EFFECT OF NON PERFFORMING LOANS ON THE PERFORMANCE OF KEFFI MICRO FINANCE BANK

BY

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BEING A RESEARCH PROJECT SUBMITTED TO THE SCHOOL OF POSTGRADUATE STUDIES NASARAWA STATE UNIVERSITY, KEFFI IN PARTIAL FULFILMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF BUSINESS ADMINISTRATION DEGREE (MBA)

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DECLARATION

I hereby declare that this research project has been written by me and it is a report of my research work. It has not been presented in any previous application for Master in Business Administration (MBA). All quotations are indicated and sources of information specifically acknowledged by means of references.

MICHAEL DALYOP DAPWE **DATE**

NSU/MBA/FIN/0013/16/17

DEDICATION

This project is dedicated to my beloved family for their moral support and encouragement during the course of this programme

CERTIFICATION

The project titled, "Effect of Non-performing loans on the performance of Keffi Micro finance bank" meets the regulations governing the award of degree of Master in Business Administration (MBA), Faculty of Administration, Nasarawa State University, Keffi for its contribution to knowledge and literary presentation.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the study

Extension of credit facilities is one of the major activities of all Microfinance institutions including Savings and Loans Companies, Rural banks, Financial Non Governmental Organization(FNGOs) and credit Unions. This is usually evidenced by the large proportion that loans constitute in the overall operating assets of these lending institutions. Healthy loan portfolios are therefore vital for lending institutions in view of their impact on Liquidity, lending capacity, earnings and profitability of the MFIs. Microfinance Institutions (MFIs) currently provide financial services to an estimated 15 percent of the country‟s total population as compared with 10 percent for the commercial banking sector.(J.Obuobi and G. Polio, 2010). Some of the loans given out by the lending institutions unfortunately become non performing and eventually result in bad debts with adverse consequences for the overall financial performance of the institutions. The issue of loan default(NPLs) is becoming an increasing problem that threatens the sustainability of MFIs. The causes of the problem are multi-dimensional and non uniform among different literatures.

NPLs are always a source of misery for lenders because if an MFI 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 Nigeria banking and non-banking industries including MFIs has been on the rise in recent years as their loan portfolio increases despite efforts by these financial institutions to deal with it.

Keffi Microfinance bankis one of the leading microfinance institutions facing the challenge of a growing non- performing loan portfolio with its attendant harmful effect on the operations of the institution and the situation calls for remedial measures to curb it. The study therefore focuses on identifying the causes of non performing loans, the implications of NPLs on the operations of MFIs and the strategies to reduce the incidence of NPLs. Specifically, the project would identify underlying reasons for non-performing loans at Sinapi Aba Trust, determine the trend of the incidence of NPLs in keffi microfinance bank,

the impact of NPLs on Interest income, the impact of NPLs on operating income and the impact of NPLs on loanable funds. Again, it will be the objective of the study to examine the sectoral distribution of NPLs and the also come up with implementable strategies to address some of the causes of the incidence of non performing loans.

The financial sector (Banking and non banking)plays a very important role in every economy. There is evidence to suggest that well functioning lending institutions help to accelerate economic growth and conversely, poorly functioning ones impede progress and aggravate poverty (Barth et al., 2004). A key function of most banking and Microfinance institutions is lending with interest incomes on loans and advances constituting a large source of revenue for these financial institutions. According to CBN annual report(2008), the total NPLs of the MFI stood at 6% in 2004 and by 2006, it has

shot up to 9%. With loans and Advances making over 50% of the total operating assets of MFIs, if the trend of the incidence of NPLs continues, it will have a huge negative impact on the operations of the MFIs in Nigeria. This issue has gained increased attention in recent years because of its adverse effects on the banking and non banking financial institutions and the country‟s economy as a whole. The immediate consequences of non performing loans are the reduction in profitability through disposal costs like provisions for credit losses and direct write-offs for bad debts and shrinking of loanable funds. Large amounts of nonperforming loans in the banking and non banking financial system have at many times threatened the failure and actually collapsed many banks and microfinance institutions. Many researches on the causes of bank failure show that poor quality of loan portfolio is statistically a major predictor of insolvency (e.g. Dermigue-Kunt, 1989; Barr and Siems, 1994) with failing banks usually having high levels of non performing loans prior to failure. Capario and Klingebiel (1996) indicated that nonperforming loans represented 75% of total loan assets in Indonesia, which led to the collapse of over sixty banks in 1997. Banks and microfinance institutions in Nigeria are not insulated from the problem of delinquent loans.(Non performing loans)

1.2 Statement of the Problem

Loan portfolio constitutes the largest operating assets and source of revenue of most financial institutions‟. However, some of the loans given out become non performing and adversely affect the profitability and overall financial performance of the lending institutions. Many lending institutions in Nigeria are confronted with the challenge of rising non-performing loan portfolios despite efforts at stemming the tide. Keffi

microfinance bank is one of the pioneering Microfinance institutions with a deteriorating trend in the health of their loan portfolio in recent years; the FNGO‟s annual reports show that non-performing loan ratio went up from 1.5% in 2006 to 2.8% in 2007 and by the year 2009, the NPL ratio has reached 4.3% after a slight dip in 2008. The situation calls for an effective strategy to remedy it before it gets out of hand and this research work seeks among other objectives to come up with recommendations that will help arrest this deteriorating trend or at least help reduce the rate of loan default in MFIs.

1.3 Objective of the study

- The general objective of the study is to identify the major causes of non performing loans in the microfinance institutions in Nigeria. Specifically, it is aimed at:
- Determining the trend of incidence of NPLs in a selected MFI
- Assessing the impact of NPLs on Interest income, Operating profit and Loanable funds. Identifying factors accounting for the incidence of non-performing loans in Keffi Micro finance bank.

1.4 Research Questions

The research work seeks to find answers to the following questions:

- What are the causes of the incidence of NPLs in Keffi Micro finance bank.?

- 2. What effect does the incidence of NPLs have on interest income, operating . profit and loanable funds?
- What has been the trend of NPLs in the selected institution in the last five years.?

1.5 Significance of the study

The loan portfolios of the lending institutions are major assets that generate a significant amount of interest income. It play a critical role in determining the financial performance of the MFIs and it can therefore be said that the healthier the loan of the MFI, the better its financial performance will be. In the light of the importance of the health of the loan portfolio, it is essential that a study be conducted to identify the problems that negatively affect the performance of the MFIs. The outcome of this project would enable keffi microfinance bank adopt workable strategies to control the problem of a growing non-performing loan portfolio in the institution and thereby improve its financial performance and profitability.

Secondly, the project would be of benefit to the Nigerian banking and non-banking financial sectors as a whole since the financial(Lending institutions) in the country operate within the same environment and deal with customers of similar characteristics.

