Credit Risk Management and Financial Performance of Banks in Nigeria (A Study of Zenith Bank Plc Akwa Ibom State)

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Abstract

In today's dynamic business environment, risk management and improvement of cash flows are very challenging. The study examined the effect of credit risk management on the financial performance of Zenith Bank Nigeria Plc Akwa Ibom State for the period of 2011-2020. Secondary data were sourced from annual reports and financial statement of Zenith Bank Nigeria Plc. The study employed ordinary least square regression technique in analyzing the data extracted with the aid of E-View Econometric tool. The R-squared which measures the overall goodness of fit of the regression shows the value of 84.5%, while the Durbin Waston statistic with value of 2.808450 shows that there is relative auto correlation among the considered variables and the overall regression is statistically significant. The result shows that risk control and risk diversification have significant positive effects on financial performance, while risk appraisal has a negative and insignificant effect on financial performance of Zenith bank Plc Akwa Ibom State. It was recommended that management of bank should ensure that credit officers adheres strictly to guidelines when issuing out credit facilities. The researcher conclude that credit risk management has a significant positive effect on the financial performance of Zenith Bank Nigeria Plc Akwa Ibom State.

Keywords: *Credit, Risk, Control, Appraisal, Diversification, Financial Performance*

Introduction

In today's dynamic business environment, Commercial Banks are one of the largest thriving institutions with branches and subsidiaries all over the world. According to Singh (2013) so many differentiations exists between these commercial banks which rests in the products and services that these banks offer. Catherine (2020) opine that commercial banks are the major financial intermediaries in any economy that operate payment mechanism and also the major providers of credits to the households and corporate sectors. These institutions deals with both retail and corporate customers, have well diversified deposit and lending book and generally offer a full range of financial services. Credit risk management is the process of managing the capital assets of banks and loan reserves. Credit risk itself means that payment may be delayed or ultimately not paid at all, which can in turn cause cash flow problems and affect banks liquidity. Credit risk management on both internal and external supervision requirements hinders the stability and performance of banks. The traditional activity of banks no doubt includes borrowing and lending money to allow business to operate and collect such fund back with interest (Poudel, 2012).

Accordingly, the main aim of credit risk management is to minimize bank's risk adjusted rate of return by maintaining credit risk exposure within acceptable boundary. A poor performing economy leaves people heavily caught up in debt and defaulting leading to bank failure, since credit is an immense component of the financial soundness of banks. Therefore, effective oversight of non-performing loans is imperative to boost bank performance and offer guidance on economic efficiency (Haneef et al, 2012). Credit management is crucial, as failure to have quality loans and credit-worthy customers' leads to an increase in default risk, which will strongly affect financial performance, growth and survival of banks (Kaplan, 2014).

One of the notable financial crises is credit risk, which has to be cautiously monitored and supervised so as to reduce default rate (Noomenand, 2018 in Catherine, 2020). General lack of a monitoring process on credit records, which includes not following up after banks give credit, and instability of governance are contributors of increased credit risk in banks. It is essential for any bank as a lender to continuously monitor the borrower's ability to repay the debt. The level to which a bank extends credit to the public for productive activities accelerates the pace of a nation's economic growth and its long-term sustainability and hence its profitability (Kaaya, 2013). However, credit risk management alleviates the effect of non-performing loans to circumvent collapse of banks, which could lead to lower economic growth and higher unemployment, which was approximately at 29% in Africa due to poor risk control and appraisal (Sujeewa, 2015). A well-structured banking system leads to a sound financial system which then results in an improved economy for the country. However, credit risk will continues to create problem in the Nigeria banking system, if credit risk is not controlled, effectively managed and monitored very well (Makriand, 2013 in Taofeek and Adeniyi, 2020).

