

**EFFECT OF CREDIT MANAGEMENT ON THE PROFITABILITY  
OF DEPOSIT MONEY BANKS IN NIGERIA**

**BY**

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**BEING A RESEARCH DISSERTATION SUBMITTED TO  
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ADMINISTRATION (PGD)**

**AUGUST, 2018**

## **DECLARATION**

I hereby declare that this dissertation has been written by me and it is a report of my research work. It has not been presented in any previous application for any academic programme in any other institution. All quotations are indicated and sources of information specifically acknowledged by means of references.

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**Date**

## CERTIFICATION

This dissertation “**Effect of Credit Management on The Profitability of Deposit Money Banks in Nigeria**” meets the regulations governing the award of Postgraduate Diploma in Business Administration (PGD), of the School of Postgraduate Studies of Nasarawa State University, Keffi for its contribution to knowledge and literary presentation.

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## **DEDICATION**

I dedicate this project Almighty God.

## **ACKNOWLEDGEMENTS**

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## ABSTRACT

*Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition, therefore, deposit money banks must therefore ensure that the management of credit is efficient and effective. The general purpose of the study is to examine the effect of credit management on the profitability of deposit money banks in Nigeria. In this research, ex post facto method of data collection was used. In achieving the objectives of the study, the audited annual financial statement of listed banks covering the period 2006-2016 were analyzed. However, a total of 10 listed banks in Nigeria were selected and analyzed for the study using the purposive sampling method. The study adopted the use of both descriptive statistics and econometric analysis using the linear regression methodology to test the hypotheses. The study revealed that there was strong relationship between profitability of DMBs and client appraisal, credit risk control and collection policy. The study concludes that client appraisal management of credit has the greatest significant effect on the profitability of deposit money banks in Nigeria and recommends among others that there is need for DMBs to enhance their client appraisal techniques so as to improve their profitability and will help in decreasing default levels as well as their non-performing loan.*

## **CHAPTER ONE**

### **INTRODUCTION**

#### **1.1 Background of the Study**

In every economy, there exist facilities for the creation, custodianship and distribution of financial assets and liabilities (Mohammed, 2002). These facilities make up the financial system in any economy of which banking is a sub-sector. Banks are global phenomena, a universal institution. In fact, banks intermediate between surplus and deficit economic units, thereby, acting as machinery for the allocation for the allocation of scarce financial resources. (Mohammed, 2002). Consequently, banks occupy a primary position in the economy as it is the fulcrum of the money market and the central nervous system of the economy. The banking industry worldwide, and in Nigeria particularly, had been witnessing a lot of structural changes. These changes are meant for the improvement of services for the betterment of its operators and for the benefit of the customers, shareholders as well as the economy at large.

Banks are profit-making organizations performing as intermediaries connecting borrowers and lenders in bringing temporarily available resources from business and individual customers as well as providing loans for those in need of financial support (Uwuigbe, 2013; Drigă, 2012). Commercial Banks play a vital role in developing economies like Nigeria, Ghana, Egypt and Algeria. Bank lending is very crucial for it makes possible the financing of agricultural, industrial and commercial activities of the country. Commercial Banks are entrusted with the funds of depositors. These funds are generally used by banks for their business. The fund belongs to the customers so a programme must exist for management of these funds. The programme must constantly address three basic objectives: liquidity, safety and income. Successful management calls for proper balancing of all these three. Liquidity enables the banks to meet loan

demands of their valuable and long established customers who enjoy good credit standing. The second objective being safety is to avoid undue risk since banks meet responsibility of protecting the deposit entrusted to them. Proper and prudent management of banks create and hence customer confidence. The third being income/profitability which is aimed at growth and expansion to meet repayment of interest charges on debt, to achieve the objective of maximizing wealth of shareholders and to survive competition in the banking industry (Uwuigbe, 2011).

As a matter of fact, a bank cannot remain in business if it neglects the credit function. Of interest to this paper is the credit component of the banks' portfolio that contributes to the profit of the banks and which has led to the problem of bad debts in Nigerian banks as a result of poor management. Credit as the name implies is described as the right to receive payments or the obligation to make payments on demand or at some future date on account of the immediate transfer of goods or money another (Uwuigbe, Uwalomwa and Ben-Caleb, 2012). It is based on the faith and confidence, which the creditor reposes in the ability and willingness of the debtor to fulfill his promise to pay. In a credit transaction the right to receive payment and the obligation to make payments originate at the same time.

The term debt is frequently used in reference to debtor's obligation to make payment. Debt and credit are therefore similar terms. Management of credit is simply the application of four management principles which are planning, organizing directing and controlling to credit concept. Commercial banks are major players in the financial sector of every country's economy. The failure or success of these banks will to a large extent affect the financial sector and the economy at large. In recent times some commercial banks have been wound up leaving customers to their fate. It is important to note that the major cause of the winding up of some of these banks is their poor

management of their finance and credit. Many of them were writing off huge amounts of debt yearly and also reflected some going concern issues that related to their management of credit and finance. The reason for the failure of these banks has sparked the interest of the researcher in conducting further studies into the management of finance and credit in Nigerian banks. It is in the light of the above, that this study examined the relationship between credit management and bank performance in Nigeria.

## **1.2 Statement of the Problem**

Sound credit management is a prerequisite for a financial institution's stability and continuing profitability, while deteriorating credit quality is the most frequent cause of poor financial performance and condition. According to Osayeme (2000), the probability of bad debts increases as credit standards are relaxed. Firms must therefore ensure that the management of receivables is efficient and effective. Such delays on collecting cash from debtors as they fall due has serious financial problems, increased bad debts and affects customer relations. If payment is made late, then profitability is eroded and if payment is not made at all, then a total loss is incurred. On that basis, it is simply good business to put credit management at the front end by managing it strategically.

As with any financial institution, the biggest risk among deposit money banks in Nigeria is lending money and not getting it back. Credit risk is a particular concern for DMBs because most bank's lending is unsecured (i.e., traditional collateral is not often used to secure microloans (Craig Churchill & Dan Coster 2001). The people covered are those who cannot avail credit from banks and such other financial institutions due to the lack of the ability to provide guarantee or security against the money borrowed. Many banks do not extend credit to these kinds of people due to the high default risk for

repayment of interest and in some cases the principle amount itself. Therefore, these institutions required to design sound credit management that entails the identification of existing and potential risks inherent in lending activities.

Matu (2008) carried out a study on sustainability and profitability of financial institutions and noted that efficiency and effectiveness were the main challenges facing banks on service delivery, Orua (2009) did a study on the relationship between capital structure and financial performance of financial institutions in Nigeria, Gitau (2010) did a study on assessment of strategies necessary for sustainable competitive advantage in the finance industry in Nigeria.

Achou and Tenguh (2008) also conduct research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (in terms of loan performance). The purpose of this study was to understand the effect of credit management on their financial performance.

There have been attempts in the past to study Micro financing and Micro lending but much focus has been on the impact of DMBs in poverty alleviation, especially in Nigeria but much less has been done to investigate the effect of credit management on financial position of DMBs institutions in Nigeria, therefore this research addresses that gap. The research question of this study is: What is the effect of credit management on the financial profitability of deposit money banks in Nigeria? The task before this study is to make an empirical analysis of the management of loans and advances and its effect (positive, negative or both) on the profitability of Nigerian banks and the causes of the problem if any, so as to be in a position to proffer solution to aid management performance towards better profitability.

### **1.3 Research Questions**

The following research questions will be answered in the study:

- i. What is the effect of credit appraisal management on the profitability of deposit money banks in Nigeria?
- ii. What is the effect of credit risk control management on the profitability of deposit money banks in Nigeria?
- iii. What is the effect of credit collection policy management on the profitability of deposit money banks in Nigeria?

### **1.4 Objective of the Study**

The primary objective of the study is to examine the effect of credit management on the profitability of deposit money banks in Nigeria. Specific objectives are to:

- i. Determine the effect of credit appraisal management on the profitability of deposit money banks in Nigeria
- ii. Ascertain the effect of credit risk control management on the profitability of deposit money banks in Nigeria
- iii. Examine the effect of credit collection policy management on the profitability of deposit money banks in Nigeria

### **1.5 Statement of the Hypotheses**

In order to assess the effect of Credit Management on profitability of Nigerian Banks; the following null hypotheses are to be tested:

**H<sub>01</sub>:** There is no significant relationship between credit appraisal management and profitability of deposit money banks in Nigeria

**H<sub>02</sub>:** There is no significant relationship between credit risk control management and profitability of deposit money banks in Nigeria

**H<sub>03</sub>:** There is no significant relationship between credit collection policy management and profitability of deposit money banks in Nigeria

## **1.6 Significance of the Study**

A study of this nature is valuable not only to the bank's management, other banks, share-holders, potential investors and depositors but to the economy as a whole.

To the bank's management and managers of other banks, the study draws their attention to the importance of this asset (loans and advances) to the overall success and growth of their organizations. As the largest component of a bank's total assets, there is the need for its effective and efficient management. Besides, loans and advances are also the most profitable and risky assets, hence the need for proper management for maximum profitability while minimizing the risk element.

The study is also significant to the shareholders, both existing and potential ones. This springs from the fact that the proper management of this resource will enhance reasonable returns on shareholders' investment.

One of the reasons adduced for bank failure is that of indiscriminate granting of loans that make collectibles virtually impossible. A study of this nature will draw the attention of bank's management to the need for proper management of loans and advance to obviate failure and its negative consequence on profitability and economy growth. Bank's failure erodes depositor confidence in the financial system, thus resulting in dearth of loanable funds to the economy. To enhance depositor confidence in the system, there must be proper management of the loans and advances portfolio to enhance growth of the bank. Students as well as other researchers would find this study worthwhile.

This study will make several contributions to both knowledge building and practice improvement in credit management and financial performance. From a theoretical standpoint, the study proposes a comprehensive framework of studying changes in credit management and financial performance. It is also expected that it will aid policy makers in their effort to revamp the sector. It shall be of great relevance to the organizations under study as well as other financial institutions. The non-financial business firms, whether manufacturing or service oriented shall also benefit from the research findings. This is because the result of the study shall enable the users especially DMBs to appraise its credit policies and to review its operations critically for more result oriented approach in the dealing with its credit facilities.

The results of this study will be valuable to researchers and scholars, as it would form a basis for further research. Scholars would use this study as a basis for discussions on credit management and financial performance. It will provide the scholars with empirical studies that they will use in their studies. The study will also add to the body of knowledge in the finance discipline by bridging gaps in credit management research in general.

The study, therefore, is timely, current and relevant not only for the continued visibility of the financial system but the overall growth and development of the economy. The findings of this study if duly and adequately incorporated by all the operators of the banking industry and the financial system in general will enhance profitability and efficiency in the provision of banking services in the country.