Thirdly, the project could serve as a source of reference for other related research works in the future.

Thus , the study would contribute immensely to the development of microfinance sector which play a significant role in the economy. This is because notwithstanding the challenges, microfinance has emerged globally as one of the effective strategies in poverty reduction with the potential for far-reaching impact in transforming the lives of the poor people.

1.6 Scope of the Study

The study focuses on the non performing loans in the Microfinance institutions in Nigeria with particular focus on keffi microfinance bank. Thus, the project seeks to establish the causes of poor loan repayment performance by the beneficiaries of Keffi bank. The reason for limiting the scope to keffi microfinance bank is that it is one of the MFIs which has been contributing significantly to expand the frontiers of microfinance operations in Nigeria since 1994. It possesses all the unique characteristics of Microfinance institutions, engages in almost all the activities undertaken by the other MFIs in the country and also they are located in almost all the ten regions in Nigeria. Additionally, microcredit activities of keffi microfinance bank covers several sub- sectors of the economy which makes it a model microfinance institution and therefore a suitable MFI which could be studied and the findings reasonably generalized as what pertains in other MFIs in Nigeria. Generally, this research work looks at the various classes of bad loans, the possible causes of bad loans, the impact of bad loans on the operations of keffi microfinance bank and the sectors with the highest default rate. The period of assessment

has also been limited to 2006-2010. This is to ensure that the result reflects the current trend in the operations of keffi microfinance bank

1.7 Limitations of the Study

Among the major constraints in this study was time. Looking at the short period required for the completion of the work, the case study approach was adopted. Even though the MFIs in the country share common characteristics and face similar challenges, there is still the possibility that some aspects regarding the topic may not be discussed if those aspects are peculiar with the MFIs that are not covered in the study. This is main reason why keffi microfinance bank which has operated in the country for over 16 years with all the typical characteristics of MFI was chosen for the study. A sample and not the entire population of credit staff and branch managers of the institution were interviewed or administered with questionnaire to obtain the primary data. This obviously imposed some limitations on the study. In addressing this limitation, an objective questionnaire and interview guides were designed for the respondents in order to reduce sampling error. Again, another limitation was access to information as not much research has been done with regards to MFIs. Most financial institutions will not readily disclose information to researchers for fear of breach of Oath of Secrecy(Duty of confidentiality). This constraints was dealt with by relying on published annual reports and financial statements and also assuring the respondents that the information was mainly for academic purposes and that their identities will not be disclosed anywhere.

CHAPTER TWO
LITERATURE REVIEW

2.0 Introduction

This chapter reviews the existing literatures related to the research problem and it is sub-divided into headings: Evolution of micro finance sub-sector, Various categories of Microfinance institutions in Nigeria, Performing and non performing loans in MFIs, Classification and Provisioning, Microfinance and development, Implication of NPLs, Causes of NPLs, Reducing the incidence of NPLs and the Challenges facing micro finance institutions in Nigeria.

2.1. Evolution of the Microfinance Sub-Sector in Nigeria

With almost thirty per cent of Nigerians living below the poverty line, microfinance has been identified as an important means of providing financial services to the population. It is therefore not surprising that the country's present and past governments have perceived microfinance as central to achieving the greater goal of poverty reduction. Through microfinance, the various governments have aimed to provide the poor, who do not have access to the formal financial sector, with greater access to customized financial services. The Government of Nigeria is committed to the goals of the Millennium Development Goals and one of the strategies is the building of a robust and sustainable microfinance industry which addresses poverty reduction, women"s empowerment and household welfare. Micro-entrepreneurs constitute about 66% of the labour force in the country

and,thus, represent a vital economic force.(Adjei, 2010) Increasing the access to financial services by this group deepens the financial sector and also links them to the economic mainstream. Indeed, the concept of microfinance is not new in Nigeria. There has always been the tradition of people saving and /or taking small loans from individuals and groups within the context of self-help to start businesses or farming ventures. For example, available evidence suggests that the first credit union in Africa was established in Nigeria in 1955 by Canadian Catholic missionaries. However, Susu, which is one of the microfinance schemes in Nigeria, is thought to have originated from Nigeria in the early twentieth century.

Over the years, the microfinance sector has thrived and evolved into its current state thanks to various financial sector policies and programmes undertaken by different governments since independence. Among these are:

- Provision of subsidized credits in the 1950s;
- Establishment of the Agricultural Development Bank in 1965 specifically to address the financial needs of the fisheries and agricultural sector;
- Establishment of Rural and Community Banks (RCBs), and the introduction of regulations such as Microfinance bank being required to set aside 20% of total portfolio to promote lending to agriculture and small scale industries.
- Shifting from a restrictive financial sector regime to a liberalized regime in 2000s
- Promulgation of Law 1998 to allow the establishment of different categories of non-bank financial institutions, including savings and loans companies, and credit unions.

These policies have led to the emergence of three broad categories of microfinance institutions. These are:

- Formal suppliers such as savings and loans companies, rural and community banks, as well as some development and Microfinance bank;
- Semi-formal suppliers such as credit unions, financial non-governmental organizations (FNGOs), and cooperatives;
- Informal suppliers such as susu collectors and clubs, Rotating and Accumulating Savings and Credit Associations (ROSCAs and ASCAs), traders, moneylenders and other individuals.

In terms of the regulatory framework, rural and community banks are regulated under the Banking Act 2004 (Act 673), while the Savings and Loans Companies are currently regulated under the Non-Bank Financial Institutions (NBFI) Law 1993 (PNDCL 328). The Bank of Nigeria has since 2011 designed operational guidelines and licensing requirements to help streamline the operations of MFIs in the country.

2.1.3 Microcredit and Microfinance

Microcredit

Microcredit is the provision of cash and in-kind loans in smaller amounts to micro and small entrepreneurs meant to improve their business operations. Microfinance consists primarily of providing financial services including, savings, micro-credit, micro insurance, micro leasing and transfers in relatively small transactions designed to be accessible to micro-enterprises and to low-income households. Microfinance may be

complemented by non-financial services, especially training, to improve the ability of clients to utilize the facilities effectively.