Despite the stringent regulations put in place by the Central Bank of Nigeria and other regulatory bodies, the banking industry is still overwhelmed with high credit risk in the form of non-performing loans. The rate of non-performing loans had its peak of 37.3% in 2009 and had a low rate of 3.0% in 2014 and it has continue to increase to the rate of 11.4% in 2018 because banks inefficient risk control, appraisal and diversification (CBN, 2019). Though, strong credit appraisal puts the milestones for an effective management of credit risk and gives the firms a competitive advantage in the market place, credit management has often been a challenge to many Deposit Moneys Banks in Nigeria. Despite best practices measures in credit risk management put in place by the management of banks, customers still have strong tendencies to delay or completely stop repayment of their loan, which often lead to problem of poor financial performance. Extant literature reveals that credit risk management have tremendous effect on profitability particularly the work carried out by Gadzo et al (2019) ; Nwanna and Oguezue, (2017); Li and Zou (2014); and Dasah (2012) which all emphasized that credit risk management have significant relationship with profitability of deposit money banks.

Many previous researchers have focused on many of the Deposit Money Banks in Nigeria. This work focuses on just one commercial bank to fill an existing gap by studying a period of global economic recession from 2011-2020, the Covid-19 pandemic and unpleasant credit risk management consequences periods for banks, hence the need for this study.

The main objective of this study is to examine the effect of credit risk management on the financial performance of Zenith bank Nigeria plc Akwa Ibom State. The specific objectives are to:

1. ascertain the effect of risk control on the financial performance of Zenith bank Nigeria plc.
2. determine the effects of risk appraisal on the financial performance of Zenith bank Nigeria plc.
3. examine the effect of risk diversification on the financial performance of Zenith bank Nigeria plc.

Hypotheses

1. Risk control has no significant effect on the financial performance of Zenith bank Nigeria plc.
2. Risk appraisal has no significant effect on the financial performance of Zenith bank Nigeria plc.
3. Risk diversification has no significant effect on the financial performance of Zenith bank Nigeria plc.

Review of Related Literature

Conceptual Review

Credit Risk Management

Credit risk management in financial institutions has become crucial for the survival and growth of these institutions. It is a structured approach of uncertainty management through risk assessment, development of strategies to manage it and mitigation of risk using managerial resources (Krahnen, 2013). Credit management policies includes the establishment of formal, legitimate and legal procedures that maintains that the proper authorities are responsible for the award of credit and to ensure that the credit awarded goes to the right person and that the granted amount is used for the intended purposes with the aim of investing in productive ventures or for business which are economically or technically viable (Singh, 2013). Also, the policies include ensuring that the right amount of credit is granted, the credit granted is recoverable and ensuring that there is an adequate flow of information within and across the organization to credibly monitor the credit awarded (Ogboi, 2013).

The primary purpose of credit risk management is to maximize the risk-adjusted return rate of a bank by keeping an exposure of credit risk within acceptable parameters that leads to improvements in economic performance (CBN, 2019). Banks, therefore, need to manage the credit risk inherent in the entire portfolio as well as the uncertainty in individual credits or transactions. Financial institutions should also consider the relationships between credit risk and other risks as well as their impact on financial performance. Effective credit risk management is a key aspect of an integrated risk management strategy, which is crucial to a banking organization's long-term achievement as well as its economic results (Catherine, 2020).

Singh (2013) postulated that Banks like other financial institutions face a number of risks and hazards including credit risks, liquidity risks, operational risks, exchange rate risks, interest rate risks, political risks, and all other internal and external risks. However, credit risk is considered as the most common and dangerous risk especially for the banks that can put them into deep trouble and even, they may face bankruptcy. Banks need to manage the credit risk inherent in the entire portfolio as well as the risk in individual credits or transactions.

Risk Control Techniques and Financial Performance

Credit control is the system used by businesses to make sure that it gives credit only to customers who are able to pay, and that customers pay on time. Credit control is part of the financial controls that are employed by businesses particularly in manufacturing to ensure that once sales are made, they are realized as cash or liquid resources.

The institutional priorities, traditions and philosophies' surrounding lending or credit decisions play a more important role than ever in lending institutions (Dasah, 2012). Taking into consideration the complex and extensive nature of the banking business, it is essential to note that credit control embraces all the factors related to credit quality, credit extension, and recurrent cyclical patterns and sequences. Moreover, a disciplined and strong credit control represents the foundation of credit risk management since it guides all the credit and ending decisions (Catherine, 2020).