### **1.7 Scope of the Study**

The Study looks at management of credit facility (Loans and advances) and its effect on profitability of Nigerian Banks using some selected banks as case study. These banks include; First Bank of Nigeria Plc. (FBN), Union Bank of Nigeria Plc. (UBN), Unity

Bank Plc and United Bank for Africa (UBA). The study period is 10 years spanning from 2006 to 2016. This period witnessed the most dramatic changes in the economic landscape of Nigerian banks in recent past, occasioned by the downturn in the national economy, political era and the consequent introduction of various policies by government to pull the economy out of recession. These changes have had considerable impact on the functioning of the financial system. For instance, the introduction of stabilization security and the withdrawal of government funds from deposit money banks to CBN. These changes have had considerable impact on the functioning of the financial system. The period chosen, therefore, will be of immense value in establishing trends in credit management over the period and will aid in predicting the likely future trend. Knowledge of the likely future trend will be of help to the bank management in bringing the future under control for effective and efficient management of credit portfolio.

## **CHAPTER TWO**

### **LITERATURE REVIEW**

#### **2.1 Conceptual Framework**

##### **2.1.1 Credit Management**

Credit management is one of the most important activities in any company and cannot be overlooked by any economic enterprise engaged in credit irrespective of its business nature. It is the process to ensure that customers will pay for the products delivered or the services rendered. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and its effective management.

It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting. Nelson (2002) views credit management as simply the means by which an entity manages its credit sales. It is a prerequisite for any entity dealing with credit transactions since it is impossible to have a zero credit or default risk. The higher the amount of accounts receivables and their age, the higher the finance costs incurred to maintain them. If these receivables are not collectible on time and urgent cash needs arise, a firm may result to borrowing and the opportunity cost is the interest expense paid.

Nzotta (2004) opined that credit management greatly influences the success or failure of commercial banks and other financial institutions. This is because the failure of deposit banks is influenced to a large extent by the quality of credit decisions and thus the quality of the risky assets. He further notes that, credit management provides a leading indicator of the quality of deposit banks credit portfolio. A key requirement for effective credit management is the ability to intelligently and efficiently manage customer credit

lines. In order to minimize exposure to bad debt, over-reserving and bankruptcies, companies must have greater insight into customer financial strength, credit score history and changing payment patterns.

Credit management starts with the sale and does not stop until the full and final payment has been received. It is as important as part of the deal as closing the sale. In fact, a sale is technically not a sale until the money has been collected. It follows that principles of goods lending shall be concerned with ensuring, so far as possible that the borrower will be able to make scheduled payments with interest in full and within the required time period otherwise, the profit from an interest earned is reduced or even wiped out by the bad debt when the customer eventually defaults. Credit management is concerned primarily with managing debtors and financing debts. The objectives of credit management can be stated as safe guarding the companies' investments in debtors and optimizing operational cash flows. Policies and procedures must be applied for granting credit to customers, collecting payment and limiting the risk of non-payments.

### **2.1.2 Financial Performance**

According to the business dictionary financial performance involves measuring the results of a firm's policies and operations in monetary terms. These results are reflected in the firms return on investment, return on assets and value added.

Stoner (2003) as cited in Turyahebya (2013), defines financial performance as the ability to operate efficiently, profitably, survive, grow and react to the environmental opportunities and threats. In agreement with this, Sollenberg and Anderson (1995) assert that, performance is measured by how efficient the enterprise is in use of resources in achieving its objectives. Hitt, et al (1996) believes that many firms' low performance is the result of poorly performing assets.

DMBs earn financial revenue from loans and other financial services in the form of interest fees, penalties, and commissions. Financial revenue also includes income from other financial assets, such as investment income. An DMB's financial activities also generate various expenses, from general operating expenses and the cost of borrowing to provisioning for the potential loss from defaulted loans. Profitable institutions earn a positive net income (i.e., operating income exceeds total expenses).

Today, Financial institutions are seeking financial sustainability. Many DMBs were restructured in order to achieve financial sustainability and finance their growth. Sustainability is defined as the capacity of a program to stay financially viable even if subsidies and financial aids are cut off (Woolcock, 1999). It embraces generating sufficient profit to cover expenses while eliminating all subsidies, even those less-obvious subsidies, such as loans made in hard currency with repayment in local currency" (Tucker and Miles, 2004). Tucker and Miles (2004) studied three data series for the period between March 1999 and March 2001 and found that self-sufficient DMBs are profitable and perform better, on return on equity (ROE) and return on assets (ROA), than developing-world commercial banks and DMBs that have not attained self-sufficiency. In order to optimize their performance, DMBs are seeking to become more commercially oriented and stress more on improving their profitability; therefore, self-sustainability.

## **2.2 Empirical Review**

Basically, banks are in place not only to accept deposits but also to grant credit facilities, hence they are exposed to credit risk. Credit risk is by far the most important risk faced by banks and the accomplishment of their business depends on accurate measurement and efficient management of this risk to a greater extent than any other risks (Gieseche, 2004 as cited in Kargi, 2011). While financial institutions have been

bedeviled with series of problems over the years for a large number of reasons, the main cause of this problems continues to be directly related to lax credit standards for borrowers and counterparties, poor portfolio risk management, or a lack of attention to changes in economic or other situation that can lead to a deterioration in the credit standing of a bank's. This occurrence is common in emerging economies such as Nigeria, Ghana, Egypt etc. However, despite the series challenges that have bedeviled the industry, the banking industry have continued to play a crucial role in the economic development of economies (e.g. Nigeria). This is because, it contributes to the real productivity of the economy and to the overall standard of living, since banks are able to simultaneously satisfy the needs and preferences of both surplus and deficit units (Owojori, 2011).

It is universally acknowledged that the banking industry plays a catalytic role in the process of economic growth and development (Uwuigbe, Uwuigbe and Daramola, 2014). This acknowledgement is reinforced by contemporary conceptualization to the effect that banks are veritable vehicles for mobilizing resources (funds) from surplus units and channeling them to deficit units. These resources belong to customers so a programme must exist for the management of these funds. The programme must constantly address three basic objectives which are liquidity, safety and income. In meeting the three basic objectives, it requires establishing a schedule of actual priorities, because the most fundamental obligation of commercial banks is to meet all the demands for withdrawal of funds. Furthermore, since banks also have an obligation to satisfy the legitimate credit requirements of their depositors and the community and to meet the aspiration of profit making of the shareholders. These objective needs must also consider loans demand. Every commercial bank is under simultaneous pressure from depositors and shareholders. Customers deposit funds with those banks that meet their request for credit; Shareholders look for growth and profit of the banks which

cannot be achieved without granting credits. It therefore requires a higher degree of management skill to reconcile the two. Bad credit management has led to so many problems; most prominent is bad debt with a devastating effect on the banks and the entire economy. It is in the light of the above that the researcher looked at what ingredients are required in credit management of commercial banks and what result if they are not adequately put in place.

Prior studies suggest that a good credit risk architecture, policies and structure of credit risk management, credit rating system, monitoring and control contributes to the success of credit risk management system Bagchi (2003). Similarly, Muninarayanappa and Nirmala (2004) in a related study opined that the success of credit risk management requires maintenance of proper credit risk environment, credit strategy and policies. Thus the ultimate aim should be to protect and improve the loan quality. In the same vein, findings from Salas and Saurina (2002) revealed that growth in GDP, rapid credit expansion, bank size and capital ratio had a significant impact on the non-performing loans.

Felix and Claudine (2008) examined the association between the performance of banks and credit risk management. As part of their findings, they observed that return on equity and return on assets both measuring profitability were inversely related to the ratio of non-performing loan to total loan of financial institutions thereby leading to a decline in profitability. Also, Hosna, et al. (2009) in their study opined that credit risk has a significant positive effect on the profitability of commercial banks in Sweden.

Correspondingly, Kithinji (2010) examined the effects of credit risk management on commercial banks profitability in Nigeria. They observed that the level of credit was high in the early years of the implementation of Basle II but decreased significantly in 2007 and 2008, probably when the Basle II was implemented by commercial banks. The findings revealed that the bulk of the profits of commercial banks are not

influenced by the amount of credit and non-performing loans suggesting that other variables other than credit and non-performing loans impact on profits. Funso and et al., (2012) investigates the quantitative effect of credit risk on the performance of commercial banks in Nigeria for the period 2000-2010. Findings from their study showed that the effect of credit risk on bank performance measured by the return on assets of banks is cross sectional invariant.

In Nigeria, Kargi (2011) examined the impact of credit risk on the profitability of Nigerian banks. Findings from the study revealed that credit risk management has a significant impact on the profitability of Nigerian banks. Hence, they opined that banks' profitability is inversely influenced by the levels of loans and advances, non-performing loans and deposits thereby exposing them to great risk of illiquidity and distress. Although, some considerable amount of literature exists on the interaction between finance and credit management on banks liquidity position, however, the same is not true in developing economies like Nigeria where there is a relatively dearth in literature in this area, coupled with the huge institutional differences between Nigeria and other developed economies. Hence this study examined the relationship between credit management and bank performance in Nigeria.

Pyle (1997), in his study on bank risk management held that banks and similar financial institutions need to meet forthcoming regulatory requirements for risk measurement and capital. However, it is a serious error to think that meeting regulatory requirements is the sole or even the most important reason for establishing a sound, scientific risk management system. It was held, managers need reliable risk measures to direct capital to activities with the best risk/reward ratios. They need estimate of the size of potential losses to stay within limits imposed by readily available liquidity, by creditors,

customers and regulators. They need mechanisms to monitor positions and create incentives for prudent risk taking by divisions and individuals.

Nagarajan (2001) in his study of risk management for financial institutions in Mozambique found that risk management is a dynamic process that could ideally be developed during normal times and tested at the wake of risk. It requires careful planning and commitment on part of all stakeholders. It is encouraging to note that it is possible to minimize risks related losses through diligent management of portfolio and cash-flow, by building robust institutional infrastructure with skilled human resources and inculcating client discipline, through effective coordination of stakeholders.

Achou and Tenguh (2008) also conducted research on bank performance and credit risk management found that there is a significant relationship between financial institutions performance (in terms of profitability) and credit risk management (interms of loan performance). Better credit risk management results in better performance. Thus, it is of crucial importance that financial institutions practice prudent credit risk management and safeguarding the assets of the institutions and protect the investors "interests. This is also true for micro finance institutions. Method used by the researchers is mixed research method. Matu (2008) carried out a study on sustainability and profitability of financial institutions and noted that efficiency and effectiveness were the main challenges facing Nigeria on service delivery.

Soke Fun Ho and Yusoff (2009), in their study on credit risk management strategies of selected financial institutions in Malaysia the majority of financial institutions and banks losses stem from outright default due to inability of customers to meet obligations in relation to lending, trading, settlement and other financial transactions. Credit risk emanates from a bank's dealing with individuals, corporate, financial institutions or sovereign entities. A bad portfolio may attract liquidity as well as credit risk.

The aim of credit risk management is to maximize a bank's risk-adjusted rate of return by maintaining credit risk exposure within acceptable boundary. The efficient management of credit risk is a vital part of the overall risk management system and is crucial to each bank's bottom and eventually the survival of all banking establishments. It is therefore important that credit decisions are made by sound analyses of risks involved to avoid harms to bank's profitability. They held effective management of credit risk is an essential component of a comprehensive technique to risk management and critical to the long-term success of all banking institutions.

