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Review

Analysis of various strategies Nigerian banking institutions use to safeguard against bad credit

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Credit transactions have been indispensable to the economic development of Nigeria and that of the world at large. Credit has been defined as the permission to use another's capital. It also means the power to obtain goods or services by giving a promise to pay a certain sum of money at a specified date in the future. It was discovered that credit puts to use property that would otherwise lie idle, thus enabling a country to more fully employ its financial resources judiciously. It was also discovered that bank credit is as old as banking business because credit giving is one of the principal functions of commercial bank all over the world. The various reasons for giving out credit were identified. Also causes of credit default were evaluated – these includes; economic recession, character of the borrower, faulty credit analysis, excessive capital commitment and adverse finding. The study shows that various ways should adequately evaluate their customers before giving out loans, should demand for adequate collateral security, insist on credit insurance, should know the proposed project for which bank loan is required, should have adequate credit policy, banks should also tackle the problem of insider abuse. While the regulatory bodies should help to instill financial discipline in both borrowers and Nigerian banks.

Key words: Bad Credit, analysis of credit, credit default, borrowing, lending culture, economic downturn.

INTRODUCTION

The basic purpose of a banking business like any other business remains maximization of profit. A bank's profitability will generally vary directly with the riskiness of its portfolio and operations and how the bank manages the different types of risk it is exposed to. As a result of its banking/business operations.

The aim of this paper is to look into the various ways Nigerian banking institutions use to safeguard against bad credit. The CBN governor Mallam Sanusi L.S. had noted that bad debtors are usually multi-billionaires who take the money belonging to those poor and not pay back; and that the owners and managers of banks, the risk borrowers and their clients in the political establishment are one and the same class of people protecting their interest, and trampling underneath their feet, the interest of the poor with impunity.

Banks in Nigeria use various ways to control bad credit because it is well-known to bank managers that controlling credit is necessary to avoid liquidity shortage from excessive bad credits. This is in addition to contemporary bank regulation intended to limit bank failures and protect bank depositors from losses steming from such failures.

Bad credit therefore is a situation whereby a bank customer who borrowed money from the bank is unable to pay back the money and the interest charged on such money.

The concept of credit

Credit according to Somoye (2008), "is defined as the permission to use another's capital". It also means the power to obtain goods or service by giving a promise to pay a certain sum of money at a specific date in the future.

Credit, in commerce and finance is the term used to denote transaction involving the transfer of money or other property on promises of repayment, usually at a fixed future date. The transferor thereby becomes a creditor, and the transferee a debtor; therefore, have credit and debt are simply terms describing the same operation viewed from opposite standpoint. (Nwite, 2010).

According to Nwabueze (2000), credit transaction occurs between the parties in which one (the creditor or lender) supplied money, goods, services, or securities in return for a promised future payment by the other (the debtor, or borrower). Such transactions normally include the payment of interest to the lender.

Credit may be extended by public or private institutions to finance business activities, agricultural operations, customer expenditure or government projects.

Most modern credit is extended through specialized financial institutions of which commercial bank are the oldest and most important.

Historical development of bank credit

The origin of bank credit no doubt could be said to be as old ad banking business. This is because banking services involve receiving, collecting, transferring, paying, exchanging, lending (credit giving), investing or safeguarding money (or its substitute) for the customers.

Prior to 17th century, rudimental banking activities have become widespread in several parts of the world. However, banking activities in Nigeria evolved to serve the interest of the colonial government, especially in the distribution of sterling coins. With the influence of European trading activities and the presence of colonial government, the African banking gradually give way to the use of currency to facilitate exchange. Hence, the story of banking credit / bank credit may not be complete without the mention of the 17th century English goldsmiths, who created the model for today's modern fractional reserve banking i.e., the practice of keeping a fraction of depositor's money in reserve while extending the remainder to the borrowers in the form of loans. Customers deposited gold and silver with goldsmiths for safeguarding and were given deposit receipts verifying their ownership of the gold deposited with the goldsmith. These receipts could be used as money because they were backed by gold but the goldsmiths soon discovered that they could take chance and issue additional receipts against the gold to other people who needed to borrow money. This worked as long as the original depositors did not withdraw all their gold at once. Hence, the amount of receipts or claims on the gold frequently exceeded the actual amount of the gold, and the idea that banker could create money was born.

Reasons for giving out credit

The following are various reasons why banks give out credit facilities.

