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Risk Management and Profitability in Nigerian Deposit Money Banks

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ABSTRACT

The study was designed to examine the effects of risk management on profitability of deposit money banks (DMB) in Nigeria. Survey research design was employed Place and The study was carried out on licensed deposit money banks in Nigeria. It covered five years from 2009 to 2014. This research involved eight (8) out of the 21 deposit money banks in Nigeria for the period 2009 to 2014. The sample was selected using judgmental sampling technique which is a non-probability sampling method. The eight banks in consideration are First Bank of Nigeria, Guaranty Trust Bank, Access Bank Plc, Zenith International Bank, Wema Bank of Nigeria, First City Monument Bank, Skye Bank and United Bank for Africa Plc. Secondary data were collected from 2009 to 2014 based on the annual reports and accounts of the chosen banks. The research used both descriptive statistics such as percentages, frequency and standard deviation and inferential statistics which are multiple regression and panel data to test the relationship between risk management and profitability. The findings revealed that banks with good credit risk management have better performance. The average Return on Asset (ROA) was 9% and the average value for Return on Equity (ROE) was 18%. The result shows that non-performing loans and provisions have an adverse effect on profitability with negative 0.1451NPL and negative 0.1452NPL on ROA and ROE respectively. The findings showed that bad loan provision eat deep into profit in Nigerian DMB.
The work concluded that risk management positively affects profitability of Nigerian deposit money banks and recommended that banks should implement effective tools and techniques to reduce credit risk failure in Nigerian DMB.

Keywords: Risk management, profitability, deposit money banks

INTRODUCTION

The emergent global crisis has impacted negatively on the nation's financial sector, triggering instability in banks and the capital market (Igbatayo, 2011). The Financial Crisis Inquiry Commission of Nigeria concluded that the

financial crisis was caused by significant failures of corporate governance, including risk management, failure of accountability and responsibility throughout each level of the lending system. This included borrowers, mortgage brokers, appraisers, originators, securitizers, credit rating agencies, and investors, which ranged from corporate boardrooms to individuals (The Economist, 2013).

In response to the global financial crisis, governments and authorities in various nations took various actions to stabilize and save financial institutions in their economies. Some of the actions taken to bolster liquidity and restore market confidence in some jurisdictions included one or more of the following: which are state guarantee of wholesale debt obligations, recapitalization of banks or partial nationalisation; asset purchases; and Central Bank liquidity schemes (Soludo, 2009).

Consequently, Nigeria was not an exception such that between 2006 and 2009, eight banks were saved from imminent collapse, with the sum of N620 billion injections by the Central Bank of Nigeria (CBN) (Institute of Credit and Collection Management- ICCM, 2014). The CBN, Securities and Exchange Commission (SEC) and National Insurance Commission (NAICOM) took significant measures to address the issues that led to the collapse or failure of the money and capital markets. Apart from the rescuing operations of the eight banks and the purchase of six of them by other banks, Assets Management Corporation of Nigeria (AMCON) was also established to take over the bad risk assets (ICCM, 2014). Thereafter, a great deal of efforts went into changing the governance structure and risk management departments of banks, including reporting on risk management issues. CBN brought risk management and compliance functions to the front burner. Profitability of Nigerian DMBs was impaired which resulted in reduced dividends, absence of bonus share and outright non declaration of dividends, even the big banks were not exempted.

The strength of the banking industry is an important prerequisite to ensure the stability and growth of economy (Halling & Hayden, 2006). As a consequence, they asserted that the assessment of banks' financial condition is a fundamental goal for regulators. Besides, Tabari, Ahmadi and Emami (2013) have remarked that the safety of banking system is depending on the profitability and capital

adequacy of banks. Profitability is a parameter which shows management approach and competitive position of bank in market-based banking, it helps banks to tolerate some level of risk and support them against short-term problems while Capital adequacy ratio (CAR) is defined as the ratio of capital to the risk-weighted sum of bank's assets. It measures the amount of a bank's capital relative to the amount of its risk weighted credit exposures.

