

## Effective Credit Processing and Administration as a Panacea for Non-performing Assets in the Nigerian Banking System

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**ABSTRACT** Lending remains one of the major functions of banks in all economies. In fact, interest charged on loans and advances today constitute a sizeable part of banks' earnings. However, the possibility of failure of loans creates nightmares for not only the borrower and lender, but also poses a serious setback to the economy. This paper identifies non-performing credit as a major threat to the profitability of banks in Nigeria. It reviews some of the past studies on the concepts of credit, evaluations of credit requests of customers and presents certain probing questions to which any prudent banker must find satisfactory answers before extending the credit facility. It emphasizes that bankers should embrace the new concept of credit rating/scoring recently enunciated by the Central Bank of Nigeria. The paper concludes that the amount of loan loss provisions is unacceptable as it jeopardizes the profitability of banks in the country. It therefore suggests that if the recommendations given are adopted, the myriads of non-performing assets would be reduced and this would pave way for increased profitability of the Nigerian deposit money banks.

### INTRODUCTION

Essentially, banks originally emerged as deposit takers. They eventually metamorphosed into intermediators of funds and thereby started assuming credit risk. Credit, thus, became the business of banking, and the primary basis on which a bank's quality and performance are judged.

Empirical studies of banking crises all over the world have shown that poor assets quality (predominantly loan) has been the most frequent factor in bank failures. Stuart (2005) emphasized that the spate of non-performing loans, is as high as 35%. Table 1 shows the ratio of non-performing credits (NPC), to total loans and advances (L and A) in Nigerian Commercial Banks between 1999 and 2009.

Umoh (1994) traced the rising non-performing loans' ratio in banks' books to poor loan processing, undue interference in the loan granting process, inadequate or absence of loan collat-

erals, among other things, which are all linked with poor and ineffective credit administration.

In essence this paper focuses on the concept of credit, evaluation of credit and recovery processes. The paper is divided into five sections, comprising the introduction, review of literature, evaluation and rating of credits, credit management and recovery and finally, conclusion and recommendations.

### REVIEW OF RELATED LITERATURE

#### The Concept of Credit

According to Onyeagocha (2001), the term credit is used specifically to refer to the faith placed by a creditor (lender) in a debtor (borrower) by extending a loan usually in the form of money, goods or securities to debtor. Essentially, when a loan is made, the lender is said to have extended credit to the borrower and he automatically accepts the credit of the borrower.

**Table 1: Asset quality in banks**

| Year   | Assets | Loans and advances | Non-performing credit (NPC)<br>(N billion) | NPC/LAA% | Loan loss provisions | Capital adequacy<br>(N billion) |
|--------|--------|--------------------|--------------------------------------------|----------|----------------------|---------------------------------|
| 2003   | 1184.0 | 485.0              | 101.0                                      | 21.0     | 64.5                 | 67.5                            |
| 2004   | 1748.0 | 652.0              | 109.0                                      | 17.0     | 85.0                 | 125.0                           |
| 2005   | 2031.0 | 789.0              | 126.0                                      | 16.0     | 94.2                 | 173.0                           |
| 2006   | 2479.0 | 929.0              | 187.0                                      | 20.1     | 138.8                | 237.3                           |
| 2007   | 2769.0 | 915.0              | 236.0                                      | 25.0     | 227.0                | 267.0                           |
| 2008-9 | 3415.0 | 1346.0             | 306.0                                      | 22.7     | 223.4                | 321.3                           |

Source: Banking Analysis System (BAS) and Returns from the banks (Adopted from CBN BULLION Vol. 29 NO.2 April - June 2005 p. 64)/Companies Reports BGL research.

Credit can therefore be defined as a transaction between two parties in which the creditor or lender supplies money, goods and services or securities in return for promised future payments by the debtor or borrower.

There are three major types of credit. These are commercial credit, consumer credit and investment credit.

Commercial credit can be bank credit such as overdraft, loans and advances; trade credit from suppliers; commercial papers (or note); invoice discounting; bill finance; hire purchase; factoring, etc.

Consumer credit is a kind of permission granted an individual or a household to purchase goods like refrigerator, television, car, electronic sets, which could not be paid for immediately but for which instalment payments are made over a period of time.

