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Poor Credit Risk Management and Bank Failures in Nigeria

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Abstract

The study was designed to evaluate the relationship of poor credit risk management and bank failures in Nigeria and propose strategies for remedial actions. Credit risk management is one of the most crucial banking functions that involve the appraisals of requests for banking facilities. It is critical to bank survival or failure because banks traditionally earn their huge profits from interest on their risk exposures. The survey research design was adopted and researcher's self designed instrument was used to generate data for the study. Chi-square statistic method was used for data analysis. It was found that poor credit risk management influences bank failures. Literature also provided credible evidence to show that weak corporate governance accelerates bank failures. Ten (10) recommendations were made based on the findings of the study.

Keywords

Macro-Prudential, Micro-Prudential, Banana Management Mentality, Toxic Assets, Non-Performing Loans, Poor Credit Risk Management, Bank Failures

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1. Introduction

The wide spread financial crises in recent banking history has been a source of major concern for both bank regulators and owners due to its severe consequences such as bank failures. The experience of many countries, including Nigeria shows that poor credit risk management, internal and external supervision requirements impede the stability and profitability of banks. One single most important symptom of bank failures in Nigeria characterized by poor credit risk management is non-performing loans. Over the years banks in Nigeria have been carrying a huge load of toxic assets that rose progressively from year to year without being reported through good credit risk management. For example, between 1994 and 2000 a total of 33 banks were liquidated in Nigeria due to huge non-performing loans well in excess of N200 billion (Nwaze, 2006). As a result of attractive interest rates on deposits and loans in the 1990s, credits were given out indiscriminately without proper credit risk appraisal and management. The resultant effects were that much of such credits became bad and irrecoverable. Consequently loan assets quality deteriorated and contributed to bank failures. Despite various prudential measures employed to wage the tide, the rising profile of non-performing loans continued unabated into the 2000s. For example, Ajekigbe (2008), reported that the non-performing loans, advances and discounts (LAD) portfolio of First Bank of Nigeria Plc, lept from N2.021 billion in 2007 to N6.015 billion in 2008. This was just a single example from one of the best rated banks in Nigeria and when such bad loans from many of the distressed banks were added, the banking system only waited patiently until the bubble was burst again in 2009 when the banking licences of 10 out of 24 banks in Nigeria were revoked by the Central Bank of Nigeria (CBN), accusing their executive management teams of high display of poor credit risk management, poor sense of judgment as well as inexperience. The banana management mentality succeeded in the Nigerian banking system because some banks chief executive officers

