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ASSESSMENT OF THE IMPLICATION OF LOAN DEFAULT AND RECOVERY DRIVE ON THE PROFITABILITY OF DEPOSIT MONEY BANKS IN ABUJA

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Abstract:

The purpose of this paper was to assess the implication of loan default and recovery drive and its impact on profitability of Deposit Money Banks in Abuja. Financial institutions were selected to gather data, which was acquired from answers obtained from our administered questionnaire. The population of the survey constituted the management and non-management staff and customers of Deposit Money Banks in Abuja. Then population of the study consists 520 randomly selected non-management and management staffs of Deposit Money Banks Abuja. 520 questionnaires were administered of which 501 questionnaires were recovered which serves as the sample size of the study. The collated data were analyzed using SPSS statistical software using Pearson's correlation. Results of the study show that there is a strong relationship between problem of recovery and overdue of loans and profitability, there is a strong relationship between deficient analysis of project viability and profitability and also that there is a strong relationship between loan default and risk management policy of Deposit Money Banks. It was concluded that risk in credit creation through loan granting cannot be completely wiped out because of the futuristic nature of loan repayment schedule. It was recommended that Deposit Money banks should monitor its outstanding loans in order to identify promptly loans which a borrower fails to repay as scheduled.

Keywords: Loan default, recovery drive, profitability, financial institutions, deposit, risk management

INTRODUCTION

Attempts to explain the operation of commercial banks began with the inception of banking institution. Lending has become a vital role in banking operations because of its direct effect on economic growth and business department. In most countries, banks and their lending activities have useful integrated into government policy formulation. As far as banks are concerned, their role as lenders is important as that of deposit taking into consideration; the interrelationship in banking system. All commercial banks have common attributes; they keep deposits for their customers, permit certain deposits to be transferred by cheques from an individual account to other accounts in any bank in the country, make loans and invest in government securities.

It is these common features particularly the holding of demand deposits that distinguished commercial banks from other financial institutions, banks like all other business organization have the commercial objective or primary to objective maximize profit, they do this through granting of loans and generate interest from such loans, this translate into profits to banks in their bid to maximize profit.

Loan default can be defined as the inability of a borrower to fulfil his or her loan obligation as at when due (Balogun and Alimi, 2018). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (2010) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust. As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers.

Loan default management therefore is crucial to the institutions because loans are their target assets, generator of income and highest reasons for their existence. Hence defaulted loans determine the quality of portfolio. For instance cooperatives are sustainable institutions that are financed from local savings and require little external subsidy. They perform an active financial intermediation function particularly mediating flows from urban and semi urban to rural areas and between net savers and net borrowers while ensuring that loan resources remain in the communities from which the savings were mobilized (Otero and Rhyne, 1994).

As the Nigerian financial sector grows, Deposit Money Banks in Abuja are gradually transforming into a financial super-market with subsidiaries covering insurance, pensions fund management, share registration and stock broking.

Statement of Problem

The issue of loan defaults is becoming an increasing problem that threatens the sustainability of Banks. The causes of the problem are multi-dimensional and non-uniform among different literatures. Unsettled loans are always a source of misery for lenders because if a microfinance has too much of it on its balance sheet, it can adversely affect its operations in terms of liquidity, profitability, debt- servicing capacity, lending capacity and ability to raise additional capital. The incidence of non-performing loans in the Nigerian banking and non-banking industries including microfinances has been on the rise in recent years as their loan portfolio increases despite efforts by these financial institutions to deal with it.

Banks occupy a critical position in a complete financial system that supply the money and credit need of the economy. Banks in recent times has failed as a result of loan recovery problems. Loan is the major source of bank profitability. However, in going about their lending activities, banks have their own objectives among which are profitability, growth, safety, suitability and liquidity. Loan, when not recovered could adversely affect banks. It is easily granted than recovered. It usually needs proficiency i.e. competency and expertise in the recovery process. It sometimes becomes an uphill task to recover. When they are not recovered, the impact is often disastrous to the bank. It can lead to illiquidity, insolvency and even distress as the case may be. There is therefore a need for arriving at strategies for efficient loan recovery. That is the peak of the problem. The study therefore addresses the problem of illiquidity, insolvency and even distress as these are caused as a result of loan default.

Objectives of the Study

The main objective of this study is to assess the implication of loan default and recovery drive on the profitability of Deposit Money Banks in Abuja. Other specific objectives are:

a) To determine how loan default impact on the profitability of Deposit Money Banks.
b) To investigate how loan default improves the deficient analysis of project viability of Deposit Money Banks.
c) To examine how loan default impact negatively on the risk management policy of Deposit Money Banks.

Statement of Hypotheses

The hypotheses of the study include:

H_{01}: There is no significant relationship between loan default and the profitability of Deposit Money Banks.

