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Effect of Bank Lending Rates on the Performance of Nigerian Economy

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Abstract
The study portrays the effect of bank lending on the performance of Nigerian economy. The specific objectives were; to examine the relationship between bank lending rate and performance of Nigeria economy and to examine the relationship between inflation and the performance of Nigeria economy. Data were sourced from Central Bank Statistical Bulletin of Nigeria, 2015. Ordinary least square of multiple regression model was adopted to statistically analyze the relationship between dependent and independent variables. The findings revealed that lending rate had a positive effect on the performance of Nigeria economy and inflation positively contributed to the performance of Nigeria economy. The study recommended that there should be a reduction in lending rate by banks in order to enhance rapid growth and development of the economy. Also recommended that a reduction in the reserve requirement increases quantum of cash held by banks and more funds should be available for extension of credit to investors.
Keywords: Inflation Rate, Lending Rate, Gross Domestic Product, Loan pricing Multiple lending

1.0 Introduction

The financial system of most developing nations has come under stress as a result of the economic shocks of the 1980s. The economic shocks largely manifested through indiscriminate distortions of financial prices which includes interest rates, has tended to reduce the real rate of growth and the real size of the financial system relative to financial magnitude. In other words, banks do grant loans and advances to individuals, business organizations as well as government in order to enable them embark on investment and development activities as a means of aiding their growth in particular or contributing towards the economic development of a country in general. Deposit money banks are the most important savings, mobilization and financial resource allocation institutions. Consequently, these roles make them an important phenomenon in economic growth and development. In performing this role, it must be realized that banks have the potential, scope and prospects for mobilizing financial resources and allocating them to productive investments and in return promote their performance. Therefore, no matter the sources of the generation of income or the economic policies of the country deposit money banks would be interested in giving out loans and advances to their numerous customers bearing in mind, the three principles guiding their operations which are profitability, liquidity and solvency (Ajayi, 2008).

This study becomes imperative because deposit money banks in Nigeria need to understand how to manage these huge assets in terms of their loans and advances. For the banks to balance their main objectives of liquidity, profitability and solvency, lending must be handled effectively and the banks must behave in a way that their potential customers are attracted and retained. Agene (2001) and Brock (2005) argued that the effects of an increase in interest rate, other things being equal, will lead to a decline in aggregate demand partly because these will encourage savings to earn higher returns. On the other hand, Adam (2001) added that in a situation where the interest payments form a significant portion of product costs, increased interest rates could result in reduced capital spending, investment, output and employment.

2.0 Theoretical framework and literature review

The research study is anchored on the following theories

2.1.1 *Loan pricing theory*

Banks cannot always set high interest rates. Banks should consider the problems of adverse selection and moral hazard since it is very difficult to forecast the borrow type at the start of the banking relationship. If banks set interest rate too high, they may induce adverse selection problems because high-risk borrowers are willing to accept these high rates. Once these borrowers receive the loans, they may develop moral hazard behaviour or so called borrower moral hazard since they are likely to take on highly risky projects or investments (Nzotta, 2004).

2.1.2 *Theory of multiple lending*

It is found in literature that banks should be less inclined to share lending in the presence of well-developed equity markets. But outside equity and mergers and acquisitions increase bank's lending capacities, thus reducing their need of greater diversification and monitoring through lending (Jhingan, 2004).

2.1.3 *Banks' lending rate*

By far the most visible and obvious power of many modern central banks is to influence market interest rates;

contrary to popular belief they rarely "set" rates to a fixed number although the mechanism differs from country to country/ most use a similar mechanism based on a central bank's ability to create as much fiat money as required. The mechanism to move the market towards a "target rate[7]' (which specific rate is used) is generally to lend money or borrow money in theoretically unlimited quantities until the targeted market rate is sufficiently close to the target (Adam, 2001). Central banks may do so to by lending money to and borrowing money from a limited number of qualified banks. For example, the Bank of Canada Sets a target overnight rate, and a band of plus or minus 0.25%. Qualified banks borrow from each other within this band, but never above or below, because the Central bank will always lend to them at the top of the band and take deposits at the bottom and lend at the extremes of the band are unlimited. This mechanism also implies to the Central Bank of Nigeria.