Despite efforts of banks at reaching effective lending decisions, adequate security documentation, follow up and monitoring, credits are still failing. Even when Know Your Customer (KYC) is implemented or seems to be implemented, many banks tend to be reporting bad debt in their annual reports. These banks appear to be declaring little or no dividend while bonus shares seem to be a thing of the past. Credit problems appear to include poor quality and poor lending decision at initial application stages, poor or inadequate security documentation, lack of follow-up and monitoring after disbursement. Perhaps if these problems are proactively managed, banks could make profit and remain in business. One begins to wonder if the supposedly dwindling profitability is linked to credit risk management. It is of great interest to see how profitability is affected by the risks being faced by deposit money banks (DMB). It behooves on all stakeholders that risk management strategies should be the concern of the day so as not to crumble the banks again. However, the extent to which credit risk management contributes to profitability of Nigerian DMB is not well documented or researched. Hence, this study investigated the effect of credit risk management on the profitability of Nigerian DMB.

The objective of the study is to examine the relationship between risk management and profitability of some Nigerian banks (DMB).

MATERIALS

The Concept of Risk Management

Risk management is a concept that has been used since the beginning of human kind; it is an evolving concept (Alina, 2011). Credit creation is the main income generating activity of banks. But this activity involves huge risks to both the lender and the borrower. Risk refers to a condition where there is a possibility of undesirable occurrence of a particular result which is known or best

quantifiable and therefore insurable (Periasamy, 2008). Risk may mean that there is a possibility of loss or damage which, may or may not happen.

Although the terms risk and uncertainty are often used synonymously, there is difference between the two (Sharan, 2009). Uncertainty is the case when the decision-maker knows all the possible outcomes of a particular act, but does not have an idea of the probabilities of the outcomes. On the contrary, risk is related to a situation in which the decision-maker knows the probabilities of the various outcomes. In short, risk is a quantifiable uncertainty. The relationship between bank performance and risk management represents the risk and return trade-off. As risk is directly proportionate to return, the more risk a bank takes, it can expect to make more money (Hamisu, 2011).

Better risk management indicates that banks operate their activities at lower relative risk and at lower conflict of interests between parties. These advantages of implementing better risk management lead to better bank performance (Olawale, 2013). Better bank performance increases bank's reputation and image from public or market point of view. Banks will get lower cost of risky capital and other sources of funds. Banks also get more opportunities to increase the productive assets, leading to higher bank profitability. Risk management introduces the idea that the likelihood of an event happening can be reduced, or its consequences minimized. Effective risk management seeks to maximize the benefits of a risk (usually a reduction in time or cost) while minimizing the risk itself (Njogo 2012).

While the above research outcomes provide valuable insights on risk management and banks generally, they have not introduced a clear effect between Risk Management and financial performance of deposit money banks. Given the gap poised by the above empirical studies, and also considering some challenges faced by deposit money banks in Nigeria such as non-performing loans and fluctuation of interest rate, it is important to conduct the study about risk management and its relationship with profitability in Nigerian deposit money banks.

However, the increase in bad loans and the antecedent provision for loan loss tend to denote that risk management is not working in banks. Similarly,

unearned interest does not enhance the bottom line of banks. These tend to mean that risk management has not been good enough to improve banks' profitability.

The major risks in banking business or 'banking risks', as commonly referred, are liquidity risk, interest rate risk, market risk, credit or default risk, operational risk, legal risk and reputational risk. However, risk management is often synonymous with credit risk in the banks.

The Risk Management Process

A process is a set of interrelated activities that interact to achieve a result. There are four processes in risk management:

i. Risk identification: Identify project, product and business risks;
ii. Risk analysis: Assess the likelihood and consequences of these risks;
iii. Risk planning: Draw up plans to avoid or minimise the effects of the risk and
iv. Risk monitoring: Monitor the risks throughout the project.

Strategies for Handling Risks

Strategy is a method or plan chosen to bring about a desired future, such as achievement of a goal or solution to a problem. There are four major strategies for handling risks which are transferring to another party, avoiding the risk, reducing the negative effects of the risk and accepting some or all of the consequences of a particular risk.

For this study, risk is taken to mean an unplanned event with financial consequences resulting in loss or reduced earnings while risk management is is the process of identifying risks, assessing their implications, deciding on a course of action, and evaluating the results

Theoretical Review

This study is based on the bank risk management theory. The theory studied why risk management is needed, and outlines some of the theoretical underpinning of contemporary bank risk management, with an emphasis on market and credit risks. This theory indicates that credit and market risks have an effect directly or indirectly on the banks' survival. As applied to this study,

this theory holds that the researcher would expect the independent variables that is, credit risk management indicators to influence or explain the dependent variable which is banks profitability.