Investment credit allows a business concern such as corporate body, sole proprietorship or partnership to obtain credit for capital goods for expansion of factory or procurement of machinery.

The tenor of a loan varies from short to medium to long term depending on the institutions, nature and functions.

The importance of credit (and consequently the role of banks) in the economic growth and development of a country cannot be over-emphasized. The functions of credit are primarily two: it facilitates the transfer of capital or money to where it will be most effectively and efficiently used; and secondly, credit economizes the use of currency or coin money as granting of credit has a multiplier effect on the volume of currency or coin in circulation. Perhaps, we need to add here that the cost of credit (notably interest and discount rates) is one of the essential tools used to control and regulate money by the Central Bank of Nigeria through its monetary policy.

Despite the important role played by credit in economic and development growth of the country, it is associated with a catalogue of risks. According to Obalemo (2004), credit risk is an assumed risk that a borrower won't pay back the lender as agreed.

The various types of credit risks include management risk, geographical risk, business risk, financial risk and industrial risk. The probable occurrence of partial or total default requires a thorough risk assessment prior to granting of loans.

## Evaluation of Credit

The devastating effect of credit loss which is the aftermath of non-performing loans and advances makes sound evaluation of credit request paramount in all our banks. The Credit Officers of banks need to properly evaluate and articulate the projects, the customers and the prevailing economic situations.

Mather (1962) described three basic principles for evaluating credit as safety, suitability and profitability. In the first instance, safety of any advance or loan is of utmost importance. Banks must emphasize among other things, the character (honesty, integrity and reliability) of borrowers. The probability that the amount granted would be repaid from the cash flows generated from the operations of the company must as a matter of requirement be high.

The borrower must be able to provide acceptable security, which will serve as something to fall back on if the expected source of repayment fails.

Secondly, the bank should be satisfied with the suitability of a loan/advance. The purpose of the loan must be legal and non-conflicting with the economic and monetary policies of the government, Central Bank of Nigeria (CBN) guidelines and Banks and Other Financial Institutions Decree (BOFID). Certain ventures such as gambling, pool betting and speculative investment should be avoided while giving credit facilities to customers.

Also, profitability is a guiding force to any operation of the bank, including credit extension. As profit oriented institutions, banks necessarily expect their facilities to yield certain level of profits with which they can declare dividends to make shareholders happy. The interest charged on loans and advances constitutes a major source of income to the banks among others.

However, the enumerated principles of lending identified by Mather were discovered to be inadequate. There are some other factors which must be considered when granting loans and advances. The factors are usually described as 'the canons of lending' and according to Adekanye (1983) are presented in question forms as follows:

How much does the customer want to borrow?  
Why does the customer want bank finance or what does he want it for?  
How long does he want it?  
How does he intend to repay?

Is the customer's business financially strong enough to keep going if there is a setback?

What security can he offer?

What is your assessment of the customer?

Adekanye emphasized that the Manager must obtain satisfactory answers to those questions before agreeing to a loan request. This proposition also has its flaws as comprehensive credit ratings and credit management and recovery procedures which are the essential requirements of modern lending were not emphasized.

### **New Credit Rating/Scoring**

The inadequacies of the traditional approaches to loan processing with its attendant problems arising from repayment and recovery have been the concerns of banking professionals over time. This then calls for an approach that can take care of the inadequacies in the credit processing and administration procedures.

The CBN (2005) maintained that the credit framework of banks should be designed to serve as a tool for monitoring and controlling risk inherent in individual credits. The concept has been referred to as 'credit scoring' in some quarters.

Credit scoring is a statistical method used to predict the probability that a loan or an existing borrower will default or become delinquent (Loretta 1997). This model assigns scores for potential borrower by estimating the probability of default of their loans based on borrower and loan characteristic data (Myra 2000). Information on borrowers to be used are applicant's monthly income, outstanding debt, financial assets, duration on the job, lending history of the customer, collateral owned, type of bank accounts, among others. The aforesaid are potential factors that may relate to loan performance and they may be used in the scorecard. The non-establishment of a credit bureau has been a source of concern when it comes to good credit rating in Nigeria.

The account management structure and pricing of the advance must commensurate with the risk involved. There is going to be a cut-off score or grade below which any loan request will be approved.