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ignored prudential guidelines that were introduced to improve the quality of loan assets, reduce the level toxic assets, ensure capital adequacy and stability of the banking system, and safeguard depositors' funds' (Oladipo, 1993; Ozigbo, 1995). The traditional activities of banks include to borrow and lend money, to allow business to operate, and collect such funds back with interest. Today, banking services have expanded to include services directed at individuals and risks in these much smaller transactions are generally high. Also many other financial services are now included such as capital issues and financial advisory services. Because of their involvement in capital issues and operations many banks have failed in recent years, and the failure or crash of the stock market in most cases is directly linked to poor credit risk management (Okorie and Uwaleke, 2010; Oyedotun, 1994, Tufano, 1996, Ugoani, 2013[a]). Since banks perform very important financial functions in Nigeria they are regulated especially by the Central Bank of Nigeria. Traditionally, a Central Bank can be said to have two main types of roles namely: macroeconomic, when ensuring price stability and a sound financial system and microeconomic, when functioning as lender of last resort. Thirdly, Central Banks have a key mandate to ensure a sound financial system through the provision of clearing facilities for banks, development of payment system, banking regulation and supervision. However, despite these regulatory functions six banks failed in 2011, putting depositors and shareholders' funds in excess of N700 billion in jeopardy. Experts note that institutional disconnect between monetary and regulatory authorities led to gaps and lapses that were believed to have contributed to the financial crisis in Nigeria. (Moghalu, 2011, Mckinley, 1990, 1992). In the literature on finance, it is generally accepted that credit risk is the most prominent risk in terms of the level to which it impacts on the quality of risk assets as well as bank performance and eventually bank failure. (Sinkey, 1992, Spadaford, 1998, Merton, 1990). Credit risk is also acknowledged as the oldest risk in financial markets. But, in contemporary times, market players, professionals, banks and other financial intermediaries and institutions have created new instruments, such as credit derivatives with which to deal or trade credit risk. At the present time, credit risk is a factor not only for lenders but also for any organization that receives funds for products or services (Abolo, 2000). Risk may be defined in the context as the possibility of loss or exposure to loss. Maynard (1970) further defines risk in terms of uncertainty of loss where the loss is caused by fortuitous accidental unexpected circumstances. The importance of credit risk management as a practical theory is coordination of the means of control towards a defined integral objective of a bank. Banking credit or counter party risk – defined as the chance that a debtor or financial instrument issuer will not be able to pay interest or repay the principal according to the terms specified in a credit agreement is an inherent part of banking. Credit risk means that payments may be delayed or ultimately not paid at all, which can in turn cause cash flow problems and affect banks liquidity. Despite innovation in the financial services sector, credit risk is still the major single cause of bank failures. The reason is that more than 80% of a bank's balance sheet generally relates to this aspect of risk management. The three major types of credit risks are: (1) personal or consumer risk (2) corporate or company risk and (3) sovereign or country risk. According to Greuning and Bratanovic (2003) because of the potentially dire effects of credit risk, it is important to perform a comprehensive evaluation of a bank's capacity to assess, administer, supervise, enforce and recover loans, advances, guarantees and other credit instruments, so as to avoid bank failures. An overall credit risk management review will include an evaluation of the credit risk management policies and practices of a bank. This evaluation should also determine the adequacy of financial information received from a borrower or the issuer of a financial instrument, which has been used by a bank as the basis for investing in such financial instruments or the extension of credits and the periodic assessment of its inherently changing risk. Banking crises have developed many times throughout history when one of more risks materializes for the banking sector as whole. Prominent examples include the US Savings and Loans crisis in 1980s and early 1990s, the Japanese banking crisis during 1990s, the bank run during the Great Depression, and the Nigerian banking crisis where over 49 banks have been liquidated by the Central Bank of Nigeria in recent history. (Matyszak, 2007).

1.1. Statement of the Problem

A major challenge in the banking sector has been poor credit risk management characterized by inept corporate governance and management. Soludo (2004) states that there are several instances where Board members and managerial staff fail to uphold and promote the basic pillars of corporate governance because they are preoccupied with the attainment of narrowly defined interests. Some of the corporate governance issues include but not limited to weak internal controls, poor compliance with laid down procedure, poor risk management practices resulting in large quantum of non-performing risk exposures, among a host of other problems. For example, the ratio of non-performing credit to shareholders funds deteriorated from 89 percent in 2002 to 108 percent in 2004. This suggests that shareholders' funds' had been completely wiped out industry-wide by non-performing credit portfolio. In the same period, total non-performing credit in the Nigerian banking sector rose from N21.27bn in 2002 through N260.19bn in 2003 to N350.82bn in 2004 (Ayininuola, 2007, Nnamdi and Nwakanma, 2011).

1.2. The Purpose of the Study

The purpose of the study was to explore the relationship of poor credit management on bank failures and purpose strategies for arresting it in Nigeria.

1.3. Delimitation of Study

The study was delimited to Aba, Owerri and Umuahia in South East Nigeria.

1.4. Hypotheses

The following hypotheses were formulalted and tested at 0.05 level of significance so as to help the investigator achieve the objective of the study.

Ho: There is no significant relationship between poor credit risk management and bank failures.

H_1: There is significant relationship between poor credit risk management and bank failures.

