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Effect of Credit Management on the Profitability of Deposit Money Banks in Nigeria

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Abstract: This study examines how credit management influences the profitability of deposit money banks in Nigeria. The research is anchored on four specific objectives: (1) To analyze the effect of non-performing loans on bank profitability, (2) To examine the effect of loan loss provisions on the profitability of deposit money banks, (3) To assess how loans and advances influence bank profitability, and (4) To determine the effect of interest rates on bank profitability. Employing anex post facto research design, the study utilizes secondary data spanning from 2002 to 2023. The analysis employs the ordinary least squares (OLS) model to evaluate effects of credit management on bank profitability .Data were sourced from the Central Bank of Nigeria's statistical bulletin (2024). The study identifies that non-performing loans have a significant and negative effects and loan loss provisions have an insignificant and negative effect on profitability, whereas loans, advances, and interest rates exhibit a significant and positive effects. Based on these findings, the study recommends that non-performing loans be rigorously monitored and loan loss provisions minimized through enhanced risk management. Additionally, interest rates should be strategically reviewed for creditworthy customers to optimize profitability.

Keywords: Credit management, Bank profitability, Loan, Interest

I. Introduction

The banking sector is integral to economic growth, serving as a financial intermediary between savers and investors. As custodians of financial resources, banks facilitate economic activities by mobilizing deposits and extending credit. According to the Banking and Other Financial Institutions Act (BOFIA) 2020, banks are responsible for accepting deposits, processing payments, granting loans, and offering financial services. Deposit money Banks (DMBs) plays a vital role in ensuring a balanced flow of funds between surplus and deficit units, maintaining liquidity while generating profits through interest on loans. Credit management is crucial for banking stability and profitability , as poor credit practices lead to increased exposure to risks such as liquidity, credit, and interest rate risks. Effective credit management strategies mitigate these risks and sustain profitability. Non-performing loans (NPLs) are a key metric for assessing credit risk, as they represent loans in default for over 90 days. Rising NPL levels can erode bank capital and investor confidence, making credit risk management essential. Proper assessment, approval, monitoring, and risk control mechanisms ensure loan recoverability and safeguard financial stability. Bank loans is the greatest earning asset, most liquid and highly risky. As a matter of fact a bank cannot remain in business if it neglects the credit function (Osayeme,2000). Therefore, proper credit assessment, loan approval process, credit monitoring and control should be adopted in administering control loans to borrowers to avoid bad debts or rising bad debts to analyze the borrower's ability, books of accounts and collateral which if overlooked can create increase on the effects on which it can pose in the banks, in turn endangers the reputation and confidence held by the banks. The existence of the department for credit management oversees the processes of credit granting in collaboration, with a good credit officer who has the ability to intelligently and resourcefully manage the borrowers credit lines to mitigate these crises to maintain a healthy balance between risk and reward.

Practically, profitability and liquidity are effective indicators of corporate health and performance of not only the commercial banks, (Eljelly,2004) but all profit-oriented ventures. These performance indicators are very important to shareholders and depositors who are major publics of a bank . Hence, proper sound credit management practices should be implemented to avoid worsening credit quality which is the most frequent cause of poor financial performance of banks. The prevalence of non-performing loans, escalating bad debts, and loan losses are major threats to banking profitability. Many Nigerian banks have faced insolvency due to poor credit management, as evidenced by the collapse of several banks in the 1990s and 2000s, including Heritage Bank. Recent economic challenges, such as the COVID-19 pandemic, have further exacerbated loan defaults. Weak credit management structures and inadequate collateralization have also contributed to rising NPL levels.

Central bank of Nigeria and other regulatory bodies have put in place constricted regulations to curb the challenges of credit management and the profitability of banks. In spite of the constricted regulations put in place , the banking industry is still having contests with high credit risk in the form of non-performing loans. Based on this, the study seeks to examine whether credit management significantly affects the profitability of Nigerian banks , utilizing data from 2002 to 2023, a period characterized by global economic fluctuations.

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Objectives of the Study

Primary aim of this study is to evaluate the influence of credit management on the profitability of deposit money banks in Nigeria. Specific objectives include:

1. Examining the effect of non-performing loans on bank profitability.

2. Assessing the effect of loan loss provisions on deposit money bank profitability.

3. Examining the effect of loans and advances on profitability of deposit money banks.

4. Determining the effect of interest rates on bank profitability.

Hypotheses

H0 1:Non-performing loans have no significant effect on the profitability of deposit money banks .

H0 2 : Loan loss provisions have no significant effect on the profitability of deposit money banks .

H0 3: Loans and advances do not significantly affect the profitability of deposit money banks .