Risk Appraisal and Financial Performance

Credit risk appraisal according to Oduro et al (2019) is the process by which the lender assesses the credit worthiness of the borrower. Procedures of credit appraisal revolves around character, collateral capability and capacity. It takes into account various factors like income of the applicants, number of dependents, monthly expenditure, repayment capacity, employment history, number of years of service and other factors which affect credit rating of the borrower.

The assessment of the various risks that can impact on the repayment of loan is credit appraisal. Depending on the purpose of loan and the quantum, the appraisal process may be simple or elaborate. For small personal loans, credit scoring based on income, lifestyle and existing liabilities may suffice. But for project financing, the process comprises technical, commercial, marketing, financial, managerial appraisals as also implementation schedule and ability. The credit risk appraisal involves measures employed by banks to avoid or minimize the adverse effect of credit risk (Catherine, 2020).

Risk Diversification and Financial Performance

This involves spreading investments into a broader range of financial services or loans such as business, personal, credit cards, mortgage, auto and educational loans. Diversification reduces both upside and down side potential and allows for more consistent performance under a wide range of economic conditions. Diversification can be performed across products, industries and countries (Kaplan, 2014). Diversification strategy probably takes place, when accompany or business organizations introduce a new product in the market. In early 1960's and 1970's there is rapid growth in diversification of businesses. But with the passage of time it became difficult to manage much diversified activities of business organization. Even in recent years, it is quite hard for any business organization to operate in diversification mode because there are a lot of different requirements that must be taken into account by the business organization. Loan portfolio risk can be reduced with an effective credit review of applicants and selective asset backing.

Financial Performance

Financial performance is a subjective measure of how well a firm can use assets from its primary mode of business and generate revenues. The term is also used as a general measure of a firm's overall financial health over a given period of time, and can be used to compare similar firms across the same industry or to compare industries or sectors in aggregation. Financial performance is crucial for a commercial bank to attain its going concern issue, banks being at the center of financial sector can disrupt the entire economy if their inherent challenge and credit management is not handled properly (Dimitrios et al, 2016).

Financial performance refers to the measure of how well a bank can use assets from its primary mode of business and generate revenues. It is necessary to assess the economic health of a bank over some time to compare or compare comparable companies in the same sector or sectors in aggregation. In risk management, the financial performance of a firm is assessed by evaluating its profitability, liquidity, and capital adequacy (Kaaya, 2013). Singh (2013) defines performance in financial sector as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. In agreement with this, Gadzo et al (2019) assert that banks performance is measured by how efficient the enterprise is in use of resources in achieving its objectives.

Theoretical Review

The Credit Risk Theory

the credit risk theory was postulated by an American economist and a Noble Prize laureate, Robert C. Merton in 1974. Merton proposed a model for assessing the credit risk of a company by modeling equity as a call option on its assets. The risk is primarily that of the lender and includes lost principal and interest, disrupt loss may be complete or partial and can arise in a number of circumstances, such as an insolvent bank unable to return funds to a depositor.

The credit risk theory which emphasis that risk is primarily that of the lender and includes lost principal and interest, disrupt loss may be complete or partial and can arise in a number of circumstances, such as an insolvent bank unable to return funds to a depositor. To reduce the lenders risk, the lender may perform a credit check on the prospective borrower, may require the borrower to take appropriate insurance, such as mortgage insurance or seek security or guarantees of third parties. In general, the higher the risk, the higher will be the interest rate that the debtors will be asked to pay on the debt.

Portfolio Management Theory

Portfolio theory was propounded by Paul Bennett in 1999 with emphasis on how a lender can profitably add value using the comparative advantages to be gained from understanding its customers without becoming overly exposed to specific categories of credit risk. Portfolio management theory points to a strategy for successfully balancing the goals of creating valuable loan assets and avoiding excessive risk concentration.