Orua (2009) did a study on the relationship between capital structure and financial performance of financial institutions in Nigeria it revealed that short-term debt significantly impacted DMB outreach positively. Long term debt however showed positive relationship with outreach but was not significant with regard to default rates, both short and long term debts showed expected results but were not significant indicating that maturity may not necessarily be of essence. Generally, highly leveraged DMBs were found to perform better by reaching out to more clients. It was also revealed that such DMBs also enjoyed economies of scales and therefore were better able to deal with moral hazards and adverse selections which also enhanced their ability to manage risks.

Sindani (2012) in her study on Effectiveness of Credit Management System on Loan Performance: Empirical Evidence from Micro Finance Sector in Nigeria found out that Credit terms formulated by the financial institutions do affect loan performance; the involvement of credit officers and customers in formulating credit terms affects loan performance. Interest rates charged had a negative effect on the performance of the loans, the higher the interest rates the lower the loan performance. Credit risk controls adopted by financial institutions have an effect on loan performance, credit insurance,

signing of covenants with customers, diversification of loans, credit rating of customers, reports on financial conditions, refrain from further borrowing had an effect on loan performance. Collection policies adopted by financial institution had an effect on loan performance, stringent policy had a great impact on loan performance, and the lenient policy had an effect but was not as great as that of stringent policy.

Wangechi (2012) in her study on Factors influencing sustainability of financial institutions in Kenya studied Kenyan Women Finance Trust and found out that that the quality of service delivered influenced KWFT Sustainability by attracting new customers through word of mouth advertising, improving on the reputation of the organization, improving financial performance and profitability, lowering operating costs and also increased customer retention rates hence boosting the overall quality of the organization. She also found out that staff competencies contributed to increased efficiency and that training boost employees' morale hence sustainability and that that the staffs at KWFT had all the needed skills to effectively carry their duties efficiently and that lack of training attributed to poor performance of KWFT. The study concluded that the level of education of the staff contributed to increased efficiency at KWFT.

According to Ebaid (2009) research, capital structure choice decision, in general terms, has weak-to-no influence on the financial performance of listed firms from 1997 to 2005 in Egypt as one of emerging or transition economies. By using three accounting-based measurements of financial performance which are return on assets, return on equity, and Gross Margin, the empirical tests come with the result that capital structure particularly Short term debts and Total debts have a negative impact on an organization's performance which is measured by ROA. Apart from that, capital structure including short-term debt, long-term debt and total debt has no significant impact on an organization's performance which is measured by ROE and Gross margin.

Kmk4Ann/ [.,3ccording to Valeriu and Nimalathan (2010) they researched on capital structure and its impact on profitability: a study of listed manufacturing companies in Sri Lanka. The result shows that debt is positively and strongly associated to all profitability ratios (gross profit ratio; operating profit ratio; and net profit ratio) except return on capital employed and ROA.

According to Iorpev and Kwanum (2012) they examined the impact of capital structure on the performance of manufacturing companies in Nigeria. The annual financial statements of 15 manufacturing companies listed on the Nigerian Stock Exchange were used for this study which covers a period of five years from 2005-2009. Multiple regression analysis was applied on performance indicators such as Return on Asset and Profit Margin as well as Short-term debt to Total assets, Long term debt to Total assets and Total debt to Equity as capital structure variables. The results show that there is a negative and insignificant relationship between Short term debt to total assets and Long term debt to total assets, and ROA and profit margin; while Total debt to equity is positively related with ROA and negatively related with profit margin. Short term debt to total assets is significant using ROA while Total Long term debt to total assets is significant using profit margin. The work concludes that statistically, capital structure is not a major determinant of firm performance.

### **2.2.1 Credit Client Appraisal and Profitability**

The first step in limiting credit risk involves screening clients to ensure that they have the willingness and ability to repay a loan. Financial Institutions use the 5Cs model of credit to evaluate a customer as a potential borrower (Abedi, 2000). The 5Cs help DMBs to increase loan performance, as they get to know their customers better. These 5Cs are: character, capacity, collateral, capital and condition.

Character - refers to the trustworthiness and integrity of the business owners .it's an indication of the applicant's willingness to repay and ability to run the enterprise. Capacity assesses whether the cash flow of the business (or household) can service loan repayments. Capital - Assets and liabilities of the business and/or household. Collateral -Access to an asset that the applicant is willing to cede in case of non-payment, or a guarantee by a respected person to repay a loan in default. Conditions-A business plan that considers the level of competition and the market for the product or service, and the legal and economic environment.

The 5Cs need to be included in the credit scoring model. The credit scoring model is a classification procedure in which data collected from application forms for new or extended credit line are used to assign credit applicants to „good“ or „bad“ credit risk classes (Constantinescu et al., 2010). Inkumbi (2009) notes that capital (equity contributions) and collateral (the security required by lenders) as major stumbling blocks for entrepreneurs trying to access capital. This is especially true for young entrepreneurs or entrepreneurs with no money to invest as equity; or with no assets they can offer as security for a loan.

Any effort to improve access to finance has to address the challenges related to access to capital and collateral. One way to guarantee the recovery of loaned money is to take some sort of collateral on a loan. This is a straightforward way of dealing with the aspect of securing depositors' funds.

### **2.2.2 Credit Risk Control and Profitability**

Key Credit controls include loan product design, credit committees, and delinquency management (Churchill & Coster, 2001). DMBs can mitigate a significant portion of default risk by designing loan products that meet client needs. Loan product features include the loan size, interest rate and fees, repayment schedule, collateral requirements

and any other special terms. Loan products should be designed to address the specific purpose for which the loan is intended.

Establishing a committee of persons to make decisions regarding loans is an essential control in reducing credit (and fraud) risk. If an individual has the power to decide who will receive loans, which loans will be written off or rescheduled, and the conditions of the loans, this power can easily be abused and covered up. While loan officers can serve on the credit committee, at least one other individual with greater authority should also be involved. The credit committee has the responsibility not only for approving loans, but also for monitoring their progress and, should borrowers have repayment problems, getting involved in delinquency management.

To minimize such delinquency DMBs can use the following delinquency management methods Institutional Culture: A critical delinquency management method involves cultivating an institutional culture that embraces zero tolerance of arrears and immediate follow up on all late payments. DMBs can also remind clients who have had recent delinquency problems that their repayment day is approaching. A logical first step toward developing a zero-tolerance institutional culture is to communicate this concept to each new client before she receives a loan.

Creating staff involvement in discouraging delinquency, through a staff incentives system, can be effective. Delinquency Penalties: Clients should be penalized for late payment. This could include delinquency fees pegged to the number of days late and limiting access to repeat loans based on repayment performance. Given the vulnerability of the target market, it is common for borrowers to be willing but unable to repay. After carefully determining that this is indeed the case it may be appropriate to reschedule a limited number of loans. Only done under extreme circumstances, this may involve extending the loan term and/or reducing the instalment size.

### **2.2.3 Credit Collection Policy and Profitability**

There are various policies that an organization should put in place to ensure that credit management is done effectively, one of these policies is a collection policy which is needed because all customers do not pay the firms bills in time. Some customers are slow payers while some are non-payers. The collection effort should, therefore aim at accelerating collections from slow payers and reducing bad debt losses (Kariuki, 2010).

### **2.2.4 Financial Performance Measures**

According to Hermes and Lensink (2007), the financial systems approach, which emphasizes the importance of financial sustainable financial programs, is likely to prevail the poverty lending approach. The argument is that financial institutions have to be financially sustainable in order to guarantee a large-scale outreach to the poor on a long-term basis. Measuring and comparing the performance of DMBs has been difficult due to both a lack of publicly available financial information and differences in reporting in a mostly nonregulated industry (Michael & Miles, 2007). A myriad of financial ratios are available for assessing the performance of DMBs (CGAP 2003) The Seep Network and Alternative Credit Technologies,2005) Although it is difficult to synchronize the different interpretations of all the ratios, they provide alternative perspectives in assessing the performance of DMBs for each of the domains namely, profitability, efficiency, leverage and risk .In essence, interpreting the determinants of DMBs' financial performance due cognisance should be taken of the precise focus of each ratio.

#### **Financial Profitability**

Return on Assets (ROA) falls within the domain of performance measures and tracks DMBs' ability to generate income based on its assets. The ratio excludes non-operating income and donations. ROA provides a broader perspective compared to other measures

as it transcends the core activity of DMBs namely, providing loans, and tracks income from operating activities including investment, and also assesses profitability regardless of the DMBs funding structure. ROA is expected to be positive as a reflection of the profit margin of the DMB, otherwise it reflects non-profit or loss. In banks and other commercial institutions, the commonest measures of profitability are Return on Equity (ROE), which measures the returns produced for the owners, and Return on Assets (ROA), which reflects that organization's ability to use its assets productively.

$$\text{ROE} = \frac{\text{After-tax profits}}{\text{Starting (or period-average) equity}}$$

Starting (or period-average) equity

$$\text{ROA} = \frac{\text{After-tax profits}}{\text{Starting (or period-average) assets}}$$

Starting (or period-average) assets

These are appropriate indicators for unsubsidized institutions. But donor interventions more typically deal with institutions that receive substantial subsidies, most often in the form of grants or loans at below-market interest rates. In such cases, the critical question is whether the institution will be able to maintain itself and grow when continuing subsidies are no longer available. To determine this, normal financial information must be "adjusted" to reflect the impact of the present subsidies. Three subsidy-adjusted indicators are in common use: Financial Self-sufficiency (FSS), Adjusted Return on Assets (AROA), and the Subsidy Dependence Index (SDI).

### **Efficiency**

Efficiency of DMBs is measured by the share of operating expense to gross loan portfolio in most cases. The ratio provides a broad measure of efficiency as it assesses

both administrative and personnel expense with lower values indicating more efficient operations.

Operating Expense Ratio = Personnel and administrative expense

Period-average gross loan portfolio

The debt equity ratio is a member of the asset/liability management ratios and specifically attempt to track DMBs leverage. This measure provides information on the capital adequacy of DMBs and assesses the susceptibility to crisis. Financial investors mainly rely on this ratio as it helps to predict probability of an DMB honouring its debt obligations. However, its use should always be contextualized as high values could lead to growth of DMBs. The Operating Expense Ratio is the most widely used indicator of efficiency, but its substantial drawback is that it will make an DMB making small loans look worse than an DMB making large loans, even if both are efficiently managed. Thus, a preferable alternative is a ratio that is based on clients served, not amounts loaned:

Cost per Borrower = Personnel and administrative expense

Period-average number of active borrowers [x GNI per capita]

If one wishes to benchmark an DMB's Cost per Client against similar DMBs in other countries, the ratio should be expressed as a percentage of per capita Gross National Income (which is used as a rough proxy for local labour costs).

### **2.2.5 Effect of Credit Management on Bank Profitability**

Credit management is the method by which you collect and control the payments from your customers. Myers and Brealey (2003) describe credit management as methods and strategies adopted by a firm to ensure that they maintain an optimal level of credit and

its effective management. It is an aspect of financial management involving credit analysis, credit rating, credit classification and credit reporting.

