# BANK CREDIT TO THE PRIVATE SECTOR AND THE PERFORMANCE OF THE BANKING SECTOR IN NIGERIA

**STEVE N O IBENTA** Professor of Banking and Finance Nnamdi Azikiwe University, Awka

**DR GABRIEL C. NKECHUKWU** Dept of Banking and Finance Chukwuemeka Odumegwu Ojukwu University, Igbariam Anambra State, Nigeria

**COURAGE A OMOGBAI** Dept of Banking and Finance Ambrose Alli University Ekpoma, Edo State, Nigeria-

## *ABSTRACT*

*The study examines the relationship between Credit to the Private Sector and the performance of the Banking Sector in Nigeria. The study made use of secondary data extracted from Central Bank of Nigeria Statistical Bulletin and World Bank Development Indicators. The main variables for the study include the contribution of Financial institutions to GDP, the ratio of credit to the private sector to GDP, the ratio of market capitalization to GDP and the interest rate. The ordinary least square (OLS) multiple regression technique was employed for data analysis and covered a time period of thirty two years from 1986 to 2017. The analysis revealed that bank credit to the private sector and all the other intervening variables did not significantly affect the performance of the banking sector in Nigeria within the period under review. A major recommendation of the study is that the monetary authorities should devise a new system of directives and incentives for banks to mobilize and channel sufficient long term funds to the productive sector of the economy; upgrade the quality of the management, project appraisal, monitoring and collection of debts in order to improve the efficiency of firms, timely recovery of loans and the stability of the banking industry.*

***KEYWORDS:*** *Bank credit, Performance of the Banking sector,, Nigeria*

## 1.INTRODUCTION

It has been well established that efficient and well developed financial institutions and markets act as catalysts for economic growth and development. They affect our everyday life because they are involved in the movement of funds throughout the economy from the surplus to the deficit units to promote creativity, productivity and economic growth. Their activity influences the goods and services that are produced, the profits of businesses and

the efficiency of the economy as a whole (McKinnon, R, 1973; Gordon, 1983; Ibenta 2000; Levine, 2005; Demirguc- Kunt and Levine, 2007). Banks are the most important financial intermediaries in both developed and developing countries. They also play a central role in the creation of money and the rapid pace of financial innovation. According to Gordon (1983):

> "they are the means by which savings are mobilized for investment and are transferred from low yielding to higher yielding ones; and by which savers and investors diversify risk, can anticipate reliable returns or enhanced security or liquidity and are thus encouraged to make longer term commitments for purposes beyond their personal horizons. They are as well the means by which fluctuations and the resource needs of the economy are smoothed out. In other words, they are the key mechanisms for adjustment and lubrication in an increasingly complex and dynamic economy".

Bank credit is the borrowing capacity provided to economic agents by the banking sector in form of loans and advances which is often accompanied by some form of collateral to ensure repayment (CBN, 2003). The theoretical expectation is that all things being equal, loanable funds increase when the size of capital available to banks increase. In addition, the less the banking sector funded government spending, the more the funds available to the private sector, the less the crowding out effect and the more the funds that can be used to promote private enterprise and production. (Fadere, 2010).

In recognition of the importance of Bank credit and banking sector development in economic growth, the Federal government of Nigeria introduced various banking reforms beginning with the Structural Adjustment Programme (SAP) in 1986 and culminating in a major bank recapitalization programme involving a 1150% increase in the minimum capital requirement for banks in the country from N2bn to 25bn in 2005. At the end of the exercise, 25 banks emerged out of the 89 which existed before the exercise (Okafor, 2010). As expected, the exercise resulted in a very huge increase in the capital and asset base as well as the liquidity levels of the recapitalized banks but this has not guaranteed the stability of the banking system nor the anticipated improvement in the performance of the economy.

The problem of the study emanates from two main sources. The first is that the issue of credit is of great concern in the banking sector because the primary business of banks is mainly the loan portfolio and the major source of its income. It therefore follows that the survival, performance and sustainability of the banking sector depends on the efficiency and ultimate survival of the firms. On the other hand, Balogun (2007) and Okafor (2010) demonstrated with the aid of available statistics that despite the increase in lending to the Nigerian economy, the share of the productive sector of the economy has remained low and indeed declined proportionately over time suggesting that the loans may have been mismanaged or channeled to unproductive uses.

