Research Journal of Finance and Accounting
ISSN 2222-1697 (Paper) ISSN 2222-2847 (Online)
Vol.5, No.18, 2014

Asset Quality and Bank Performance: A Study of Commercial Banks in Nigeria

Dr Abata, Matthew Adeolu,
Department of Accounting ,Faculty of Management Sciences,Lagos State University, Ojo
E-mail: abatamat@gmail.com

Abstract
The consolidation phenomenon in the Nigeria financial service industry is aimed at ensuring financial stability as the industry experienced severe loan problems and unexpected losses in the past with different loan severity due to divergent banks' financial strategies. This study examined and evaluates banks asset quality and performance in Nigeria using secondary data obtained from the annual reports and accounts of the six largest banks listed on the Nigeria Stock Exchange based on market capitalization with a sample interval of fifteen-year period from 1999 to 2013. The study adopted the use of ratios as a measure of bank performance and asset quality since it is a verifiable means for gauging the firms' level of activities while the data were analysed using the Pearson correlation and regression tool of the SPSS 17.0The findings revealed that asset quality had a statistically relationship and influence on bank performance. Based on the findings the study recommends policies that would encourage revenue diversification, minimize credit risk, and encourage banks to minimize their liquidity holdings. Further research on factors influencing the liquidity of commercials banks in the country could add value to the profitability of banks and academic literature.

INTRODUCTION

The present world of business operation is characterized by considerable amount of uncertainty regarding the demand, supply and market price as there are operational costs for every business activities while business information is costly and not evenly distributed. Similarly, every firm has its own limits on the production capacity and technology in terms of core competency which determine the nature of investments and financing risk. The above problems impose the requirement for the provision of sufficient assets to support various aspects of business operations.

The banking business is not immune from this market trends as their stock in trade is money which they deals in terms of deposits from various economic agents as well as onward lending to different set of economic agents in forms of loans and advances. However, this bank money creation process requires adequate asset for survival, sustenance and development as its shape the fortune of the firm in both the short and long run of business process (Omolumo, 1993).

Asset quality is an aspect of bank management entails the evaluation of a firm asset in order to facilitate the measurement of the level and size of credit risk associated with its operation. It relates to the left-hand side of a bank balance sheet and focused on the quality of loans which provides earnings for a bank. Asset quality and loan quality are two terms with basically the same meaning while its management is considered extremely important by the banking sector. According to the Basle Committee on Banking Supervision, the core principles for effective banking supervision comprised twenty-five core principles out of which seven are designed to address the relevant issues of bank asset quality or credit risk management (Basle, 1997). This implied that asset quality is of general concern to financial supervisory authorities in every country throughout the world.

Similarly, Nagle (1991) specified that the problems of asset quality may become the future time bomb for banks, just as the standards for safety and soundness which was established by the United States Federal Reserve Board, became effective in 1995 which required U.S. financial institutions to set up asset quality monitoring systems for identifying possible emerging problems of bank asset quality, and demanding banks to regularly present the asset quality reports to the board of directors so as to evaluate the risks associated with asset quality deterioration.

This deterioration in bank asset quality affects it's operating and financial performance as well as the general soundness of the financial system in which it is an entity. Yin (1999) observed that the deterioration of bank asset quality arising from the ignorance of loan quality is one of the proximate cause of the Asian Financial Crisis while Tsai (1999) stated that based on the Standard and Poor's (S&P) 1994 global credit rating reports which comprise sixty-one countries' financial systems, Taiwan belonged to the division of frail financial systems. Banking institutions residing in a country with frail banking systems should pay more attention to managing asset quality in order to warrant the sound development of the banking industry.