H_{02}: There is no significant relationship between loan default and the deficient analysis of project viability of Deposit Money Banks.

H_{03}: There is no relationship between loan default and risk management policy of Deposit Money Banks.

LITERATURE REVIEW

In accordance with the words of Ralph, (2018) "*Lending decision"*, "Very much like investment decisions are generally full of risk but the ability to banks to thoroughly assess and analyze such risk will lead to qualitative and more pragmatic decision". Lack of adequate knowledge of the loan sector could result to most bad debts and moreover, the success of most loans depends on the perfect assessment of the customer's character. If the customers are introduced by another customer, the market fairly becomes simpler because the introducer may often guarantee on behalf of the new customer. He suggested that loan for speculative business should not be granted even if it is fully supported by collateral. Here, possibility of default is high.

Loan default can be defined as the inability of a borrower to fulfil his or her loan obligation as at when due (Balogun and Alimi, 2018). High default rates in SMEs lending should be of major concern to policy makers in developing countries, because of its unintended negative impacts on SMEs financing. Von-Pischke (2010) states that some of the impacts associated with default include: the inability to recycle funds to other borrowers; unwillingness of other financial intermediaries to serve the needs of small borrowers; and the creation of distrust.

As noted by Baku and Smith (1998), the costs of loan delinquencies would be felt by both the lenders and the borrowers. The lender has costs in delinquency situations, including lost interest, opportunity cost of principal, legal fees and related costs. For the borrower, the decision to default is a trade-off between the penalties in lost reputation from default versus the opportunity cost of forgoing investments due to working out the current loan.

Causes of Loan Defaults

Ahmad, (2017), mentioned some important factors that cause loan defaults which include; lack of willingness to pay loans coupled with diversion of funds by borrowers, willful negligence and improper appraisal by Credit Officers. In addition, Hurt and Fesolvalyi (2018), cited by Kwakwa, (2019) found that, corporate loan default increases as real gross domestic product decline, and that the exchange rate depreciation directly affects the repayment ability of borrowers.

Many factors have been identified as major determinants of loan defaults. Okorie (1986) shows that the nature, time of disbursement, supervision and profitability of enterprises which benefited from small holder loan scheme, contributed to the repayment ability and consequently high default rates. Other critical factors associated with loan delinquencies are: type of the loan; term of the loan; interest rate on the loan; poor credit history; borrowers' income and transaction cost of the loans. Poor academic performance is the number one reason for student departure, and departure before degree completion is the number one reason for student loan default (Volkwein and Cabrera, 1998).

According to Gorter and Bloem (2012) non-performing loans are mainly caused by an inevitable number of wrong economic decisions by individuals and plain bad luck (inclement weather, unexpected price changes for certain products, etc.). Under such circumstances, the holders of loans can make an allowance for a normal share of non-performance in the form of bad loan provisions, or they may spread the risk by taking out insurance. The problem of non-performing loans is widespread. Nishimura, Kazuhito, and Yukiko, (2011) state that one of the underlying causes of Japan's prolonged economic stagnation is the non-performing or bad loan problem.

They explain that some of the loans made to companies and industries by financial institutions during the bubble era became non-performing when the bubble burst. This delayed structural reforms and prevented the financial intermediary system from functioning properly. Most of the defaults arose from poor management procedures, loan diversion and unwillingness to repay loans, Kohansal and Mansoori (2019). According to them a number of factors can cause loan defaults some of which are;

1. Interest rate ceilings usually imposed by the government

2. Monopoly power in credit markets often exercised by informal lenders

3. Large transaction costs incurred by borrowers in applying for loans

4. Moral hazard problems

Ways of Reducing Loan Defaults

Golden and Walker (1993) identify the 5Cs of bad credit, which represent things to guard against to help prevent the effect of the bad loans or the defaulted loans.

a) Complacency refers to the tendency to assume that because things were good in the past they will be good in the future. Common examples are over reliance on guarantors, reported net worth or past loan repayments success because things have always worked out well in the past.
b) Carelessness involves poor underwriting typically evidenced by inadequate loan documentation, lack of current financial information or other pertinent information in the credit files and a lack of protective covenants in the loan agreement.
c) Communication ineffectiveness refers to when a Lenders credit objectives and policies are not clearly communicated. This is when loan problems can arise. Management must effectively communicate and enforce loan policies and loan officers should make management aware of specific problems with existing loans as soon as they appear.

d) Contingencies refer to lenders tendency to play down or ignore circumstances in which a loan might result in default. The focus is on trying to make a deal work rather than identifying downside risk.

e) Competition involves following competitors behavior rather than maintaining the lenders own credit standards. Doing something because another lender is doing it does not mean it is a prudent business practice.