The other problem is the paradoxical nature of the situation. Even-though some of the banks seem to be making huge profits, the risks resulting from the weak and fragile nature of the economy and business conditions is such that the volume of non-performing loans in the country is too high and has been identified as the major source of bank distress in the country. While some available studies tend to blame the financial crises on greedy, inexperienced and short-sighted executives or government financial mismanagement or the result of ineptitude of the CBN over-sight functions, others tend to concentrate the analysis on the effect on economic growth. But the thesis of this paper is that the inability of the banking sector to sustain a viable productive sector with the requisite creative and wealth regenerating capability to absorb and recycle available loanable funds is responsible for the recurrent instability in the banking sector. Hence the main objective of this study is to evaluate the long term relationship and the causal effect of Credit to the Private Sector (CPS) on the performance of the banking sector in Nigeria.

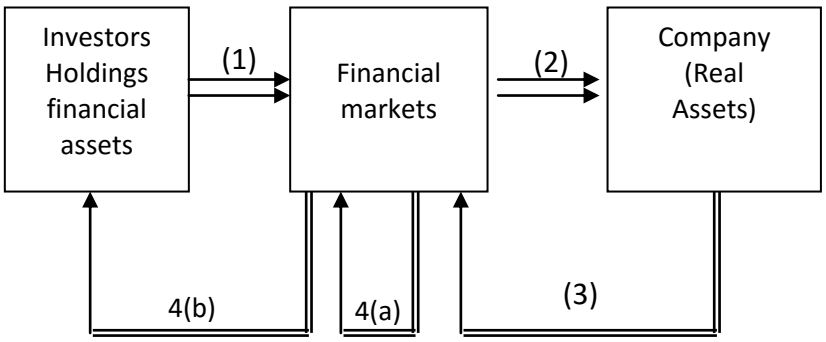
## 2.CONCEPTUAL FRAMEWORK:

### Bank Credit, Economic Growth and Performasnce of the Banking Sector

A business firm is an economic unit, an entity or an organization devoted to the production and marketing of particular goods or services. The activities of these economic agents determine the quantity of goods and services produced in an economy, known as the gross national product (GNP) which is the accepted yardstick for measuring the level of economic growth of any nation.

The activities of business firms may be grouped into three basic functional arrears, viz: production, marketing and financing. However, the most crucial decisions of the firm are those which relate to finance because almost all kinds of business activities directly or indirectly depend on acquisition and use of capital. In general, firms obtain the necessary funds by borrowing from banks or the public by selling financial assets.

To ensure its survival and growth, the firm needs to invest the funds in real or productive assets like manufacturing to ensure that the assets generate enough cash to recoup the principal and interest or dividend payments in addition to the surplus cash expected for growth and expansion of the organization. Figure 1 below is a simplified diagrammatic illustration of the flow of funds between the financial markets and the firms operations (Ibenta, 2005):




**Key :**

1. Cash pooled together in banks by selling financial assets to investors
2. Cash invested in firm's operations and used to purchase real assets
3. Cash generated by firms operations

4(a) Cash reinvested to expand firms operations

4(b) Cash returned to investors in form of dividends, interests etc.

It therefore follows that for growth to occur, a country must invest to build up productive capacity. It is this capacity that determines the level of output of goods and services in the economy. If investment, which represents the net increase in an economy's capital stock

leads to growth, then there is a relationship between capital accumulation and economic growth (Soyode, 1990). When sustained growth has occurred, it is expected that over time, with appropriate policies that allow for more equitable distribution of the fruits of economic growth among a progressively larger percentage of the population, economic development would follow. The question is whether our banking sector

Unlike the developed economies, the Nigerian economy is passing through crises of structure due to inherent instability in the monetary, banking and financial framework which cannot sustain the productivity and growth required by the economy in order to protect the safety and soundness of the banking system.

If the growth in banking assets and money supply has been channeled strictly toward the expansion of the productive capacity, real growth in the economy would have occured. Accordingly, more employment would have been generated and more real income would have been pumped into the economy to create a new order of stable equilibrium.

