

# Prime Lending Rates and the Performance of Microfinance Banks in Nigeria

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## Abstract

This paper sets out to examine the relationships between the prime lending rate and performance of microfinance banks in Nigeria. Variables such as, total asset, total loan obtained, deposits, shareholders fund, were used to measure the performance of microfinance banks in Nigeria. Data were obtained from the Central Bank of Nigeria statistical bulletin (CBN, 2011) and analyzed using regression aided by SPSS software. Evidence showed lending rate as a weak determinant of microfinance banks' performance. High lending rate reduces capacity to obtain loans and advances since it constraint their access to credit facilities from big banks and other financial institutions. Therefore, there is need to reiterate credit mobilization, source long-term bank funding, and canvass for fund from big banks.

**Keywords:** Lending rate, Microfinance banks, Commercial bank, Small Scale Enterprises

## 1. Introduction

In the early 1900s, informal financial institutions like esusu (Yoruba), adashi (Hausa) were predominant as the rotating savings and credit association in Nigeria. In 1936, government in support of the cooperatives promulgated the cooperative society's ordinance. This made the cooperatives have regular/compulsory savings as one of their goals while thrift and credit societies combined regular savings of members with lending. In Eastern Nigeria, in the 1940s a large number of all cooperatives were established on the basis of pre-existing isusu (Igbo) of which had previously evolved from rotating to non rotating association with permanent loan funds. By 1950s, majority of informal financial institutions had transformed into registered cooperatives while others degenerated into notorious money lender controlled racket. Community Banks were created in 1990 for the provision of non-sophisticated loans to the community. It later metamorphosed into Microfinance Banks (MFBs) in 2005 by the Central Bank of Nigeria (CBN) policy. The policy mandated all community banks to convert to MFBs under a new capital base of ₦20 Million with a deadline for compliance in December, 2007. Since Nigeria's participation in the international conference on microfinance in 2000, some economic reforms which directly or indirectly impact microfinance banks have been undertaken and part of the policy provides for the setting up of private sector driven microfinance banks to provide financial services to the poor and low income groups. The main target of the policy is to increase the share of micro credit as percentage of GDP from 0.2% in 2005 to at least 5% in 2020 and to increase the number of linkages among universal banks, developed banks, specialized finance institutions and microfinance banks by 10% annually.

Microfinance banks (MFBs) are created to assist the poor to grow their businesses, but inadequate funding to perform this function have been the major challenge. This funding is not available at the moment and that is why many of them are on the verge of fading away (Akinlade, 2013). Commercial Banks (CBs) traditionally lend to medium and large enterprises which are judged to be creditworthy but because the interest rate on treasury bills is high, Commercial banks (CBs) are now encouraged to invest their loanable funds in treasury bills therefore making access to loanable funds less available to micro and medium enterprises including microfinance banks. This saddles the MFBs with the increased burden of having to mobilize more deposits from the grassroots in order to effectively play their economic role of providing credit facilities to small enterprises due to little access to needed credit for growth from the Commercial Banks.

### 1.1 The Prime Lending Rate

The Prime Consumer Lending Rate is 24 per cent, but some banks process at 26 per cent, which is PLR + 2 for individuals and commercial customers. For government, the PLR is 22 per cent, but processed at 20 per cent, which is PLR - 2. Enquiries from MFB's managers about lending rates for microfinance banks confirmed that the interest rates are high. The claim is that treasury bills are somewhere between 14 per cent and 15 per cent which encouraged bigger banks to shift their loanable funds to investment in treasury bills. This scenario curtailed the willingness of bigger banks to give out loans, even if they choose to, it will definitely be at higher rate. As businesses continue to lament the dearth of credit facilities and high interest rates, MFBs are faced with unwillingness of bigger banks to grant loans which may either increase the lending rate of MFBs or reduce their lending capacity. Lending rate is an important economic cost of capital; it has fundamental implications for the economy whether seen from the point of view of cost of capital or from the perspective of opportunity cost of funds (Acha, 2011).

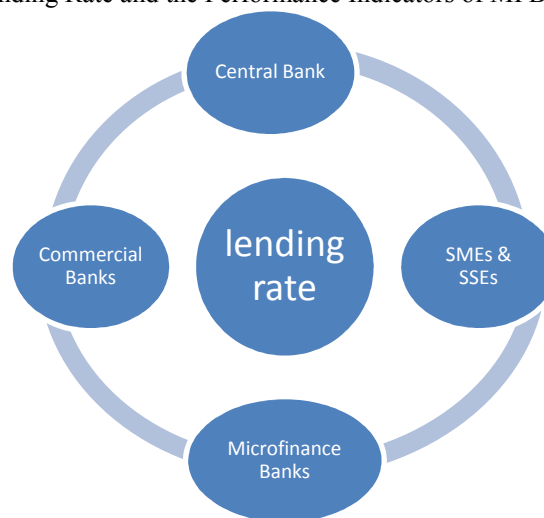
The rate varies little among banks, and adjustments are generally made by banks at the same time, although this does not happen with frequency. The interest rate is important because it affects liquidity in the financial markets. As direct relationship between lending rate and profitability is well established, the important role of lending rate cannot be down played. It is extremely important for financial institutions that seek to grow, to understand the influence of lending rate on the performance parameters of MFBs.