1. It Provides Interest to Financial Institutions: It provides banks the opportunity of making surplus funds. When banks give out credit to company(s) or individuals it attracts interest which accrued during the time of repayment.
2. To Finance Agricultural Sector: Banks give out loan / credit in order to encourage agricultural development. People who want to engage in intensive farming usually borrow money from banks.
3. For Industrial Development: Odi (2007), outlines some of the reasons for banks giving out credit as for industrial development.
4. To Build Houses: Banks give out credit to people to enable them build residential homes or for commercial purposes.
5. Provision of Vehicle: Most civil servants borrow money from banks to purchase vehicles. They mortgage their salaries for certain time. In fact, today in Nigeria, salary is one of the major collaterals people pledge to borrow money from the bank. (Nwite, 2004)
6. For Infrastructural Development: Also, government or other corporate organizations may obtain loan from bank in order to provide infrastructural facilities such as good road, pipe borne water, electricity, etc (Somoye, 2004)
7. To Settle other Immediate pressing Needs: Individuals, corporate organization and government also obtain loans from banks in order to settle a humiliating pressing problems and look for a way towards repaying the loan (Nwite, 2004)

Various ways Nigerian banks use to safeguard against credit default

An important function of credit management is credit control. Controlling credit is necessary to avoid liquidity shortage from excessive investment in debtors or loans and to secure an optimum balance between giving credit to make more sales and the financial risks from non-payment or late payment.

The various ways are as follows:

1. Credit Terms: At the commencement of the credit, the two parties always fix terms for the transaction as an agreement which must be binding on them.
2. Management of Payment (Payment Cycle): The period the credit will be paid and how it will be paid is also a necessary consideration.
3. Arranging Secured Method of Payment: The bank will arrange for secured method of payment like insisting on having credit insurance, a good collateral etc.
4. Credit Analysis: Banks have credit department that analyses the possibilities of giving out loans and in what terms and duration of payment.

5. Credit Policy: The banks as one of the major lending institutions should establish a workable credit policy. This will govern all types of loan the bank will give.
6. Credit Limit: The bank will also determine the credit limit it can comfortably assure to ensure and maintain adequate liquidity.
7. Organization and Planning System: The time the organization needs the money and what the money will be used for to avoid keeping idle fund is also very important.

Causes of credit default

Banks exist for economic growth. They render a lot of financial services and from there make their own profits. Banks in Nigeria as identified earlier in this work use various ways to control credit default. But in most cases the top executives in the banking industry because of personal interest do give instructions to the middle managers to give out loans on personal recognitions.

According to Nwabueze (2000), “There are in most cases, no security or collateral. In most cases, such loans are not always paid. The accumulations (aggregate) of such non payments result to a lot of problems to the banking industry and that is the problem most banks face in Nigeria”. This does not solve the problem, rather more money is being wasted. The usage of credit insurance policies will help to safeguard such defaults and also protect the bank. Some of the major causes of credit default are as follows:

1. Economic Recession: This can result to poor prediction of risks and that can bring loan default to banks.
2. Character of the Borrower: Because of moral hazard, it is difficult to predict who is good or bad, who can pay loan given and who cannot. Some people are fraudulent, some very careless in safeguarding their business. Due to all these, their business can collapse.
3. Faulty Credit Analysis: Faulty credit analysis can result due to human error. A man cannot perfectly predict the future all that we do as human beings is to romance with nature (Emeka, 1999).
4. Excessive Capital Commitment: Companies that are doing well can experience heavy capital investment in projects an the government later failed to pay as it is happening in Nigeria today.
5. Adverse Trading: The business world today is full of risk. Adverse trading can bring more risk in terms of business returns. This could lead to credit default.
6. Some companies that engage in creative accounting can bring false information in the financial statement which the company uses in analyzing the credit standing of the organization or company thereby resulting to credit default.

The implication of credit default control on economic development of Nigeria

Commercial banks extend credit to different types of borrowers for different purposes. For most customers, bank credit is the primary source of available debt financing. For banks, good loans may be the most profitable assets. As with any investment, extending loans to the businesses and individuals involves taking risk and to earn high returns. Returns comes in the form of profit/ interest, the income and investment income from due deposits. On the contrary, an entire industry such as energy, agriculture, or real estate, can decline because of general economic events. Firm specific problem may arise from changing technology, strikes, and stiffs in consumer preferences or bad management. Individual borrowers find that the ability to repay closely follows the business cycle as personal income rises and falls. Loans exhibit the highest charge-offs among bank assets. So banks regularly set aside substantial result against anticipate losses. This is why it is of utmost important for banks to always apply effective credit management decisions in giving out loans to their customers.