## 2.12 CREDIT TO PRIVATE SECTOR

Credit to Private Sector refers to financial resources provided to the private sector by other depository corporations (deposit taking corporations except central banks) such as through loans, purchases of non-equity securities, and trade credits and other accounts receivable, that establish a claim for repayment. For some countries these claims include credit to public enterprises (IMF, 2016). Private sector credit indicates the extent to which banks finance the economy, and more specifically the extent to which banks finance private investment and private sector development (World Bank, 2009). Domestic credit provided by the private sector includes financial resources which establish a claim for repayment such as loans, purchase of non-equity securities, trade credits and other accounts receivable (World Bank, 2009). The credit to private sector is the most comprehensive indicator of the activity of deposit money banks and it is calculated as the amount of domestic credit allocated to the private sector (by the banking sector) divided by GDP. This measure of banking development is critical for poverty reduction and for financing consumption, production and capital formation, which helps to stimulate aggregate demand and, in turn, advance economic activity (World Bank, 2008). This proxy according to Beck, Levine and

Loayza (2000) is superior to other measures of financial intermediary developments because it extends credit to public sector.

Bencivenga and Smith (1999) assert that the banking sector, which is the main source of credit to the private sector, is an important channel of financial intermediation through which financial resources can be mobilized for productive investment needed for the realization of the performance of the banking industry. When credit or resources are properly channeled to the private sector,they do not only bring about economic development but also enhance the performance of the banking sector and other financial institutions that made it possible.

## 2.13 MEASUREMENT OF BANKS' PERFORMANCE

The significant changes that have occurred in the financial sector of developing country like Nigeria have increased the importance of performance analysis of modern banks. As observed by Casu, Giratdon and Molyneux (2006), performance analysis is an important tool used by various agents operating either internally to the bank or who form part of the bank's external operating environment. This is why investors in share and bonds issued by banks consider the investment before forming an opinion about the ability of its management. One of the means of measuring the performance of banks and other business organizations is the financial analysis. Financial analysis can be described as the process of identifying the financial strengths and weaknesses of a firm by establishing relationship between the items on balance sheet and profit and loss account (Abdulkadir, 2007). These financial statements are prepared as general information models of an enterprise at regular periods, normally at the end of each year (Ajayi, 2007).

Casu, Giratdon and Molyneux (2006) reported that the financial ratio analysis is used to determine the different areas of banks performance, such as profitability, asset quality and solvency. The tool is also employed to assess the performance of banks using information derived from periodic financial reports of statements produced by the accounting system of such banks. Examples of such ratios are total deposit to gross domestic product, financial institution contributions to gross domestic product, total bank asset etc. Ajayi (2007) noted that the quality of a bank's asset is determined using both performing and non-performance loans which is a vital tool for monitoring authority in

assessing the performance of banks in Nigeria. However, Casu, et al (2006) observed that the parameter for measuring performance varies from country to country, depending on the sectors involved. Another yardstick for measuring performance in the banking industry is the CAMEL approach. This approach is equally used by the monitoring authority to assess the level of performance of banks before making any pronouncement on their soundness, solvency and liquidity position.

The acronym CAMEL means:

C = Capital Adequacy

A = Asset Quality

M = Management Efficiency

E = Earning Strength

L = Liquidity.

This serves as a major tool for assessing solvency level of banks by the monitoring authority (Abdulrasheed, Yahaya and Aliu, 2011).

## 2.2 THEORETICAL REVIEW

There is a large volume of theoretical literature which shows the importance of a well-developed financial system in economic development (Demirgurc-Kunt and Levine 2004, Honohan 2004).

### 2.21 Agency Theory and Transaction Costs

The wedge between the expected internal rate of return of a project and the rate of return that external investors require to finance it is introduced by two familiar constraints, which hamper the ability to write and enforce financing contracts; these are principal-agent problems and transaction costs. We consider the agency problem first. The canonical analysis of principal-agent problem in finance was developed by Stiglitz and Weiss (1981). They explained the access discrepancy by referring to agency theory. Van Horne and Warchovicz (2005) consider agency theory as a branch of economics which deals with the relationship between the interests of principals, and agents in an organization. Adverse

selection and moral hazard effects are due to information asymmetry between the principal (lender) and the agent (borrowers). In the case of ordinary goods or services, the price is determined by the interplay of the forces of demand and supply to reach an equilibrium point. If the price is too high for some, they will not use it. But all who are willing to pay the price will be able to use it. So if prices do their work well, there will be no access problem. As explained by Stiglitz and Weiss (1981), credit markets are different, because information problem can lead to credit rationing even in equilibrium. The reason for this anomaly is that banks making loans (or buying debts) are concerned not only about the interest they charge on the loan but also about the riskiness of the loan. At the same time, the interest rate that a bank charges may itself affect the riskiness of the portfolio of loan either by attracting high-risk borrowers (adverse selection effect) or by adversely affecting the action and incentive of borrowers (moral hazard effect).