According to Campbell (2011), understanding risk and how it is perceived is a crucial step toward creating programs and campaigns to raise awareness and make communities and workplaces safer. Risk perception, or the ability to discern risk, is tied to risk tolerance, or an individual's capacity to accept a certain amount of risk. Research suggests that programs to discourage risk-taking behavior need to address both of these concepts. Overall, the idea presented is that occupational and non-occupational risk taking are related.

Measure of profitability

Corporate profitability is assessed by the use of profitability ratios. Profitability ratios measure an organisation's efficiency at generating profits. Some of the basic profitability ratios are return on assets (ROA) and return on equity (ROE). The profitability ratio shows the firm's result in its ability to make profit from its activities. Profitability ratio is calculated by the establishment of a relationship between profit figures, sales and assets. Egungwu (2005) defined profitability as a measures of management overall effectiveness as shown by the returns generated on sales and investment. The ratios under profitability are as follows:

Profit Margin Ratio (PMR) which consists of gross profit margin ratios and the net profit margin ratios. It measures the profit made on sales.

Return on Asset (ROA) is the ratio of net operating profit that a company earns from its business operations in a given period of time to the amount of the company's total asset.

Return on Equity (ROE) measures the return on shareholders' investment in the bank.

Relationship between Risk Management and Profitability

The relationship between Risk Management and Profitability can be measured by relating the Returns on equity or asset with the expenses and losses recorded

on risk assets (loans and advance). Felix and Claudine (2008) investigated that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. Njanike (2009) found that the absence of effective credit risk management led to occurrence of the banking crisis, and inadequate risk management systems caused the financial crisis. Kithinji (2010) indicated that the larger part of the banks' profits was influenced by other variables other than credit and nonperforming loans. Aduda and Gitonga (2011) found that the credit risk management effected on profitability at a reasonable level. Aruwa and Musa (2012) investigated the effects of the credit risk, and other risk components on the banks' financial performance. They found a strong relationship between risk components and the banks' financial performance. Kolapo, Ayeni and Oke (2012) showed that the effect of credit risk on bank performance measured by ROA was cross-sectional invariant, though the degree to which individual banks were affected was not captured by the method of analysis employed in the study. Poudel (2012) explored the various credit risk management indicators that affected banks' financial performance, he found that the most indicator affected the bank financial performance was the provision for bad debt. Ogboi and Unuafe (2013) concluded that bank's financial performance had been affected by sound credit risk management and capital adequacy. Abiola and Olausi (2014) revealed that banks' profitability had been affected by credit risk management. Idowu and Awoyemi (2014) revealed that credit risk management had an effect on the banks' profitability. Kodithuwakku (2015) showed that non-performing loans and provisions have an adverse impact on profitability of deposit money banks. The findings of the studies reviewed reveal diverse outcomes. The position of several scholars on the relationship between risk management and firm performance (profitability) differs. Based on the foregoing, the outcome of this study clarified the effect of risk management on profitability of Nigerian deposit money banks.

METHODOLOGY

The study was carried out on licenced deposit money banks in Nigeria. Eight out of the twenty two banks in Nigeria were selected using judgemental sampling technique which is a non- probability sampling method. The eight banks in consideration are First Bank of Nigeria, Guaranty Trust Bank, Access

Bank Plc, Zenith International Bank, Wema Bank of Nigeria, First City Monument Bank, Skye Bank and United Bank for Africa Plc. Data were collected from 2009 to 2014 based on the annual reports and accounts of the chosen banks. The researchers decided to start the study from 2009 because that was the year the ripples of global bank failure that started in America in 2008 were felt in Nigeria. It was in this year 2009 that the Central Bank of Nigeria took over some banks such as Afribank, Spring bank and Habib bank and their licences withdrawn, published list of debtors and risk management was again revisited in Nigerian banking industry. Annual profit, total asset, total equity, Tier 1 and Tier 2 capitals, weighted average asset, total debt, gross loan, non-performing loan (bad, impaired or lost) and others were extracted from the annual reports. The research used both descriptive statistics such as percentages, frequency and standard deviation and inferential statistics which are multiple regression and panel data to test the relationship between risk management and profitability. The dependent variable was profitability measured by Return on Asset (ROA) and Return on Equity (ROE) while the independent variables which were Capital Adequacy Ratio (Y_1), Cost per Loan ratio (Y_2), Loan loss provision to Non-Performing loan ratio (Y_3), Leverage ratio (Y_4), and Non-performing loan to Total loan ratio (Y_5) represented credit risk management indicators. Capital adequacy ratio was used because it is an important measure of the financial soundness of a bank. It is used by banks to determine the adequacy of their capital keeping in view their risk exposures. CAR of banks determines how well banks have enough cushions to absorb a reasonable amount of losses before they become insolvent and consequently lose depositors' funds. Cost per loan ratio measures the average cost per loan advanced to customers in monetary terms. The function of this is to point out efficiency in distributing loans to customers.

