually attributed to the lack of effective monitoring and supervision on the part of banks, lack of effective lenders' recourse, weaknesses of legal infrastructure, and lack of effective credit recovery strategies (HANEED; RIAZ, 2012).

Despite the activities of AMCON the ratio of NPLs to total loans in Nigeria remains high at 5.82 percent as at 2011, and short of the global best practice of 3 percent. In view of the worrisome situation, the CBN has ordered commercial banks to double provisions on performing loans (PLs) to 2 percent from 1 percent, to build adequate buffers against unexpected losses (Abioye, 2015).

To this extent, lending institutions like the Bank of Industry (BOI) is paying greater attention to the recovery of NPLs. The bank reports that it has hastened the pace of recovery of NPLs that yielded N1.3billion as at December 31, 2014. According to Olaoluwa (2015) as at December 31, 2013, the bank's NPL ratio was 12.98 percent.

And by the end of 2014, the ratio improved to 5.81 percent and by March, 2015 it further improved to 4.09 percent. The bank states that its target is to reduce the NPLs ratio to not more than 3 percent, in "accordance with the global best practice". The amount of nonperforming loans recovered by the bank between January and March 2015 was N403 million.

### **3. METHODOLOGY**



### **3.1. Research design**

The exploratory research design was adopted for the study. By this method, the researcher studied a sample of the target population (Nachmias & Nachmais, 1976)

### **3.2. Population of the study**

The target population comprised all the 20 Deposit Money Banks (DMBs) in Nigeria.

### **3.3. Sample of the study**

Among the 20 DMBs, 3 banks were selected for the study through the judgmental method. The sample is adequate, based on the 1/10th principle.

### **3.4. Data collection procedure**

Information about nonperforming loans, credit risk policy, credit recovery system as well as default rate are usually confidential to commercial banks in Nigeria. Therefore data for the study were obtained through Annual Reports and Statement of Accounts of the Nigeria Deposit Insurance Corporation, Central Bank of Nigeria, Journals, Newspapers, among other financial reports. To ensure consistency and accuracy, data collected were organized and coded before they were classified.

### **3.5. Data analysis procedure**

Data were analyzed through descriptive and regression statistical methods using the statistical package for the social sciences for the regression. The regression equation used was:  $Y = a + bx$

Where Y – Bank Profitability

x – NPLs

a – a constant term

b – the regression slope coefficient.

The results were presented in tables.



#### 4. PRESENTATION OF RESULTS

Table 1: Asset quality of some selected insured banks as at 31<sup>st</sup> December, 1990 and 1991

Banks group	Loans & advances (N Million)		Classified loans & advances (N million)		Proportion of classified loans and advances to total loans & advances (%)	
	1990	1991	1990	1991	1990	1991
State government owned commercial banks	6,847	7,565	4,715	5,014	69.0	66.3
Non state government owned commercial banks	14.362	17,491	6.079	5,657	42.3	32.3
Merchant banks	5,743	7,823	1,111	2,146	19.3	27.0
All banks	26,952	32,879	11,905	12,817	44.1	39.0
Distressed banks	6,405	5,380	4,660	4,113	72.8	76.5

Source: Nigeria Deposit Insurance Corporation (1991) Annual Report & Statement of Accounts. Pp 21.

Table 2: Indicators of Insured Banks' Assets Quality for the Last Quarters of 2002, 2003 and 2004.

Asset quality indicators (%)	2002	2003	2004
Total non-performing credit (Nb)	21.27	260.19	350.82
Ratio of nonperforming credits to total credits	59.38	21.59	23.08
Ratio of nonperforming credits to shareholders' funds	89.17	91.99	107.82

Source: Nnamdi and Nwakanma (2011).

Table 3: Asset Quality of Insured Banks

Item	Year	
	2010	2011
Total loans (N, billion)	7,166.76	7,312.72
Non performing loans (N, billion)	1,077.66	425.96
Ratio of Nonperforming loans total loans (%)	15.04	5.82
Total of nonperforming loans to shareholders funds (%)	250.85	17.13

Source: NDIC (2011) pp: 134

Table 4: Bridge Banks Purchased by AMCON

S/N	Bridge banks	Capital injected N. Million	Bond face value N'million
1	Mainstreet Bank Limited	318.631	433.132
2	Keystone Bank Limited	296.898	403.590
3	Enterprise Bank Limited	121.417	165.049
	<b>Total</b>	<b>736.946</b>	<b>1,001,771</b>

Source: NDIC (2011) pp: 127.



**Table 5: Model summary of regression analysis**

Model	R	R Square	Adjusted R.Square	Std. Error of the Estimate
1	-0.206a	.043	-.014	21.48897

a) Predictors: (Constant), NPLs Factor Score

b) Dependent Variable: Profitability

**Table 6: Result of Anova of Regression Analysis**

Model	Sum of square	df	Mean	F	Sig.
2. Regression	349.041	1	349.041	.756	.397a
Residual	7850.187	17	461.776		
Total	8199.227	18			

a) Predictors: (Constant), NPLs Factor Score

b) Dependent Variable: Profitability

**Table 7: Regression Coefficients**

Mode	Unstandardized Coefficients		Standardize d Coefficients	t	Sig.
	B	Std. Error	Beta		
2. (Constant)	78.353	4.930		15.893	.000
NPL Factor Score	-4.404	5.065	-.206	-.869	.297

c) Dependent Variable: Profitability

#### 4.1. Interpretation of regression result

In table 5,  $R^2 = 0.043$ , this value was not adequate at 5% level of significance.

