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Credit Risk Management Strategies of Deposit Money Banks on Loan Facilities

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Abstract

The collapse of many banks is due to poor management of credit facilities. The objectives of this study are to investigate loan supervision and monitoring as a strategy for effective credit risk management.The design for the study was a survey design.The targeted population of this study comprises of all thestaff of the 5 top Deposit Money Bank operating in Nigeria. This study revealed that loan supervisor and monitoringare strategic tool for effective credit risk management, also, collateral security is a strategic tool to effective credit risk management. Arisen from the findings of this study, the study recommended that banks should ensure their credit risk management strategy is effective and for every new product (in form of loan) introduced, there should be efficient loan supervisor and monitoring, and banks should ensure that no loan is granted without corresponding collaterals, because, collateral security is a robust strategic tool to effective credit risk management.

Keywords: ***Credit Risk Management Strategies, Collateral, Deposit Money Banks, LoanFacilities***

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I. INTRODUCTION

Deposit money Banks today are the largest financial institutions around the world, with branches and subsidiaries throughout the world. These banks offer different products and services to the public, and because of their high liquidity, these intermediary operations are quite risky. Therefore, the banks are faced with diverse risks in the course of carrying out their operations. In view of the risks inherent in bank lending and the need to minimize or contain the risk (since they cannot be avoided entirely), and in view of the need for liquidity and profitability consistence with safety and regulatory constraints, the central issue in managing the lending portfolio is balancing the potential risk with returns. This involves effective credit risk management strategies and credit analysis. The borrower's ability to repay the loan has to be determined, the borrower capacity and capital have to be assessed (Nwankwo, 2010). Banks are corporate bodies; they have the following objectives which are; profit maximization, maximization of owners' wealth, corporate social responsibility Loans and advance constitute the major source of operating income of banks as the act as the most profitable asset for employment of bank fund. As much as banks generates income through interest accruable to those facilities, the also run the risk of losing both the interest and principal if the credit risk management strategies employed are weak.

Credit risk management strategies on the other hand, is one of the most important and challenging functions of all banks. It is the act of managing debtors who might have received services from banks in exchange for promise of repayment in future. Credit risk management strategies is faced with credit risk which is the most significant risk faced by banks. The success of their business depends on accurate credit risk management

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strategies and efficient management of this risk to a greater extent than any other risk (Giesecke, 2004). Credit risk is critical since the default of a small number of important customers can generate large loses, which can lead to insolvency (Kargi,2011).

In the history of development of the Nigerian banking industry, it can be seen that most of the failures experienced in the industry prior to the consolidation era were as a results of imprudent lending Poor credit risk management strategy that finally led to bad loans and some other unethical factors (Job, Ogundepo&Olanirul 2008). Also, the problem of poor attention given to distribution of loans has its effect on the bank's performance. Most customers collected loan from the banks and diverted the money to unprofitable ventures. Some banks are not actually considering the necessary criteria for disbursement of loans to customer this is as a result of failure of banks to make use of trained qualified and experienced personnel in their credit risk management department. To address this challenge, it imperative for banks to inculcate certain modalities and strategy in credit risk management this include the supervision and monitoring of loan, technology applications, strict adherence to collateral security as back up in case of default from customers.

The objectives of this study are toinvestigate loan supervision and monitoring as a strategy for effective credit risk management.

II. REVIEW OF RELATED LITERATURE

According to Kithinji (2017), 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 debtors. 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. 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 to 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 factoring or procurement of machinery. The tenor of a loan varies from short to medium, role to long-term depending on the institution, 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-emphasize. 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 (notable interest and discount rate) is one of essential tools to be used to control and regulate money by the central bank of Nigeria through the monetary policy despite the important role played by credit in the economy, it is associated with a catalogue of risks (Odufuye, 2007).

According to Obalemo (2018), 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 through risk assessment prior to granting of loans.

Credit risk management covers the process of monitoring the uses of credit funds until they are fully repaid to the lending bank. According to

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Onyiriuba, 2009),credit is the right to receive payment on demand or the obligation to make payment on demand or at a future time on account of the immediate transfer of goods or money. This is generally based upon the confidence which the creditor reposes on the ability to pay, the right to receive payment and the obligation to make payment originate simultaneously in credit transaction. Attah, further stated that granting credit to customers is a noble objective since both parties stand to benefit from such transaction. However, the issues of faithfulness and unassessed investment risk have made the otherwise good relationship to become something worrisome.