The following models represented the effect of credit risk management on financial performance as follows:

$$\textbf{ROA } (\mathbf{X_1}) = a_o + a_1Y_1 + a_2Y_2 + a_3Y_3 + a_4Y_4 + a_5Y_5 \qquad (1)$$

$$\textbf{ROE } (\mathbf{X_2}) = a_o + a_1Y_1 + a_2Y_2 + a_3Y_3 + a_4Y_4 + a_5Y_5 \qquad (2)$$

Results

The study examined the relationship between risk management and profitability of some Nigerian deposit money banks (DMB). Data obtained from

the annual reports and risk reports of eight deposit money banks in Nigeria for a period of six years giving a total of forty eight (48) observations were used for analysis. In addition, annual statements, journals, magazines, newspapers, periodicals, available literatures through the internet, Central Bank of Nigeria brief series, bullion magazines and many others were used. Simple descriptive statistics of percentages, mean and standard deviation were computed using pooled data regression. The data collected were analysed with panel data regression using the random effect model. The random effects model assumes the intercept is a random outcome variable, random effect is used where some omitted variables may be constant over time but vary between cases.

The research objective evaluated the relationship between credit risk management and profitability in selected deposit money banks in Nigeria. Table 1 gives a descriptive summary of Leverage ratio (LR), Non- performing loans (NPL), Return on Assets (ROA), Returns on Equity (ROE), Interest to Loan ratio and Loan Loss Provision of eight Nigerian banks covering a six-year period resulting in forty-eight observations.

Concerning the financial performance indicators, all the eight banks were profitable. The average ROA was 9% and the average value for ROE was 18% indicating that most of the Nigerian deposit money banks have a higher return on equity more than return on assets; ROA is averagely half of ROE. On average, Provision for facilities loss/Net facilities equals to 9% which means the banks make a general provision of 9% of their gross loan to cover unexpected losses from bad loans. General loan loss provisions are made in recognition of the fact that even performing credit facility harbors some risk of loss no matter how small while specific provisions are made on the basis of perceived risk of default on specific credit facilities. The Leverage ratio is 27% which means an average Nigerian bank has 27% debt financing for her business. The non-performing loan ratio, a measure to capture banks' credit risk shows a mean value of 78% implying that for every loan given out, 78% have either principal, interest or both outstanding.

Table 1: Descriptive Analysis Result of the Research Variables

	MIN	MAX	MEAN	STD.DEV	Observation
CAR	0.16844375	0.55503625	0.3169	0.1439	48
LEVRATIO	2.0796125	140.2806463	27.0650	55.9311	48
DLR	0.00669	2.7594	0.7841	1.14938	48
CICF	0.007	38.9500	8.060	15.76	48
LLNPL	0.012	46.2700	9.0460	18.56	48
CPL	0.044	29.9900	5.8210	12.12	48
CISTC	22.7515	73654.89	9356.37774	25981.34923	48
ROA	0.025574	0.227881	0.0960	0.0860	48
ROE	0.185488	9.044975	1.8690	3.5300	48

Source: Field report, (2016)

Table 2: Regression Output for Model 1 (Return on Asset)

ROA	Coefficient	Standard Error	t-Statistics	Probability(t)
CAR	0.02011805	1.42619	0.7450	0.3085
LEVRATIO	18.319873	0.0043605	-6.039	0.3570
DLR	-0.1451	1.313929388	0.7425	0.4699
CICF	0.086	2.439	0.2090	0.5740
LLNPL	3.219	0.23	-0.9070	0.7030
CPL	-0.112	2.191	-0.2310	0.5650
CONSTANT	0.270798	0.244154	2.3038	0.2489
R-Squared 0.56424		F-Statistic 4.526406		

Source: Field report, (2016)

CAPITAL ADEQUACY RATIO= 0.02
LEVERAGE RATIO= 18.32
DEFAULT LOAN RATION= -0.15
CREDIT INTEREST/CREDIT FACILITY= 0.09
LOAN LOSS PROVISION/NON PERFORMING LOAN= 3.22
COST PER LOAN= -0.11

Table 3: Regression Output for Model 2 (Return on Equity)