H0 4: Interest rates have no significant effect on profitability of deposit money banks.

II. Literature Review

Conceptual Review

Credit Management /Administration Credit management

Credit Management primarily involves investigating customers, deciding on the credit terms to be offered and keeping records of outstanding accounts. On the other hand, credit administration refers to a loan administering. In some banks, a separate department administers credit and serves as a watchdog over the banks loan portfolio, while in some others, the functions are concentrated in a single department, but with well-defined checks and balances.

Theoretical Framework

The theoretical framework relating to this study anchores on Anticipated Income Theory: Anticipated Income Theory : This theory was propounded by Prochnow (1949), and his approach was predicted on the premise that the loan applicants anticipated income would serve as the source of repayment for the term loan. The loan is issued with the idea that repayment will be made in installments from the debtors predicted cashflow, as opposed to a single payment upon expiration of the credit. As this will enable the banks to provide high liquidity, when the cash inflows are regular and can be expected. Deposit-money banks can manage its liquidity through appropriate credit management that is directing of granted loans, and ensuring that these loans are collected as at when due in a timely manner and minimize the possibility of delays in repayment as the maturity date (Okoh, Nkechukwu and Ezu,2016) . If this is considered a true source of bank loan repayment, it stands to reason that bank lending should not be restricted to the traditional commercial loan theory; the important issue in bank lending is the borrower's ability to repay the loan and their future income constitutes the source for that

Empirical Review

Several studies have examined the effectof credit management strategies on the financial performance of Deposit Money Banks (DMBs) in Nigeria and other countries. The following is a synthesis of relevant empirical literature on the subject.

Bala, Auwal, and Salisu (2022) studied how credit risks influence the profitability of Nigerian DMBs listed on the stock exchange. Employing an ex-post facto research design, they selected eight out of twenty-four publicly traded DMBs and analyzed audited financial statements covering the period from 2015 to 2019. Using Ordinary Least Squares (OLS) regression, their results suggested that non-performing loans (NPLs) had an insignificant effect on the profitability of the sampled banks.

Similarly, Okafor, Okafor, and Isibor (2021) explored the relationship between loan management and the performance of DMBs in Nigeria. Analyzing secondary data from the financial reports of three selected banks spanning 2000 to 2019, they employed OLS regression to assess the relationship between non-performing loans and bank performance. Their findings indicated that return on assets (ROA) had an inverse relationship with NPLs, whereas bank advances exhibited a positive correlation with ROA.

Enoch, Digil, and Arabo (2021) conducted a comparative analysis of credit risk management strategies and their outcomes in Nigerian microfinance banks. The study utilized a multi-stage sampling technique, selecting 21 respondents from a population of 52 credit officers. Data were collected through questionnaires and analyzed using both descriptive and regression techniques. Their findings underscored the necessity for microfinance banks to enhance their credit risk management frameworks to bolster profitability.

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Acknowledging the pivotal role of banks in economic growth, Ayunku and Uzochukwu (2020) examined the relationship between credit management and bad debts in Nigerian DMBs from 2014 to 2019. Utilizing correlation analysis and OLS regression, their study concluded that credit management practices significantly influenced both ROA and Tobin's Q.

Further, Folajimi (2020) assessed the impact of credit risk on the performance of Nigerian DMBs from 2006 to 2018, using descriptive and regression analysis. The results suggested a positive association between credit risk and bank performance. Similarly, Oke and Wale-Awe (2018) explored the relationship between credit risk and bank profitability in Nigeria. Their study examined key financial metrics, including Return on Equity (ROE), loans and advances, loan loss provisions, and total assets. Employing regression analysis, they found that credit risk did not exert a statistically significant impact on ROE.

Kajola et al. (2018) adopted the Generalized Least Squares (GLS) method to assess the effect of credit management on the financial performance of Nigerian DMBs from 2005 to 2016. Their findings established a significant correlation between credit risk variables and both ROE and ROA. Similarly, Olabamiji and Michael (2018) employed descriptive and regression techniques to analyze primary data on credit management and bank performance. Their study indicated a positive relationship between credit management and bank profitability.

Hamza (2017) examined the impact of credit risk management on the financial performance of Nigerian commercial banks using pooled regression analysis. The study reported an inverse relationship between credit risk and profitability. Specifically, while the Capital Adequacy Ratio (CAR) and loans and advances positively influenced ROA, variables such as Loan Loss Provision Ratio (LLPR), Liquidity Ratio (LR), and Non-Performing Loan Ratio (NPLR) had a negative impact.