A proper credit management will lower the capital that is locked with the debtors, and also reduces the possibility of getting into bad debts. According to Edwards (1993), unless a seller has built into his selling price additional costs for late payment, or is successful in recovering those costs by way of interest charged, then any overdue account will affect his profit. In some competitive markets, companies can be tempted by the prospects of increased business if additional credit is given, but unless it can be certain that additional profits from increased sales will outweigh the increased costs of credit, or said costs can be recovered through higher prices, then the practice is fraught with danger.

Most companies can readily see losses incurred by bad debts, customers going into liquidation, receivership or bankruptcy. The writing-off of bad debt losses visibly reduces the Profit and Loss Account. The interest cost of late payment is less visible and can go unnoticed as a cost effect. It is infrequently measured separately because it is mixed in with the total bank charges for all activities. The total bank interest is also reduced by the borrowing cost saved by paying bills late. Credit managers can measure this interest cost separately for debtors, and the results can be seen by many as startling because the cost of waiting for payment beyond terms is usually ten times the cost of bad debt losses.

Effective management of accounts receivables involves designing and documenting a credit policy. Many entities face liquidity and inadequate working capital problems due to lax credit standards and inappropriate credit policies. According to Pike and Neale (1999), a sound credit policy is the blueprint for how the company communicates with and treats its most valuable asset, the customers. Scheufler (2002) proposes that a credit

policy creates a common set of goals for the organization and recognizes the credit and collection department as an important contributor to the organization's strategies. If the credit policy is correctly formulated, carried out and well understood at all levels of the financial institution, it allows management to maintain proper standards of the bank loans to avoid unnecessary risks and correctly assess the opportunities for business development.

### **2.2.6 Profit Measures and Determinants of Commercial Banks Profitability**

With regards to the main focus of this study, the elaboration of the various profit measures and determinants theories which has been considered in other related studies is very significant to the realisation of the factors to be investigated in this study. There have been a number of research papers on determinants of profitability of commercial banks. Some of the research papers focused on single country and others too concentrated on panel of countries. But the underlining fact of these papers is that the profit measurements which also serve as the dependent variable in the profitability model are in the form of ratios. Devinaga Rasiah (2010) documented that most researchers who focused their studies in this area are for instance, Cavallo and Majnoni (2001), Bennaceur (2003), Bikker and Metzmakers (2004), Davis and Zhu (2005) Toni Uhomoibhi (2008) divide the determinants of commercial banks performance and profitability into two categories thus, the Internal and the External factors.

#### **Profit Measures of Commercial Banks**

In most research papers relating to this study the profitability is measured in the form of ratios which are normally reported by commercial banks in their annual reports. Devinaga Rasiah (2010) claims that the use profitability ratios are not influence by changes in price levels. And it is said to be the most appropriate way of measuring profitability as one make use of time series analysis. This is because the real value of

profits cannot be affected by the varying inflation rates. According to Devinaga Rasiah (2010) for one to realise how well a bank is performing it is much more useful to consider return on assets (ROA) and return on equity (ROE).

Return on assets (ROA) is the ratio of Net Income after Taxes divided by Total Assets. The ROA signifies managerial efficiency in other words it depicts how effective and efficient the management of banks has been as they seek to transform assets into earnings. And the higher ratio indicates the higher performance of the banks. It is a useful tool for comparing profitability of one bank with other or the whole commercial banking system. Moreover, the ROE is said to measure the rate of return on the bank's shareholders equity and it is calculated by dividing banks net income after taxes by total equity capital which includes common and preferred stock, surplus, undivided profits, and capital reserves; Bourke (1989), and Molyneux and Thornton (1992).

This measure of profitability gives an indication of what the banks earns on the shareholders' investment; Devinaga Rasiah (2010). According to Anthony Karkrah and Ameyaw (2010) many researchers have presented ROA as an appropriate measure of bank profitability. Among them are Rivard and Thomas (1997) who argued that bank profitability is best measured by ROA in the sense that, ROA cannot be distorted by high equity multiplier. However, Hassan and Bashir (2003) also claims that as ROA tend to be lower for financial intermediaries, most banks heavily utilized financial leverage to increase their ROE to competitive levels.

### **Internal Determinants of Commercial Banks Profitability**

According to Husni (2011) the internal determinants of banks profitability are normally consisting of factors that are within the control of commercial banks. They are the factors which affect the revenue and the cost of the banks. Some studies classified them into two categories namely the financial statement variables and non-financial variables.

The financial statement variables include factors that are directly related to the bank's balance sheet and income statement. Whiles, the nonfinancial statement variables include factors like the number of branches of a particular bank, location and size of the bank etc; Haron, Sudin (2004).

### **Income**

Rasiah (2010) presented that banks generate income mostly on their assets and the assets could be termed as income and non-income generating. With regards to commercial banks income Rasiah (2010) classified it into two, namely interest and non-interest income. The interest income consist of rates charge on loans, overdraft and trade finance which the banks offers to customers. Whereas, the non-interest income is consisting of fees, commissions, brokerage charges and returns on investments in subsidiaries and securities. According to Vong et al (2009), the major source of banks revenue is interest income. It contributes about 80% of commercial banks earnings. The other source of banks revenue includes dividends and gains from dealing in the securities market. There could be also some minor sources of income for instance earnings from trust activities and service charges on deposit accounts; Vong et al (2009).

### **Loan Quality**

As it has been mentioned above, one of the major roles of banks is to offer loans to borrowers and loans serve as one of the ultimate source of earnings for commercial banks. In other words, loans represent one of the highest yielding assets on banks' balances sheet. It is obvious that the more banks offer loans the more it does generate revenue and more profit; Abreu and Mendes (2000). But then banks have to be courteous in offering more loans because as they offer more loans to customers they expose themselves to liquidity and default risks which impacts negatively on banks'

profits and survival (Rasiah 2010). Example is the recent financial crisis which started in the United States of America in 2007 and 2008. It is well known that most banks engaged in the offering of more loans including non-prime loans during this period. And when the housing prices fell most banks suffered large number of defaults on non-prime loans which in turn resulted in lost of profits and the collapsed of some banks; Gaurav & Kelly (2011). Even as the Nigerian banks are said to be experiencing profits during these years of global financial crisis, (IMF Country Report 2011) has indicated that the commercial banks' in Nigeria exposure to stability risk has heightened as a result of continues increase in non-performing loans.

Moreover, empirical evidence from Suffian et al (2008) on the profit determinants of banks in

Philippi reveals that the proportion of loan loss provisions to total loans was statistically significant. As the amount of loan loss provisions indicates the level of credit risk, the results claims that Philippines banks with higher credit risk tend to exhibit lower profitability levels. Also study conducted by Vong et al (2009) indicated that the asset quality, as measured by the loan-loss provisions, negatively impacts on the performance of banks in Macao.

With regards to the loan to total assets (LOTA), Vong et al (2009) findings revealed that instead of positively affecting profitability, it rather decrease profitability and according to these authors, this result was in confirmation with the initial finding of Vong (2005). According to them the reason is that it is due to stiff competition in the credit market and interbank placement of idle funds in foreign countries. Their finding was also in line with the citation they made on the observations of Bashir and Hassan (2003) and Staikouras and Wood (2003) which reveals that a higher loan ratio actually impacts negatively on profits because banks that depend more on non-loan earning assets are more profitable than those that rely heavily on loans.

On the other the investigation of Husni (2011) reveals that interest margin on loans provided by the banks in Jordan is a significant driver of profitability and poses a positive relationship with profitability. This is in line with a citation made by Vong et al (2009) on findings of Abreu and Mends (2000) which exhibits a positive relationship between the loan ratio and profitability.

To measure the quality of loans on the banks' balance sheet Rasiah (2010) suggested the use of non-performing loans as an indicator of the loans quality. And. Vong et al (2009) used the amount of loan-loss provision to total loans (PRTO) as proxy to non-performing loans. In addition, in order to incorporate loans and advances (interest income) as a variable in the profit determinants model, Anna P. I. Vong et al (2009) used loans as a percentage of total assets (LOTA) as variable in the model. LOTA is measured by total loans divided by total asset.

### ***Deposits***

Banks are said to be heavily dependent on the funds mainly provided by the public as deposits to finance the loans being offered to the customers. There is a general notion that deposits are the cheapest sources of funds for banks and so to this extent deposits have positive impact on banks profitability if the demand for bank loans is very high. That is, the more deposits commercial bank is able accumulate the greater is its capacity to offer more loans and make profits; Devinaga Rasiah (2010). However, one should be aware that if banks loans are not high in demand, having more deposits could decrease earnings and may result in low profit for the banks. This is because deposits like Fixed, Time or Term deposits attract high interest from the banks to the depositors, Devinaga Rasiah (2010). Investigation done by Husni (2011) on the determinants commercial banks performance in Jordan disclosed that there is significant positive relationship between ROA and Total liability to total Assets. To capture deposits in the model Vong

et al (2009) presented the effect of deposits (DETA) on profitability as deposits to total assets ratio.

### ***Capital Ratio***

Devinaga (2010) and Vong et al (2009) included capital ratio (EQTA or CTRA) as a variable in their study of determinants of banks profitability and performance because capital also serve as a source of funds along with deposits and borrowings. They argue that capital structure which includes shareholders' funds, reserves and retained profit affect the profitability of commercial banks because of its effect on leverage and risk. They documented that, commercial banks assets could be also financed by either capital or debt. But debt financing could be very risky as compared to capital financing with regards to credits and liquidity risks with which commercial banks are expose to. This is because for instance, if a commercial bank experience lost of profit as result of credit default or liquidity problem the bank still has the obligation to services its debt, on the other hand a commercial bank with enough capital is able take higher risk and also absorb shocks which emanate from liquidity and credits risks.

Sufian (2008) argued that banks in developing countries needs a strong capital structure, because it provides them strength to withstand financial crises and offers depositors a better safety net in times of bankruptcy and distress macroeconomic conditions. And according to Molyneux (1992) banks with high level of equity can reduce their cost of capital and that could impact positively on profitability. In addition, Both Basel II and III accord admits that most frequent bank insolvencies are mostly coursed by credit losses and for this reason it is prudent for commercial banks to have higher quality of capital in order to be able to absorb more loss hence to better withstand stress periods; (Basel Committee's response to the Financial Crises 2010). Berger (1995) also asserted

that lower level of capital put the banks into risky position and impact negatively the bank's profitability; Berger (1995)

The argument presented above makes the decision of the bank of Nigeria to continue increase regulatory capital requirement in the banking industry very appropriate because having the strong capital structure would enable them to reduce cost of capital and withstand financial crises hence continues experience in profitability. The Nigeria banks' Capital to risk weighted assets is said to have experienced an increase from 9.1% in 2003 to 19.1% in 2010 whereas, the Tier I capital to risk-weighted assets has also increased from 16.2% in 2005 to 18.6% in 2010 (IMF Country Report 2011). This proves that the total minimum capital of the commercial banks in Nigeria is even much higher than the Basel II accord total minimum capital which stands at 8% (Basel Committee's response to the Financial Crises 2010). This might be one of the reasons behind continues experience in profitability by the Nigeria banks during these years of global financial crisis.