2.1.4 *Principles of lending*

Bankers often use the six C's of lending which is according to CIBN is otherwise known or called "canons of lending" and they are similar to the ones considered under basic questions asked by the lending banker. These principles are: character; capacity; cash flow; collateral; condition and control.

1. **Character**: The bank must be convinced that the customer has a will defined purpose for requesting bank credit and a serious intention to pay. Next thing is to determine whether the purpose is consistent with the bank's policy. Even with good purpose, the loan officer must determine that the borrower has a responsible attitude towards using borrowed funds, is truthful in answering the banks questions and will make every effort to repay what is owed. Responsibility, truthfulness, serious purpose and serious intention to pay all moneys owed, make up what is called "character".
2. **Capacity:** The capacity to borrow is another consideration that the customer requesting credit has the authority to request for a loan and the legal standing to sign a building loan agreement. A minor cannot be legally held responsible for signing a credit agreement. In case of a corporate body, the board resolution is an appropriate evidence of capacity. In case if partnership, the partnership agreement should name which individuals are authorized to borrow for the firm.
3. **Cash flow**: This is the business cash flow, the ability to generate enough cash flow to repay the loan or advance. In general, borrowing customers have only tree sources to draw upon to repay their loans; Cash flows generated from sales or income, sale of assets and fund raised by using securities. Any of these sources may provide sufficient cash to repay the bank loan and advance. However, bankers have a strong preference for cash flows as the principal source of loan repayment because assets sale can weaken a borrowing customer and make the banks' position as a creditor less secure. Moreover, shortfalls in cash flow are common indicators of failing business and troubled loan relationships.
4. **Collateral**: Such features as the age, conditions and degree of specialization of the borrower's assts to be offered as collateral are important. Technology also plays an important role her as well. If the borrower's assets are technologically obsolete, they will have limited value as collateral because of one difficulty of finding a buyer for those assets should the borrower's income falter.
5. **Conditions**: The bank's loan officer and credit analyst must be aware of recent trends in the borrower's line of business or industry and how changing economic conditions might affect the loan. A loan can look very good on paper, only to have its value eroded by declining sales or income in a recession or by high interest rates occasioned by inflation. To assess industry and economic conditions, most banks maintain files of information containing newspaper cuttings, magazines articles and research reports on industries represented by their major borrowing customers.
6. **Control**: The last factor is assessing the borrower's credit worthiness status is "control" which centres on such questions as whether the banks and the regulatory authority are standard of loan quality.

The following five (5) P's of lending are personal factor analysis; purpose analysis; payment analysis; protection analysis; perspective analysis. According, these principles are important and if lenders follow them, the incidence of bad debt could be reduced to the barest minimum. Moreover, the principles are applicable to every type of lending, from the personal borrowing to buy aircraft and ship

1. **Personal factor analysis**: Here, the borrower's attention should shift to the human resources, who are to co-ordinate the various factors of production in achieving the desired purpose of the loan. Unfortunately, bankers do not give much attention to this, perhaps because human beings are the most difficult factors to predict. Moreover, information about individuals is the most difficult thing to come by in Nigeria.
2. **Purpose analysis**: A loan purpose which is not consistent with the borrowers funding needs should not be granted no matter the attraction of profitability of the proposal. Company's funding needs should fall in any of the categories: support or acquire asset replacement of liabilities.
3. **Payment analysis**: This is the core of the credit analysis because it is the essence of any other analysis specifically here; we would talk about the payment source, the direction, volume and timing this can only be done if the bankers understand the dynamics of the customer's transaction flow. The lender should familiarize himself with the customers operating cycles. It requires the examination of the past cash flows as a basis for projecting future cash flows. If there were any significant changes in the cash flows, it would be because there is

significant development such as merger, acquisitions or dividend.
4. **Protective analysis**: A good lender would need to protect him against unforeseen events. He could not be the only one to take all risks. He should ask for and receive good collateral to support his lending. Collateral should be analyzed as to its ownership, control, location and market ability. The four factors can affect the reliability or usefulness of the collateral as a source of protection.
5. **Perspective analysis**: Here, the borrower should be concerned about the future outlook of the transaction to be financed. The lending bank should evaluate the risks that have been identified and what can be done to migrate them.