Ajayi and Ajayi (2017) adopted a panel regression approach to assess the effects of credit risk management on Nigerian DMBs from 2001 to 2015. They utilized Profit After Tax (PAT) as a measure of bank performance, while NPLR, LLPR, Loan to Total Asset Ratio (LTAR), and Cost per Loan Ratio (CPLR) were used as credit risk indicators. Their findings revealed that NPLR, LLPR, and CPLR negatively affected bank profitability, whereas LTAR had a positive effect.

Ogbulu and Eze (2016) employed econometric methodologies such as ECM, Granger causality tests, IRF, and VDC to investigate the impact of credit risk on the performance of Nigerian DMBs. Their data, sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin and NDIC Annual Reports from 1989 to 2013, revealed that credit risk variables significantly affected ROE, ROA, and return on shareholders' funds. However, the study found no significant Granger causality relationship between credit risk indicators and bank performance, except for a unidirectional causality from ROE to RNPD and from ROTA to RNPS.

Li and Zou (2014) conducted a study on Asian commercial banks, investigating the relationship between credit risk management and profitability using regression analysis. Their findings revealed that credit risk management positively influenced profitability, with non-performing loan ratio, ROA, and ROE showing a positive relationship. However, the capital adequacy ratio exhibited a negative and statistically insignificant correlation.

Other studies, such as those by Nwanna and Oguezue (2017), Ndubuisi and Amedu (2018), and Ojiong, Okpa, and Egbe (2014), also explored various aspects of credit risk management and bank performance. Their findings generally indicated that effective credit management could enhance bank profitability, while poor credit management, characterized by high non-performing loans, could negatively affect financial performance.

Echobu and Okika (2019) analyzed data from 15 listed DMBs in Nigeria between 2006 and 2017. Using regression analysis, they found that non-performing loans and impairment loan charge-offs had a significantly negative impact on bank performance. Additionally, while capital adequacy negatively affected financial performance, the impact was not statistically significant.

In a study focusing on Turkish banks, Ekinci and Poyraz (2019) investigated the relationship between credit risk and financial performance from 2005 to 2017. Their findings revealed that non-performing loans had a negative correlation with both ROA and ROE. Similarly, Innocent, Ademola, and Teryima (2019) examined the combined effect of credit risk, capital adequacy, and operational efficiency on Nigerian banks between 2008 and 2017, concluding that both credit risk and operational efficiency negatively impacted financial performance.

Several other researchers, including Gabriel, Victor, and Innocent (2019), Okpala et al. (2019), and Philip and Abisola (2019), have contributed to this discourse. Their findings consistently highlight the significant impact of credit risk on bank profitability, with variations in the magnitude and direction of this impact depending on factors such as bank size, capital adequacy, and macroeconomic conditions.

Otitolaiye (2020) investigated the relationship between credit risk and financial performance in Nigerian DMBs from 2006 to 2018. Using return on capital employed (ROCE) and dividends paid (DPRS) as proxies for financial performance, and variables such as NPLs, capital adequacy ratio, loan loss provisions, and loan-to-deposit ratio as indicators of credit risk, the study employed an ex-post facto research design. The findings demonstrated that non-performing loans significantly and negatively affected ROCE and DPRS, while capital adequacy had a significant positive effect on ROCE.

In summary, empirical studies indicate that credit risk management plays a crucial role in shaping the financial performance of banks. While some studies suggest a direct positive relationship between credit risk and bank profitability, others highlight the detrimental effects of poor credit management, particularly in cases of high NPL ratios. Overall, effective credit risk management

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strategies, such as robust loan monitoring and prudent credit policies, are essential for enhancing the financial stability and profitability of **banks.**

III. Methodology

This study employs a time series analysis and OLS regression to examine the effect of credit management on bank profitability . Data for non-performing loans, loan loss provisions, loans and advances, andinterest rate s were sourced from the Central Bank of Nigeria statistical bulletin.

The regression model used is:

PBT = f(NPL, LLP, LAA, INT)

Where:

PBT = Profit Before Tax

NPL = Non-Performing Loans Ratio

LLP = Loan Loss Provisioning

LAA = Loans and Advances

INT = Interest Rate

In econometrics, the above equation 1 is not sufficient in specification due to the absence of the Constant Parameter and error term. Therefore, we introduce the Constant Parameter and error terms

but firstly, state the mathematical model as follows:

PBT = NPL + LLP + LAA + INT …………………………………… (ii) $PBTt=\beta0+\beta1NPLt+\beta2LLPt+\beta3LAAt + \beta4INT+ \mu t$ ……………….…… (iii)

Where: The variables remain as explained above βo = Constant Parameter $\beta 1, \beta 2, \beta 3, \beta 4$, = Estimation parameters

μ = Error terms A priori $\beta 1> 0, \beta 2>0, \beta 3>0, \beta 4> 0, \beta 5> 0, \beta 6>0$. Description of

Variables

Profit Before Tax: This is a financial metric that measures a company's net profit before paying income tax.