The adverse selection problem arises because high-risk borrowers are the ones that are more likely to look for external finance. A banker/financier may be willing to provide financing for some debtors or projects by increasing the risk premium charged, but this approach can back fire at some point due to the adverse selection problem. The reason is that as the risk premium required by lenders rises, so does the riskiness of the pool of those interested in borrowing. High risk borrowers are “adversely selected” by higher risk premiums. Faced with the adverse selection risk, lenders will try to use non-price criteria to screen debtors and projects, and ration and apportion credit, rather than further increasing the risk premium.

The moral hazard problem refers to the situation after the agent, the debtors has received the resources from the principal (the lender). The problem arises because the agent may have hidden information and decides to use the resource in ways that are not consistent with the interest of the principal. For example, the agent may divert the borrowed resources to riskier activities, strip and loot assets, or run away with the money, while the creditor has no effective way to monitor and prevent such errant behavior. The moral hazard problem may also arise if the principal faces high costs of enforcing the contract subscribed with the agent. Because of these dilemmas, results of investment in these areas will fall below the social optimum, unless government intervenes to distribute costs and benefits efficiently.

### 2.22 Finance-Leading Hypothesis

The positive view of finance-led growth focuses on the role played by finance in mobilizing domestic savings and investment through a more open and liberalized financial system and promotion of productivity through creation of efficient financial markets. Joseph Schumpeter (1959) first propounded the supply-leading hypothesis. He observed that production required credit to materialize. He said "one can only become an entrepreneur by previously becoming a debtor… Before he requires any goods whatever he requires purchasing power. He is the typical debtor in the developing society". He contends that a well-functioning financial system will spur technological innovation through efficiency of resource allocation from unproductive sectors to productive ones.

Schumpeter's hypothesis found support in McKinnon (1973) and Shaw (1973) who also argued that the creation and strengthening of financial institutions and markets could increase the supply of financial services, increase savings and allocate them to more productive investments. Another apostle of finance –led hypothesis, Goldsmith (1960) contends that evolution of domestic financial markets would enhance and lead to a high level of capital accumulation. Resources for investment emanate from the savings by households when they do not consume all they earn as income. The capital market channels such savings for investment in capital goods, which adds to the nation's capital stock and provides for expansionary production; and so the economy grows (Samuelson, 1976)

### 2.23 Theoretical Framework

This study is based on the McKinnon's model (1973) which explains that any distortion or limitation of the banking sector such as interest rate controls, reserve and liquidity requirements and government rationing of available credit to so-called priority sectors, inhibit financial development mainly by depressing the interest rate. In this case McKinnon's model is depicted as

$Md = F(Y, RIR)$

$INV_t = F(RGDPt_1, RIR, PDCt, FS_t)$

$RGDP_t = F(INF_t, FS_t, IVTgt, FLP_t, RIR)$

Structured econometric model

$LogMd = a_0 + a_1LogY_t + a_2LogINV_t + a_3RIR_t + \mu_{at}$ (3.1)

$INV_t = \beta_0 + \beta_1LogRGDP_{t-1} + \beta_2RIR_t + \beta_3LogPDC_t + \beta_4LogFS_t + \mu_t$ (3.2)

$LogRGDP_t = Y_0 + Y_1INF_t + Y_2LogFS_t + Y_3LogIVTg_t + Y_4FLP_t + Y_5RIR + \mu$ (3.3)

Where

Y = National Income

Inv = Investment Level

Md = Real Money Demand

PDC = Private Domestic Credit

FS = Financial Saving

INF = Inflation Rate

RIR = Real Interest Rate

RGDP = Real Gross Domestic Products

## 2.3 EMPIRICAL LITERATURE

Kablan (2010) examines Banking efficiency and financial development. The variables used are Money supply, credit to private sector, Non performing loans, lending rate, GDP per capita and Bank cost efficiency. The study employed Stochastic frontier analysis and found that sub-Sahara Banks are generally cost-efficient, but non performing loans undermine efficiency, which suggests that improvement in the regulatory and credit environments should improve efficiency. Arbak, Ben-Naceur & De Groen (2013) examined the relationship between financial sector development, bank efficiency and economic growth. The variables used are Credit to private sector, Bank deposit, stock market size and liquidity. The study employed OLS method and found that credit to the private sector and Bank deposits relate negatively to growth. Okey and Iheanacho (2017) examine banking reforms and credit creation in the Nigerian banks. The variables used are loan and advances to deposit ratio, money supply ratio and liquidity ratio. The study employed the ordinary least square correlation coefficient and found that the 2005 reforms increased credit creation capacity for the banks.