Since the Nigerian business environment is not completely immune from this global trend, the Central Bank of Nigeria (CBN) over the years has developed several measures aimed at providing sound banking environment and safeguarding various stakeholders interest in the financial system. But despite their efforts, the banking system continues to experience some hitches that erode investors and depositors such as the bail-out of

some ailing banks. This banking challenge raised a research enquiry on the nature of the relationship between banks asset quality and performance in Nigeria due to the indispensable nature of banking operation in the financial intermediation process and development. The remaining aspects of the study comprise a brief literature review, research methods, result presentation and discussion as well as conclusions and recommendations.

LITERATURE REVIEW

Bank asset quality is a popular issue in banking literatures because most authors on bankruptcy agreed that before a bank can be declared bankrupt, a sizeable amount of non-performing loans must exists since bank asset quality is an indicator for the liquidation of banks (Demirguc-Kunt, 1989 and Whalen, 1991). Similarly, investigation on the production efficiency of financial institutions has reported that normal financial institutions have comparatively higher costs and lower profits than the most efficient financial institutions with the visible signs of inefficient output to include acquisition, brokerage problems, company governance, and foreign holding factors (Berger et al., 1993).

Osayameh (1986), Orji (1989), Omolumo (1993) emphasized that when loans are not repaid as it often happens, banks get into problems, as such debts are sometimes written off as bad. The balance sheet of any lending bank is believed to confirm this. Orji (1989), explained further that ability to repay the point of any lending decision, one may then ask why bad debt does occur? Some reason given by Orji and Osayameh (1986) include non- existence of a loan policy set out by the banks, non-compliance with such a loan policy analysis of financial data, bad judgement, inadequate project monitoring, incomplete knowledge of customers' activities etc.

However, asset quality and bank efficiency are non-related, because operating personnel normally are not involved in the selection and supervision of borrowers, and loan and credit personnel do not engage in the management of operations. However, banks at the edge of bankruptcy appear to have a high non-performing loan ratio as well as a low cost efficiency. Some authors discovered that the level of liquidated banks and high efficient banks (the most efficient banks) is huge (DeYoung and Whalen, 1994; Wheelock and Wilson, 1995). Other researchers found that banks having non-bankruptcy problems exhibit a negative relationship between efficiency and non-performing loans (Kwan and Eisenbeis, 1994).

DeYoung (1997) opined that a bank's ranking is significantly affected by asset quality which is always an essential factor in rating and management evaluation. Marshall (1999) also observed that one of the key features that the best community banks hold is good quality assets. Given that bad quality assets can prompt a bank rating downgrade and that it becomes more difficult to earned depositors' trust, such banks can therefore only attract deposits by having a higher deposit rate. Together, a conclusion can be drawn: asset quality will not only influence the operating costs of banks, but will also affect the interest costs of the banks as well as their operating performance.

Streeter (2000) reported that asset quality management is considered one of banks major management problems in 2001 based on the self administered questionnaires served to the members of American Bankers Association Board which composed of one-third of bank officials from all U.S. banks, the result of the above survey sufficiently proves that asset quality management is a common issue for bankers in practice. Similarly, Gene Miller (CEO of America Corp.) considered asset quality as the second most important management issue and formed a task force to specifically handle rising bad assets.

According to Achou and Tenguh (2008), non-performing loans (NPL) has an inverse relationship with banks' profitability. Hence, they suggested that it is of crucial importance that banks practice prudent credit risk management and safeguarding the assets of the banks and protect the investors'interests. Similarly, Aboagye and Otieku (2010) contended that for banks to continue operations; they must make enough money through lending and fiduciary activities or services to cover their operational and financing costs, plough back retained earnings to finance future operations. This will enhance not only the survival but also their growth and profitability.

From the management accounting perspective, bank asset quality and operating performance are positive related because if a bank's asset quality is insufficient such will have to increase its bad debt losses as well as expend more resources on the collection of non-performing loans (Abata, 2010). When banks list the loan amount for collection, banks will incur extra operating costs from non-value-added activities so as to handle and supervise the collection process such as a regular tracking the debtor's financial status, being vigilant of the collateral value, rearranging the amortization plan, paying expenses for contract negotiation, calculating the costs to withhold etc. The costs include winning the trust from management and the public, preserving the safety and completeness of the banks, preventing the banks from being rated poor as a consequence of external affairs, reducing deposits because of a loss in clients' faith, extra costs to monitor loan quality, and higher future costs generated by the ignorance of the problems from other operations that is generated when the loan quality issues grips the attention of the senior management (Khalid, 2012).

