International Journal of Economics, Commerce and Management
United Kingdom Vol. III, Issue 5, May 2015
http://ijecm.co.uk/ ISSN 2348 0386

BAD DEBTS AND INVESTMENT GROWTH AMONG NIGERIAN BANKS: AN EMPIRICAL ANALYSIS

Ayodele Thomas D.
Department of Accounting & Finance, Ajayi Crowther University, Oyo, Nigeria
Ayodeleconcept@yahoo.com

Abstract

The principal task of bank management is to generate sufficient return on their shareholders investment. However, of recent, there have been criticisms and allegations of bad and doubtful debts reported by banks annually. This raise the question as to whether banks accomplish the task of maximizing shareholders' returns on their investment and whether the banking system is still one of the most enviable and profitable investment options in Nigeria. In the study, an attempt was made to identify the causes of bad and doubtful debts, effects on banks' profits and investment and how they can be ameliorated with the use of appropriate securities and management teams put in place. The study made use of secondary data collected from ten-year annual reports of First Bank Nig. PLC, a sample selected purposively from Nigerian commercial banks. Regression analysis was used to determine the effect of bad debts on the investment growth of the bank. And it was discovered that bad and doubtful debts has an inverse relationship with investment growth of the bank. And, loan losses and credit risk if not checked will lead to low investment growth rate thereby jeopardizing shareholders' returns. It is therefore suggested that both commercial banks and monetary authorities should put necessary machineries in place to safeguard any impending loan losses in the banking sector in order to instill confidence among depositors and boost the Nigerian economy as a whole.

Keywords: Bad Debt, Investment Growth, Shareholders, Credit Management, Banking, Return on Investment, Nigeria

INTRODUCTION

The services rendered by commercial banks in Nigerian cannot be over-emphasized. The banks basically in any economy are financial intermediaries that perform two main traditional functions which include deposit collection and lending. As business establishments, they must meet up with their obligations in order to satisfy the shareholders through the payment of maximum or adequate returns on the investment in order to remain as investors of the banks (Nwankwo, 1991).

In an attempt to satisfy the shareholders and other stakeholders maximally, there is the need for the banks to generate enough returns inform of interest which automatically is a function of the size and quality of loans and advances given to potential borrowers for other investment purposes. This calls for effective lending portfolio management.

Due to the shortcomings in the management of the lending portfolio of commercial banks and the inability of the decision makers, in this case, the banker to make perfect and accurate predictions and forecast of loan repayment, bad and doubtful debts become inevitable. This arises based on the fact that lending involves a certain degree of risks and there is no standard measure of a customer whose loan will go bad or whether payment will be made at the agreed period with the price of the loan.

The paper is therefore set to evaluate the effects of bad debts on the investment generation among Nigerian banks.

LITERATURE REVIEW

The Concept of Bad Debts

A debt is said to be bad when there is no hope of recovering the amount from the debtor. As soon as a debt is recognized to de bad, it should be transferred from the debtor's account to the debit of an account called Bad Debts Account (Inanga et al, 2001).

In banks, a bad debt is normally written off as a loss and classified as an expense because the debt owed the bank is unable to be collected and all reasonable efforts have been exhausted to collect the amount owed. Before a debt can become bad it will be doubted by the bank of recovery. After the bank is sure that the debt is irrecoverable, then it becomes a bad debt.

Kent (1960) agreed that an account does not becomes bad overnight at it must have shown some red signs for some time. He pointed out that it is the banker's duty to show considerable interest in such accounts because large volume of credit is likely going to give rise to a large account of bad debts if the credit is not well analyzed and managed. Therefore a credit manager should focus on desirable loan.

According Holden (1995), a loan is desirable when it falls within the operation area of the bank. A profitable loan or lending is the one that will be repaid and would not be detrimental to the growth and development of the bank in particular but which would also promote the economic growth and development of the community in general. Generally, loan is desirable and suitable only if it is in accordance with the government directive and bank policy.

This was buttressed by Nwankwo (1991) who stated that effective lending is that which maximizes profitability, liquidity and security requirements of the banker and the development of the economy.

Credit Management

One of the primary functions of commercial banks is the extension of credit to worthy customers. This has evolved from being a pure accounting function into a front-end customer facing function (Henry, 2003). It involves screening of customers and only those who are worthy are allowed to do business. A sound review of accounting position of the customers and understanding of their businesses is the first step in ensuring that a customer does not default in paying back.

Corley (2000) stated that credit is a crucial factor in the growth process of any economy and that by lending, banks provide a valuable service to the community as they serve as a medium through which those who have idle money can transfer it to those who can put it to constructive use without any fear. Through this action, commercial banks render great service not only to the borrowers, but the economy at large because production is increased, capital investments are expanded and higher standard of living is realized, hence, the monetary authorities pay greater attention to the level of banks' loan and advances.