Considering different types of bank credit loan and advances:

i) Overdrafts: These are the most common and simplest forms of credit facilities. They are usually granted for working capital purposes and the amount outstanding is expected to fluctuate over the life of the facilities, depending on the borrower's working capital financing needs, at any material time. Overdrafts permit the borrower to use those amounts required on a day-to-day basis, thus saving unnecessary interest charges. In accordance with general banking practice, overdrafts are repayable on demand and can be cancelled at the banks option without prior notice to the borrower. The overdraft limit is usually communicated to the customer and this limit serves as the banks reference point in all drawings by the beneficiary.

ii) **Advances**: An advance is a short-term credit which is granted for a definite period, usually between 30 and 180 days. They are usually granted for specific purposes, for example, payment of various collections, refinancing of maturing loans, project bridging finance, refinancing of letters of credit for project equipment imported etc. The exact maturity date of an advance is normally determined at the onset and this makes it possible for the project to have a lower interest charge on the advance due to the reduced risk (money rate and credit risk). Short-term loans are also used in financing seasonal increases in working capital and also in temporary accommodations of a project capital expenditure needs, and other long-term commitments, pending final negotiation of long-term loan. Most times, short term loans are usually renewed at maturity. Banks predominantly extend substantial amounts of short-term loans to farming, manufacturing, small-scale project etc. Short-term loans may be secured or unsecured. Banks extend secured loans to borrowers who have a high debt/equity ratio, or projects that have not established a record of satisfactory performance and stable earnings or generated enough sales revenue in relation to their capital.

iii) **Medium- Term Loans**: These constitute important sources of intermediate funds for projects and businesses. Medium-term loans are usually granted for specific purposes such as investments, equipment financing, housing, share acquisitions, agricultural financing, construction etc. A medium-terms loan is a facility with an original maturity of more than one year or a loan granted under a formal agreement (revolving credit or credits) on which the original maturity of the commitment is in excess of one year. Medium-term loans have maturities of between 1 and 5 years. They are negotiated between a borrower and a lender and are most prevalent in industrial projects characterized by heavy fixed capital requirements. Most of the loans however are made to small projects and businesses which rely on these sources, due to their limited access to the capital market. Medium-term loans provide flexibility for the user and are amortized in fixed instalments on a monthly, quarterly, semi-annual or even annual basis, as the case may be. The interest rates on this type of loan amongst other factors depend on the general level of interest rates prevailing in the market, the amount and maturity of the loan and the credit standing of the borrower. Generally, the interest rates are higher than in ordinary advances or short-term loans due to higher money and credit risks and the fact that it is less liquid. Medium-term loans are usually supported by a loan agreement between the bank and the borrower.

Loans are classified as:

i)Substandard: A loan in this category is inadequately protected by the current worth and paying capacity of the obligor or of the collateral pledged, if any. A credit so classified must have a well-defined weakness or weaknesses that jeopardize the liquidation of the debt. It is characterized by the distinct possibility that the bank will sustain some loss if the deficiencies are not corrected.Furthermore, Repayment of this category of loans are stopped or irregular but has reasonable prospect of improvement.

ii)Doubtful: A loan in this category has all the weaknesses inherent in one classified as substandard with the added characteristic that the weakness makes collection or liquidation in full on the basis of currently known facts, conditions and values highly questionable and improbable.Also, repayment is unlikely repaid but special collection efforts may result in partial recover.

iii) Loss\bad: A loans classified loss is considered uncollectible and of such little value that its continuance as a bankable asset is NOT warrantee. This does not mean that the loan has absolutely no recovery potential or salvage value. However, it is not practical to defer writing off this asset, even though partial recovery may be affected in the future.

Credit risk management greatly influences or prevent the failure of a bank. This is because the failure of a bank is influenced to a large extent by the quality of credit decisions and thus the quality of the risk assets. Credit risk management provides a leading indicator of the quality of banks credit portfolio (McNaugton, 1994). The key element in an effective credit risk management includes are Well-developed credit policy framework and procedures, Strong portfolio management Effective credit controls and Well-trained human resource to implement system. Bank management must conduct a market definition as a starting point in credit risk management. This also includes the determination of the target markets. The credit policies are a necessary guide for the determination of the target market, and customers, and define the acceptable and unacceptable risks.