METHODOLOGY

The study adopted the use of secondary data obtained from the annual reports and accounts of the six largest

banks listed on the Nigeria Stock Exchange based on market capitalization with a sample interval of fifteen-year period from 1999 to 2013. The study exploited the use of ratios as a measure of bank performance and asset quality since it is a verifiable means for gauging the firms' level of activities. The surrogate employed in the model specified below is based on standard measures stipulated by the CBN as well as the availability of data. While the return on asset (ROA) was used as a proxy for firm performance, the surrogates used for asset quality comprise the loan-loss ratio (LLR) and the total Investments to total assets ratio (TTR).

Using the statistical packages for social scientist (SPSS 17) software, the relationship among the specified variables had been examined through the use of regression and correlation matrix while the Ordinary Least Square (OLS) regression model is represented as:

$ROA = \beta_0 + \beta_1 LLR + \beta_2 TTR + \varepsilon$----------------------1

$ROA = \beta_0 + \beta_1 TTR_{it} + \varepsilon$ ----------------------------- 2

Where,

ROA = Return on Assets of Selected Banks (Earnings before Tax/Total Asset)

LLR = loan-loss ratio (Classified Loan & Advances/Total loan Portfolio)

TTR = Total Investments to total assets ratio (Total Loan / Total Asset)

HYPOTHESES

H_0- There is no relationship between bank asset quality and its performance.

H_0- There is no relationship between bank loans and its profitability.

RESULT PRESENTATION AND DISCUSSION

Model 1 Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.870[a]	.756	.513	1.09947644	2.114

a. Predictors: (Constant), LLR, TTR

b. Dependent Variable: ROA

Coefficients[a]

Model		Unstandardized Coefficients		Standardized Coefficients		
		B	Std. Error	Beta	T	Sig.
1	(Constant)	-17.746	8.026		-2.211	.158
	TTR	55.722	22.745	3.039	2.450	.134
	LLR	17.649	7.119	3.075	2.479	.131

Correlations

		ROA	TTR	LLR
ROA	Pearson Correlation	1	.088	.159
	Sig. (2-tailed)		.888	.798
	N	15	15	15
TTR	Pearson Correlation	.088	1	-.960**
	Sig. (2-tailed)	.888		.010
	N	15	15	15
LLR	Pearson Correlation	.159	-.960**	1
	Sig. (2-tailed)	.798	.010	
	N	15	15	15

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

The model above represents the relationship between the dependent variable; ROA and the independent variables; TTR and LLR. From the above model, the correlation (R) value of 0.870 indicates the existence of a

strong positive correlation among the specified variables. Similarly, the regression value of the two specified independent variables showed that the ROA is negative without the influence or interaction of either the LLR or TTR while their interaction influences the ROA positively with the TTR having the greatest influence. The coefficient of determination value ($R^{2)}$ of 0.756 indicates that about 75.6% of variation ROA can be explained by the combined influence of TTR and LLR. The Durbin Watson test statistic of serial correlation value of 2.114 showed that there is no autocorrelation among the successive values of the variables in the model. The pair wise correlation output shows positive relationship between asset quality indicators and profitability. Hence, we reject the null hypothesis and accept the alternative hypothesis, that there is a relationship between bank asset quality and its performance

Model 2 Summary[b]