2. Literature Review

Recent banking history shows how critical it is for banks to control the risks of lending, because poor loan quality is the main factor in the growing number of bank failures in recent times. According to Nwankwo (1991) "The experience of the eighties (and nineties) has underlined the importance of credit risk in domestic and international banking. Many banks across the wide range of countries suffered both from realized losses and loan rescheduling in the domestic market and from large and well publicized rescheduling of syndicated international credits". It is therefore obvious that banks fail for very many reasons including:

- Macro economic problems leading to enterprise failures.
- Error in judgment or market strategy by bank management
- Sudden changes in market conditions such as devaluation, natural disaster or stock market crash;
- Internal management disputes or labour problems
- In-experienced staff operating in new fields; violation of regulations;
- Connected lending to shareholders; managers or other bank staff,
- Poor internal accounting records
- Poor bank supervision, and
- Perfunctory external audit exercises

The term risk management denotes a situation in which an individual or firm makes decisions to alter the risk/return profile of future cash flows. In other words, if managers are attempting to reduce risk through their actions, they are said to be hedging; if managers are trying to increase the bank's risk exposure because they believe that such a strategy will yield abnormal profits, they are said to be speculating. Therefore, the risk-return trade-off paradigm is critical to credit risk management (Markowitz, 1952, 1959). The characteristics and quality of a bank's loan portfolio are also assessed through credit risk management process. A loan portfolio reflects a bank's market position and demand, its business and risk strategy, and its credit extension capabilities. A good and detailed credit portfolio management should involve these areas, so as to provide proper classifications:-

- All loans to borrowers with aggregate exposure longer than 5 percent of the bank's capital
- All loans for which the interest or repayment terms have been rescheduled or otherwise altered since disbursal
- All loans to shareholders and connected parties
- All loans for which cash payment of interest and/or principal is more than 30days in past due, including those for which interest has been capitalized or rolled over
- All loans classified as substandard, doubtful, or lost (James, 1987).

A sound credit risk management is important in making a bank a good financial supermarket through the observation of these processes (Tyree, 2003)

Corporate governance issues and poor credit risk management continue to impede banking system profitability and stability in many places. For example, Udunze (2013) reports that as the result of investigations regarding corporate governance breaches the CEO of Ecobank transnational agreed to forgo US$1.14m bonus he was to earn for the 2012 financial year as part of efforts to rebuild public confidence in the bank against the backdrop of accusations of maladministration, fraud and technical incompetence in the bank. Inept management and corruption accelerate the rate of bank failures in Nigeria. For example, Itua (2013) reports that the ex-MD/CEO of one of the failed banks was involved in fraudulent deals involving US$11m. The number of banks adjudged as satisfactory dropped from 63 in 2001 to 51 in 2004. The bank failure syndrome continued through the years to 2011, when six banks collapsed due largely to poor credit risk management with a potential loss of about N700bn

Table 1. Details of Failed Banks in Nigeria in 2011.

S/N	name of failed bank	name of bridge bank	failed bank taken over by	estimated loss (el)
1	Afribank	Mainstreet Bank		
2	Bank PHB	Keystone Bank		
3	Spring Bank	Enterprise Bank		
4	Fin Bank		First City Monument Bank	
5	Intercontinental Bank		Access Bank	
6	Oceanic Bank		Eco Bank	
				N700 billion

Source: Field Work, 2011.

Table 1 showed that the Bridge Banks were created by CBN to assume the assets and liabilities of three of the six Failed Banks while the remaining three were taken over by three other existing banks. All the failed banks had exceeded their credit ceilings through unauthorized lendings and other micro-financial credit risk abuses that were estimated to be in excess of ₦700 billion. The Bridge Banks will serve as undertakers specifically set up to attempt to manage the assets and liabilities of the failed banks with little or no compensation to shareholders of the failed banks. They will be expected to meet all the obligations and commitments of the failed banks. However, there may be uncertainty about the viability, profitability and marketability of the failed banks because of the poor public perception. (Sanusi, 1995, Sheppard, 1991). As soon as the licenses of the affected banks were withdrawn by the Central Bank of Nigeria, the Asset Management Corporation of Nigeria (AMCON) injected N679 billion into the failed banks to enable them meet their obligations to depositors. Recently AMCON confirmed that a total sum of N1.3 trillion was spent on the bailout exercise (Chiejina, 2012). Also, AMCON is in touch with possible Advisors that would guide it through the process of disposing the three nationalized banks now managed by the bridge banks. (Nweze, 2012[a]). According to Obi (2012) the Advisors would determine the fate of the bridge banks as soon as possible.

