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CREDIT RISK MANAGEMENT AND PROFITABILITY IN SELECTED DEPOSIT MONEY BANKS IN NIGERIA (2008 – 2014)

BY

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B. Sc. Accounting (ACU)

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BEING A THESIS SUBMITTED TO THE DEPARTMENT OF MANAGEMENT AND ACCOUNTING, FACULTY OF ADMINISTRATION, OBAFEMI AWOLOWO UNIVERSITY, ILE-IFE, NIGERIA IN PARTIAL FULFILMENT OF THE REQUIREMENT FOR THE AWARD OF THE DEGREE OF MASTER OF SCIENCE IN ACCO

2016

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CERTIFICATION

This is to certify that FADEMI, SAMUEL JESUYE carried out this research work under my supervision in the Department of Management and Accounting, Faculty of Administration, Obafemi Awolowo University, Ile-Ife Nigeria.

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Prof. D. O. Elumilade Date

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DEDICATION

This thesis is dedicated to GOD ALMIGHTY, the source and sustainer of life, for his grace, wisdom and strength, which has made this programme a success. All glory be to God.

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FADEMI Samuel Jesuye

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ABSTRACT

The study examined the trend of profitability in deposit money banks in Nigeria. It also determined the influence of credit risk management on profitability of the banks in Nigeria and examined the effect of capital adequacy ratio on profitability of Nigerian Banks. These were with a view to providing information on how credit risk management affects profitability of deposit money banks in Nigeria.

Data were collected from secondary sources for this study. It considered 2008-2014, because it covers pre-crisis period, crisis period and post crisis period. A sample of 15 quoted deposit money banks out of the 21 listed on the Nigerian Stock Exchange (NSE) were purposively selected for the study based on availability of complete data covering the sample period. Data on variables such as Non-Performing Loan, Loans and Advances and Capital Adequacy Ratio were sourced from the Nigerian Stock Exchange (NSE) Factbook and Financial Statements of Banks. Descriptive statistics such as mean, median, maximum, minimum, standard deviation etc and also inferential statistics such as pool ordinary least squared with fixed effect and random effect were used.

The results of the trend of profitability showed that nine banks namely Access, Diamond, Fidelity, First Bank, GTB, Skye, Stanbic, Standard Chartered, and UBA did not experience any decrease at any point in the year from 2008 to 2014 on return on equity while Sterling, Union, Unity, Wema and Zenith had a fluctuating increase and decrease on return on equity between 2008 to 2014. The result of Influence of Credit Risk Management and Effect of Capital Adequacy Ratio on Profitability of Nigerian Banks showed that Non Performing Loan Ratio (NPLR) has significant negative effect on Return on Equity (ROE) of the deposit money banks

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(coefficient=-0.364, $t = 3.844$, $p < 0.05$). Loans and Advances (LA) has significant negative effect on the Return on Equity (ROE) of deposit money banks in Nigeria (coefficient=-0.257, $t = 0.813$, $p < 0.05$), Capital Adequacy Ratio (CAR) showed significant negative effect on the ROE of the deposit money banks in Nigeria (coefficient=-0.080, $t = 0.78$, $p < 0.05$ respectively). This result shows that credit risk management is not adequately manage in the deposit money bank in Nigeria, as its measuring variables (Non Performing Loan Ratio (NPLR), Capital Adequacy Ratio (CAR) and Loan & Advance (LA) are significant and have negative impact on profit.

The study concluded that credit risk management practice is inadequate in deposit money banks profitability in Nigeria. Therefore it is important for deposit money bank to subjecting credit risk to rigorous process of control and management.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

Economic activities are challenged with risk and some of these risks lead to huge losses that could deprive a firm of its continuity. Management of risk has become a matter of necessity in recent times.

Das and Ghosh (2007) affirms that health of financial system has important role in the country as its failure can disrupt the economic development of a country. The more complex a risk type is the more specialized, concentrated and controlled its management must be (Seppala, 2000; Ramos, 2000). Risk is not avoidable, but it is manageable; as a matter of fact, most banks live reasonably well by incurring risks, especially "intelligent risks" (Payle, 1997; Greuning and Bratanovic, 1999).

Financial institutions are exposed to a variety of risks such as; interest rate risk, foreign exchange risk, political risk, market risk, liquidity risk, operational risk and credit risk (Gardener, Mills and Cooperman, 2000). Though, one of the foremost causes of serious banking problems continues to be ineffective credit risk management, the provision of credit remains the primary business of every bank in the World. For this reason, credit quality is considered a primary indicator of financial soundness and health of banks (Boahene, Dasah, and Agyei, 2012). Therefore, thorough credit management is a necessity for a financial institution's stability and continuing profitability, while declining credit quality is one of the frequent causes of deprived financial performance.

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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 creation of credit (Campbell, 2007). The management of credit risk is critical for the survival, growth and development of banks or financial institution.

Risk is defined in the international risk-management standard ISO31000:2009 as the 'effect of uncertainty on objectives'. Appa (1996), defined risk management as the individual effort which incorporates acknowledgment of risk, risk evaluation, developing policies to control it, and lessening of risk by means of managerial resources, whereas credit risk is the possibility of loss caused by debtor's default of a loan or other earnings that relate to credit (principal and/or interest).

Credit risk is simply defined as the potential that a bank borrower or counterparty will fail to meet its obligations in accordance with agreed terms. The goal of credit risk management is to maximise a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable parameters. Appa (1996) explains risk management as the human activity which integrates recognition of risk, risk assessment, developing strategies to manage it, and mitigation of risk using managerial resources whereas credit risk is the risk of loss due to debtor's non-payment of a loan or other line of credit (either the principal or interest or both) (Campbell, 2007). Default rate is the possibility that a borrower will default, by failing to repay principal and interest in a timely manner. Credit risk management is extremely essential to banks, as it is an essential part of the loan process.

The Basel Committee on Banking Supervision (2001) defined credit risk as the possibility of losing the outstanding loan partially or totally, due to credit events (default risk). The Basel

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Committee on Banking Supervision (1999) observed that banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transaction.

Risk sometimes entails some economic benefits, as firms may derive considerable gains by taking risk. Organizations need to understand its mission and articulate it clearly, which makes it easier for organizations to determine the risks associated with the mission. As market conditions change rapidly, adequacy and effectiveness of internal controls should be reviewed at least quarterly.

Credit risk is an essential significance of a vibrant economy. It is also the most significant risk faced by banks and the success of their business depends on accurate measurement and efficient management of this risk to a greater extent than any other risk (Gieseche, 2004). Increases in credit risk will raise the marginal cost of debt and equity, which in turn increases the cost of funds for the bank (Basel Committee, 1999).

The credit risk crisis has forced banks to take a critical look at how they manage risk and has exposed some significant weaknesses in risk management across the financial industry. As an outcome of the likely huge and widespread of economic impact of risk 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. Different types of organisation operate in different ways and also their risk management. Failure in risk management practices may prevent firms from meeting their expectations and result to business and project failures. Most companies have peculiar

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policies, procedures and guidelines, and it is doubtful that any two organisations will have the same policies, procedures and guidelines.

Pandey (2004) stated that credit is a means of marketing tool for expanding sales. Credit sales to customers must be monitored irrespective of an organizations' share of the market and demand of its products. If measures put in place to regulate sales made to customers on credit

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