Model	R	R Square	Adjusted R Square	Std. Error of the Estimate	Durbin-Watson
1	.092[a]	.009	-.322	1.81106416	2.888

a. Predictors: (Constant), TTR

b. Dependent Variable: ROA

Regression Coefficients[a]						
		Unstandardized Coefficients		Standardized Coefficients		
Model		B	Std. Error	Beta	t	Sig.
1	(Constant)	2.928	4.502		.650	.562
	TTR	-1.737	10.810	-.092	-.161	.883

a. Dependent Variable: ROA

Correlations

		ROA	TTR
ROA	Pearson Correlation	1	-.092
	Sig. (2-tailed)		.883
	N	15	15
TTR	Pearson Correlation	-.092	1
	Sig. (2-tailed)	.883	
	N	15	15

The model above show the relationship between the ROA and TTR, with the correlation (R) value of 0.092 indicates a very weak positive correlation which is near zero while the coefficient of determination value (R^2) of 0.009 indicates that ROA can hardly be explained by TTR. The Durbin Watson statistic measure of serial correlation value of 2.888 indicates that there is no autocorrelation among the successive values of the variables in the model. Hence, we accept the null hypothesis that there is no relationship between bank loans and its profitability.

It is clear from analysis that there is a strong positive relationship between good asset quality and profitability, with the coefficient of correlation being 0.756. This means banks that monitors their credit loans tend to be more profitable than those that pay less attention to assets quality and vice-versa. This is in line with the theory that increased exposure to credit risk is normally associated with decreased bank profitability (Kosmidou, 2008). The second hypothesis showed that there is no relationship between bank loans and its profitability though this contradicts Khalid (2012) which reported that asset quality and profitability are negatively correlated in the banking industry.

CONCLUSIONS AND RECOMMENDATIONS

The study examined the influence of bank asset quality and its performance in Nigeria. From the findings it is concluded that there is a relationship between bank asset quality and its performance while there is no relationship between bank loans and its profitability. Hence, It is therefore, concluded that linear relationship exist between the dependent and the independent variables of the model. The evidence established that the

independent explanatory variables (asset indicators) have individual and combine impact on the return of asset of banks in Nigeria.

This study shows that there is a significant relationship between bank performance (in terms of profitability) and asset quality (in terms of loan performance). Loans and advances, loan loss provisions and non performing loans are major variables in determining asset quality of a bank. These risk items are important in determining the profitability of banks in Nigeria. Where a bank does not effectively manage its risk, its profit will be unstable. This implies that the profit before tax has been responsive to the credit policy of Nigerian banks. The asset structure also affects profit performance. Banks become more concerned because loans are usually among the riskiest of all assets and therefore may threatened their liquidity position and lead to distress. Better credit risk management results in better bank performance. Thus, it is of crucial importance for banks to practice prudent credit risk management to safeguard their assets and protect the investors' interests.

The Central Bank of Nigeria (CBN) should regularly assess the lending attitudes of financial institutions. One direct way is to assess the degree of credit crunch by isolating the impact of supply side of loan from the demand side taking into account the opinion of the firms about banks' lending attitude. Finally, strengthening the securities market will have a positive impact on the overall development of the banking sector by increasing competitiveness in the financial sector. When the range of portfolio selection is wide people can compare the return and security of their investment among the banks and the securities market operators.

Management need to be cautious in setting up a credit policy that will not negatively affects profitability and also they need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits and maximization of profit. Improper credit risk management reduce the bank profitability, affects the quality of its assets and increase loan losses and non-performing loan which may eventually lead to financial distress. As a result, banks still need to make efforts to improve their financial soundness via the following:

1. The use of collaterals as security of granting loans should be further reviewed to reduce further incidence of bad debts;
2. All credit risk managers and lending officers should adhere strictly to good lending practice; they should know the purpose of the loan and ensure the feasibility of every loan proposed.
3. Bankruptcy law should be enforced to the letter and a sound credit culture should be introduced;
4. Credit management should be viewed as part of a co-ordination group efforts made by all departments involved with customers to minimize bad debts and maximize profit instead of leaving it in the hands of the credit risk management department.

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