In Nigeria a whole lot of fraudulent loan workouts and fraudulent waivers have contributed to bank failures. Despite the Federal Government's seemingly desperate measures to stem the incidence of bank collapse so many unpleasant facts are still coming up regarding the reasons for the most recent bank failures of 2011. For example, the Economic and Financial Crimes Commission (EFCC) is now investigating how a keyman using various subsidiaries as fronts obtained credit facilities in excess of N9 billion, from a collapsed bank. And the huge credit became bad and the bank distressed, the management team hired by the Central Bank of Nigeria to resuscitate the ailing bank instead quickly "wrote-off" the bad loan of about N9.7 billion by way of "waivers". It is believed that credit risk management and corporate governance abuses in the banking subsector are a deadly problem. The Financial Malpractice Investigation Unit (FMIU) of the Nigerian Police is also probing the N7 billion unpaid loan in 103 micro-finance banks (MfBs) in the country. These unbecoming situations have forced the Central Bank of Nigeria, the Nigeria Deposit Insurance corporation, (NDIC), and the Financial Institutions Training Center (FITC) to mount compulsory training programme for all banks' directors because they seem to have abandoned their primary function which is the proper protection of banks against losses and/or failures (Nweze 2012[b], Austin, 1991, Hempel, Coleman, and Simonson 1990).

3. Methodology

The survey research was adopted, and the respondents were chosen from within the top, middle and lower management levels of the managerial echelon of banks. They were selected using the simple random sampling technique to make sure that only those people who were conversant in the issues of interest were involved. Two methods of data collection were employed. One was a self-administered questionnaire, and the other informal in-depth interview, meant to complement, supplement and validate the data collected through each other. The data gathered were organized, coded and classified for the correction of errors and ensuring accuracy, consistency and completeness. For the systematic analysis of data, tables and the Chi-Square statistic tool were used, after which opinions, recommendations and conclusions were made.

4. Presentation of Result and Discussion

Weight

By VAR00003

NPAR TEST

Chisquare = VAR00003

Expected = Equal

From the Chi-Square Test, it was noted that the calculated value of 304.051 was significantly greater than the table value of 9.49 at 0.05 level of significance with 4 degrees of freedom. Therefore, it was concluded that poor credit risk management leads to bank failures. This empirical result supports the popular view in Nigeria that the bank failure culture is highly correlated with poor credit risk management. For example, it has come to public knowledge that the defunct City Express Bank and Finbank had ₦12 billion and N16 billion bad loans respectively that were directors-related (Abiodun & Ojo, 2012). The inordinate ambition of some directors of failed banks especially those controlled by family members to get rich quick led to reckless granting of loans that ultimately resulted in losses and bank failures. For example, Onyekwere (2013) reports that some managing directors/chief executive officers (MD/CEOs) of some of the failed banks are still standing trail for granting questionable loans to the height of N125bn. The Nigerian Deposit Insurance Corporation (NDIC) and the Economic and Financial Crimes Commission (EFCC) are at present blaming each other over how to recover insider related loans that led to the collapse of Gulf Bank. Omonode, (2013) reports that MD/CEO and other key officers of the failed bank colluded among themselves in grand and sophisticated style to the drain and collapse of the bank. The highly placed insiders most of them qualified in their respective areas engaged in serial frauds characterized by manipulation of records, suppression of information criminal concealment, misrepresentation and forgeries of public documents all leading to colossal loss of funds to the defunct bank and unprecedented enrichment of the perpetrators; who were accused of stealing over US$80m or about ₦13bn. This level of fraud was only made possible through poor credit risk management that continues to be a major cause of bank failures. For example, in 2009, 10 out of the 24 banks in Nigeria collapsed and again in 2011 6 of the remaining 14 banks failed with the CBN using about ₦700bn of good public money to clean the mess of few bank thieves. Both private and public bad loans continue to grow like the pawpaw due to poor credit risk management. According to Central Bank of Nigeria (2011) statistical bulletin, the Federal Government's Domestic Debt Outstandings grew from ₦2.242trn in 2009 to ₦4.139trn in 2011(The Guardian, 2011).