Non-Performing Loans : Non-performing loans are those loans that are not earning income and full payment of principal and interest is no longer anticipated, principal or interest is ninety days or more delinquent or the maturity date has passed and payment in full has not been made

Loan Loss Provision: The guideline further states that licensed banks are required to make adequate provisions for perceived losses based on the credit portfolio classification system prescribed above in order to reflect their true financial condition.

Deposit money banks' Loans and Advances:

Advance can be in the form of overdraft, where a customer is allowed to withdraw money which exceeds his current account balance, based on certain agreements between him and the bank. Interest Rate on Loans and Advances: These are rates set by the federal reserve.

The probability that fluctuating interest rates will result in significant appreciation or depreciation of the value of and return from the banks assets is known as interest rates risk. (Folpmers, 2022).

IV. Result and Discussions Data Analysis

The descriptive data of the variables are shown in table 1

Table 1: Descriptive Statistics

	PBT	NPL	LLP	LAA	INT
Mean	342.1618	11.68045	665.8830	10740.17	24.90663
Median	406.7250	9.325000	392.6639	8819.601	25.21771
Maximum	982.8600	37.30000	1977.503	29045.64	30.60036
Minimum	-1377.000	3.010000	61.13100	954.6300	18.36250

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Std. Dev.	496.5257	8.724478	561.3968	7872.477	4.087856
Skewness	-1.747061	1.275516	0.672629	0.664216	-0.208284
Kurtosis	7.560300	4.282596	2.411350	2.673310	1.733882
Jarque-Bera	30.25479	7.473417	1.976542	1.715502	1.628535
Probability	0.000000	0.023832	0.372220	0.424115	0.442964
Sum	7527.560	256.9700	14649.43	236283.8	547.9458
Sum Sq. Dev.	5177293.	1598.447	6618495.	1.30E+09	350.9219
Observations	22	22	22	22	22

Source: Eviews 11 Descriptive Statistic Output, 2024

The descriptive statistics shown in table 1 reveals that profit before taxes of deposit money banks averaged N342.16bn per year over the reviewed period. DMBs distributed an average loans and advances of N10,740.17bn annually from 2002 to 2023, with a total of N236,283.8bn. Non-Performing loans ratio averaged an annual value of 11.68% annually with a minimum value of 3.01% and a maximum value of 37.3%. The probability of the Jarque-Bera test statistic shows that except for profit before tax and non-performing loans ratio, all the variables are normally distributed ($p>0.05$). Data Analysis The time series data were analyzed using the OLS regression method Ordinary Least Square Regression The results of the OLS regression are shown in table 2. Table 2

Data Analysis

The time series data were analyzed using the OLS regression method

Ordinary Least Square Regression

The results of the OLS regression are shown in table 2.

Table 2: OLS Regression for NPL and PBT

Dependent Variable: PBT				
Method: Least Squares				
Date: 10/04/24 Time: 02:04				
Sample: 2002 2023				
Included observations: 22				
Variable	Coefficient	Std. Error	t-Statistic	Prob.
NPL	-39.43730	8.157114	-4.834713	0.0001
LLP	-0.305875	0.236573	-1.292940	0.2133
LAA	0.044011	0.018992	2.317396	0.0325
INT	41.80310	19.60957	2.131771	0.0471
C	-196.1571	468.2402	-0.418924	0.6805
R-squared	0.724971	Mean dependent var		342.1618
Adjusted R-squared	0.660258	S.D. dependent var		496.5257
S.E. of regression	289.4119	Akaike info criterion		14.37030
Sum squared resid	1423907.	Schwarz criterion		14.61826
Log likelihood	-153.0732	Hannan-Quinn criter.		14.42871
F-statistic	11.20290	Durbin-Watson stat		1.492341
Prob(F-statistic)	0.000123			

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Source: Eviews OLS Regression Output, 2024

The corresponding regression coefficients between NPL and PBT shown in table 2 (- 39.437) reveals that the ratio of non-performing loans is negatively associated with the profit before tax of DMBs in Nigeria. It follows that every percentage increase in the ratio of non-performing loans will likely coincide in a decrease of 39.44 billion naira in PBT of deposit money banks in Nigeria.