ROE	Coefficient	Standard Error	t-statistics	Probability(t)
CAR	-1.1156	1.23595	-0.1363	0.2646
LEVRATIO	0.013274	0.036083488	14.6963	0.2814
DLR	1.145179075	2.6098512	0.7600	0.3216
CICF	146.9	6.454	-4.6300	0.3360
LLNPL	-0.162	0.063	-8.0780	0.2740

CPL	16.66	16.66	6.5280	0.3740
CONSTANT	1.319102	1.319102	0.7538	0.4835
R-Squared 0.55324		F-Statistic 4.786802		

Source: Field report, (2016)

CAPITAL ADEQUACY RATIO= -1.12
LEVERAGE RATIO= 0.01
DEFAULT LOAN RATIO= 1.15
CREDIT INTEREST/CREDIT FACILITY RATION= 146.9
LOAN LOSS PROVISION/NON PERFORMING LOAN= -0.16
COST PER LOAN= 16.66

No.	Abbreviation	Description	Measurement
1.	CAR	The capital adequacy ratio. CAR is a ratio that measures the total capital of a bank articulated as a percentage of its risk weighted credit coverage. The total capital of a bank is divided into tier 1 and tier 2. The tier 1 capitals include share capital, share premium, other reserves and retained earnings while tier 2 includes revaluation reserves and other borrowings.	Tier 1 capital + Tier 2 capital/Risk weighted assets
2.	CPL	Average cost per loan advanced to customer in monetary terms. CPL is the average cost per loan advanced to customers in monetary terms. The function of this is to point out efficiency in distributing loans to customers.	Total Operating Cost/ Total Amount of Loans
3.	NPLR	Provision for facilities loss /Net facilities ratio. Percentage of provision for facilities lost out of net facilities.	Facilities Loss Provision/NFR
4.	LR	The leverage ratio. LR is the ratio of total debt to total equity	Total debt/total equity
5.	DR	Default Loans ratio. DR is a ratio that measures the proportion of non-performing loans as against the total loans for a period. It simply measures the efficiency of the loan portfolio management for a given bank within a given period.	Non-performing loans/Total loans to customers

6.	ROA	Return on assets. ROA is the ratio of net operating profit that a company earns from its business operations in a given period of time to the amount of the company's total asset	Net income/Total assets
7.	ROE	Return on equity. ROE measures the return on shareholders' investment in the bank.	Net income/Total equity

The empirical findings show that there is a negative effect of the credit risk indicators of Non- performing loans, cost of loan and gross loans ratio on profitability in agreement with Felix and Claudine (2008) who submitted from their findings that return on equity (ROE) and return on assets (ROA) both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. This is in contrast to Li and Zou (2014) who found that Non-performing loans/Gross loans have positive effects on the financial performance of banks, as measured by ROA and ROE. The findings also revealed a positive effect of Provision for Facilities loss/Net facilities ratio and the credit interest and credit facilities ratio on profitability in line with Boahene, Dasah and Agyei (2012) who found that some credit risk indicators have a positive effect on banks' financial performance.

CONCLUSION

The study examined the effect of credit risk management on the profitability of selected deposit money banks in Nigeria. From the findings it is concluded that banks with good or sound credit risk policies have lower loan default ratio (bad loan) and higher interest income (profitability). Banks with higher profit potentials can better absorb credit losses whenever they crop up and therefore record better performance. The study showed that there is a significant relationship between bank performance (in terms of profitability) and credit risk management (in terms of loan performance). Loans and advances and non-performing loans are major variables in determining the asset quality of a bank. These risk items are important in determining the profitability of banks in Nigeria. Where a bank does not effectively manage its risk, its profit will be unstable.

Credit risk management has positive effect on profitability in Nigerian DMB. Banks with sound risk management report better profit.

RECOMMENDATION

Management needs to be cautious in setting up a credit policy that will negatively affect profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits and maximization of profit. Improper credit risk management reduces bank profitability, affects the quality of its assets and increases loan losses and non-performing loan which may eventually lead to financial distress. Finally, strengthening the securities market will have a positive impact on the overall development of the banking sector by increasing competitiveness in the financial sector. When the range of portfolio selection is wide people can compare the return and security of their investment among the banks and the securities market operators. In view of the above conclusions, it is recommended that banks in Nigeria should enhance their skills in credit analysis and loan administration and managers of banks with high ratio of non-performing loans to total loans also have to improve their credit risk management policies in consideration of their role as agents of proprietors whose wealth are at stake with such ratio.

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