Banks as custodians of depositors' funds are expected to exercise due care and prudence in their lending activities. In order to facilitate efficient utilization of loanable funds, every bank is expected to have a written credit policy which will incorporate guiding principles such as lending philosophy and strategies, loan authorization, approval levels, recovery procedures, collateral protection, and credit review procedures, et cetera. This is very important because credit portfolio usually represents the largest risk asset of a bank. But experience over the years has revealed that the failure of bank management to establish sound lending policies, adequate credit management procedures and failure to monitor lending function within established guidelines result in poor quality loan assets. (Okorie & Uwaleke) 2010, Agbada 2010, Ugoani, 2013[b])

Table 2. Frequencies

	Observed N	Expected	Residual
8.00	8	70.4	-62.4
23.00	23	70.4	-47.4
40.00	40	70.4	-30.4
93.00	93	70.4	22.6
188.00	188	70.4	117.6
Total	352		

Table 3. Test Statistics.

	VAR00003
Chi-Square	304.051
df	4
Asymp. Sig.	.000

a. 0 cells (.0%) have expected frequencies less than 5. The minimum expected cell frequency is 70.4.

Table 4. Summary of Insider-related Credit Abuses at defunct Gulf Bank.

S/N	Date	Amount Involved		Recovery		Suspects		Total Loss
		₦	$	₦	$	Insiders	Outsiders	
1	1999	10.5m		4.4b				
2	2001	40m						
3	2002	55m						
4	2003	90m						
5	Others	400m				Directors, Managers, and others	Phony Companies And other Skilled fraudsters	
6	Others	548m						
7	Others		9.2m					
8	Others	577.1m						
9	Others	622.9m						
10	2013							$80m

Source: Field Work, 2013

Investigations show that there was no single documentation to back the N400 million transactions and that the exposure of N548 million was backed up with fake security documents. Insider challenges continue to threaten bank success in addition to corporate governance lapses. For example, Eco bank chairman plans to step down on December 31st 2013 amid allegations of fraud being probed by regulators. He agreed to go after board members had decided that his departure was necessary to restore confidence among depositors and shareholders after a long controversy and boardroom battle over governance issues. Trouble started when CBN drew ECO bank's attention to the chairman's alleged failure to repay debts to the bank in order to reduce its nonperforming loans in the wake of 2009 banking crash (Ebhodaghe, 2013). As a sign of recovery from the 2009 crisis that shook the sector to its foundation, the banking industry has been recording impressive performances, with the shareholders' funds rising to N2.37trn. in 2012. According to the Nigeria Deposit Insurance Corporation's annual report and statement of accounts for the (2012) financial year, the total shareholders' funds of the 20 Deposit Money Banks that survived the banking sector crisis of 2009 rose by N434.24bn from N1.934trn in 2011 to N2.369trn in 2012. The report attributes that 22.44 percent rise in shareholders' funds to the activities of the Asset Management Corporation of Nigeria, especially the purchase of the nonperforming loans of the banks. The reports notes that the activities of AMCON has impacted positively on the industry as the banking sector recorded improvements in all performance indices, which culminated in an increase in the shareholders' funds. The report adds that the three banks acquired by AMCON, Enterprise Bank, Mainstreet Bank, and Keystone Bank, remained adequately capitalized during the review period, with their respective capital adequacy ratios well above the regulatory minimum of 10 percent. A further review of the report showed that out of the N2.369trn shareholders funds for the 20 banks, Zenith Bank is the most capitalized with N331.95bn. First Bank of Nigeria Plc, Union Bank Plc, Guarantee Trust Bank Plc and Access Bank Plc, with shareholders' funds of N279.80bn, N239.71bn, N213.69bn, and N209.35bn, followed in that order. The report put the shareholders' funds of United Bank for Africa Plc as a December 2012 at N170.06bn, Fidelity Bank Plc, N132.74bn, Ecobank, N127.41bn, First City Monument Bank, N119.14bn, Diamond Bank, N106.37bn, and Skye Bank, N102.98bn. Others are Standard Chartered N59.83bn, Unity Bank, N38.50bn, Citibank, N36.11bn, Keystone Bank, N35.50bn, and Mainstreet Bank, N32.76bn, Enterprise Bank, N26.05bn, and Wema Bank, N9.37bn. In terms of market share of the assets, the report state that the industry's assets are concentrated in few banks.