Loan repayments should be monitored and whenever a customer defaults action should be taken. Thus banks should avoid loans to risky customers, monitor loan repayments and renegotiate loans when customers get into difficulties. Kohansal and Mansoori (2019) are of the view that, lenders devise various institutional mechanisms aimed at reducing the risk of loan default (i.e. pledging of collateral, third-party credit guarantee, use of credit rating, collection agencies, etc.).

Again, loan repayment should be constantly monitored and whenever there is a default in repayment, a quick action should be taken. The Microfinance should also avoid granting loans to the risky customers or for speculative ventures, monitor loan repayments, and renegotiate loans whenever borrowers get into difficulties (Kay Associates Ltd, 2015).

Kay Associates Limited (2015) cited by Aballey (2019) states that bad loans can be restricted by ensuring that loans are made to only borrowers who are likely to be able to repay, and who are unlikely to become insolvent. Credit analysis of potential borrowers should be carried out in order to judge the credit risk with the borrower and to reach a lending decision.

Effects of Loan Default

The lending of funds deposits with banks to those who require them implied risk taking by the lending credit may not materialized as planned. The lending institution demands may be made by depositors. If this happens, the lending institution would not be able to attain the objectives expected of them. The overall effect would be a loss of confidence in the banking system. Other negative effects of default on loan repayments are:

1. **Loss to banks:** The un-recovered loans constitute a very heavy loss on the part of the banks. When the debts are not paid, the banks have to write them off which sometimes have significant adverse effects on the banks operations.

2. **Decline in revenue:** The interest loss adversely affects the bank"s major revenue. The main activity of the banks is the granting of loans and credit to customers. They charge interest on loans and this forms a major source of revue for them. Failure to pay interest on loans means that the banks will lose substantial revenue.

3. **Distress:** In a situation where bad accumulate largely to the extent that the bank cannot write them off, it may lead to the bank becoming illiquid. After this stage, if the situation does not improve, the affected banks may become distressed and ultimately go into liquidation.

4. **Increased overhead:** When the debt foes bad, the bank may resort to legal action to receive part or the whole of the debt. The legal fee involved in most cases is usually very enormous. Regrettably, they may lose the case after spending the huge amount on litigation.

5. **Limited Credit Creation Capacity:** As bad debt increase, the capital of the bank decreases and the money available to the banks for lending becomes depleted, thereby hampering the capacity of the banks to create credit.

Empirical Review

Although several empirical academic studies have analyzed credit risk on corporate bonds, very few studies have been applied to bank loans. The reason for this is that, as bank loans are private instruments, few data are publicly available.

With reference to the studies by Altman (1989) and Altman and Suggitt (2010), the mortality approach is applied. It must be noted that the mortality approach was applied to measure the percentage of bonds or loans that defaulted *n* years after origination. The application of mortality to loan recovery rates is, to the best of our knowledge, novel. It examines the percentage of a bad and doubtful loan that is recovered *n* months after the default date. This methodology is appropriate because the population sample is changing over time. For some default loans, those of June 1995, we have a long recovery history (66 months), while for the '2000' loans in default, we have an incomplete history of recovery. The actuarial-based mortality approach, based on the Kaplan-Meier estimator (Greene, 1993) adjusts for changes over time in the size of the original sample.

Similar to Carey (1998), Asarnow and Edwards (1995), Carty and Lieberman (1996), Hurt and Felsovalyi (2018) and La Porta *et al.* (2013) the *Cumulative Recovery Rate* at time T, CRR_T, represents the proportion of the initial default loan that has been repaid (in present value terms) T periods after default. Note that these authors report only the total cumulative recovery rate over a long (unidentified) period, whereas we, adopting the Altman mortality-based approach, report the extent of cumulative recovery over time.

METHODOLOGY

This research will focus on Deposit Money banks in Abuja. Data for the study will be limited to the operation efficiently as regards credit and the management of credit, loan recovery and the impact of loan and suggested recovery drive default to Deposit Money banks in Abuja. Primary source of data was employed via personal interview and structural questionnaire while secondary data were got from the internet journals, bulletin and relevant text books. The selection of the sample population was done randomly according to the availability. The population of the study constituted of Five hundred and twenty (520) management and non-management staff and customers of Deposit Money Banks in Abuja. Five hundred and twenty (520) questionnaires were administered of which the researcher were able to retrieve five hundred and one (501) questionnaires. Based on the described research objective, this study adopted correlation as the statistical tool in analyzing the data. Correlation allows us to predict an outcome and know the relation between variables.

RESULT AND DISCUSSIONS

The purpose of this paper is to assess the impact of loan default and recovery drive on profitability, and determining ways of reducing loan defaults in Deposit Money banks in Abuja. The collated data were analyzed using the simple percentage (%) and the correlation was calculated with the aid of Statistical Package for Social Science (SPSS).