Risk ratings should be assigned at the inception of lending and retrieved at least half-yearly and when adverse events occur (CBN 2005). However, whenever deterioration in risk is noted, the score assigned to a borrower facility should be immediately changed. The model does not

approve or reject application but rather takes a closer look.

### **CREDIT MANAGEMENT AND RECOVERY**

Every bank has to develop and implement comprehensive procedures and Information systems to follow up the condition of individual credits. An effective loan monitoring system according to Odufuye (2007) will include measures to:

- Monitor compliance with established covenants,
- Assess, where applicable, collateral coverage, relative to creditor's current condition,
- Identify contractual payment delinquencies and classify potential credits on a timely basis, and,
- Direct actions at solving problems promptly for remedial management.

Loan monitoring which is the work of the relationship manager in most cases is not a choice, but an imperative for effective and efficient credit administration in the banking sector. Problem loans can easily be spotted out. The banker's experience, knowledge of the customer's business and above all, faith in the customer can be a guide in taking a decision as to how far the customer can be supported before declaring the loan as bad.

In some occasions, the customer may be in need of more support. Any or a combination of the following strategies can then be employed:

- (a) Alteration or waiver of some of the terms and conditions of loan covenant in a way not to tamper with the bank's interest. However, this must be communicated to the credit department.
- (b) Issue of additional collateral security, if available.
- (c) Granting of additional funds, if borrower's circumstances and analysis require the need.
- (d) Extension of loan repayment period supported by fresh cash flow statement.

Regardless of genuine efforts of parties to a loan, default can still occur. The recovery of loans should be a prerogative of the Recovery Unit to ensure that appropriate recovery strategies are implemented. However, assistance may also be sought from Corporate Banking / Relationship Management.

The Recovery Unit must perform the following functions:

Determination of account action plan.

Pursuance of all alternatives to maximize recovery, including placing customers into receivership or liquidation as may be appropriate.

Ensuring that adequate and timely loan loss provisions are made based on actual and expected losses and,

Regular review of deteriorating loans.

It should be emphasized that after a loan has been classified as substandard, it should be assigned to a specific Account Manager in the Recovery Unit. The Account Manager serves as the primary customer contact during the recovery process. A number of methods exist for recovering debts owed by banks. Some of these, according to Ademmu (1998) are:

- (i) Appeals to debtors
- (ii) Threats and blackmail
- (iii) Legal action
- (iv) Use of debt-factoring companies
- (v) Invoice discounting
- (vi) Seizure and sale of collaterals
- (vii) Use of Nigerian Deposit Insurance Corporation's services

## CONCLUSION AND RECOMMENDATIONS

This paper identifies non-performing credit as the major threat to the profitability of banks in Nigeria. It is emphasized that bankers should embrace the new concept of credit rating/scoring recently enunciated by the Central Bank of Nigeria in order to improve their credit administration and management which will eventually increase their profitability.

It is no gainsaying that effective loan processing, good credit scoring, aggressive recovery are the foundation upon which the superstructure of sound banking system is built. Banks must therefore receive sufficient information to enable a detailed assessment of the true risk profile of the borrowers. The inexistence of a credit bureau, which engenders paucity of necessary information, has been the bane of the Nigerian banks' credit administration and management.

Effective credit administration will ensure:

The efficiency and effectiveness of credit operations including monitoring, good documentation of credit, contractual requirements, legal covenants and collaterals;  
The accuracy and of course, timeliness of information provided;  
Good management information systems;

Adequate segregation of duties;

Effective internal control over all "back office" procedures;

Religious compliance with the bank's management policies and procedures and where necessary laws and regulations in the system; and more importantly,

Sincerity and transparency of the bank's staff involved in the process of credit administration.

Reversal of the current trend of increasing non-performing loans as could be seen in table 1 shows that the amount of loan loss provisions rose from 64.5 billion in 1999 to 223.4 billion in the year 2004. This position is unacceptable as loan loss provisions continue to deplete the profit figures of the banks every year. If the above recommendations are implemented by the banks' credit analysts, it will lead to improvement in the profitability of the deposit money banks and reduce the spate of non-performing loans in Nigeria.

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