Ekong and Udonwa (2015) investigate financial sector reform and bank performance. The variables used are credit allocation to the private sector, lending rate, non performing loans, bank performance, inflation rate and RGDP and covers a period of 1982 to 2013. The

study employed the co-integration technique and found out that reform in the banking sector increases the performance of commercial banks. Mugano and Roux (2017) examine bank concentration, country income and financial development. The variables used are Herfindah-Hirchman index, private sector credit, money supply to GDP, comprehensive industrial concentration and RGDP. The study employed the Panel dynamic fixed and random effects model and found that Herfindah-Hirchman index reveals a high level of concentration of bank assets. Poudel (2012) studied credit risk management and banks' financial performance. The variables used are credit risk, return on asset, capital adequacy ratio and lending rate and covers a period of 2001 to 2011. The study employed the correlation and regression analyses and the study reveals that credit risk management is a significant predicator of banks' financial performance. Okorie (2013) investigated the effect of private sector credit on domestic investment. The variables used are private sector credit and private domestic investment. The study employed the error correction model and found that increase in private sector credit though not statistically significant leads to increase in private domestic investment.

## 3.0.METHODOLOGY

The study adopts the expost-facto research design. The data were sourced from the Central Bank of Nigeria (CBN) Statistical Bulletin, World Development Indicators and the National Bureau of Statistics and covered a period of thirty two years (1986 - 2017).

**Model Specification**

The study is based on the McKinnon's model (1973). In order to examine the effect of banks' credit on the performance of banking sector, a model was derived from a similar work by Okorie (2013) and adapted to suit our purpose. Okorie (2013) used private sector credit, inflation rate and exchange rate to explain private sector credit. The modified version of the model however, expressed financial institution contribution to gross domestic product as a function of ratio of credit to the private sector to GDP, market capitalization to GDP, and lending rate. Therefore, the functional form of the model is depicted as

FIGDP = F(CPS/GDP, MCAP/GDP, LR)

Meanwhile, the econometric model is thus

$FIGDP = \beta_0 + \beta_2 CPS/GDP + \beta_1 MCAP/GDP + \beta_3 LR + \mu$

FIGDP = financial institution contribution to gross domestic product.

CPS/GDP = Ratio of Credit to the private sector to Gross domestic Project

MCAP/GDP = Ratio of Market capitalization to Gross Domestic Product.

LR = Lending Rate

## 4.0 MODEL ESTIMATION

**Table 1: Estimated OLS Result of the Model**

| Variable | Coefficient | Std. Error | t-Statistic | Prob. |
|---|---|---|---|---|
| C | 0.038797 | 0.004768 | 8.137730 | 0.0000 |
| MCAP/GDP | -0.004588 | 0.015682 | -0.292574 | 0.7723 |
| CPS/GDP | -0.039643 | 0.022328 | -1.775521 | 0.0880*** |
| LR | 7.59E-05 | 0.000119 | 0.636619 | 0.5302 |
| AR(1) | 0.769281 | 0.084404 | 9.114301 | 0.0000 |
| R-squared | 0.845232 | Mean dependent var | | 0.034237 |
| Adjusted R-squared | 0.820469 | S.D. dependent var | | 0.008380 |
| S.E. of regression | 0.003551 | Akaike info criterion | | -8.292263 |
| Sum squared resid | 0.000315 | Schwarz criterion | | -8.058730 |
| Log likelihood | 129.3839 | Hannan-Quinn criter. | | -8.217554 |
| F-statistic | 34.13307 | Durbin-Watson stat | | 1.971584 |
| Prob(F-statistic) | 0.000000 | | | |
| Inverted AR Roots | .77 | | | |

Dependent variable: FIGDP

Note: * denotes statistical significant at 1%, ** denotes statistical significant at 5%; *** denotes statistical significant at 10%

Source: Authors' computation from Eviews 8.0

## 4.1 INTERPRETATION AND DISCUSSION OF REGRESSION RESULTS

Table 1 shows that credit to private sector (CPS/GDP) has a negative but statistically insignificant effect on banking sector performance (proxied by FIGDP). This implies that credit to private sector has a negative influence on banking sector performance. The result also indicates that both market capitalization and lending rate are not statistically significant, implying that they are not the major determinants of banking sector performance. The adjusted $R^2$ of 0.820469 implies that the explanatory variables explained 82.0469% of the changes in banking sector performance.