A. Securities for Bank Credit

Securities are usually described as a „second way out" for bank lending. Banks usually realize the securities if the customer fails or is unable to repay his loan. A security also enables the bank to exert a better control on his customers financial commitments. Taking adequate security infuses activity Responsibility on the borrower. A collateral security is defined as "some right or interest in a property given to a creditor by a debtor so that in the event of the debtor failing to pay his dents as at when due, the creditor may reimburse himself for the debt out of the property charged". Securities are also defined in the widest sense by the Union Bank of Switzerland as "documents giving title to property or claims on income which may be lodged, e.g., as securities for bank loan" it goes further to say that securities may take the form of a pledge of securities, as assignment, a guarantee, a surety, or real or personal collaterals. Four types of securities for bank lending are easily discernible (Abiola &Olausi 2014).

B. Causes of Bad and Doubtful Debts

Bad and doubtful debts are part of inherent risks in bank lending. Bad and doubtful debt is usually associated with the total loss of both interest and capital (principal amount of loan). Olashore (2014) summarized the causal factors thus:

(i) Lack of proper appraisal of the customers need; credit worthiness and business experience.
(ii) Indiscriminate acceptance of securities as collateral for credit facilities without regard to their suitability, worth and the ease of realization, in cause of need
(iii) Failure to obtain and review periodically the financial statements of borrowing customers and determine the conduct and volume of their business.
(iv) Absence of information on credit records and other commitment of borrowing customers.
(v) Excessive zeal on the part of borrowing customers to expand their businesses beyond their capacity, considering various other factors.

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(vi) The conscious actions of unscrupulous customers to defraud the bank.
(vii) The usual vicissitudes of business life.
(viii) Failure of bank officials to observe the banks own credit policy"

The above causal factors could be expanded further to include the following:

(a) Natural phenomena
(b) Changes in government policy (political instability
(c) Bad management (by the customer)
(d) Sudden change in fashion (resulting in change in consumer preference and change in technology, which all lead to loss of business for customer)

C. Loan Supervision and Monitoring

Loan supervision and loan monitoring is a very vital function in credit risk management it is prudent for the lending bank to continuously assess the borrowers use of the credit facility together with the performance of the business of the customer.This will prevent abrupt or sudden collapse of the customers business making him able to repay the loan.Most collapse show warning signs which only an alert banker could spot before things get worse. A verity of unexpected happenings could develop and the lending banker should be quick to spot those in other to take the necessary actions.It is possible for the lending bank to salvage a customer's deteriorating situation by timely advice and action.This tends to improve the repayment of credit by customers (Adekenye, 2011).

D. Moral Hazard Theory

The moral hazard problem implies that a borrower has the incentive to default unless there are consequences for his future applications for credit. This result from the difficulty lenders have in assessing the level of wealth borrowers will have accumulated by the date on which the debt must be repaid, and not at the moment of application. If lenders cannot assess the borrowers' wealth, the latter will be tempted to default on the borrowing. Forestalling this, lenders will increase rates, leading eventually to the breakdown of the marketAhmadu, Takeda & Shawn. 2018).

Abiola and Olausi (2014) have investigated the impact of credit risk management on the performance of commercial banks in Nigeria. Financial reports of seven deposit money banksfirms were used to analyze for seven years (2005–2011). Panel regression model was employed for the estimation of the model. In the model, return on equity (ROE) and return on assets (ROA) were used as the performance indicators while non-performing loans (NPL) and capital adequacy ratio (CAR) as credit risk management indicators. The study revealed that credit risk management has a significant impact on the profitability of deposit money banks in Nigeria.

Kargi, (2011) has analyzed the impact of poor credit risk management on the performance of the deposit money in Sri Lanka by using both primary and secondary data. The return on assets (ROA) is used as performance indicator and loan provision to total loan (LP/TL), loan provision to non-performing loans (LP/NPL), loan provision to total assets (LP/TA) and non-performing loans/ total loans (NPL/TL) were used as indicators of poor credit risk management. The result shows that non-performing loans and provisions have an adverse impact on the profitability.