It is on this basis that bankers should not be left uncovered but must ask for adequate collateral securities as a manifestation of the customers' confidence in his/her project and as something upon which the banker can fall upon if things go wrong and expected results are not achieved. In this connection, it must be emphasized that the banker is lending other peoples' money and therefore must have something in return to show for it.

Nevertheless, the bank should not rely only on security while making decisions as to lend or not but an effective credit analysis or investigation must be carried out. Nwankwo (1991) therefore outlined the factors to be considered in credit investigation and management. They are character, capital, capacity, collateral, conditions and management. Security therefore should not be used as a substitute to prudent and thorough credit analysis. Securities for bank lending are based principally on trust and faith in the customer and his/her business, the subject matter for which the loan is been sought.

Orji (1989) also asserted that the type of security to be obtained by a bank depends on the amount of the credit, the duration of repayment and the nature of transaction. It is also worthy to note that it is the type of security that determines the type of legal documentation for the credit given. The common types of securities for bank credit include: lien, pledge and hypothecation, mortgage, landed property, shares certificates and life policy.

Investment Generation Among Banks

According to Hennie et al (2003) a sound banking system is built on profitable and adequate capitalized banks. Profit is a revealing indication of banks' competitive position in banking market and the quality of its management. This allows a bank to maintain certain risk profile and provide a cushion against short term problems. Therefore, when the management makes enough profit, the investor will be satisfied with the bank and will be in a better position to meet demand of other interest groups.

Specifically, the need for banks to generate sufficient return on their investment is imperative because banks profit is needed to pay shareholders' dividend, make adequate provision to absorb the adverse pressure on the banks' operation arising from unexpected loan losses and bad debts, retained profit for investment purpose and to strengthen its capital base to attract more customers.

For a bank to be able to attract deposit from the general public and even other financial institutions, it must be able to win and retain public confidence. A bank that has good profit record will obviously find it easy to win such confidence than a bank known for making losses. Also, the ability of a bank to attract more capital from money and capital markets at reasonable cost depends on its past profitability record and the price and term of any new issues of shares of banks quoted on the stock exchange are greatly influenced by its past glorious records. Therefore, there is every need for a bank to minimize losses associated with bad debts so as to generate adequate and satisfactory profit on its investment.

The question may then arise concerning the appropriate levels of profit capital base and total investment a bank should have. On this, Brass (1979) stated that the level of a banks' capital base and total investment which is difficult if not possible to quantify in monetary terms can be given in various conflicting terms: an adequate return on the capital employed, an adequate fund to pay shareholders dividends, ability to make prudent provision and have sufficient fund to retain depositors confidence in time of their needs. Whatever the level may be, there is the need for banks to strive and ensure consistent record of adequate profit. This is because an unbroken inconsistent records result not only in irregular dividend payment but also in lower capital gain forming shares price depreciation.

Hence, it is important to state categorically, that a bank's profit depends on the rate of return on loans and investment, the level of various fees and charges imposed on customers for services rendered, the size and composition of assets as well as the level of operating expenses.

METHODOLOGY

For the purpose of this study, purposive sampling was used in selecting First Bank Nig.PLC as the sample out of the total number of twenty four (24) Nigerian Commercial Banks. This bank was chosen due to the fact that it is the oldest in the Nigerian financial system and it is the biggest among the commercial banks we have and has been very consistent in its growth and performance.

The Data

The data for the study were secondary data extracted from the various financial statements of First Bank Nig.PLC for ten years (2000-2009). Multiple regression analysis was used to analyze the data gathered.

Model Specification

The model consists of one dependent variable and three independent variables of which provision for bad and doubtful debts is the main focus in our study.

The model is stated below:

Inv = f (PBD, POS, LA) - - - - - - - - - - - -- - - - - - - - - - - - - -eq (1)

Where Inv =Investments.

PBD = Provision for bad and doubtful debts.

POS = Profit attributable to ordinary shares.

LA = Loan and advances.

In mathematical and explicit form, the model is specified as

$Inv = B_o + B_l PBD + B_2 POS \; B_3 LA + U$ - - - - - - - - - - - - - - - -eq (2)

Where:

B_o=Constant or the intercept parameter.

B_l = Coefficient of provision for bad and doubtful debts.

B_2= Coefficient of profit attributable to ordinary shares.

B_3= Coefficient of loan and advances

On a priori ground it is expected that:

(i) $\frac{\delta Inv}{\delta PBD} = B_1 < 0$

This shows that an increase in provision for bad and doubtful debts will have negative impact on investment.

(ii) $\frac{\delta Inv}{\delta POS} = B_2 > 0$

This means that increase in the profit attributable to shareholders will increase the level of investment.