In table 6, the regression was not significant in other words, Nonperforming loans portfolio has negative effect on bank profitability.

In table 7, the regression coefficients calculated using the equation stated was shown as in table 8.

**Table 8: Regression model**

$Y = 78.353 - 4.04x$
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The slope coefficient,  $b$ , was not significant at 5% level. So, we accepted  $H_0$  and concluded that NPL has negative effect on bank profitability. This result supports the findings of Lata (2014) that nonperforming loans are negatively related to banks' profitability.

#### 4.2. Discussion



Research evidence regarding identification, measurement, effect and cause of bank failure suggests that NPLs rate is the most important issue that has negative effect on bank profitability and inability to survive.

This is true because NPLs have serious negative impact on loan growth rate; in which case, there will be a negative effect on banks profitability as it reduces loan amount and interest income of the banks simultaneously.

In the 1990s and up to 2011, banks in Nigeria almost operated without a responsive corporate governance mechanism which is frequently critical for the profitability and survival of any corporate organization. A sound corporate governance structure is a vehicle for formulating necessary policies for the proper management of a bank.

Bank directors are expected to review policies, including credit risk policies, and responsibilities. That enables the banks to operate in a safe and profitable manner. But it is unfortunate to note that the accumulation of NPLs by many Nigerian banks and poor loan recovery strategies and scams have been attributable to incompetent board of directors.

Experience has also shown that no matter the quality of regulation, it does not substitute for the role of an active and efficient board of directors of a bank. To reduce NPLs, make profit and survive, banks require a competent board to ensure the highest level of confidence of the members of the public.

An important way of ensuring the profitability and survival of banks is for their board to show the highest sense of discipline, integrity, steadfastness and tenacity of purpose. Over the years, the regulatory and supervisory agencies in Nigeria had continually raised issues bordering on corporate governance breaches in some of the banks that could impair their viability and stability.

But rather than work on improvement, some of them worked hard to undermine laid down rules and regulations, which invariably led to the creation of huge NPLs that had negative effect on their profitability. Huge nonperforming loans portfolio erodes the ability of banks to make profit.

In the 1990s and beyond many Nigerian banks were weak and unprofitable due to nonperforming loans that led to their demise. A major challenge of the banking



sector in Nigeria is poor credit risk management. There are instances where bank promoters and executives collude with both insiders and outsiders alike to create risk assets without complying with laid down lending principles.

Such risk assets often become nonperforming and irrecoverable leading to huge losses. For example, the ratio of nonperforming loans to shareholders' funds deteriorated from 89 percent in 2002 to 108 percent in 2004. This suggests that most banks were reporting huge losses and that stakeholders funds had been completely erased by nonperforming loans portfolio.

The banks had no profits to support their capital funds which were so low and unable to absorb losses arising from nonperforming risk assets. Despite the injection of cash by the CBN to revive badly managed banks, sound regulatory measures to arrest the incidence of inept corporate governance that contributes to poor credit appraisal and nonperforming loans portfolio did not help matters. This result support empirical evidence to confirm that nonperforming loans portfolio has negative effect on bank profitability.

#### **4.3. Recommendations**

- Insider dealing should be outlawed in banks in Nigeria. This was a major source of huge nonperforming loans portfolio in 1990s. Over extension of loans to promoters, directors and other large shareholders is often done at the detriment of depositors because such funds often become irrecoverable.
- Banks must endeavour to comply with both internal and external lending procedures. Most failed banks were victims of compromising of lending principles because loans that were granted with full knowledge of the violation of sound banking and credit risk principles are hardly repaid.
- In attempts to outperform others in the market place most failed banks were over ambitious over profitability and growth. A situation where appetite over earnings outweighs the soundness of lending decisions leads to bad lending and multiplication of nonperforming loans.
- Loans ought to be made on the basis of sound collateral. Even though not a condition for sound lending, it could serve as a soft cushion for the recovery of nonperforming loans.





- Regular regulatory supervision is imperative for sound banking. This will expose lapses of technical incompetence on the part of management and enforce disclosure of vital information needed for the evaluation of the state of the bank.

#### **4.4. Scope for further study**

Further study should examine the effect of poor corporate governance on bank stability. This is necessary as an attempt to finding a solution to the problems of bank failures in Nigeria.

### **5. 5. CONCLUSION**

Although there may be other causes of bank losses and failures, the bank failure phenomenon in Nigeria in the 1990s, and beyond was caused mainly by huge nonperforming loans portfolio created by bank promoters and management which had negative effect on the profitability of the banks.

To clean up the banking system and return banks to the paths of sound management and profitability the CBN had to replace some bad management teams with Interim Management Boards (IMBs) among other regulatory actions. With the regression result of  $Y = 78.353 - 4.04x$  it was found that nonperforming loans portfolio has negative effect on bank profitability. This result supports Lata (2014) that nonperforming loans portfolio does not explain bank profitability. This is the crux of the study.

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