Fredrick (2012) has analyzed the impact of credit risk management on the financial performance of commercial banks in Kenya. The study has used CAMEL model as a proxy for credit risk management. The author found that the strong impact of CAMEL (credit risk components) on the financial performance of commercial banks. Paudel (2012) has examined the impact of credit risk management on the financial performance of commercial banks in Nepal using the financial report of 31 banks for eleven years (2001-2011). The methods of data analysis in the study were descriptive, correlation and multiple regressions. The financial performance indicator used in the study was return on assets (ROA). The predictors of the banks‟ financial performance used in the study were: default rate, cost per loan assets and capital adequacy ratio. The author asserts that all these parameters have an inverse impact on banks' financial performance. However, among the risk management indicators, default rate (NPLR) is the

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single most influencing predictor of bank financial performance in Nepal whereas cost per loan assets is not significant predictors of bank performance. The author concludes that credit risk management is crucial on the bank performance since it have a significant relationship with bank performance.

III. METHODOLOGY

The design for the study was a survey design. As regards to this work, the targeted population of this study comprises of all thestaff of the 5 top Deposit Money Bank operating in Nigeria(Zenith Bank; Guaranty Trust Bank; First Bank of Nigeria; Ecobank Nigeria; and Access Bank). Population was drawn from each bank with a branch in Lagos state, making a total 460 respondents.

Using Krejcie and Morgan sample size determination, A total of 106 respondents were determined,and copies of questionnaire were distributed to the 97 respondents of different insurance firmswhich were filled and returned and are valid for this study.

For the purpose of this research work, the hypotheses were tested using the regressions, the statistical tool will be employed in analysing the collected data and this will be done via the Statistical Package for Social Sciences SPSS, 25.0 version).

IV. DATA ANALYSIS

TABLE 1
Descriptive Statistics and Correlation

Variables	N	Mean	Std Dv.	kew ness	Kur tosis	1	2	3
loan supervisor and monitoring	86	27.51	3.78	.31	-.13	1.0		
Collateral security	86	31.38	4.08	.11	-.38	.21	1.00	
credit risk management	86	21.20	3.52	-.45	-.38	.25	.01	1.0

Source: fieldwork (2020)

From the above descriptive statistics, the independent variables result shows that the mean value for collateral security has31.3800 which is higher than the mean of the other independent variables. The descriptive analysis also shows that loan supervisor and monitoringhave a mean value of 27.5050 which is lower than the mean value of collateral security. This simply means that collateral security is a more efficient and effective strategic tools for credit risk management.

Multicollinearity

Multicollinearity is a dilemma that happens when the independents variables are extremely interrelated to as high as 0.9 and above (Eze&Agbo, 2005). As soon as two or more constructs are excessively interrelated, they enclose unnecessary information, and for that reason, not all of them are required in the same analysis, since they enhance or increase the size of error terms, and weaken the analysis. If the multicollinearity problem is detected, it can be resolved by deleting the offending variables(s). To screen for multicollinearity, Variance Inflation Factor (VIF) and tolerance level were examined via regression results from the SPSS.

The general rule of the cut-off points is that the VIF and the tolerance values should not exceed 10 and not be less than 0.10. From the Table 2, it clearly shows that tolerance ranges between 0.812 – 0.822 significantly > 0.10 and less than 10. Similarly, VIF ranges from 1.005– 1.013, and, thus, is good enough as being < 10 (Eze&Agbo, 2005). Consequently, it is concluded that there is no multicollinearity problem among the variables.

Table 2
***Collinearity Statistics* - Multicollinerity Test based on Tolerance Values and VIF**

Variables	VIF	Tolerance
loan supervisor and Monitoring	.791	1.002
Collateral security	.824	1.004

Source: field survey 2020.

A. Hypothesis One

H_{01}: Loan supervisor and monitoring does not have a significant effect on credit risk management.

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Table 3
Model Summary [b] for Hypothesis One

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.727[a]	.693	.689	1.15526

a. Predictors: (Constant), Loan supervisor and monitoring
b. Dependent Variable: Credit risk management

Table 4
Coefficients[a] for Hypothesis One

Model	Unstandardized Coefficients		Standardized Coefficients	t	Sig.
	B	Std. Error	Beta		
(Constant)	1.216	.152		7.978	.000
Loan supervisor and monitoring	.483	.044	.490	11.063	.000

a. Dependent Variable: Loan supervisor and monitoring

Table 3 shows the result of the relationship between Credit risk managementand loan supervisor and monitoring of Banks. The coefficient of determination (r^2= 0.727) shows that there is about 72% relationship between Credit risk managementand loan supervisor and monitoring.