2.2 Performing Loans

Legally, a credit facility is defined to mean a contractual promise between two parties where one party, the creditor agrees to provide a sum of money to a debtor, who in turn promises to return the said amount to the creditor either in one lump or in installments over a specified period of time. The agreement may include provision of additional payment of rental charges on the funds advanced to the borrower(debtor) for the time the funds are in the hands of the debtor. The additional payments that are in the form of interest charges, processing fees, commissions, monitoring fees, among others are usually paid in addition to the principal sum lent. Indeed, these additional payments if made in accordance with the covenants of the credit facility constitute the interest income to the lender/creditor. A loan /credit facility may therefore be considered as performing if payment of both the principal and interest charges are up to date as agreed between the lender and the borrower. Per the Bank of Nigeria(BoG) classification, loans are considered current if the payment of principal and interest are up to date. It goes further to stipulate that an overdraft is classified as current or performing if there are regular activities(swing) in the account with no sign of hard core debt build-up.(BoG, 2008). It can therefore be deduced that loans that are up to date in terms of principal and interest payment are described as performing loans and they constitute the healthy asset portfolio.

2.3 Non Performing Loans (NPLs)

The term Non-Performing Loans is used interchangeably with Bad loans and impaired loans as identified in Fofack(2005). Berger and De young (1997) also describes these types of loans as"problem loans" In broad context, loans that are outstanding in both interest and principal for a period of time contrary to terms and conditions spelt out in the loan agreement are considered as non performing loans. Available literature gives varied descriptions of non performing loans. Some researchers observe that whilst certain countries use quantitative criteria, e.g the number of days the credit facility is overdue, others rely on qualitative criteria such as information about the customer"s financial status and management judgement about future payments.(Bloem and Gorter,2001)

Alton and Hazen(2001) described non performing loans as loans that are ninety days or more past due or no longer accruing interest. Caprio and Klingebiel(1990) cited in Fofack(2005), consider non performing loans as loans which for a relatively long period of time do not generate income, that is both the principal and interest on these loans remain unpaid for at least 90 days. A non performing loan may also refer to one that is not earning income and full payment of principal and interest is no longer anticipated, principal or interest is 90 days or more or the maturity date has passed and payment in full has not been made.(http://teachmefinance.com/FinanceTerms/nonperformingloan.html)

The above descriptions of non performing loans indicates that loans for which both principal and interest have remained unpaid for at least 90 days are considered non performing loans. Analysis of the loan portfolio of Microfinance institutions namely keffi micro finance bank, Pro Credit, Opportunity International, First Allied S & L and La Community Bank in December 2010 showed that out of a total loan portfolio of 108,214,000, 6,125,000, representing 5.6% was classified as non performing. These were the loans falling into the adverse classification category. The problem of NPLs in MFIs is a widespread phenomenon in Africa and some East Asian countries such as India and Bangladesh. For instance, the National Bank of Rwanda reports that NPLs owed to Microfinance Institutions rose from 3.6 billion dollars in 2010 to 6.8billion in 2011. Quantitative criteria for identifying non performing loans will be used in this study. Thus, any loan whose repayment has been outstanding for atleast 90 days is considered a non performing loan. According to Berger and De Young (1997), such loans could be injurious to the performance of the financial institutions.

2.4 Loan Classification and Provisioning

All licensed financial institutions are required to monitor and review their portfolio of credit and risk assets at least once every quarter on a regular basis. Assets are classified into four grades of risk: (i) standard; (ii) sub-standard;(iii) doubtful; and (iv) loss. Assets in risk grades (ii) to (iv) are considered non-performing and therefore no income may be accrued on them. BOG has specified prudential norms for microenterprise and small business finance which take into account the characteristics of the enterprises and businesses in these two categories. Microfinance and small business loans are required

to be reviewed once every month and are to be classified into (i) current, or (ii) delinquent. A delinquent loan is one on which payment of interest or scheduled payment of principal has not been received as of due date. BOG does not permit interest income to be accrued on delinquent loan accounts.

2.4.1 Provisioning for portfolio at risk.

Across the world, the major factor considered by the lending institutions before granting loans is the ability and the willingness of the borrower to repay the loan on the due date. When the probability of collecting a loan becomes very low, the normal practice is to charge the loan off by deducting its value from the loan portfolio balance by reducing loan loss reserve or, if there is no reserve, by charging an equivalent expense to the income statement . Thus, as a results of uncertainties in future cashflows and willful defaulting and to be able to minimize the risk of default, microfinance institutions normally require security in the form of guarantee and/or deposit, (usually up to 25% of the loan amount). Borrowers who miss payments are pressured at the due date and if the arrears continue, legal action is initiated against the borrower and guarantor(s) to recover any amounts owed, but usually after the designated collateral has been seized and liquidated to reduce the borrowing(outstanding loan balance). Provisioning for delinquent microfinance and small business loans is made on a “basket” basis, rather than on an individual loan basis. Basket-based provisioning involves making a blanket provision for the aggregate outstanding balances of loans grouped in each age basket, without regard to any security available for individual loans.

The prescribed rate of provisioning for microfinance and small business loans is shown below: In addition to the specific loss provisions to be made for delinquent or non-performing microfinance and small business loans, BOG requires licensed MFIs to maintain a general loss provision of 5% of the aggregate outstanding of all the current or standard class of loan assets. Microfinance institutions are also required to separately disclose, in their financial accounts and reports, the specific and general loss provisions made for non-performing or delinquent loans and standard/current loan assets.

Loans Classification and provisioning.

Table 2.1

PROVISION NO OF DAYS OF DELINQUENCY

1 5% Up to 30 days

2 20% 31-59 days

3 40% 60-89 days

4 60% 90-119 days

5 80% 120-149 days

6 100% 150 days and above.

2.5 Implication of NPLs for Microfinance Institutions

The interest income generated from loans contribute significantly to the profitability performance of the microfinance institutions. However, when loans become delinquent, it has a serious negative effect on the health and operations of the MF institution. One of

the reasons is that, in line with the Bank of Nigeria regulations, the lending institution has to make provision and charges for credit losses(bad debt/impairment) which ultimately reduce the profit level.

Again, large non performing loan portfolio tend to undermine the Microfinance company‟s ability to grant more credit. This is because the loanable funds tend to deplete when repayment of loans delays or fail to come.

Another important implication of non performing loans; which is sometimes described as „toxic asset‟ is the loss of confidence on the part of depositors and investors leading to liquidity challenges. Yet again, another implication of non performing for the microfinance institutions is the that huge amounts written off as bad debt adversely affect the growth of the shareholders wealth since the profit which is reinvested(ploughed back) into the business to grow the capital base is reduced as a result of provision for credit losses. In a similar token, dividend payment is equally negatively affected because the provision for credit losses are deducted before dividends are declared.

Some foreign literatures indicate that failing banks have huge amount of non performing loans prior to failure and that asset quality is a significant predictor of insolvency.(Berger and De Young(1997). Indeed in Nigeria, most MFIs have collapsed mainly on the account of non performing loans. The issues discussed above show the gravity of the implication of non performing loans on the operations of MFIs and this study attempts to identify the major causes of these NPLs among other objectives and proffer some suggestions aimed at reducing the incidence of NPLs in MFIs in Nigeria.