Table 1 Distribution of Response Rate

Variables	Frequency	Percentage (%)
Questionnaire Administered	520	100
Questionnaire Retrieved	501	96.3
Questionnaire not retrieved	19	3.7

Source: Survey Data, 2021

Table 1 shows that out of 520 questionnaires administered, 501 questionnaires representing 96.3% of the total questionnaires administered were retrieved while 19 questionnaires representing 3.7% were not retrieved. The numbers of questionnaire retrieved is therefore viable for the purpose of this study.

Demographic Characteristics of the Respondents

Based on analysis of the collected data and using description statistics for demography, it was found that 85.8% of the respondents were males, while 14.2% of them were females. 384 respondents representing 76.6% of the total respondents are single while 117 respondents representing 23.4% of the total respondents are married. 44.9% of the total respondent fall between the age range of 18-30 years, 40.9% of the respondents are between 30-40 years while 14.2% of the total respondents are between 40 years and above. 34.9% of the total respondents have OND/HND, 54.9% of the total respondents have B.Sc./B.A while 10.2% of the total respondents have M.Sc./MBA The table shows a high level of education and technical depth.

Test of Hypotheses

H_{01}: There is no significant relationship between loan default and the profitability of Deposit Money Banks.

H_{02}: There is no significant relationship between loan default and the deficient analysis of project viability of Deposit Money Banks.

H_{03}: There is no relationship between loan default and risk management policy of Deposit Money Banks.

Table 2: Correlations between recovery and overdue of loans, deficient analysis of project viability and profitability.

		Profitability	Deficient analysis of project viability	Risk Management Policy
Profitability	Pearson Correlation	1	0.622**	0.593**
	Sig. (2-tailed)		0.000	0.000
	N	501	501	501
Recovery and overdue of loans	Pearson Correlation	0.593**	0.521**	1
	Sig. (2-tailed)	0.000	0.004	
	N	501	501	501
Risk Management Policy	Pearson Correlation	0.622**	1	0.521**
	Sig. (2-tailed)	0.000		0.000
	N	501	501	501

Source: SPSS, 2021.

To achieve the research objective, the relationship between loan default and the profitability of Deposit Money Banks, loan default and the deficient analysis of project viability of Deposit Money Banks and the relationship between loan default and the risk management policy should be assessed, and from table 6, the Pearson correlation was utilized.

With the aid of SPSS 16 statistical software, Pearson's correlation shows that there is a strong relationship between recovery and overdue of loans and profitability with a correlation coefficient of 0.593 at the 0.01 level (2-tailed), deficient analysis of project viability and profitability with a correlation of 0.622 at the 0.01 level (2-tailed), and even though the main purpose was to know the impact of loan default and recovery drive on profitability, the researcher found out that there is a strong relationship between loan default and risk management policy of Deposit Money Banks with a correlation coefficient of 0.521 at the 0.01 level (2tailed). These relations are positive, meaning proper management of loans given to clients will results in higher profitability of firms.

Discussion of Results

The findings show that there is a strong relationship between recovery and overdue of loans and profitability with a correlation coefficient of 0.593 at the 0.01 level (2-tailed), there is a strong relationship between deficient analysis of project viability and profitability with a correlation of 0.622 at the 0.01 level (2-tailed) and finally there is a strong relationship between loan default and risk management policy of Deposit Money Banks with a correlation coefficient of 0.521 at the 0.01 level (2tailed)

CONCLUSION AND RECOMMENDATIONS

Conclusion

The researcher wish to conclude by saying that risk in credit creation through loan granting cannot be completely wiped out because of the futuristic nature of loan repayment schedule. Most of the loans granted by Nigerian Commercial Banks do not get repaid and turn out to be bad debts. The reasons for situation are:

No security to dispose and realize fund: Some of the bank loans have no collateral pledged against them. Consequently, if such beneficiaries default, there will be no security to dispose off and recover at least part of the loan.

Peoples’ attitude towards loan payment: Some people (borrowers) take loan to be national gifts from the government and as such, they do not repay them. Banks do not down to watch the defaulters. They make serious effort to see that they recover those loans.

Finally, it is time that the banks do provide bad debts, doubtful debt etc. This is done to ensure adequate protection for the size of credit portfolios rather than a reflection of actual losses to the banks.

Recommendations

Based on the conclusion of the study, the following recommendations were made:

a) Deposit Money banks should monitor its outstanding loans in order to identify promptly loans which a borrower fails to repay as scheduled.

b) Banks should use some of the risk control procedures to guide against deficient analysis of project viability. An example of this is covenant which is a written agreement whereby the borrower commits himself of providing specific financial statement at specific intervals during the life of the loan.

c) Banks should device a system to curb the problem of recovery and overdue loans so as to offset to avoid issues of bad debt.

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