Scope for Further Research:

Bank failure in Nigeria is mostly related to human behaviours. In view of this, further research should focus on the reasons why highly placed bank executives commit bank frauds. It will also be necessary for further research to examine the adequacy or otherwise of the mechanisms of the regulatory authorities to punish "executive" fraudsters in Nigeria. It is further suggested that further research should examine the problem of capital inadequacy and bank failure in Nigeria. These suggestions could lead to new ideas of how to curb the dangerous cankerworm of bank failures in Nigeria.

5. Conclusion and Recommendations

The empirical result of this study implicates the theory that poor credit risk management is critical to bank failures. This means that a sound credit risk management is a crucial factor for the survival and profitability of a bank. Most importantly, the credit risk management function is to the greatest extent the most diverse and complex activity in banking business. This is so because the risk portfolio involves management, depositors and other shareholders. To avoid loan losses and bank failures the integrity and credibility of the credit risk management processes should never be in doubt but rather should depend on objective credit decisions that ensure an acceptable risk appetite level in relation to the speculated margin of returns. Also literature of the study provides credible evidence to show that weak corporate governance accelerates bank failures.

- Banks in Nigeria should establish sound credit risk management policies. This will make it impossible for the current trend where insider non-performing loans lead to bank failures.
- The regulatory authorities in Nigeria should always look into integrity and credibility issues involving top bank executives before their appointments. This will in no small measure reduce the current evidence whereby almost all the chief executive officers of failed banks were involved in fraudulent activities. This is a sharp betrayal of the confidence of the appointing authorities.
- Bank Regulatory Authorities should fine-tune the macro-prudential and micro-prudential guidelines for banks. This will make for early identification of potential loan losses.
- Banks should not be allowed to lend to their so called subsidiaries. These are conduit pipes for stealing as such loans/facilities usually go bad and irrecoverable.

- There should be less emphasis on banking "kidwizards" (self-professed banking gurus) because experience has shown that some are raw criminals.
- The Central Bank of Nigeria should review the tenure of banks external auditors to a maximum of two (2) years. This has become necessary because long tenure up to five years gives room for corruption.
- The Central Bank of Nigeria should strictly enforce annual audit reports of banks. It was found during field work that some of the failed banks in Nigeria such as the defunct Fin Bank Plc did not audit its accounts for over three (3) years. This apparently provided a fertile ground for manipulation and falsification of accounts and records.
- The appointment of bank chief executive officers should not be restricted to "old friends and boys" in the banking system. Experience has shown that some of the "old hands" brought back only came to enrich themselves. If not so, how could a chief executive officer of a technically distressed bank write off a loan of over N9 billion!!, without significant recovery attempts
- The Central Bank of Nigeria and the Nigerian Deposit Insurance Corporation in collaboration with the Economic and Financial Crimes Commission should go after the third party assets of "multiple borrowers" as a result of their spread across Nigeria and beyond. This will help in bringing back some stolen depositors funds.
- AMCON should liaise with reputable banks for the details of credible ex-senior bank managers to serve as debt recovery agents. This will complement the services of lawyers and consultants in debt recovery efforts.

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