2.6 Factors Accounting for NPLs

Some research findings and publications indicate that non performing loans are caused by poor management. Berger and De Young (1997) .They argue that managers in most banks or MFIs with the problem of non performing loans do not practice adequate loan underwriting, monitoring and control Credit culture is another factor which has been identified by some research findings(e how) as a cause of NPLs. Sometimes borrowers decide to apply for loan without thinking enough about the future and what else they need to buy with their income. When this occurs, a credit culture can develop where borrowers take out large loans not because it is financially wise to do so but because they see others do it. This can result in defaulted loans.

A world Bank policy research working paper on NPLs in Sub-Saharan Africa revealed that NPLs are caused by adverse economic shocks coupled with high cost of capital and low interest margins (Fofack, 2005) Goldstein and Turner (1996) stated " the accumulation of NPLs is generally attributable to a number of factors, including economic downturn, macroeconomic volatility, terms of trade deterioration, high interest rate, excessive reliance on overly high-priced inter-bank borrowings, insider borrowing and moral hazard.

Another literature(e how) identified sudden market changes as yet another factor which account for NPLs. Any sudden market change can change the loan market by affecting how much money people can take as loans and make payments. If the market suddenly

changes and prices of items increase due to shortage or increased demand, borrowers will have less money to pay off their loans which can lead to loan default.

Nicholas Rouse (1989) indicated in his work that problem loan can emanate from overdrawn account where there is no overdraft limit or overdraft taken on account which has not been actively operated for some time and overdraft taken in excess of the reasonable operational limit. He also identified lack of good skills and judgement on the part of lenders as a possible cause of NPLs. Bloem and Gorter(2001) asserted that NPLs may be caused by less predictable incidents such as the cost of petroleum products, prices of key exports, foreign exchange rates, or interest rate change abruptly. They also indicated that poor management, poor supervision, overoptimistic assessments of creditworthiness during economic booms and moral hazards resulting from generous government guarantees could also lead to loan default.

Again, another publication(kalyan-city.blogspot.com) identifies speculation : i.e investing in high risk assets to earn high income and also fraudulent practices such advancing loans to ineligible persons or advances without security or reference as some of the causes of NPLs. It also cites internal reasons such as labour agitation/shortage and market failure as some of the causes of the incidence of NPLs. External factors such as recession in the economy and natural calamities/disasters were also cited by the same publication as some of the factors accounting for loan default.

2.7 Loan Processing in MFIs

There is an element of risk in any loan granted because the expected repayment may not occur. Lending involves a lender providing a loan in return for a promise of interest and principal repayment in future(Kay Associate Ltd), 2005). Because of this risk of default in loan repayment, lenders needs to project into the future and make sound judgment that will ensure that repayment is effected at the agreed date. Available literature places so much importance on the lender‟s role in ensuring good decisions relating to the granting of loans in order to minimize credit risk. The lender must always aim at assessing the extent of the risk associated with the lending and try to reduce factors that can undermine repayment. The lender should therefore assemble all the relevant information that will assist him/her in arriving at a sound credit decision. In view of the possibility of non payment which leads to NPLs, MFIs have adopted a standard loan request procedures and requirements usually contained in credit policy manual to guide loan officers and customers. Some of the factors that the MFIs consider before granting loans include the following which are often referred to as the canons of good lending:

1. The character of the prospective borrower
2. Amount being requested by the customer
3. Margin(Interest margin, commissions and relevant fees.)
4. The purpose of the loan
5. Ability of the borrower to manage business successfully.
6. Repayment(source of repayment must be credible)
7. Insurance(security provided by the customer)

8. Technical and financial viability of the business

Individuals and micro-entrepreneurs that apply for loans from Keffi Microfinance bankproceed through three stages prior to obtaining approval.

(i) Preliminary Screening

In this stage, loan applicants make contact with the institution and are carefully screened and asked to answer specific questions regarding the status of their business and household accounts, in order to establish whether they qualify under KEFFI MICROFINANCE BANK‟s eligibility guidelines. This is one of the most critical stages in the loan processing procedures since it is the stage where the information about the business and creditworthiness of the customer is analysed.

(ii) Loan Proposal and Credit Committee

Loan applicants are assigned to specific loan officers. Applicants undergo a further review to verify the information taken at the initial stage, and a visit to the applicant‟s businesses and household is arranged. The information thus developed is organized into a formal loan proposal and presented to the credit committee for approval. The loan amount and tenure are determined based on the adequacy of the cash flows generated by the borrower‟s business, sufficient personal collateral and or guarantors agreeing to cosign the loan agreement.

(iii) .Monitoring and Repayment

After disbursement, the account officer frequently visits the borrower‟s business to ensure that the credit facility(loan) are being used for the specific purpose(s) for which the loan was granted, and to remind borrowers of their next repayment date. According to Rouse(1989) this is one area many lenders pay little attention but if it is properly followed, the incidence of NPLs can be reduced considerably. He identified internal records, visits and interviews, audited and management accounts as some of the things that help in the monitoring and control process.

Monitoring can help minimize the incidence of NPLs in the following ways:

 Ensuring the utilization of the loan for the intended purpose

 Identifying early warning signals of any problem relating to the operations of the business that are likely to affect the performance of the loan

 Ensuring compliance with the covenants of the loan facility.

 Affording the lender the opportunity to discuss the problems and prospects of the borrower‟s business. Borrowers who miss *repayments* are pressured at this stage; if the arrears continue to pile up, legal action is initiated against the borrower and guarantor(s) to recover any amounts owed, but usually after the designated collateral has been seized and offset against the indebtedness.

2.8 Reducing Non-Performing Loans in Microfinance Institutions

The incidence of NPLs can be reduced by ensuring that loans are granted to only applicants who demonstrate the ability to repay the loan at the agreed date. Credit

analysis of the prospective borrower should be carried out to determine their risk profile and to reach a sound credit decision.

Again, loan repayment should be constantly monitored and whenever there is a default in repayment a quick action should be taken. The MFIs 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, 2005) Golden and Walker (1993) also identify the 5Cs of bad credit, which represent things to guard against to help prevent the incidence of NPLs.

1. 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.

2. 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. Each of these makes it difficult to monitor a borrower‟s progress and identify problems before they become unmanageable.

3. Communication ineffectiveness refers to when a Lender‟s 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.

4. 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.

5. Competition involves following competitor‟s behaviour rather than maintaining the lender‟s own credit standards. Doing something because another lender is doing it does not mean it is a prudent business practice.