Empirical evidence presented by Karkrah and Ameyaw (2010) on profitability determinants of commercial banks in Nigeria revealed that the equity ratio which is the measure of the capital strength of the banks posted a positive relation with the banks ROA. They documented that their finding is in line with the findings of Suffian et al (2008) which reveals positive relation between Philippines banks level of capitalization and profitability. The result was also consistent with the finding of Berger (1995), Demirguc-Kunt and Huizinga (1999), Pasiouras and Kosmidou (2007). Capital ratio was presented in Devinaga (2010) study as (**CTRA**) Capital and reserve as a percentage of total assets.

### ***Liquidity Ratio***

According to Devinaga Rasiah (2010) commercial banks are required by regulators to hold a certain level of liquidity assets. And the reason behind this regulation is to make sure that the commercial banks always possess enough liquidity in order to be able to deal with bank runs. He further argue that a bank assume the status of highly liquid only if it has been able to accumulate enough cash and have in possession other liquid assets as well as having the ability to raise funds quickly from other sources to be able to meet its payment obligation and other financial commitments on time. He claims that for instance, in a situation where a commercial bank is faced with the problem of bank run, the bank may encounter liquidity problem. In such a situation the bank might be compelled to raise additional liquid funds by borrowings or selling off some of their liquid assets and it is well known that short-term borrowings are usually costive. In addition, the situation where by the bank rush to sell off the liquid assets creates an impression in the minds of investors that the bank is trying to dispose of bad assets and for this reason these liquid assets normally attracts lower prices from investors and as a result there could be loss of income from the sale of liquid assets.

These two issues tend to have an adverse effect on commercial banks profitability. This is relative to what happened in the United States in 2007- 2008 at the early stage of the crisis most banks experience bank runs and the inter-bank market freeze lending to counter parties due to the lost of confidence in the banking systems as result of huge default of sub- prime loans and there was strong decline of prices of securities associated with the sub-prime loans. This made it difficult for the banks to refinance these sub-prime loans and borrowing became very expensive for banks. This situation triggered the global financial crisis. For this reason the Basel III accord introduced the liquidity coverage ratio (LCR) with which banks are required to have enough high

quality liquid assets to be able deal with stress funding situations (Basel Committee's response to the Financial Crises 2010).

This means that commercial banks in Nigeria are in better position to withstand stress funding situations hence making profits during these years of global financial crisis. This is because the findings of Bourke (1989) on concentration and other determinants of bank profitability in Europe, North America and Australia indicated a positive relationship between banks level of liquidity and profitability. The IMF Country Report 2011 has indicated that Nigeria banks are more liquid and liquidity with regards to the banks' assets has increased tremendously after the financial crisis. The report estimated that Liquid asset to total assets in 2010 recorded 25.3% and Liquid asset to shortterm liabilities in 2010 stood at 32.9%. So, Nigeria banks having high level of liquidity might be one of the reasons for recording profit in these years of the crisis.

However, Rasiah (2010) asserted that the lower returns on liquid assets and excessive fund which has not been invested may also negatively affect the profitability of banks. And because of this, liquidity management serves as an important determinant of commercial bank profitability. It may not be prudent for commercial banks to hold huge amount of an idle funds because it deprives the banks of income and profitability. This is because the more the banks turn funds into loans or invest them the more its accumulate income and profit. This has been confirmed by the study of Eichengreen & Gibson (2001) which documented that the fewer the amount of funds tied up in liquid investment and the liquid assets the higher the profitability.

In order to capture liquidity ratio in profitability model Rasiah (2010) used loan to deposit ratio (LIQ) as a proxy for liquidity. He did this with the view that data on loans to deposits of commercial banks are normally disclosed in their annual reports and also because the loans to deposit ratio can be calculated.

### *Non-Interest Income*

Non-interest income represents other sources besides earnings from loans of the commercial banks. This type of sources of income may include fees earned from offering unit trust services, service charge on deposit account, standard fees and charges for other bank services. Rasiah (2010) stated that the traditional commercial bank business with regards to financial intermediation has gradually been change towards the provision of other financial services as result of on-going financial globalization and liberalization and because of that commercial banks are able to increase their income and profit.

This seems to be supported by the empirical findings of Karkrah and Ameyaw (2010) which revealed that non-interest income is an important driver of commercial banks profitability in Nigeria and there is a positive relationship existing between non-interest income and profitability in the Nigeriaian banking sector. However, Vong et al (2009) cited in their study that the findings of Gischer and Juttner (2001) prove that non-interest income generating services impact negatively on commercial banks' profitability. According to them, Gischer and Juttner (2001) claim that the negative relationship exhibited by their observation is attributed to the fact that the non-income generating services are more prone to intense competition than the traditional income activities of the banks. Meanwhile, the study of Vong et al (2009) captured the importance of fee-based services and other income resulting from diversification to commercial banks profitability by the non-interest income to gross income (NIGI).

### *Expenses*

Expenses as a variable in the profit determinants model of commercial banks is found in almost all the studies done in this area of study; examples are Vong et al (2009), Rasiah (2010) etc. According to some of these researcher especially Rasiah (2010) the commercial banks expenses reflects on the expenditures that fall within the control of banks management and they could be classified into two categories thus interest and non-interest expenses. One of the major expenses incurred by the commercial banks as they generate revenue is interest paid out to depositors which is termed as interest expenses. On the other hand, non-interest expenses include overhead expenses, operating expenses, salaries and wages paid to employees and miscellaneous expenses. Even though it is obvious that the more expenses incurred by the bank, the less profit the bank will make.

But according to Vong et al (2009), the effect of expenses as a variable on banking performance and profitability is mixed. They stressed that investigations of Bourke (1989) and Jiang et al. (2003) revealed a negative relationship between expense and profitability which implies that banks with low operation cost makes high profits. This is in line with the observations of Karkrah and Ameyaw (2010) which revealed that non-interest expense represents a significant driver of profitability of commercial banks in Nigeria and impacts negatively on profitability.

On the other Vong et al (2009), further document that the findings of Molyneux and Thornton (1992) show that, the expense variable impact positively on European banks profitability because the payment of high wages and salaries to employees reflects on the higher level of productivity of the employees which is in line with the efficiency theory. Moreover, Bennaceur (2003) and Guru et al. (2002) also observed positive relationship between profitability and expenses. Both researchers argued that this

relationship exist because banks are able to pass on their overheads cost to depositors and borrowers in terms of lower deposit rates and larger lending rate. In order to include the expense variable in their model, Karkrah and Ameyaw (2010) presented the ratio of non-interest expenses to total assets (NETA) as proxy for total expenses.

### ***Taxation***

Vong et al (2009) defined the tax variable (TOPB) in their study as taxes over operating profit before tax. This study treated it as separate variable others like Devinaga Rasiah (2010) added it to the expense variable but whatever way one sees it, one still cannot ignore its impact on the profitability of banks. Vong et al (2009) argues that If a positive relationship exists between the tax variable and the profitability, it indicate that the bank is able to pass the tax cost on to its Customers by increasing the fees and the interest spread. Moreover, they further stressed that findings of Demirguc-Kunt and Huizinga (1999), Bashir (2000) and Jiang et al. (2003) indicated a positive relationship existing between the tax variable and profitability.

### **External Determinants of Commercial Banks Profitability**

External factors are said to be the factors that are beyond the control of the management of commercial banks. The external determinants of commercial banks profitability are indirect factors, which are uncontrollable, but have an enormous impact on bank's profitability. According to Karkrah and Ameyaw (2010) macroeconomic variables has been a major components of the external profit determinants in most studies. The most external factors that have been presented in most studies includes competition/market share/firm size, inflation, GDP growth, and interest rate.

### **Gross Domestic Product (GDP)**

According to Vong et al (2009) the economic growth, which is measured by the real GDP growth rate (RGDP), was expected to affect banking profitability positively by its

inclusion in the profit determinants model. And according to the author there is a perception that loan defaults are normally lower in times of favorable economic growth and vice versa. Besides, higher economic growth may lead to a greater demand for loans which will result in both interest and non-interest incomes hence increase in the profits of commercial banks. However, empirical studies have revealed a mixed effect on the relationship between economic growth rate and banks profitability. As some studies support the general expectation of positive relation between these two variables others too exhibits a contradictory findings in terms of negative or insignificant relation between the two.

Karkrah and Ameyaw (2010) cited that study done by Sufian et al. (2008) on the relationship between macroeconomic and return on assets (ROA) regarding Philippian banks revealed a positive relationship between GDP and banks profitability. According the authors this result was in line with the findings of Kosmidou and Staikouras et al. (2008). Furthermore, The results of the research done by Fotios Pasiouras and Kyriaki Kosmidou (2007) on factors influencing the profitability of domestic and foreign commercial banks in the European Union shows a positive correlation between GDP growth rate and banks profitability and to the Authors the findings was in consistent with the results of Kosmidou et al. (2005), Kosmidou (2006) and Hassan and Bashir (2003) among others, which is in support to the argument of positive association between economic growth and financial sector performance.

On the hand the Husni (2011) observations on the Jordanian banking shows a significant and negative relationship between ROA and Annual Growth Rate for Gross domestic product (GDPGR) of the commercial banks in Jordan. Meanwhile, the finding of P. I. Vong et al (2009) also exhibited an insignificant relationship between GDP and commercial banks profitability in Macao and their finding is consistent with the findings of Bennacaur & M. Goaid (2008).

### ***Interest Rate***

Rasiah (2010) advocates that interest rate have been captured in most studies as profitability determinant of commercial banks because net interest income which results from the deference between interest income and interest expenses has enormous impact on banks profitability. He stated that most research papers on banks' profit determinants present the interest rate as external variable because changes in interest rates is mostly cause by government economic policies and supply and demand market conditions.

Moreover, He mentioned that the impact of interest rate changes on the commercial banks profitability depend on the extent and speed at which the change have on short and long term period of banks portfolio. And also the speed and flexibility with which the bank can amend its revenue sources and cost of funds to match up to the change. In addition, it is also about the proportionality of the bank's assets and liabilities that are long period rather than short period.

According to Rasiah (2010) commercial banks normally alter the rate of return on their assets to offset any differences caused by interest rates fluctuations resulting from economic policies. This is because most of the commercial banks assets for instance short term loans have short maturity and the rates on short term loans are normally flexible and because of that it easy for banks to change the rate of return to suit the changes with the interest rate. Rasiah (2010) further stated that the interest rate fluctuations does affect the long term maturity assets of the commercial banks as well hence profitability with a view that whenever the general market interest rates falls the market value of longer assets with fixed contractual terms will increase. In this case the banks can sell some of these assets at a higher price and the short period these sales would increase the bank's profitability.

Just like other nations, interest rate has been the main determinant of base lending rates of the banks in Nigeria. The stress test performed by IMF team in 2010 indicates that commercial banks in Nigeria have the capacity to withstand interest rates changes because most of their lending is base on variable rates. However, the report also claim that increase in interest rates can decrease the income and debt service capacity of borrowers in Nigeria which may indirectly affect the balance sheet of the banks hence profitability (IMF Country Report 2011).