2.1.5 *Empirical studies*

A lot has been reviewed in terms of lending activities of various deposit money banks. Some opinions deliberated on the factor responsible for banks willingness to extend much credit to some sector of the economy. Brock (2005), Darnel (2008) and Giant (2003) carried studies on non parametric method of the relationship between lending rates and other macro-economic variables, including savings and investment. In their studies, they grouped 64 (sixty four) developing countries including Nigeria into three bases on the level of their lending rate. They computed economic rate among which are gross savings, income and investment for countries. Applying the Mann-Whiting test, the finding showed that the impact of lending was not significant for the three groups. Amato (2000) and Adam (2001) used ordinary least square method to ascertain the assessment of the effects of lending rate in enhancing agricultural productivity in Nigeria. The study found out that lending rate plays a significant role in enhancing economic activities and as such, monetary authorities should ensure appropriate determination of rate lend that will break the double edge effect of rate on savers and local investors. McKinsey (2002) used error correction model (ECM) to investigate lending rates determination in Nigeria. The study found out that as the Nigerian financial sector integrates more with global markets, returns on foreign assets will play a significant role in the determination of domestic interest rates.

3.0 Method and material

The focus of this study has been on bank lending rate on Nigeria economy. Secondary sources were used and data were obtained from Central Bank of Nigeria Statistical Bulletin. Multiple regression model was employed to establish the relationship between dependent and independent variables. The variables that are employed in the study are
GDP = f (LR, INF)
Where
GDP = Gross Domestic Product
LR = Lending Rate
INF = Inflation Rate
The use of ordinary least square, we have
GDP = bo+b1LR+b2INF+e
GDP = Dependent Variable
INF, LR = Independent variables, U_t = error term

4.0 Analysis and interpretation

The regression results on bank lending rates and Nigeria economy (1986-2015)

Table 1 Dependent variable: GDP

Variables	Coefficient	Std error	t-stat	Prob
C	7.709163	1.530530	1.530530*	0.0010
LLR	1.237801	8.403532	8.403532*	0.0017
LINF	0.09047	2.725831	2.725831*	0.0133

Source: Researchers Computation
R^2 = 0.815857 R^2 (adj) = 0.786782 DW = 2.03 SER = 2.366486
F-stat = 28.06020 * significant at 1% level

The result showed a constant parameter of 7.709163, this means that there is a positive linear relationship between the dependent and independent variables. Specifically, if all the independent variables are held constant ceteris paribus, bank lending rate will increase by 7.709163m. The estimated coefficient of INFR is positive. This implies that a unit increase in each of them/on the average, will increase in each of them. R - squared of 0.815857 indicates that about 82 percent variation in GDP was explained by the independent variables and the R-squared adjusted of 79 percent shows that the model exhibits a goodness of fit of about 79 percent. The D.W value of 2.03 indicates that there is autocorrelation among the variables.

4.0 Findings

From the analysis of the effect of bank lending rate in Nigeria economy, the researchers made some findings as regard to the subject at hand and below are the findings. The lending rate exerts strong influence on Nigeria economy in the period under study; inflation rate had a positive influence on Nigeria economy. The result is in conformity with the works of Brock (2005) who posit that deposit money banks are the most important savings, mobilization and financial resource allocation institutions.. The result gives a positive linear equation between the dependent and explanatory variables. The economic and financial market implication of the result can be explained as thus; the lending rate movement can have significant effect on the economy as a result of the effect of an increased lending rate, other things being equal, will lead to an increase aggregate demand partly because these will encourage savings to earn higher returns. In a situation where the lending interest rate payments form a significant portion of production cost, increased lending rates could result in reduced spending, investment, output and employment

5.0 Conclusion/Recommendations

From this study, the slow growth of the industrial and manufacturing sector is as a result of the lending processes of banks in Nigeria, as a result of their high lending rates. A decrease in the accumulation of loanable funds/savings is likely to exert an upward pressure of lending interest rates just as a reverse situation would tend to have a moderating effect.

The following recommendations are proffered

1. There should be a reduction in lending rates by banks in order to enhance the rapid growth, and development of the economy.
2. A reduction in the reserve requirement increases quantum of cash held by the banks and more funds available for extension of credit to investors.

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