Therefore, the implications of credit default control on economic development of Nigeria are as follows:

1. It encourages the banks to continue their operations: If credit risk are effectively managed or controlled in the banking industry, it reduces the threat of distress in banking industry thereby encouraging banks to move on with their operations.
2. The Confidence the Public have on the banks will increase since necessary measures have been taken to manage credit risks. This will prevent run on banks and encourage financial stability of the country.
3. It keeps the banking industry in better profit making positions.
4. It helps to reduce the incidence of credit default in banking industry in Nigeria.
5. Since credit default has been taken care of, it brings about improvement in the performance of banking operations.
6. Reduction in Bad Debt: Effective credit control ensures that only individuals or corporate organizations that credit worthy will have access to bank credits. This will drastically reduce bad debt/credit default in Nigerian banks.
7. More Profit: Effective credit control ensures that banks make more profit from their lending activities. Banks due to effective valuation of customers only give out loan to customers that can repay the principal and the interest charges on it. The accumulation of these interest result to more profit to the lending bank.
8. General Economic Growth and Development of Nigeria: This is because the banking system plays a catalistic role in economic advancement. Once the banking industry is stable and reliable, there will be economic growth and development – foreign investors will come and invest in Nigeria, they will bring infrastructural development, employment opportunities in the different sectors of the Nigerian economy.

Challenges facing credit payment in Nigeria

The challenges facing credit payment in Nigeria are numerous depending on the angle from which one is viewing it. However, the major challenges are briefly highlighted as follows:

1. Economic Downturn: The adverse economic condition in Nigeria since mid 1980s' had been characterized by high inflation, depreciating value of the naira, large fiscal deficits, heavy external and internal debt and slow growth arising from that stress in the economy. Many borrowers (corporate bodies and individuals as well as government at all levels) were unable to service their loans, thereby making many Nigerian banks to come under severe crisis. (Nwite, 2004)
2. Borrowing and Lending Culture: This problem of economic downturn has been exacerbated by the attitude of some borrowers who are unwilling to repay their debts. Such borrowers seek refuge under the inadequate legal framework and cumbersome loan recovery process which make it difficult for lending banks to foreclose collateral.
3. There are also the challenge posed by professional borrowers who through bank staff take loans without collateral or no intention to repay such loans. Sometimes the loan applications are poorly appraised with inadequate documentation.
4. Insider abuse by bank owner, directors and management staff is another challenge facing credit payment in Nigerian banks. Insiders in those banks obtain loans and advances without collateral in contravention of banking regulations.
5. Poor Investment Outlet: Another challenge facing borrowers of und from the bank is poor investment outlet in Nigeria. There is always the problem of poor return on investment in most cases which could lead to credit default.
6. Death of viable Credit Policy in most Banks: credit policy provides the policy frameworks as well as a document which clearly explain the basic principles governing the disbursement of finance / credit.

Conclusion

In conclusion, it was discovered that the principal functions of credit is to transfer property (finance) from those who own it to those who wish to use it, as in granting of loans and other credit facilities by banks to individuals who plan to initiate or expand a business venture. The transfer is temporary and is made for a price known as interest, which varies with the risks involved and also with the demand for, and supply of credit. This credit transaction despite the benefit both to the bank and borrowers expose the bank to "credit risk" due to bad debt and delay in loan repayment. Hence, Nigerian banks apply various way to safeguard against bad credit.

Recommendations

Based on the findings of this work, the following recommendations are made to ensure proper management of credit risks in the Nigerian banking industry.

1. Banks should adequately evaluate their customers who want to borrow money from the bank to know their past credit records and ascertain if they have bad moral hazard.
2. Banks should demand for adequate security from certain categories of customers before giving out loan.
3. Credit insurance should also be embraced or insisted on to guard against the risk of bad credits.
4. Banks should also know the nature of their customers business to ascertain their financial strength before giving out credit.
5. The problem of insider abuse in the banking industry should adequately be tackled.
6. The proposed project for which bank loan is required must show prospects of good earning to both the bank and the borrower before loans could be given out.
7. Nigerian banks should have adequate credit policies that will guide them on how loans should be approved to their customer.
8. There is need for the regulatory bodies to help instill financial market discipline to both Nigerian banks and borrowers of fund.

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