The probability value of 0.0001 is less than 0.05 indicating that this relationship is significant. The matching regression coefficients between LLP and PBT shown in table 2(-0.3058) reveals that the provision for loan losses is negatively associated with the profit before tax of DMBs in Nigeria. The probability value of 0.2133 is greater than 0.05 which indicates that there is insignificant effect. The corresponding regression coefficients between LLA and PBT shown in table 2 (0.44011) reveals that the value of loans and advances is positively associated with the profit before tax of DMBs in Nigeria. By implication, every billion naira increase in the loans and advances will likely coincide in an increase of 440.11 million naira in PBT of deposit money banks in Nigeria.

The probability value of 0.0325 is less than 0.05 indicating that this relationship is significant. The regression coefficients between INT and PBT shown in table 2 (41.8031) reveals that the interest rate is positively associated with the profit before tax of DMBs in Nigeria. It implies that every percentage increase in the interest rate will likely coincide in an increase of 41.8 billion naira in PBT of deposit money banks in Nigeria . The probability value of 0 .0471 is less than 0.05 which is an indication that this association is significant.

Test of Hypotheses

Hypothesis H0 1:

Nonperforming loans have no significant effect on the profitability of deposit money banks in Nigeria. The p-value for NPL on PBT shown in table is 0.0001 which is less than 0.05. Therefore, Nonperforming loans have negative and significant effect on the profitability of deposit money banks in Nigeria.

Hypothesis H0 2 :

Loan loss provisioning have no significant effect on the profitability of deposit money banks in Nigeria. The p-value for Ordinary least square regression of LLP on PBT shown in table 2 is 0.2133 which is greater than 0.05. This indicates an acceptance of the null hypothesis. Therefore, Loan loss provision have no significant effect on the profitability of deposit money banks in Nigeria

Hypothesis H0 3: Loans and advances does not have effect on the profitability of deposit money in Nigeria. The p-value for Ordinary least square regression of LAA on PBT shown in table 2 is 0.0325 which is less than 0.05. This indicates a rejection of the null hypothesis. Therefore, Loans and advances significantly affect the profitability of deposit money in Nigeria .

Hypothesis four: H0 4

Interest rate has no significant effect on the profitability of deposit money banks . The p-value for Ordinary least square regression of INT on PBT shown in table 2 is 0.0471 which is less than 0.05.. Therefore, Interest rate has significant effect on the profitabilityof deposit money banks .

V. Findings and Conclusions

Discussion of the Findings

The study sought to examine the effect of credit management on the profitability of deposit money banks in Nigeria. Credit management was measured in terms of non- performing loan , Loan loss provision , loans and advances and interest rate while profitability of DMBs was measured using Profit Before Taxes of deposit money banks in Nigeria. The findings of the study revealed that , non-performing loan is negatively and significantly associated with the profit before tax of deposit money banks in Nigeria . It is contradicting to the findings of Juba et al., (2022) which observed that non-performing loans (NPL) have an insignificant influence on the profitability of deposit money banks in Nigeria . Likewise, Echobu and Okika (2019) found that show that non-performing loans have negative and significant effect on the financial performance of banks.

The findings of the study also revealed that the loan loss provision has negative and insignificant effect on the profit before tax of deposit money banks in Nigeria. This indicates that as banks profitability increases , their loan loss provisions decreases and it is actually the increase in profitability that caused the decline in loan loss provision. It is also confirming the findings of Echobu and Okika (2019) which found a negative association between loan provisions and the financial performance of deposit money banks in Nigeria. The findings of the study revealed that as expected, loans and advances is positively and significantly associated with the profit before tax of deposit money banks in Nigeria. The finding of the study also reveals that a causal relationship exists between loans and advances and profit before tax of deposit money banks in Nigeria. This indicates that banks profitability has significantly improved in times when more loans and advances were extended by the DMBs in Nigeria and it is actually the increased extension of credit that has cause the improvement in profitability of DMBs in Nigeria. This finding corresponds with the priori expectation of the researcher .

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It is also confirming the findings of Okafor et al., (2021) which observed that loans and advances have a positive and significant influence on the profitability of deposit money banks in Nigeria . SUMMARY OF FINDINGS: ?

Non-performing loans have a negative and significant impact on profitability.?

Loan loss provisions negatively affect profitability, though insignificantly. ?

Loans and advances have a positive and significant effect on profitability. ?

Interest earnings on loans and advances positively influence profitability. The study concludes that effective credit management, particularly through prudent lending and interest rate adjustments, is critical for banking profitability.

Recommendations

1. Banks should enforce prudential guidelines to limit non-performing loans and enhance profitability.
2. Loan loss provisions should be minimized through improved credit risk monitoring.
3. Deposit money banks should prioritize extending loans to creditworthy clients.
4. Interest rates should be adjusted to balance credit accessibility and profitability.

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