The data provided by the IMF report indicates that average lending rate which depends on the interest rates from 2004 to 2010 stood between 25% to 30%. Obviously this level of lending rate is much higher than what most banks in western countries charge on loans. Depending on this it not surprising that they are able to make profits in this time of crisis because this could be the reason why non-performing loans on the banks' balance sheet continues to increase.

Moreover, most empirical evidence on the impact of the interest rate on commercial banks profitability shows a positive relation between interest and profitability. for instance, Toni Uhomoibhi, ( 2008) investigation on the impact of macroeconomic variables on commercial banks profitability in Nigeria over the period of 1980-2006 reveal that real interest rate is a significant macroeconomic determinants of banks profitability in Nigeria. The finding also exhibits a positive relation between interest rate and profitability; Husni (2011). This finding is in support of the observation of Sufian et al. (2008) which portrays a positive impact of macroeconomic conditions including interest rate on commercial banks profitability in Philippi; Karkrah and Ameyaw (2010). Moreover, a research done by Pasiouras and Kosmidou (2007) on factors influencing the profitability of domestic and foreign commercial banks in the European Union also revealed a positive relation between interest rate and banks'

profits with regards to domestic banks. They reported that inflation was positively related to profitability of domestic banks because the levels of inflation were anticipated by domestic banks and because that the banks got the opportunity to adjust the interest rates accordingly and consequently earned higher profits. To measure the effect of interest rate on profitability Devinaga Rasiah (2010) use base-lending rate (BLR) as a proxy for market interest rate and presented it as variable in his studies.

### ***Inflation Rate***

Revell (1979) indicated that inflation is one of the factors which may cause variations in commercial banks profitability. Devinaga Rasiah (2010) in his study asserted that central banks in their capacity to control inflation increase the cost of borrowing and reduce the credit creating capacity thus the funds being given to the commercial banks as loans. As result of this the cost of borrowing becomes higher and the banks becomes more stringent in their lending policies which will subsequently lead to lower demand for funds and a fall in the volume of spending. Obviously the advent of such situation may adversely affect the profitability of the commercial banks because banks earn their revenue mostly from the loans they give to the customer so if the demand of loans falls as a result of the higher cost of borrowing then definitely earnings as well will fall hence the profit.

Rasiah (2010) further stated that inflation impact negatively on commercial banks profitability by decreasing the real value of bank's assets as compared to their liabilities. This is because commercial banks nominal assets might be larger than their nominal liability due to their nature of being net monetary creditors and because of this in times of high inflation the value of the nominal assets would decrease more relative to the increase in the value of nominal liability. Some empirical evidence seems to support this notion that inflation impact negatively on the profitability of commercial banks.

This has been confirmed by the observation of Husni (2011) which revealed a significant and negative relationship between the ROA of Jordanian commercial banks and inflation rate. This finding is in line with the result of Sufian et al. (2008) investigation on profits determinants of commercial banks Philippi.

To this extent Rasiah (2010) in his study documented that the impact of inflation on banks profitability to large extent depend on banks' ability to anticipate the occurrence of the inflation. This is because if banks are well assured of the possible inflation then interest rate would be increase to offset the imbalance and this would make the real value of the bank's assets and liabilities to stay unchanged and vice versa. This is in line with the findings of Pasiouras and Kosmidou (2007) which reported that inflation was positively related to profitability of domestic banks in Europe because the levels of inflation were anticipated by domestic banks. This gave them the opportunity to adjust the interest rates accordingly and consequently earned higher profits. This result is similar to those results cited by Husni (2011) in his observation which includes Demerguç-Kunt and Huizingha (1999), Toni Uhomoibhi, (2008), and Benaceur and Goaid (2010)

Haron and Sudin (2004), are some of the researchers in this area of study who have assessed the effect of inflation on commercial banks profitability and it has been revealed that their researched posted a significant positive relationship between the rate of inflation and bank profitability. Moreover, Devinaga Rasiah (2010) presented the effect of inflation rate on profitability by the use of annual percentage increase in the consumer price index as a measure of the rate of inflation (**INF** Annual percentage increases in the Consumer price Index).

### ***Competition (Market share/market growth rate)***

According to Michael Porter there are certain competitive forces that impact on profitability in every industry. These forces are said to be the drivers of competition and profitability in every industry which as well include banking industries around the world. He further stressed that it is difficult for firms which operates in highly competitive industries to earn favorable returns on investment. On the basis of this statement it obvious that commercial banks profitability is highly influence by certain competitive forces and even some studies have argue that intensive competition within commercial banking industry tends to decrease profits (Smith, 1984).

Among these forces is what Michael E. Porter termed as “Rivalry among Existing Competitors” with which some of its forms make it appropriate to consider in this study because of the possibility that they could be quantified hence their inclusion in the profitability model. He documented that higher rivalry among existing competitors which takes many forms including the fight for higher market share erodes profitability of an industry. Especially in slow growth markets with numerous competitors who are equal in size and power (Harvard Business Review 2008). There are two variables from this discussion with which some researchers have included in their studies and these include the market shares or the size of various commercial banks and market growth rate of commercial banking industry in particular country.

### ***Market Share / Bank Size***

Both Vong et al (2009) and Devinaga (2010) included market share in their studies. According to Devinaga (2010) market share could be included in the profitability model as an external determinant because if commercial banks could be able to expand their market share then they may be able to increase their income as well hence profit. This is because the ability to increase market share requires selling more so in the case of

banking if commercial banks are able to for example offer more loans to more customers then they stand a greater chance of increasing interest income as well as profits.

More over being able to sell more in order to increase your market share requires efficiency and low cost in your operation and Smirlock (1985) with his efficient structure hypothesis advocate that commercial banks that are in the position to ensure superior efficiency and having low cost structures stand the chance of achieving supernormal profits.

Furthermore, according to Karkrah and Ameyaw (2010) market share or size of banks is normally used to capture potential economies or diseconomies of scale in the banking sector. Secondly, the size of banks as a variable control for cost differences and product and risk diversification. They argue that the first factor (economies or diseconomies of scale) is expected to lead to a positive relationship between bank size and profitability if there are significant economies of scale and their argument was based on the empirical evidence of Akhavein, Berger & Humphrey (1997) Bourke (1989), Molyneux & Thornton (1992), Bikker & Hu (2002), Goddard, Molyneux & Wilson (2004) which they cited. This argument also seems to be supported by the investigation of Andreas & Gabrielle (2011) on determinants of bank profitability before and during the financial crisis in Switzerland. Their investigation revealed a positive relationship between larger and smaller banks and profitability. According to them there was an indication that Larger and smaller banks were more profitable than medium-size banks before the crises. And the reason was that larger banks were benefiting from the offering of large number of products, loan diversification and economies of scale.

Karkrah and Ameyaw (2010) further presented that the second part which has to do with risk diversification could lead to a negative relationship between bank size and profitability. In the sense that, increased diversification may lead to lower credit risks

and as a result cause lower returns. There are quite a number of researchers which seems to support this notion of negative relationship which exists between the bank size and profitability. For example according to Dietrich, Wanzenried (2011) large banks in Switzerland were less profitable than small and medium-sized bank in these years of the financial crisis. And their main reasons for this negative relationship between size and profitability was that larger banks in Switzerland had relatively higher loan loss provisions during the crisis and that larger banks were found to have significantly lower net interest margins in times of turmoil than smaller banks. Observation of Sufian et al. (2008) on Philippines banks also shows a negative relationship between bank size and profitability. To these researchers the negative correlation was an indication of smaller banks earning higher profits than larger banks and in support to the earlier studies which observed economies of scale and scope for smaller banks or diseconomies of scale for larger banks.

Even though, researchers like Berger, Hanweck & Humphrey (1987); Boyd & Runkle (1993);

Miller & Noulas (1997); Athanasoglou, Brissimis & Delis (2008) who were cited by Sufien et al. (2008) have concluded that decreasing marginal cost can be achieved by increasing the size of the banking firm during the time of markets development. Eichengreen and Gibson (2001) suggest that the impact of a growing bank's size on its profitability may be positive up to a certain limit. Beyond this limit, the effect of its size could be negative due to bureaucratic and other factors; Karkrah and Ameyaw (2010).

To capture the effect of market share or bank size on profitability, Devinaga Rasiah (2010) stressed that as both deposits and loans represent commercial banks output, one has to make a choice between deposits and assets to be use as proxy of banks market share. However, he argued that the fact that assets components may also comprise of

investment in securities and subsidiaries with which they might be the same across all commercial banks, the choice of deposits for the measurement of market share is considered to be more impartial.

### ***Market Growth***

Study conducted by Bourke (1989) indicated that total market development could be attributed to higher level of entry barriers which may ensure the incumbent banks in the industry to earn higher profits. The reason for this argument may stem from Micheal Porter's argument that if the market is growing it does attract new entrants into the market and these new firms have the desire to gain some market share. When this happened it courses the market to be very competitive which may result in low profitability of the firms in the industry (Harvard Business Review 2008). For example (IMF Country Report 2011) has indicated that number of licensed banks in Nigeria increased from 15 in 2000 to 25 in 2010, whereas the number branches increased from 200 in the year 2000 to 750 in 2010. The higher level of competition within the industry has resulted in the reduction of concentration. The report revealed that the percentage of share of five largest banks in the country has decreased from 61% in 2005 to 46% in 2010. Devinaga Rasiah (2010) documented that earlier studies conducted by researchers like Smirlock (1985), Clark (1987) and Rhoades (1987) used growth in commercial banks total deposits as proxy for market growth.

However, other studies like Bourke (1989), and Molyneux and Thornton (1992) used annual growth in money supply (money in circulation) as a proxy for market growth. Karkrah and Aaron Ameyaw (2010) finding on profit determinants of commercial banks in Nigeria shows that increase in total money in circulation within the years considered in their research was major driver of profitability and there was positive relation between banks profitability and money in circulation.

## **2.3 Theoretical Framework**

This chapter summarizes the information from the available literature in the same field of study. It will review theories of debt management on financial performance of banks. Previous literature has shown that there exists information asymmetry in assessing bank lending applications (Binks & Ennew, 1997). Information asymmetry describes the condition in which relevant information is not known to all parties involved in an undertaking (Ekumah & Essel, 2003). Studies on transaction costs have shown that transaction costs occur “when a good or a service is transferred across a technologically separable interface”. Therefore, transaction costs arise every time a product or service is being transferred from one stage to another, where new sets of technological capabilities are needed to make the product or service. Therefore, it may very well be more economical to maintain the activity in-house, so that the company will not use resources on example contacts with suppliers, meetings and supervision. Managers must therefore weigh the internal transaction costs against the external transaction costs, before the company decides whether or not to keep some activity in-house. Williamson (1981). This study will utilised asymmetric information theory and Transaction cost theory in debt management as theories adopted for the study.

### **2.3.1 Asymmetric Information Theory**

Information asymmetry refers to a situation where business owners or manager know more about the prospects for, and risks facing their business, than do lenders (PWHC, 2002) cited in Eppy (2005). It describes a condition in which all parties involved in an undertaking do not know relevant information. In a debt market, information asymmetry arises when a borrower who takes a loan usually has better information about the potential risks and returns associated with investment projects for which the funds are earmarked. The lender on the other hand does not have sufficient information

concerning the borrower (Edwards and Turnbull, 1994). Binks (1992) point out that perceived information asymmetry poses two problems for the banks, moral hazard (monitoring entrepreneurial behavior) and adverse selection (making errors in lending decisions).