The Portfolio theory however, emphasizes that a bank’s owners already can diversify their own risks to a large extent by spreading purchases over a large number of investments. Portfolio theory does not imply that a bank can neglect diversification, rather, it suggests that a bank should diversify strategically. Owners and investors will place a high value on the bank that exploits its comparative skill advantages to make profitable loans. At the same time, the bank requires sufficient diversification to avoid the types of risk concentrations that would seriously weaken its organization, franchise, and deposit base. Banking institutions requires in addition to an ability to identify profitable lending opportunities, a sound approach to measuring the risk of a loan portfolio as well as an effective means of managing that risk.

Empirical Review

Gadzo et al. (2019) assessed the effect of credit and operational risk on the financial performance of universal banks in the context of the structural equation model (SEM). Data were collected from all the 24 universal banks in Ghana without missing variables and using the PLSSEM, the results showed that credit risk influences financial performance negatively contrary to the empirical study but in line with the information asymmetry tenant of the lemon theory.

Oduro et al. (2019) identified the factors that determine the level of bank credit risk and further estimate the effects of bank credit risk on corporate financial performance using financial data from banks on the Ghana Stock Exchange over a 15-year period from 2003 to 2017. Using the method of 2SLS, it was observed variables such as capital adequacy, operating efficiency, profitability, and net interest margin are inversely related to credit risk.

Taofeek and Adeniyi (2020) study was aimed at establishing the relationship between the credit management and financial performance in financial institutions in Nigeria. Correlation and Regression analyses were used to estimate the causal relationships between credit management and financial performance and other related variables. The results of the analyses revealed that when a company implements effective credit management systems, the firm's efficiency is enhanced.

Patrick (2020) examined Credit management, credit policy and financial performance of commercial banks In Uganda. The study used universal sampling techniques, where all banks licensed and operational in Uganda were selected, multiple regressions was used. The findings indicated a significant relationship (r=0.639) between credit management credit policy and financial performance of commercial banks in Uganda.

Methodology

The research used secondary data obtained from the annual reports and audited financial accounts of Zenith Nigeria Plc from (2011-2020). Ordinary least square regression analysis was carried out on data collected. Also, descriptive statistics and correlation test were equally conducted to establish the effect of credit risk management on the financial performance of the bank under review.

Model Specification and Variable Definition

The independent variable is credit risk management proxy with risk control, risk appraisal and risk diversification. While the dependent variable was financial performance proxy with return on assets.

Variable	**Measurement**
Risk Control	Obtain from credit control+ financial statements
Risk Appraisal	Collaterals +repayments
Risk Diversification	Profit before tax+investment/net charge-offs
Return on Assets	Profit after Tax/Total assets X by 100

Source: Researcher Computation, (2024).

Model Specification

ROA= α0+αRKScn+RKSapp+RKSdv+ε

Where:

ROA: Return on Assets

α0: Constant

LA: Risk Control

NPL: Risk Appraisal

LLP: Risk Diversification

ε: Error Term.

Result and Discussion

Descriptive Statistics

Table 1

	ROA	RKScn	RSKapp	RSKdv
Mean	1.123	8192.19	494.408	513.9625
Median	2	7974.7	180.525	277.95
Maximum	4.29	13222.7	2922.8	1977.5
Minimum	-9.28	2524.3	123.56	160.9
Std. Dev.	3.849087	3065.887	860.616	557.3036
Skewness	-2.191428	-0.2133	2.584745	2.082258
Kurtosis	6.683963	2.697704	7.845285	5.956769
Jarque-Bera	13.65875	0.113901	20.91684	10.86903
Probability	0.001082	0.944641	0.000029	0.004363

Sum	11.23	81921.9	4944.08	5139.625
Sum Sq. Dev.	133.3392	84596993	6665939	2795286
Observations	**10**	**10**	**10**	**10**

Source: E-view Output (2024)

Table 1 above presents the various descriptive statistics and distribution of the independent and dependent variables used in the study. It shows that financial performance which was represented by return on assets had a mean of 1.123 with a standard deviation of 3.849087. The mean values and standard deviation of the independent variables shows the extent of the relationship return on assets had on the independent variables.