**The Research Question:** Does lending rate of commercial banks influence the performance of microfinance banks in Nigeria? This paper aims at examining the effect of prime lending rate on the performance of microfinance banks. The objective would be achieved by analytically examining the relationships between the prime lending rate and the performance of Microfinance banks proxied by total assets, total loans from commercial banks, total deposits and shareholders fund of MFBs. This is to redress the unwillingness of conventional banks in supporting microfinance banks which will consequently result in increased linkages between the universal banks, development banks, specialized financial institutions and the MFBs annually to 10%. The scope of the study covers the period 1992 to 2011<sup>1</sup>. The choice of this period is to capture all data relating to operations of community banks from inception in 1990 through its transformation into MFBs in 2005 and post transformation operations.

## 2. Conceptualization and Theoretical Overview

Microfinance represents a market solution aimed at mitigating poverty as it was initially a form of voluntary help to the most deprived populations. (Ugur, 2006). From the perspective of the borrower, the condition attached to accessing loans is less stringent in MFBs than in bigger banks. This explains MFBs' commitment to the goal of reducing poverty and its service in promoting innovative savings by the deprived populations. Commercial banks avoid doing business with the poor and the micro enterprises because of the associated cost and risks which are considered to be relatively high. Microfinance banks (MFBs) have therefore become the main source of funding to micro enterprises in Africa and in other developing regions. (Anyanwu, 2004). Commercial banks are to relate with MFBs banks through partnership building. Commercial Banks can lend to microfinance banks and in turn, MFBs can utilize the capital by lending to the poor and small business owners. With the greater amount of capital comes increases in loan sizes, and the more investment level, the greater economic activities. (Ugur, 2006).

Fig. 1. Interrelationship of Lending Rate and the Performance Indicators of MFBs



The above diagram shows the workings of lending rate, how the lending rate of central banks determines the rate at which commercial bank will lend to other financial intuitions (MFBs) which in turn determines the rate at which the small and medium enterprises will access loan from the MFBs. Theoretically, if the central bank increases its lending rate, there will be an increase in the rate at which commercial bank lend out to MFBs. (Acha, 2011)

To achieve the desired level of interest rate, the Central Bank of Nigeria (CBN) adopts various monetary policy tools, key among which is the Monetary Policy Rate (MPR). This rate, which until 2006 was known as the Minimum Rediscount rate (MRR), is the rate at which the CBN is willing to rediscount first class bills of exchange before maturity. Raising or lowering this rate, the CBN is able to influence market cost of funds. If the CBN increases MPR, banks' lending rates are expected to increase with it, showing a positive relationship (Onoh

<sup>1</sup> With effect from December 2006, all the existing Community Banks were required by law to transform into microfinance banks.

2007).

In recent past, the need to possess certain class of assets as collateral to access the CBN's discount window was dispensed with due to global crisis (Business Day, 2009). The prime lending rate is the interest rate that commercial banks charge their most creditworthy customers. Generally a bank's best customer consists of large corporations. The Prime rate is also important for retail customers, as the prime rate directly affects the lending rates which are available for mortgage, small business & personal loans. . This rate is used as a guide for computing interest rates for other borrowers. When lending rates are low, savings and investment increases hence, businesses expand and so does the economy. Similarly, a high interest rate reduces savings and investment which is capable of engendering a downturn in economic activities (Uchendu, 1993).

The lending rate is also important for retail customers, as the rate directly affects the cost of Capital available to start a business. Capital is the money invested in a business required to make the business function effectively. It can take the form of debt and equity, both of these expenses are affected by the prevailing market rate of interest on loans, although the former causes more of an effect, as it affects the amount of interest that must be paid on the debt which invariably affect the cost of capital, when interest rate on debt falls by discrete amount, it discretely reduces the cost of capital .The positive relationship between investment and economic development is well established, it therefore becomes expedient for any economy that wishes to grow to pay proper attention to changes in interest rate. (Acha, 2011).