2.9 Challenges facing the Microfinance Sector

The key challenges confronting the microfinance institutions in developing countries such as Nigeria include Inadequate funding for capacity building, inadequate and expensive infrastructure base, Inadequate credit delivery and management, the inability to target the vulnerable and the marginalized, information gathering and dissemination, regulation and supervision, consumer protection and research, monitoring and evaluation.

(i) Capacity Building

The growing competition, poaching of staff and lack of training and increasing demand for higher pay levels make human resources one of the most intractable problems in the

sector. Capacity building in the form of a skilled and professional human capital base and adequate access to funding is essential for the building of a sustainable and efficient microfinance sector.

(ii) Inadequate and expensive Infrastructure base

Inadequate and expensive infrastructure such as communication, information technology, roads and electricity results in high operational cost within the microfinance sector. The current limited supply of these resources limit operations and drives up cost. In respect of infrastructure development, there is the need to establish a solid base and provide adequate logistics such as telecommunications and information technology to support the operations of microfinance institutions to make them more efficient.

(iii) Inadequate Credit delivery and management

The mechanism for credit delivery within the microfinance sector is inadequate and the microfinance institutions do not have the expertise to categorize their client into the various poverty categories so as to meet their specific needs.

(iv) Information Gathering and Dissemination

Lack of adequate and reliable information remains a challenge to the microfinance industry. These problems adversely affect the ability to properly target the right clients in order to meet the specific needs of such clients. There is also a paucity of information on microfinance institutions and their operations.

(v) Regulation and Supervision

Microfinance institutions in the formal sector operates within a rigid regulatory and supervisory environment which presents some challenges for innovation, outreach and overall performance of the institutions. There is also an absence of specific BoG regulatory guidelines for the apex bodies in the semi-formal and informal sectors for the supervision of their members.

2.1 Theoretical Framework

Asymmetric Information Theory

This is a theory relevant for situations where there is imperfect knowledge. In particular it occurs where one party has different information to another. Asymmetric information is a problem in financial markets such as borrowing and lending. In these markets the borrower has much better information about his financial state than the lender. Akerlof (1970) first presented this theory in the easy; "The Market for Lemons". It is the single most important study in the literature on economics of information. Mirrlees (1996) study Asymmetry of information related to access to information among participants in the process of making economic decisions.

Pagaon and Jappelli (1993) show that information sharing reduces adverse selection by improving banks information on credit applicants. Auronen (2003) The theory of asymmetric information tells us that it may be difficult to distinguish good from bad borrowers, which may result into adverse selection and moral hazards problems. The theory explains that in the market, the party that possesses more information on a specific item to be transacted (in this case the borrower) is in a position to negotiate optimal terms for the transaction than the other party (in this case, the lender) (Auronen, 2003). The

party that knows less about the same specific item to be transacted is therefore in a position of making either right or wrong decision concerning the transaction. Adverse selection and moral hazards have led to significant accumulation of non-performing loans in banks (Bofondi and Gobbi, 2003). Commercial bank managers may know more about effects of nonperforming loans on profitability of Microfinance bank than other stakeholders. In this case, they could fail to disclose nonperforming loans and/ or use provisions for losses on non performing loans for profit smoothening.

Agency Theory

The first scholars to propose, explicitly, that a theory of agency be created, and to actually begin its creation, were Ross (1973) and Mitnick (1973), independently and roughly concurrently. Ross (1973) is responsible for the origin of the economic theory of agency, and Mitnick (1973) for the institutional theory of agency, though the basic concepts underlying these approaches are similar. Indeed, the approaches can be seen as complementary in their uses of similar concepts under different assumptions.

The agency theory is gaining a lot of popularity in explaining the financial performance of organizations. The theory seeks to explain the relationship that exists between the management of an organization and the owners of the organization who are usually the people holding stocks for the organization. The theory posits that there is an agency conflict. The management of an organization is usually considered as an agent who has been contracted by the stockholders to work towards enhancing the stockholder value through good financial performance. The management is therefore expected to act in the best interests of the owners and enhance the financial performance of the organization.

However, the theory suggests that the managers who are agents may be involved in activities that are aimed at serving personal interest at the expense of the owners of the organization. The theory suggests that when this happens, the financial performance of the organization may easily suffer. Stockholders therefore can employ a number of strategies to ensure the management acts in the interest on the organization. The theory suggests that management can be rewarded financially in order to motivate them to work for the interests of the company. The owners can also issue threats such as hostile takeover to force management to perform the required duties.

Modern Portfolio Theory

Markowitz (1952) Modern portfolio theory (MPT) is one of the most important and powerful economic theories dealing with finance and investment. Modern portfolio theory measures the benefits of diversification, known as "not putting all your eggs in one basket". Modern portfolio theory (MPT) is an investment theory which tries to explain how investors could maximize their returns and minimize their risks by diversification in different assets. Tobin (1958) expanded the theory of Markowitz's (portfolio theory) by adding the analysis of risk free assets which made it possible to influence portfolios on the efficient frontier. Markowitz (1952) and Tobin (1958) showed that it was possible to identify the composition of an optimal portfolio of risky securities, given forecasts of future returns and an appropriate covariance matrix of share returns.

The portfolio theory approach is the most relevant and plays an important role in bank performance studies (Atemnkeng & Nzongang, 2006). According to the Portfolio balance

model of asset diversification, the optimum holding of each asset in a wealth holder's portfolio is a function of policy decisions determined by a number of factors such as the vector of rates of return on all assets held in the portfolio, a vector of risks associated with the ownership of each financial assets and the size of the portfolio. It implies portfolio diversification and the desired portfolio composition of Microfinance bank are results of decisions taken by the bank management. Further, the ability to obtain maximum profits depends on the feasible set of assets and liabilities determined by the management and the unit costs incurred by the bank for producing each component of assets, Atemnkeng & Nzongang, (2006. Microfinance bank should consider diversifying investments portfolio to minimize risk of credit takers defaulting in loans repayments and causing non-performing loans portfolios that affects profitability.

The concept of revenue diversifications follows the concept of portfolio theory which states that individuals can reduce firm-specific risk by diversifying their portfolios. The proponents of activity diversification or product mix argue that diversification provides a stable and less volatile income, economies of scope and scale, and the ability to leverage managerial efficiency across products and for the case of Microfinance bank, reduce non performing Loans and increase Return on Assets which is a measure of profitability.

2.4 Empirical Review

Several empirical studies have been conducted on non performing Loans and profitability of Microfinance bank and confirm that adverse changes in economy contribute to non-performing loans and adversely affect the banks' performance.

Hou and Dickinson (2007), which examined the non-performing loans on microeconomics, specifically at the bank level to empirically evaluate how non-performing loans (NPLs) affect Microfinance bank' lending behavior. In particular, it is discussing some consequences of nonperforming loans (NPLs) on the economics. They have used empirical methodology for testing the effect of non-performing loans (NPLs) which the data taken from individual bank's balance sheet to assess whether non-performing loans (NPLs) will negatively affect bank's lending behavior.