(iii) $\frac{\delta Inv}{\delta LA} = B_3 < 0$

This shows that loan and advances will have a negative impact on the investable incomes of the bank.

The following hypotheses is to be tested: Ho: $B_1 = B_2 = B_3 = 0$

This means that all coefficients simultaneously of the entire variables taken together are not different from zero. That is they are equal to zero. This will be tested against the alternative hypothesis: H_1: $B_1 \neq B_2 \neq B_3 \neq o$

This means that all the coefficients are simultaneously significantly different from zero.

EMPERICAL RESULTS

The results obtained from the regression analysis carried out on our variables are as shown in the table below.

Table 1. Regression analysis

Variables	Coefficient	Standard error	t-Statistic	Probability
C	-12532.26	20115.86	-0.623003	0.5562
PBD	-0.002580	3.828066	-0.000674	0.9995
POS	4.339849	2.028866	2.139052	0.0763
LA	-0.097679	0.102313	-0.954704	0.3766
R-squared	0.776230	Mean dependent variable.	31524.00	
Adjusted R-squared	0.664346	Standard dependent variable	30835.58	
S-E of regression	17864.80	Akiake info criterion	22.70823	
Sum square residual	1.91E+09	Schwarz criterion	22.82962	
Log Likelihood	-109.5411	F-statistic	6.937767	
Durbin-Watson statistic	1.285324	Probability(F-statistic)	0.022352	

Dependent Variable: Inv, Method: Least square, Included observations: 10

From the result above, there is no doubt that the outcome was impressive due to the fact that the entire variables turn out with their apriori expectations. It is shown that the constant parameter was inversely related to investment and the variable was significant.

Provision for bad and doubtful debts (PBD) which was the major variable in the model was inversely related to investment because of its negative value though not significant. The implication of this is that high bad and doubtful debts will reduce the investment position of First Bank of Nigerian plc. From the table, a 1% increase in bad and doubtful debt leads to about 0.3% fall in the investment rate. The result is however not significant, meaning that bad and doubtful is not a major variable that determines investment in the bank.

Profit attributable to ordinary shares (POS) was positively related to investment in the bank and also significant. The result conforms to the apriori expectations. Based on the result, an increase in profit attributable to ordinary shares will lead to a rise in investment. It shows that a 1% increase in profit attributable to ordinary shares will lead to about 434%rise in investment. The significant of this result indicates that profit attributable to ordinary shares is an important variable that determines the rate of investment in First Bank Nig plc.

Loan and advances (LA) shows an inverse relationship with investment. This result also conforms to the a priori expectations. It shows that an increase in loan and advances by 1% will reduce the ability of First Bank Nig plc to invest by 9.8%. The result is in order because a rise in loan and advances to the public will reduce the income at hand and hence reduce the ability to invest. The result therefore shows that loan and advances is an important variable that determines investment in First Bank Nig plc.

The coefficient of determination, which is the R-square (R^2) from the result shows that investment is explained with about 78% of the explanatory variable. This result was further confirmed by the higher value of adjusted R-square of about 66%.

The F-statistic which was used to test the overall significant of the entire overall model gives a value of 6.94. This shows that the overall model was significant at 95% confidence level.

CONCLUSION

From the analysis so far it can be concluded that bad and doubtful debts impacts negatively on bank’s performance, though the bank still makes huge profit from its operations and hence considerable increase in its investment rate over the years considered. This was due to the recapitalization exercise which has really increased its capital based to finance more investments. However, there is the need for banks to monitor their loans so as not to incure huge bad debts as this will reduce the strength of the bank in the period of post consolidation.

Effective lending therefore requires the banker to be proactive in dealing with financial proposals of would-be borrowers because the banker controls an essential commodity-money- which if not carefully handled can impact negatively on the banking sector and at large can trigger the economy.

RECOMMENDATIONS

Based on the foregoing, the following recommendations are given.

– That banks should put in place an efficient credit analysis and management to control the level of loan losses.

— Both commercial banks and monetary authorities should put in place a periodical enlightenment concerning banking loans. This would erase the wrong impression by some borrowers that the banking loan is a national cake that should be used anyhow.

— Lastly, the monetary authorities should always ensure that they create encouraging environment to enable the banks to adapt to bank policies that will enhance their performance especially in their lending activities. Also, the monetary authorities should be given adequate legal power to prosecute loan defaulters of various banks in order to get the loans recovered.

Therefore, it is believed that if the above recommendations are adhered to, they will undoubtedly provide an assurance of safe and profitability of depositor's and shareholders' funds respectively and also lead to reduction (if not total elimination)of bad debts and this in turn would translate to investment prosperity for our banking industry.

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