Trends in profitability of banks in Nigeria before and during interest rate deregulation explained that deregulated interest rate is important for both economic stabilization and development. Ahmed (2003). The proposition that interest rate is vital for economic stabilization and deregulation explained further the relationship between interest rate and investment, as t high lending rates discourage borrowing for investment and vice versa (Lawal, 1982; Anyanwu and Oaikhenan, 1995).

Since economists hold that investment plays a fundamental role in capital formation, and hence on economy's growth and developments, it becomes obvious that lending rates through perceived influence on investment plays a developmental role. That is, a decrease in lending rate is theorized to cause investment borrowing to rise which leads to increased capital formation and eventually to economic growth (Onoh, 2007).

### **2.1. The Performance of Micro Finance Banks (MFBs)**

Two major criteria, outreach and sustainability, have been selected for evaluating the performance of MFIs Many studies have been conducted using these criteria. Outreach is defined as the ability of an MFI to provide high quality financial services to a large number of clients. The indicators of outreach performance include changes in number of clients, the percentage of female clients, total value of assets, amount of savings on deposit, value of outstanding loan portfolio, average savings deposit size, average credit size, number of branches, etc. Sustainability on the other hand requires MFBs to meet all transaction costs, including loan losses (CGAP, 1996 and Yaron, 1997, Youssoufou, 2002). Examining the impact of Microcredit in the performance of women owned micro enterprises in Oyo, factors influencing microfinance banks financing of micro-enterprises such as profitability of business, gender, age, collateral, formal registration of business and repayment ability were analysed using descriptive analysis showed that the performance of those that patronized micro credit did not improve significantly, this was due to high interest rates and short repayment periods (Olusola2012).

A World Bank policy research working paper on financial performance and outreach of global leading micro banks investigates why high repayment rates observed in microfinance are not always translated into profitability. Different lending methods such as individual, solidarity group and village lending type were considered. For the individual lending type, the author observed positive return on asset but as interest rate rises beyond the threshold of 60%, profit reduces. Contrary to this, increasing interest rates result in poorer performances for solidarity group, Village banks are the least profitable lending type as they serve the poorest (Cull, 2006).

Studies also show that Nigeria has a low amount of domestic investment through loans vis-à-vis other emerging markets Majority of the loans granted are issued to large corporations (Oyeyinka,2010).

The MFIs are funded through a number of sources. Donations and grants from international organizations accounted for about 51.2 per cent of total funding source in 2003 (Table 3). This source was followed by mobilized savings which contributed 20.9 per cent and owners' capital 9.0 per cent. Unidentified sources and bank loans accounted for 7.0 and 1.9 per cent, respectively. (Anyanwu,2004).

### **3. Methodology**

The study set out to examine the relationship that exists between the commercial prime lending rate and the performance of MFBs. We proxy the performance of MFBs by their total assets, the total loan to MFBs, total deposits mobilised by MFBs and Shareholders fund of MFBs This was done using multi correlation analysis. Secondary data are used to estimate the model below. The data used were obtained from CBN Statistical Bulletin, details of which are presented in appendix i-iv. Data were analyzed using Pearson correlation aided by Social Science Statistical Packages (SPSS) software.

The model was specified to capture the effective performance of MFBs' economic role to the poor and small business owners as measured by total assets of MFBs. The explanatory variables employed are prime lending rates, total loan of MFBs, total deposits and shareholders' funds. The essence is to practically review whether the theorized relationship among these variables exists.

This goal will be achieved by analysing the following specified model:

$$TAMFBs = f(PLR, DE, SHF, TL, \mu)$$

$$TAMFBs = \ln PLR + \ln DE + \ln SHF + \ln TL + \mu$$

Where;

*TAMFBs* represent Total assets of microfinance banks

*PLR* represent Prime lending rate

*DE* represents Deposit mobilised by microfinance banks

*SHF* represent Shareholders fund

*TL* represent Total loan to microfinance banks

**Table 1. Descriptive statistics Table**  
**Descriptive Statistics**

	N	Minimum	Maximum	Mean	Std. Deviation
LTAMFBS	20	6.87	12.16	9.8003	1.58670
LTL	20	2.48	8.78	5.2845	1.77435
LPLR	20	2.61	3.39	2.9384	0.16922
LDE	20	6.46	11.36	9.2821	1.47413
LSHF	20	5.42	10.76	8.3611	1.67122
Valid N (listwise)	20				

**Table 2. Correlation analysis Table**  
**Correlations**

	LTAMFBS	LTL	LPLR	LDE	LSHF
LTAMFBS Pearson Correlation	1	.821**	-.473*	.998**	.998**
Sig. (2-tailed)		.000	.035	.000	.000
N	20	20	20	20	20
LTL Pearson Correlation	.821**	1	-.445*	.807**	.824**
Sig. (2-tailed)	.000		.049	.000	.000
N	20	20	20	20	20
LPLR Pearson Correlation	-.473*	-.445*	1	-.484*	-.483*
Sig. (2-tailed)	.035	.049		.031	.031
N	20	20	20	20	20
LDE Pearson Correlation	.998**	.807**	-.484*	1	.996**
Sig. (2-tailed)	.000	.000	.031		.000
N	20	20	20	20	20
LSHF Pearson Correlation	.998**	.824**	-.483*	.996**	1
Sig. (2-tailed)	.000	.000	.031	.000	
N	20	20	20	20	20

\*\* . Correlation is significant at the 0.01 level (2-tailed).