Kolapo, et al. (2012) also analyzed the influence of credit risk on performance of five banks in Nigeria by taking data from 2000-2010. Credit risk is measured by taking ratio of nonperforming loans to loans plus advances, total loans to advances plus deposits and ratio of loan loss provisions while performance is measured by return on assets. Fixed effect model used in the study and according to results of regression analysis, non-performing loans and loan losses provisions are adversely affecting the performance while total loans to advance plus deposit ratio has positive significant effect on the performance. This is evident from the study that banking industry needs to improve their loan administration processes for maximization of profits.

Mohammed (2012) studied the bank performance in context of corporate governance for which mainly the ratios of non-performing loans and loan deposits have been used. Study was conducted on 9 banks of Nigeria for a period of 10 years from 2001-2010. According to generalized least square regression results, non-performing loans ratio has significant negative effect while loan deposit ratio has insignificant negative effect on performance.

So, survival of banks is strongly dependent upon the better asset quality means dependent upon minimizing the non-performing loans ratio.

Azeem & Amara (2013) study Impact of profitability on quantum of non-performing loans in Pakistani Banks. The Data of one business cycle of sixteen Pakistani banks were collected from 2006 to 2012. The sample comprised of sixteen public and private banks with different sizes. Three models were adopted to check the relationship between profitability and nonperforming loans. Model one represented return on asset as dependent variable while nonperforming loans were taken as independent variable. Model two represented Return on Equity as dependent variable while non-performing loans were taken as independent variable.

Model three represented Stock Return as dependent variable while non-performing loans were taken as independent variable. The results of the study were as follows; Model one using Returns on Assets indicated that profitability and non-performing loans have negative relationship and that One thousand increases in non-performing loans may decrease the profitability up to 0.00527 %. Model two with Return on Equity indicated that profitability and non-performing loans have negative relationship and that One thousand increases in non-performing loans may decrease the profitability up to 0.00371%. Model three revealed that stock returns and non-performing loans have no significant relationship and no room for generalization of results is possible on this finding. The study found that NPLs disturb the profitability of banks and every other financial institution, which is involved in lending activity and that in State Bank of Pakistan, there are some reasons noted to have intensify this issue which are namely;

marks up on mark up, embezzlement in amount, wrong calculation procedures and divergent practices in calculating amount of NPLs. However, data of non- performing loans in Pakistan was only available from six years 2006 to 2012 and a Short panel of sixteen Banks only was used in the study.

Shingjergji (2013) studied the impact of different bank specific factors on non-performing loans of Albanian banks by taking quarterly data from 2002-2012. Dependent variable used in the study is non-performing loans (NPLs) while independent variables include capital adequacy ratio (CAR), loan to asset ratio (LTA), return on equity (ROE), natural log of total loans, and natural log of net interest margin (NIM). Regression results obtained by using ordinary least square revealed negative insignificant relation of CAR with NPLs. Relation of loan to asset ratio has been found negative but total loans level is positively influencing the NPLs means increased loans level will result in increased level of NPLs. On the other hand, NIM and ROE are negatively linked with NPLs depicting that high NPLs deteriorate the performance of banks.

Kaaya and Pastory (2013) analyzed effect of credit risk (measured by ratios of nonperforming loan, loan loss to gross loan, loan loss to net loan and impaired loan to gross loan) on banks' performance (measured by return on assets) by controlling the effect of deposits and bank size. A sample of 11 banks in Tanzania has been used for this analysis. According to correlation and regression results, credit risk measures of non-performing loans, loan loss to gross loan, loan loss to net loan have significant negative influence on banks' performance. It is concluded that performance of banks can be increased by effective risk management as it help to reduce non-performing loans and

loan losses. Vatansever and Hepsen (2013) investigated the presence of any significant relation (if exists) of non-performing loans with macroeconomic indicators, global and bank level factors in Turkey for a period of January 2007 to March 2013. Results obtained from ordinary least square regression helped in categorizing the factors significantly affecting the non-performing loans. Among various macroeconomic, global and bank level factors used in the study, only the variables of industrial production index, Istanbul stock exchange 100 Index, inefficiency ratio of all banks have significant negative effect while unemployment rate, ROE and capital adequacy ratio have positive significant effect on non-performing loans.

CHAPTER THREE
RESEARCH METHODOLOGY

3.1 Research Design

In conducting research, there are many strategies that can be used. The research strategy could be experiment, survey, case study, grounded theory and archival research. (Saunders et al, 2007). No research strategy is inherently superior or inferior to any other. What is most important is that a particular research strategy will enable the researcher to answer a particular research question(s) and realize the objectives (Saunders et al, 2007). Many components of a given social situation. Robson (2002:178) as cited by Saunders et al, 2007; defines case study as „a study for doing research which involves an empirical investigation of a particular contemporary phenomenon within its real life context using multiple sources of evidence".

The study is of descriptive survey design nature. A descriptive survey is a design that involves establishing what is happening as far as a particular variable is concerned and the design has been used to investigate the effect of non-performing loans on profitability of Microfinance bank in Nigeria. The study covered the period between 2004 and 2013. Profitability measured by Return on Assets (ROA) has been taken as dependent variable and non performing loans measured by non performing loans ratio of nonperforming loans over total loans and advances has been taken as independent variable. CAMEL factors affecting profitability namely; Capital adequacy, Operational

costs efficiency and Liquidity have been considered in the analysis as controlling variables.

3.3 Population

The targeted population for the study includes all the Microfinance bank that are registered by Central Bank and operational in Nigeria as at 31st December 2013. According to the Central Bank of Nigeria, there were 43 Microfinance bank that were operating in the country (CBN, 2013). The study collected data from all the 43 Microfinance bank since the population was a small population and implied that a census was more applicable.

3.4 Data Collection

The data utilized in the study is secondary data. It comprised of Return on assets (ROA), Non performing Loans ratio computed from the financial statements of the Microfinance bank for the period year 2004 to 2013. Beside this the ratios for computing; Capital adequacy, Operational costs efficiency and Liquidity were computed from the financial statements of the Microfinance bank for period under study and used as control variables. The data were collected from; The Central Bank of Nigeria reports, audited published accounts of Microfinance bank in Nigeria, Banking Survey (East Africa) Report and the Nigeria National bureau of statistics. A data collection sheet was prepared to assist in gathering the data.

3.5 Data Analysis

The data collected was sorted and organized before capturing the same in Statistical packages for social sciences (SPSS) for analysis. ANOVA, Univariate, Multivariate analysis of MultiFactor ANOVA and Partial Correlation Analysis was done.