Regression results of the equation:

ROA= α0+αRKScn+RKSapp+RKSdv+ε

Table 2

Dependent Variable: ROA
Method: Least Squares

Included observations: 10

Variable	Coefficient	Std. Error	t-Statistic	Prob.
C	-0.312652	1.783331	-0.175319	0.8666
RSKcn	0.000495	0.000213	2.319712	0.0595
RSKapp	-0.014518	0.002706	-5.365131	0.0017
RSKdv	0.009800	0.001731	5.662811	0.0013

R-squared	0.845179	Mean dependent var	1.123000
Adjusted R-squared	0.767769	S.D. dependent var	3.849087
S.E. of regression	1.854888	Akaike info criterion	4.362700
Sum squared resid	20.64366	Schwarz criterion	4.483734

Log likelihood	-17.81350	Hannan-Quinn criter.	4.229926
F-statistic	10.91818	Durbin-Watson stat	2.808450
Prob(F-statistic)	0.007631		

Source: E-view Output (2024)

Table 2 above, R-squared show that 84.5% of the variations in financial performance as proxy by (ROA) can be attributed to explanatory variables (RSKcn, RSKapp, and RSKdv), While the remaining 15.5% variations in the respective dependent variable were caused by other factors not included in the model. Durbin-Watson statistics stands at 2.808450 which signify that there is though evidence of autocorrelation detected in the sample data for the study.

Also, from the result of the analysis presented in Table 2, Risk control (RSKcn) has a significant positive effect on financial performance (ROA). This is shown by a regression coefficient of 0.000495 statistically significant at 5%. This indicates that risk control and management helps to increase the financial performance of Zenith Bank. Risk appraisal (RSKapp) has a negative effect on financial performance (ROA) as indicated by a coefficient result of -0.014518 at 1% level. This implies that increase in risk appraisal is detrimental to Zenith Bank financial performance (ROA).

Risk diversification (RSKdv) has a positive significant effect on financial performance (ROA). This is indicated by a regression coefficient of 0.009800. The effect is statistically significant at 1%. This means that the increase in risk diversification brings about increased financial performance.

Test of Hypotheses

Table3. Summary of regression result

Variables	Coefficients	P-value	DecisionRule	Conclusion
Risk Control	0.000495	0.0595	P-value≤0.05	Significant
Risk Appraisal	-0.014518	0.0017	P-value<0.05	Significant
Risk Diversification	0.009800	0.0013	P-value<0.05	Significant

Risk control has a positive coefficient of 0.000495 showing a significant positive effect on financial performance (ROA).The result showed consistency with the earlier findings of Singh (2013).Risk appraisal has a negative coefficient of -0.014518 indicating a negative relationship with financial performance of the bank under review. The finding is in line with prior findings of Aduda (2011) Risk diversification has a positive coefficient of 0.009800, showing a significant positive effect on financial performance. The finding is in disagreement with result of Poudel

(2012). However, the result aligns with the findings of Catherine (2020) who finds that risk diversification has positive and significant relationship with banks financial performance.

Research Findings

Based on analysis and interpretation carried out, this study note the following finding:

1. Risk Control (RSKcn) has a significant positive effect on Return on Asset (ROA).
2. Risk Appraisal (RSKapp) has a negative effect on Return on Asset (ROA.
3. Risk Diversification (RSKdv) has a significant positive effect on Return on Asset (ROA).

Recommendations

In view of the findings, it was therefore recommended that:

1. Management of banks should ensure that credit officers adheres strictly to guidelines when issuing out credit facilities.
2. Zenith Bank Nigeria Plc should ensure they apply effective measures in measuring and monitoring of credit for effective controls over credit risk.
3. Banks should put in place sound credit management policies to guide against wrong diversification practices.

Conclusions

This study examines the effect of credit risk management on the financial performance of Zenith Bank Nigeria Plc and as a result the following conclusions were reached based on the findings of the study:

1. Risk control (RSKcn) has a positive effect on Return on Asset (ROA)
2. Risk appraisal (RSKapp) has a negative effect on Return on Asset (ROA), with significant effect to Risk appraisal on financial performance.
3. Risk diversification (RSKdv) has a positive effect on Return on Asset (ROA) with significant effect of Risk diversification on financial performance.

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