Banks will find it difficult to overcome these problems because it is not economical to devote resources to appraisal and monitoring where lending is for relatively small amounts. This is because data needed to screen credit applications and to monitor borrowers are not freely available to banks. Bankers face a situation of information asymmetry when assessing lending applications (Binks and Ennew, 1996, 1997). The information required to assess the competence and commitment of the entrepreneur, and the prospects of the business is either not available, uneconomic to obtain or difficult to interpret. This creates two types of risks for the Banker (Deakins, 1999). The risk of adverse selection which occurs when banks lend to businesses which subsequently fail (*type II error*), or when they do not lend to businesses which go on to become" successful, or have the potential to do so (*type I error*) Altman (1971).

#### **2.4 Summary**

First developed by Schwartz (1974), this summarize the conjectures that suppliers may have an advantage over traditional lenders in checking the real financial situation or the credit worthiness of their clients. Suppliers also have a better ability to monitor and force repayment of the credit. All these superiorities may give suppliers a cost advantage when compared with financial institutions. Three sources of cost advantage were classified by Petersen and Rajan (1997) as follows: information acquisition, controlling the buyer and salvaging value from existing assets. The first source of cost advantage can be explained by the fact that sellers can get information about buyers faster and at lower cost because it is obtained in the normal course of business. That is,

the frequency and the amount of the buyer's orders give suppliers an idea of the client's situation; the buyer's rejection of discounts for early payment may serve to alert the supplier of a weakening in the credit-worthiness of the buyer, and sellers usually visit customers more often than financial institutions do.

## CHAPTER THREE

### RESEARCH METHODOLOGY

#### 3.1 Research Design

In this research, *exposé facto* method of data collection will be adopted. This is defined as a “systematic empirical enquiry in which the Researcher does not have direct control of independent variables because their manifestations have already occurred. This method measures the impact of events after the events have occurred (Kerlinger 1973). The advantage of this method is that it sharpens managerial decisions against the future as it helps in many cases to point to the direction of future events.

In achieving the objectives of this study, the audited annual financial statement of listed banks covering the period 2006-2016 were analyzed. The choice of these periods arises based on the fact that it was plagued with a number of corporate frauds arising from poor corporate governance practice and institutional failures. However, a total of 10 listed banks in Nigeria were selected and analyzed for the study using the purposive sampling method. Nevertheless, in analyzing the research hypotheses, the study adopted the use of both descriptive statistics and econometric analysis using the linear regression methodology consisting of periodic and cross sectional data in the estimation of the regression equation.

#### 3.2 Population, Sample and Sampling Techniques

The population of this research consists of the 10 listed Banks in the economy. Four (4) Banks – First Bank of Nigeria Plc. (FBN), Union Bank of Nigeria Plc. (UBN), Unity Bank Plc and United Bank for Africa (UBA). Following the Central Bank of Nigeria’s Banks audit in 2009, the first two (2) Banks were cleared as healthy while the last two (2) Banks had their Managing and Executive Directors replaced. The later banks were

also bailed out by the Central Bank of Nigeria owing to various levels of stress signal exhibited. This selection was made to aid in analyzing the impact an Asset Management Corporation would have had in turning around the fortunes of these Banks as it was discovered that their poor performances was a reflection of their poor debt/loan management strategies.

Random sampling was not adopted because of the nature of the population which possesses identical information except for size and volume. The selection was made by a mixture of convenience sample and purpose sample. Convenience sample as the name suggests is that unit which is conveniently available while purpose sample otherwise called judgement sample is that which is selected subjectively in an attempt to select that which appears to the Researcher to represent the population. To this end, the four Banks were selected on the following basis: Their data were readily available and to test whether good debt management or otherwise can contribute to banks profitability and the impact an Asset Management Corporation would have in ensuring this, hence the choice mixture of two healthy and two bailed out Banks.

### **3.3 Method of Data Collection**

Data collection instruments used were questionnaires, annual reports and financial statements on record and data from the Mix market. Primary data was collected using questionnaires where all the issues on the questionnaire were addressed. Secondary data was collected from annual reports and financial statements on record as at 31<sup>st</sup> December 2016.

The secondary data from the financial statements included the after tax profit, total assets, written off debt, and value of loans outstanding. The researcher administered the questionnaire to each respondent in the study. The questionnaire had both open and close ended questions.

The closed ended questions were used to test the rating of various attributes and this helped in reducing the number of related responses in order to obtain more varied responses. Semi structured interview refers to the use of already prepared questions during the study (Shenghverzy, 2003). The open-ended questions provided additional information that may not have been captured in the close-ended questions.

### **3.3.1 Data Validity and Reliability**

The reliability of a research instrument concerns the extent to which the instrument yields the same results on repeated trials. Although unreliability is always present to a certain extent, there will generally be a good deal of consistency in the results of a quality instrument gathered at different times. The tendency toward consistency found in repeated measurements is referred to as reliability (Carmines and Zeller, 1979).

One method of testing for reliability is the internal consistency method. The internal consistency method provides a unique estimate of reliability for the given test administration.

The most popular internal consistency reliability estimate is given by Cronbach's alpha. It is expressed as  $\alpha = \frac{Np}{[1+p(N-1)]}$  Where N equals the number of items and p equals the mean in the correlation.

Validity is defined as the extent to which the instrument measures what it purports to measure (Allen and Yen, 1979). Content validity pertains to the degree which the instrument fully assesses or measure the construct of interest. The questionnaire will be carefully designed and tested with a few members of the population for further improvements. This will be done in order to enhance its validity and accuracy of data to be collected for the study

### 3.4 Techniques for Data Analysis

The data that was collected through questionnaires was tabulated and analyzed using the Statistical Package for the Social Sciences (SPSS) software package these includes mean and standard deviations. Descriptive statistics was used to analyze data. Furthermore, descriptions were made based on the results of the tables.

Before processing the responses, the completed questionnaires were edited for completeness and consistency. The data was coded to enable the responses to be grouped into various categories. The findings were presented using tables, percentages, and tabulations. Tables were used to summarize responses for further analysis and facilitate comparison.

For this study, the researcher was interested in establishing the effect of Credit Management on Financial performance of DMBs. The model used in the study took the form below:

$$Y = \alpha + \beta_1 X_1 + \beta_2 X_2 + \beta_3 X_3 + \epsilon$$

Where:

Y= Financial Performance as measured by ROA

$\alpha$ = Constant Term

$\beta$ = Beta Coefficient –This measures how many standard deviations a dependent variable will change, per standard deviation increase in the independent variable.

X1= Client Appraisal

X2= Credit risk controls

X3= Collection policy

$\epsilon$ = Error term

Table 3.1: Summary of variables and measurement

<b>Variable</b>	<b>Definition</b>	<b>Formulae</b>
Y	Financial Performance	ROA= Return on Assets = net operating income-taxes/ average total assets
X1	Client Appraisal	As per the questionnaire
X2	Credit Risk controls	As per the questionnaire
X3	Collection policies	As per the questionnaire

### **Decision Rule**

In other to carry out regression analysis model, the Statistical package for social sciences (SPSS) will be used to determine the outcome. The procedure entails a description of the dependent and independent variables. In this case credit management is considered the independent variable; while bank performance is the dependent variable. The performance will be measured by profitability. SPSS was run and the output shows the constant ( $b_0$ ) coefficient of regression were ( $\beta$ ) is obtained. The output shows that P- values the coefficient that resulted in either rejecting or failure to reject the hypothesis at 5% level of significance. The P-value therefore indicates that the probability of getting result that show the critical value. The null hypothesis is rejected if the p-value is less or equal to the critical value. The output of the study will equally show the coefficient determination ( $R^2$ ), which measures the proportion of the

dependent variable that can be explained by the regression model. The P- value of less than or equal to critical value of the null hypothesis is rejected, there will be a slope between the variables. In this case, linear relationship will exist when the P-value or significance level is less than or equal to the critical value

### **3.5 Justification of the Method**

Linear regression method was used to assess the impact of debt management on the performance of listed banks in Nigeria. Credit management was regressed against the performance of banks in terms of profitability. This method is considered simple and quite explicit, and can easily be used to ascertain the significant of banks debt performance on each of the variables identified. The findings from this method will enable us draw a more reliable and far reaching conclusion on the subject matter.

### **3.6 Summary**

This chapter emphasized the relevant of procedures and methods needed to prosecute this study. This procedure range from research design, population and sampling technique, method of data collection, a description procedures for data analysis and model specification. This was also concluded with justification of the method used. Equally, descriptive research was also employed in the study. Data collection through the questionnaires and annual reports was analysed using descriptive statistics, while regression was used to test the hypothesis.

## CHAPTER FOUR

### DATA PRESENTATION AND ANALYSIS

#### 4.1 Presentation of Data

This chapter discusses the interpretation and presentation of the findings obtained from the field on the effect of credit management on the financial performance of deposit money banks in Nigeria. Descriptive and inferential statistics were used to discuss the findings of the study. The study targeted a population size of 59 respondents from which 53 filled in and returned the questionnaires making a response rate of 90.9%. This response rate was satisfactory to make conclusions for the study.

#### 4.2 Data Analysis and Results

##### 4.2.1 General Information

Table 4.1: Period within which DMB had been in existence

Period of time	Frequency	Percentage
Less than 5 years	10	18.9
Between 5 to 10 years	20	37.7
Between 10 to 15 years	15	28.3
15 years and above	8	15.1
<b>Total</b>	<b>53</b>	<b>100</b>

Source: Field Survey, 2017

The study sought to establish the length of time which the DMBs had been in existence in the organization, from the findings 37.7 % of the respondents indicated 5 to 10 years 28.3 % of the respondents indicated 10 to 15 years 18.9% of the respondents indicated less than 5 years whereas 15.1% of the respondents indicated for more than 15 years this implies that most of the DMBs had been in existence for 5 to 10 years.

Table 4.2: Adoption of Credit Management Practices

	<b>Frequency</b>	<b>Percentage</b>
Yes	46	86.8
No	7	13.2
<b>Total</b>	<b>53</b>	<b>100</b>

Source: Field Survey, 2017

The study sought to determine the organizations that had adopted Credit Management practices. From the findings 86.8% of the respondents indicated that their organizations had adopted Credit Management practices, whereas 13.2 % indicated that their organizations had not, this implies that a significant number of organizations had adopted the use Credit Management practices.