3.5.1. Analytical Model

The multi-linear regression model similar to one used by Kaaya and Pastory (2013) to analyzed effect of credit risk on banks' performance in Tanzania by controlling the effect of deposits and bank size was used. Profitability measured by return on Assets was taken as dependent variable, non-performing loans measured by non performing loans over total loans and advances was taken as independent variable and Capital adequacy, Operational costs efficiency and Liquidity were taken as controlling variables in the multi-linear regression as follows;

$$Y = \alpha + \beta 1X1 + \beta 2X2 + \beta 3X3 + \beta 4X4 + e$$

Where:

Y= Profitability measured using Return on Assets

α = Constant

βi = Beta Coefficient of variable i which measures the responsiveness X to unit change of in i X1= Non performing Loans, measured using Non performing loans ratio. Computed as total non-performing Loans over Total Loans and advances (Total non-performing Loans / Total loans and advances).

X2-X4: Control Variables

The Controlling variables have been added to take consideration of the CAMEL factors that also affects profitability in the analysis.

Where:

X2- Capital Adequacy. Measured as a ratio of Core Capital over Total Risk Weighted Asset Computed as (Core Capital / Total Risk Weighted Assets)

X3- Operational Cost Efficiency – Measured as Cost income ratio and computed as; (total expenses/Total Revenue)

X4- Liquidity – Measured as Ratio of Liquid Assets to Total Liabilities. Computed as (Quick Assets/ Total liabilities)

e= error term

Test of significance

Parametric tests were estimated to determined the significance of the relationship using; The correlation coefficient (r), coefficient of determination (r^2), coefficient of multiple correlation (R^2), Univariate Analysis, Bivariate Analysis, Partial correlation, and ANOVA using F-Test. Correlation coefficients, r, measures the strength and the direction of a linear relationship between the two variables. The coefficient of determination, r^2, determines the degree of linear-correlation of variables ('goodness of fit') in regression analysis. The coefficient of multiple correlation R^2 measures how well a dependent variable could be predicted using a linear function of a set of other variables (covariates).

Bivariate analysis of variables showed the relationships between any two variables for the purpose of determining the empirical relationship between them. Partial Correlation tests examined relationship between dependent variable and independent variable, while controlling for other variables that may be related to the dependent variable. ANOVA provided statistical test of whether or not the means of several groups are equal. F-test showed if variances of two variables were equal and two-tailed test was used to test against the alternative that the variances are not equal. Univariate analysis of dependent variable and Control Variables shows the relationships between dependent variable and control variables.

CHAPTER FOUR

ANALYSIS AND PRESENTATION OF DATA

4.1 Introduction

This chapter presents data analysis, results and discussion made from the study on the effects of nonperforming Loans on profitability of micro finance banks in Nigeria.

4.2 Findings

The regression analysis was performed with the independent variables being non performing Loans ratio and non performing loan coverage ratio. Profitability measured by Return on assets (ROA) was the dependent variable. Capital Adequacy, Operational efficiency and Liquidity have been used as control variables. The population consisted of 23 banks licensed by the Central bank of Nigeria and operational in Nigeria in the period and the data was collected from the financial statements of each commercial bank and annual mean aggregates for all the Microfinance bank were obtained for each period under the study. Data obtained were transferred to SPSS as variables for regression analysis and results were obtained.

Results are as indicated in tables 4.1. The findings of the study show; descriptive statistics, Univariate analysis of dependent variables and control variables, findings before control variables are incorporated, the findings when effects of control variables are incorporated and interpretations of the findings. The adjusted R-square measures the

degree of variability of the dependent variable due to the change in the independent variable. Two tail Test of significance was carried out for all variables studied at 5 % test of significance and 95% confidence level. From the observation, any p-value that is greater than 0.05 was deemed to show significant relationship between variables tested, else the relationship was considered insignificant. The dispersion of all observations is divided into variance explained by the regression and residual variance, unexplained. R^2 has been taken as the proportion of variance explained in relation to the total variance. The standardized coefficient and the Fstatistic indicated the strength of the relationship between the variables and the appropriateness of the set of data to the regression model and/or test.

4.2.1 Descriptive statistics

Table 4.1: Descriptive Statistics of all the Variables

N Minimum Maximum Mean

Std.

Deviation Skewness Kurtosis

Statistic Statistic Statistic Statistic

Std.

Error Statistic Statistic

Std.

Error Statistic

Std.

Error

Y 10 10.88 15.21 12.7410 .34514 1.09142 .896 .687 3.282 1.334

X1 10 3.67 21.27 9.0670 1.94886 6.16284 1.143 .687 .048 1.334

X2 10 13.06 16.15 14.6470 .36487 1.15382 -.370 .687 -1.569 1.334

X3 10 50.36 60.13 55.6910 1.13189 3.57936 -.196 .687 -1.440 1.334

X4 10 31.35 40.29 37.0420 .94450 2.98677 -.933 .687 -.340 1.334

Valid N

(listwise)

The table shows the summary of minimum, maximum, mean, standard deviation, Skewness and Kurtosis of data used to analyze the variables. Minimum, and maximum, mean and standard deviation from the mean of the variables in 10 year period/ time series in the study. Skewness indicates asymmetry and deviation from a normal by data in the distribution analysis. Kurtosis indicates flattening or "peakedness" of data in the distribution

4.2.2 Inferential Statistics

This shows the findings of the regression analysis obtained. It shows findings on effects on non performing loans on profitability of Microfinance bank before incorporating control variables on regression analysis, then correlations between all variables and finally the effect of nonperforming loans on profitability when control variables are incorporated in the regression analysis.

4.2.2.1 Findings before Control variables are incorporated

The findings show ANOVA of Return on Assets (Y) and Non Performing Loans (X1) and before control variables are incorporated.

Table 4.2 Model Summary of ANOVA of Profitability (Y) and Non Performing Loans (X1)

Change 1 .705a .497 .434 .82077 .497 7.914 1 8 .023

Univariate Analysis of Dependent Variable and Control Variables

Dependent Variable: Y

Type III Sum of

Squares df Mean Square F Sig. Corrected Model 6.396a 3 2.132 2.958 .120

Intercept .976 1 .976 1.355 .289

X2 1.022 1 1.022 1.418 .279

X3 .697 1 .697 .967 .363

X4 .023 1 .023 .032 .864 Error 4.325 6 .721 Total 1634.052 10 Corrected Total 10.721

a. R Squared = .597 (Adjusted R Squared = .395)

The Table 4.3 above shows the relationships between dependent variable and control variables. The results shows Adjusted R squared of 0.597 meaning that control variables can explain up to 39.5 % of the variances between dependent variable and control variables. The fact that significance tests are greater than 0.05 indicates that not all control variables are significant in explaining the variance between dependent variable and the control variables.