\* . Correlation is significant at the 0.05 level (2-tailed).

#### 4. Data Analysis and Interpretation

Table 1. Shows the summary statistics for the variables, the mean ratio of each variable is within the unit proximity and the standard deviation is relatively low showing small variability. Result of data analysis

explained the degree of relationship that exists between the variables employed in the study. Multi Correlation coefficient is a measure of linear association between two or more variables. Correlation analysis was used to determine the predictive ability of Prime lending rate on total assets of MFBs as performance indicator of the bank. The result exhibited positive and strong relationship between TAMFBs and explanatory variables - TL, DE, SHF showing that upward movement in any of the explanatory variable will result in increased level of MFBs performance by 82.1%, 99.8% & 99.8% respectively at 0.05 level of significance while the relationship between TAMFBs and explanatory variable - PLR is negative but weak.

The negative relationship between TAMFBs and PLR is in line with what is expected of the behaviour of PLR which usually moves in opposite direction such that any increase in PLR would have a negative effect on the performance of MFBs as proxied by TAMFBs. However, the weak relationship depict that PLR does have little significant effect on the performance of MFBs. In terms of the significance of explanatory variables, it is observed that TAMFB, TL, DE and SHF are significant determinants of MFBs performance in Nigeria for the period of analysis. The correlation coefficients shows that total assets of MFBs as the dependent variable moves in the same direction with the explanatory variables which are total loans, total deposits and the shareholder funds with the exception of prime lending rate which moves in opposite direction. The result thus brings evidence of type of relationship that exists between the variables employed.

## 5. Findings and Conclusion

Specifically, high lending rate to customers increases the total asset of MFBs and it shows that high lending rate is profit generating which increase level of asset (Cull, 2006). High lending rate reduces the ability of MFBs to grant loan & advances thus connoting that higher lending rates deter MFBs from accessing credit facilities from commercial banks and other financial institutions since lending rate positively influence the commercial banks loan to small scale enterprises, showing that commercial banks will be willing to lend when the interest rate is high. The prime lending rate (PLR) is correctly signed and significant. For instance, it is shown that total credit of commercial banks to private sector reduces as lending rate rises, this is an indication that private individuals will be less willing to borrow at high interest rate form the bank, they will prefer alternative source of funding, this may indicate that there is low contribution of Commercial banks to performance of MFBs in Nigeria. On this note, there is need to reverse the trend, to reiterate credit mobilization, source long-term bank funding, and negotiate funding arrangements with big banks.

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**Appendix I**

**Data Table for Prime Lending rate and MFBs Performance Indicators**

YEAR	LTAMFBS	LTL	LPLR	LDE	LSHF
1992	6.874405	3.608212	3.394508	6.460843	5.42495
1993	8.070468	4.312141	2.907993	7.690835	6.438232
1994	8.45387	5.18906	3.044522	8.076111	6.840974
1995	8.320326	4.681205	3.004692	7.949656	6.758095
1996	8.396719	4.59512	2.982647	7.96426	6.769297
1997	8.456679	4.355426	2.605648	8.065234	7.234033
1998	8.776044	4.919981	2.906354	8.401603	7.299324
1999	9.094211	4.135167	3.059646	8.328528	7.527471
2000	9.393886	3.508256	2.88926	8.947598	7.927901
2001	8.493802	2.480731	2.906354	8.099858	6.941963
2002	9.646238	3.730741	3.212858	9.179799	8.249471
2003	10.26428	4.350536	3.030617	9.802285	8.85525
2004	10.43888	4.594413	2.953868	9.971515	9.006558
2005	11.32499	5.915771	2.88759	10.76898	9.80407
2006	10.91774	5.951476	2.848392	10.43464	9.459527
2007	11.23255	6.210399	2.829678	10.62662	9.990156
2008	11.71794	8.017627	2.71734	11.0279	10.51926
2009	11.92907	8.186186	2.943913	11.24716	10.7181
2010	12.04555	8.16704	2.867331	11.23506	10.69189
2011	12.15857	8.780111	2.773838	11.36261	10.76495

**Source:** CBN (2011) Statistical Bulletin - Section A, Final Web



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