They results of the study reflect economic contradictions in the economy built up over the years. Because the human desire for maximum profits is not tempered by the code of ethics, the system allows accumulation of wealth based on illegitimate earnings. In this regard, the role of banks in the current economic impasse is most suspicious.

The underlying assumption is that efficient financial intermediation would propel economic growth and potentially increase bank returns through revenue efficiency gains and reduction of industry risks and non performing loans. The economy needs a steady flow of long term funds to expand the productive sector, but this role that has been largely neglected by the banking sector in this country. Rather, they have tended to concentrate all their activities on short term money market and foreign exchange operations even when there was statutory prescription for each loan portfolio. In a nutshell, the primary cause of our problems today resides in the unstable framework for our monetary, banking and financial system which does not provide a proper equilibrium supply of money to satisfy the function of new investment and capital formation necessary for the production of the goods and services that are needed by the economy.

Now under the statuesque financial framework, a large portion of any extra supply of money in the system went purely for speculative purposes; and the application of what is termed the new economic philosophy of liberalism led to an even greater degree of inflation, unemployment, chronic deficit in the budget and balance of payments and the resultant instability in the banking system.

## 5.0 SUMMARY OF FINDINGS, CONCLUSION AND RECOMMENDATIONS

The paper reviewed the effectiveness of bank credit to the private sector from 1986 to 2017 to explore its effect on the performance of the banking sector.

Arising from the data analysis, the following findings are made

1. Credit to private sector has a negative and statistically insignificant impact on financial institution contribution to GDP (our proxy for bank performance).
2. Market capitalization has a negative and statistically insignificant impact on financial institution contribution to GDP.
3. Lending rate has a positive but statistically insignificant impact on financial institution contribution to GDP.

The study therefore concluded that the critical nexus between the banks and firms, not only in financing but also for efficiency and ultimate survival has not been emphasized. This also suggests that the banking sector does not have the expertise for proper project and credit evaluation, effective monitoring and collection of loans. Banks rely for their survival and profitability on debt repayment and the real solution to the unstable banking sector lies in the building of a strong and sustainable productive sector.

In order to establish a long-run effect of banks' credit to private sector on the performance of banking sector, the researchers made the following recommendations::

1 Since economists argue that in a modern credit economy, the money supply expands to meet the needs of the economy, liquidity and credit in the system is therefore not necessarily a bad thing but the money rules must be set in such a way that any extra money supply must be channeled into the productive areas of the economy to create new goods and services, employment and real income and a new order of stable equilibrium.

2 The Central Bank of Nigeria and International lending agencies must devise new systems of directives and incentives that would induce banks to extend their lending horizon, to increase substantially the proportion of medium and long term loans, upgrade the quality of their project appraisals and monitoring staff, and crate a policy environment that would promote mobilization of long term investment funds for young entrepreneurs.

3 The Federal government and the Central Bank should legislate intensive training and retraining of senior staff, management and members of the Board of Directors of banks to equip them with the requisite expertise, ethical culture and the confidence to maintain effective corporate governance and quality management.

4 All banks should be made to create a Business Advisory or Consultancy Unit made up of experts in Forensic Accounting, Investment Analysis and Project management to handle clients' loan portfolios to ensure effective packaging, monitoring and timely repayment.

5 The CBN must not only strengthen it regulatory roles, but also mobilize all resources at its disposal to promote active expansion of the productive capacity of the nation and discourage the reaping of huge profits by banks and money speculators. Industry, agriculture and human capital development would be focus of the new policy.

We have actually come to a dangerous stage where the consequences of our past failures are fast becoming unmanageable, and will require commitment, foresight and sacrifice from all Nigerians to work our way out of the present unpasse. The Central Bank of Nigeria must provide the desired leadership in the identified areas while banks themselves will take steps to ensure compliance, restore ethical and quality banking and hence confidence in the banking system.

We must not just seek policies, but policies allied to vigorous strategies to obtain the desired results. Free competition alone cannot create conditions of stable equilibrium, unless it is acting in an environment governed by a carefully constructed institutional framework like in developed economies where economic freedom and economic justice are treated with the same standard of scientific objectivity.

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