4.2.2.3 Bivariate Analysis of Variables

This shows the findings of relationships between any two variables for the purpose of determining the empirical relationship between them. The table 4.4 indicates that independent variable X1 and control variables X2 and X3 are significant and appropriate in explaining relationships with dependent variable Y because it has significant tests of 0.23, 0.017 and 0.029 respectively when regressed with Y. The table also show that shows that variables X1, X2,X3, and X4 have relationships between themselves meaning there is Multicollinearity between the variables. It also and show that control variable X4 is not appropriate and is not significant because it has significant tests of 0.544 when regressed with dependent variable Y.

This indicates that Liquidity has no significant linear relationship with return on assets and other control variables used in the test.

4.3 Discussion of Findings

Result of tests without taking into account effects of Control Variables indicates that return on assets (Y) and Non performing Loans Ratio (X1) have correlation coefficient of

negative ()0.705 and significance test of 0.023. The results also gives the adjusted R square of 0.434 which indicates that non performing Loans explains 43.4% of the variation between non performing Loans and profitability of Microfinance bank. The test of correlation of coefficients to establish effects of incorporating control variables into the relationship between dependent variable and independent variables shows that non performing loans ratio negatively affects profitability of Microfinance bank to extend of negative 40.4 %.

It is evident from the findings that non performing loans negatively affect profitability of Microfinance bank in Nigeria. This can be illustrated by the results of test of nonperforming loans measured by non performing loans ratio and profitability measured by return on Assets. The findings also established that some control variables such as; Capital adequacy and operational cost efficiency are significant in explaining variances with profitability while other control variables like liquidity are in appropriate and insignificant in explaining the variances with profitability and non performing loans

CHAPTER FIVE:

SUMMARY, CONCLUSION AND RECOMMENDATIONS

5.1 Introduction

The study set out to find the effect of nonperforming loans on performance of micro financebanks in Nigeria. This chapter presents discussions of the key findings, conclusion and recommendations from the findings.

5.2 Summary

The study is on the effect of nonperforming loans on profitability of Microfinance bank in Nigeria. The key concepts in the study are non performing loans and profitability in context of Microfinance bank in Nigeria. Profitability is measured by Return on Assets (ROA) and non performing Loans are measured by non performing Loans ratio. Other CAMEL factors affecting profitability were considered as control variables. The control variables considered are; Capital Adequacy, Operational Efficiency and Liquidity. This study was conducted through the use of a descriptive design. The Population of study comprised of the entire 43 Microfinance bank that have been licensed by Central Bank of Nigeria. The secondary data in this analysis covered a period of 10 years from 2004 to 2013.

Multi linear regression model was used to analyze the data. The findings established that non performing loans negatively affects profitability of Microfinance bank. It also indicate that non-performing loans ratio measured by non-performing loans over total

loans and advances is a good measure of nonperforming loans as the findings indicate that it is appropriate and statistically significant in explaining variance with return on assets. The study also indicates that Capital Adequacy and Operational cost efficiency affects profitability of Microfinance bank in Nigeria. In essence, the study informs that mere reporting of increases in profits and increases in nonperforming loans could be misleading and that financial ratios have importance of enhancing understandability of financial performance. In particular non performing loans ratio and return on assets ratio analysis can inform better on the effects of nonperforming loans on profitability of Microfinance bank than mere comparison of quantum figures.

5.3 Conclusion

This study examines the effect of nonperforming Loans on profitability of Microfinance bank in Nigeria. The regression results indicate that non performing loans negatively affects profitability of Microfinance bank in Nigeria. The study found that non performing loans ratio measured by non performing loans over total loans and advances is appropriate and significant in explaining effect of non-performing loans on profitability of Microfinance bank. The findings also indicated that Multi linear regression model is appropropriate for testing the effects of nonperforming loans on profitability using non performing loans ratio as independent variable and return on assets are dependent variable respectively. This study therefore confirmed that non performing loans negatively affects profitability of Microfinance bank in Nigeria. The findings are supported by Berger et al (1997), Batra (2003), Michael et al (2006) and Mausya (2009).

5.4 Recommendations

On the basis of the foregoing Analysis, discussion and observations in the study it would be appropriate to make the following recommendations; Central bank of Nigeria being the regulator of banking sector should consider reporting on ratios rather than mere changes in trends of specific items especially non performing loans and profitability. The reporting of mere increases in nonperforming loans and profits by commercial could be misleading as ratios such as return on assets, Non performing Loans ratio and Non performing Loans coverage ratio can enhanced understandability of relationships between changes in profitability and non performing Loans gross volumes. Central bank and share holders of Microfinance bank should be aware of possible use of provisions for losses on non performing Loans by managers for smoothening of profits & develop financial reporting models that can help prevent occurrence of the menace. The share holders specifically should be ready to meet agency costs to reduce manager's information asymmetry by hiring competent internal and external auditors.

Management of Microfinance bank should mitigate against Moral hazard and adverse selection risks when advancing loans to minimize occurrences of nonperforming loans. This can be achieved by good credit appraisal procedures, effective internal control systems, diversification along with efforts to improve asset quality in the balance sheets. Maintaining profitability is a challenge too for Microfinance bank in Nigeria and Microfinance bank should remain innovative especially on cost cutting techniques which include leveraging in technology and minimizing occurrences of nonperforming loans.

5.5 Limitations of the Study

The scope of the current study was limited to the secondary data obtained from financial statements of Microfinance bank in Nigeria for the last ten (10) years. The researcher faced a problem with accessing financial data from the Central Bank of Nigeria and Microfinance bank directly because of lengthy processes involved in obtaining the information and published financial statements and reports were used to extract data. Secondly the limitation of time was much pronounced since the sources of the data operate on working days and the researcher is equivalently an employee. The data for the period under the study were also posing a challenge especially the year 2013 where some financial ratios were not available and had to be computed and consumed a lot of time. The study also indicated multicolinearity between the dependent variable, independent variable and some control variables; this means that the estimate of nonperforming loans impact on the profitability while controlling for the Control variables may be less precise.

5.6 Suggestions for Further Studies

Future research could expand this scope to include other parameters that are used to measure profitability and non performing Loans of Microfinance bank in Nigeria. Other factors such as the interest rates charged on the loans and diversification of portfolios and how they relate to the overall profitability of the Microfinance bank can be considered as moderating or controlling variables in future studies. Further studies should be done on possible use of provisions for losses on non performing loans for profit smoothening by managers of Microfinance bank in Nigeria. The study on effect of non-performing loans

on profitability should also be done on other financial institutions such as Micro Finance Institutions to find out if the same results would be achieved

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