Table 4.3: Clients the organization has

<b>Number of clients</b>	<b>Frequency</b>	<b>Percentage</b>
Less than 100 clients	10	18.9
Between 100 to 250 Client	15	28.3
Between 250 to 500 clients	23	43.4
above 500 clients	5	9.4
<b>Total</b>	<b>53</b>	<b>100</b>

Source: Field Survey, 2017

The study sought to determine the number of clients the organization had, from the findings 43.4 % of the respondents indicated that their organization had Between 250 to 500 clients 28.3% of the respondents indicated that their organization had Between 100 to 250 Clients 18.9% of the respondents indicated that their organization had Less than 100 clients whereas 9.4% of the respondents indicated that their organization above 500

clients this implies that majority of the organizations featured in this study had Between 250 to 500 clients

#### 4.2.2 Client Appraisal

Table 4.4: Extent to which DMB use client appraisal in Credit Management

Number of clients	Frequency	Percentage
Very great extent	19	35.8
Great extent	24	45.3
Moderate extent	10	18.9
<b>Total</b>	<b>53</b>	<b>100</b>

Source: Field Survey, 2017

The study sought to determine the extent to which DMBs used client appraisal in Credit Management, from the findings 45.3% of the respondents indicated to a great extent, 35.8% of the respondents indicated to a very great extent whereas 18.9 % of the respondents indicated to a moderate extent, this implies that most DMBs used client appraisal in Credit Management to a great extent

Table 4.5 Level of agreement on client appraisal in DMBs

Statements	St ro ng ly ag	Ag re	Ne ut ra	Di sa gr	St ro ng ly di sa	an M	St d de vi ati
Client appraisal is a viable strategy for credit management.	21	30	2	0	0	1.70	0.26

The DMB has competent personnel for carrying out client appraisal.	16	33	4	0	0	1.77	0.27
Client appraisal considers the character of the customers seeking credit facilities.	15	36	2	0	0	1.75	0.29
Aspects of collateral are considered while appraising clients.	18	32	3	0	0	1.72	0.27
Failure to assess customers capacity to repay results in loan defaults.	16	35	2	0	0	1.74	0.29

Source: Field Survey, 2017

The study sought to establish the level at which respondents agreed or disagreed with the above statements relating to client appraisal in DMBs, from the findings majority of them respondents agreed that Client appraisal is a viable strategy for credit management as shown by a mean of 1.70, Aspects of collateral are considered while appraising clients as shown by a mean of 1.72. Failure to assess customers capacity to repay results in loan defaults as shown by a mean of 1.74, Client appraisal considers the character of the customers seeking credit facilities as shown by a mean of 1.75 and that the DMBs have competent personnel for carrying out client appraisal as shown by a mean of 1.77.

### 4.2.3 Credit Risk Controls

Table 4.6: Extent to which DMB use credit risk control in Credit Management

<b>Number of clients</b>	<b>Frequency</b>	<b>Percentage</b>
Very great extent	15	28.3
Great extent	30	56.6
Moderate extent	8	15.1
<b>Total</b>	<b>53</b>	<b>100</b>

Source: Field Survey, 2017

The study sought to determine the extent to which DMBs used credit risk control in Credit Management, from the findings 56.6 % of the respondents indicated to a great extent, 28.3 % of the respondents indicated to a very great extent whereas 15.1% of the respondents indicated to a moderate extent, this implies that DMBs used credit risk control in Credit Management to a great extent.

### 4.3 Discussion of Findings

From the findings as shown in Table 4.10, the value of adjusted R squared was 0.761 an indication that there was variation of 76.1% on financial performance of DMBs in Nigeria due to changes in client appraisal, credit risk control and collection policy at 95% confidence interval. R is the correlation coefficient which shows the relationship between the study variables, there was a strong positive relationship between the study variables as shown by 0.892.

From research finding as shown on Table 4.11, the calculated value was greater than the critical value ( $1.699 < 2.213$ ) an indication that client appraisal, credit risk control and collection policy significantly influence financial performance of DMBs in Nigeria. The significance value was of 0.012 which was less than 0.05 an indication that the model was statistically significant.

The regression equation established from table 4.12 indicated that that holding client appraisal , credit risk control and collection policy to a constant zero , financial

performance of DMBs would be 0.218 , a unit increase in client appraisal would lead to increase in performance of DMBs in Nigeria by a factor of 0.239, a unit increase in credit risk control would lead to increase in performance of DMBs in Nigeria by a factor of 0.392 and also unit increase in collection policy would lead to increase in performance of DMBs by a factor of 0.284. The significance of the variables was supported by the t values whose significance values were less than 0.05 which indicates that the variables were statistically significant in influencing financial performance of DMBs in Nigeria.

## CHAPTER FIVE

### SUMMARY, CONCLUSION AND RECOMMENDATIONS

#### 5.1 Summary

The study presents the discussion of key data findings, conclusion drawn from the findings highlighted and recommendations made there-to. The conclusions and recommendations drawn were focused on addressing the objective of the study. The researcher had intended to determine the effect of credit management on the profitability of deposit money banks in Nigeria.

The study revealed that DMBs use client appraisal in Credit Management to a great extent. Further it established that client appraisal is a viable strategy for credit, Aspects of collateral are considered while appraising clients, failure to assess customer's capacity to repay results in loan defaults, client appraisal considers the character of the customers seeking credit facilities and that DMBs have competent personnel for carrying out client appraisal.

The study established that DMBs use credit risk control in Credit Management to a great extent. The study further established that interest rates charged affects performance of loans in the DMB, Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk, the use of credit checks on regular basis enhances credit management, Penalty for late payment enhances customers commitment to loan repayment, the use of customer credit application forms improves monitoring and credit management, flexible repayment periods improve loan repayment and finally that the use of credit checks on regular basis enhances credit management.

The study revealed that DMBs use collection policy in Credit Management to a great extent. Formulation of collection policies have been a challenge in credit management ,

enforcement of guarantee policies provides chances for loan recovery in case of loan defaults, Staff incentives are effective in improving recovery of delinquent loans, a stringent policy is more effective in debt recovery than a lenient policy, regular reviews have been done on collection policies to improve state of credit management, and finally that available collection policies have assisted towards effective credit management.

## **5.2 Conclusion**

From the findings, the study concludes that client appraisal, credit risk control and collection policy had effect on financial performance of DMBs. The study established that there was strong relationship between financial performance of DMBs and client appraisal, credit risk control and collection policy.

The study also concludes that a unit increase in client appraisal would lead to increase in financial performance of DMBs in Nigeria; this is an indication that there was positive association between client appraisal and financial performance of DMBs, an increase in credit risk control would lead to increase in financial performance of DMBs in Nigeria, which shows that there was positive relationship between financial performance of DMBS and credit risk control and a unit increase in collection policy would lead to increase in performance; this is an indication that there was a positive relationship between financial performance of DMBs and collection policy. Client appraisal, credit risk control and collection policy significantly influence financial performance of DMBs in Nigeria

## **5.3 Recommendations**

The study recommends that DMBs should enhance their collection policy by adapting a more stringent policy to a lenient policy for effective debt recovery.

The study also recommends that there is need for DMBs to enhance their client appraisal techniques so as to improve their financial performance. Through client appraisal techniques, the DMBs will be able to know credit worth clients and thus reduce their non-performing loans.

There is also need for DMBs to enhance their credit risk control this will help in decreasing default levels as well as their non-performing loans. This will help in improving their financial performance.

#### **5.4 Limitations of the Study**

The respondents approached are likely to be reluctant in giving information fearing that the information sought would be used to intimidate them or print a negative image about them or their Micro Finance Institution. Some respondents may even turn down the request to fill questionnaires. The study handled the problem by carrying an introduction letter from the University and assuring them that the information they give would be treated confidentially and it would be used purely for academic purposes.

Employees operate on tight schedules; respondents are not able to complete the questionnaire in good time and this might overstretch the data collection period. To mitigate this limitation, the study made use of network to persuade targeted respondents to fill up and return the questionnaires.

The researcher also encountered problems in eliciting information from the respondents as some of the information required was subject to areas of feelings, emotions, attitudes and perceptions, which cannot be accurately quantified and/or verified objectively.

This might lead to lack of response due to the veil of confidentiality surrounding the Micro Finance institutions. The researcher encouraged the respondents to participate

without holding back the information they might be having as the research instruments would not bear their names.

### **5.5 Suggestions for Further Research**

The study sought to determine the effect of credit management on the profitability of deposit money banks in Nigeria. Further research is recommended on the effect of Credit management on loan performance of microfinance institutions in Nigeria. Further research should also be done on the relationship between credit management and nonperforming loans on Microfinance Institutions in Nigeria and on the reasons for loan default in microfinance organizations from the clients' perspective.

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## APPENDIX: QUESTIONNAIRE

Name of bank \_\_\_\_\_

### Part A: General Information

1. For how long has your DMB been in existence

Less than 5 years [ ]      Between 5 to 10 years [ ]  
]

Between 10 to 15 years [ ]      Above 15 years [ ]  
]

2. Has your organization adopted Credit Management practices Yes [ ] No [ ]  
]

3. How many clients does your organization have?

Less than 100 clients [ ]      between 100 to 250 Client [ ]

Between 250 to 500 clients [ ]      above 5000 client [ ]

### Part B: Credit Risk Management Practices

#### CLIENT APPRAISAL

4. To what extent does the DMB use client appraisal in Credit Management?

Very great extent [ ]

Great extent [ ]

Moderate extent [ ]

Low extent [ ]

Not at all [ ]

5. What is your level of agreement on the following statements relating to client appraisal in DMBs?

	St ro ng ly ag	Ag re	Ne ut ra	Di sa gr	St ro ng ly di sa
Client appraisal is a viable strategy for credit management.					
The DMB has competent personnel for carrying out client appraisal.					
Client appraisal considers the character of the customers seeking credit facilities.					
Aspects of collateral are considered while appraising clients.					
Failure to assess customers capacity to repay results in loan defaults					

### CREDIT RISK CONTROL

6. To what extent does the DMB use credit risk control in Credit Management?

Very great extent [ ]

Great extent [ ]

Moderate extent [ ]

Low extent [ ]

Not at all [ ]

7. What is your level of agreement on the following statements relating to credit risk control in DMBs?

<b>Statement</b>	St ro ng ly ag	Ag re	Ne ut ra	Di sa gr	St ro ng ly di sa
Imposing loan size limits is a viable strategy in credit management					
The use of credit checks on regular basis enhances credit management.					
Flexible repayment periods improve loan repayment.					
Penalty for late payment enhances customers commitment to loan repayment					
The use of customer credit application forms improves monitoring and credit management as well					

Credit committees involvement in making decisions regarding loans are essential in reducing default/credit risk					
Interest rates charged affect performance of loans in the DMB					

### COLLECTION POLICY

8. To what extent does the DMB use collection policy in Credit Management?

Very great extent [    ]

Great extent [    ]

Moderate extent [    ]

Low extent [    ]

Statement	St ro ng ly ag	Ag re	Ne ut ra	Di sa gr	ng ly St	di sa gr
Available collection policies have assisted towards effective credit management.						
Formulation of collection policies have been a challenge in credit management.						
Enforcement of guarantee policies provides chances for loan recovery in case of loan defaults						
Staff incentives are effective in improving recovery of delinquent loans.						
Regular reviews have been done on collection policies to improve state of credit management.						
A stringent policy is more effective in debt recovery than a lenient policy						

Not at all [ ]

9. What is your level of agreement on the following statements relating to collection policy of DMBs?

Thank you