The value of the intercept 1.216 is the predicted value of Credit risk managementif the independent variable is equal to zero. Loan supervisor and monitoring has a coefficient value of β_1= .483, t-test = 11.063 and P-value of 0.000. The value indicated that a positive and significant relationship exist between Credit risk managementand loan supervisor and monitoring of Banks. This means that loan supervisor and monitoring is a strategic tool for effective credit risk management

Since the P-value is less than 0.05 (that is, 0.05 >0.000), we reject the null hypothesis. Therefore, loan supervisor and monitoringare strategic tool for effective credit risk management.

B. Hypothesis Two

H_{02}: Collateral security is not a strategic tool to effective credit risk management.

Table 5
Model Summary for Hypothesis Two

Model	R	R Square	Adjusted RSquare	Std. Error of the Estimate
1	.747[a]	.627	.621	1.36277

a. Predictors: (Constant), Collateral security

Table 6
Coefficients[a] for Hypothesis Two

Model	Unstandardized Coefficients		StandardizedCoefficients	t	Sig.
	B	Std. Error	Beta		
1 (Constant)	1.592	.147		10.864	.000
Loan supervisor and monitoring	.451	.043	.470	10.476	.000

a. Dependent Variable: banks' Collateral security

R Square explain the relationship between variables. As shown in the model summary (table 5), the relationship between rate of Credit risk managementand Collateral security is about 63%. R being the determinant of correlation explains the extent to which increase in Collateral security by Banks could explain the increase in Credit risk managementof Banks.

The p value (0.000) < 0.05, the null hypothesis is rejected and conclude thatCollateral security is a strategic tool to effective credit risk management.

C. DISCUSSION OF FINDINGS

This study reveals that loan supervisor and monitoring has significant effect on credit risk management, Collateral security is a more strategic tool to effective credit risk management.

Findings of this study is in line with the study carried out by Abiola and Olausi (2014) who investigated the impact of credit risk management on the performance of commercial banks in Nigeria. Financial reports of seven deposit money banksfirms were used to analyze for seven years (2005–2011). Panel regression model was employed for the estimation of the model. In the model, return on equity (ROE) and return on assets

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(ROA) were used as the performance indicators while non-performing loans (NPL) and capital adequacy ratio (CAR) as credit risk management indicators. The study revealed that credit risk management has a significant impact on the profitability of deposit money banks in Nigeria.

Findings of this study is in line with the study carried out by Kodithuwakku (2015) who analyzed the impact of poor credit risk management on the performance of the deposit money in Sri Lanka by using both primary and secondary data. The return on assets (ROA) is used as performance indicator and loan provision to total loan (LP/TL), loan provision to non-performing loans (LP/NPL), loan provision to total assets (LP/TA) and non-performing loans/ total loans (NPL/TL) were used as indicators of poor credit risk management. The result shows that non-performing loans and provisions have an adverse impact on the profitability.

Findings of this study is in line with the study carried out by Fredrick (2012) whoanalyzed the impact of credit risk management on the financial performance of commercial banks in Kenya. The study has used CAMEL model as a proxy for credit risk management. The author found that the strong impact of CAMEL (credit risk components) on the financial performance of commercial banks. Paudel (2012) has examined the impact of credit risk management on the financial performance of commercial banks in Nepal using the financial report of 31 banks for eleven years (2001-2011). The methods of data analysis in the study were descriptive, correlation and multiple regressions. The financial performance indicator used in the study was return on assets (ROA). The predictors of the banks‟ financial performance used in the study were: default rate, cost per loan assets and capital adequacy ratio. The author asserts that all these parameters have an inverse impact on banks' financial performance. However, among the risk management indicators, default rate (NPLR) is the single most influencing predictor of bank financial performance in Nepal whereas cost per loan assets is not significant predictors of bank performance. The author concludes that credit risk management is crucial on the bank performance since it have a significant relationship with bank performance.

CONCLUSION

In conclusion, the more the supervisor, monitoring of loan and collateral security, the more credit risk management is enhanced.

RECOMMENDATIONS

Arisen from the findings of this study, the following recommendations were made:

1. Banks should ensure their credit risk management strategy is effective and for every new product (in form of loan) introduced, there should be efficient loan supervisor and monitoring.
2. Banks should ensure that no loan is granted without corresponding collaterals, because, collateral security is a robust strategic tool to effective credit risk management.

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