

HUMAN ASPECTS OF LOAN DEFAULTS IN NIGERIAN BANKS AND MANAGEMENT STRATEGIES

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Abstract

This paper examined the human factors for loan defaults in Nigerian Banks, the implication of loan default on the Nigerian economy and the management strategies to deal with the problems. The economic basis for loans and the factors for loans defaults were addressed. The emphasis on the individual, economic and the psycho-spiritual forces (the flight of conscience) which could lead to loan defaults were highlighted. Finally, the need to improve the institutions of loans, using the information from publications such as the one reported here and ideas on the management of loan defaulters from other societies, with more cognate research studies were discussed.

Introduction

In the management literature, there is a general agreement that there are three resources being used in business, the engine of economic and industrial growth. These resources are material, financial and human. From these resources, human resources are the most important because they are those who will utilize other resources to achieve organizational goals (Akinmayowa, 2006). Naturally, human beings, in general, are psychologically driven to improve their standard of living on a daily basis through, innovations, discoveries, adventures, business investments etc, which require other resources, especially financial resources. Logically, human resources are the hub on which the search and application of funds revolve. The irony is that loan defaults occurs as a result of human failure, errors, intransigence, greed etc, while the failure of the system, such as

the unpredictable economic environment and infrastructural failure, etc., may be the other factors responsible for human beings, not being able to meet their loan obligations. The demand for money for investment, has given the banks the opportunity to see the granting of loans as a lucrative business, but they often face difficulties because some of those who borrow money from banks often default. In the Bank and Other Financial Institution Act (BOFIA, 2004), it was stated that the bank is a financial institution with the objectives amongst others, to lend money (loan) to other individuals, institutions and government. It is a corporate body with a legal identity, to sue and be sued, during the course of its transactions with the external or internal bodies, as the case may be. However, some banks often fail or find it difficult to turn potential bad debts to serviceable ones. For example, the Governor of the Central Bank of Nigeria (CBN) in 2009, revealed that aggregate Non-performing Loans (NPLs) of five rescued banks stood at N1,143 billion, representing 40.81 per cent of the Nigerian banking industry's NPLs at that time (Sanusi, 2009). After the discovery of these huge loans that threatened the existence of most Nigerian banks in 2009, the role of debt collectors in recovering debts for banks became prominent (Nwokoji, 2011). This study therefore set to investigate human factors responsible for loan default, the implication of loan default on the Nigerian economy and management strategies to deal with it.

Literature review

Banking business is bound to thrive on the understanding and assurance that the banker will be able to meet its obligations to depositors whenever the latter makes demand of his/her deposit and must be willing to honor every aspect of the loan conditions, the depositors may be granted. The granting of loans by banks to its clients or customers (individuals, government and corporate bodies) is done with the expectation of repayment of the capital and/or the interest accruing to such funds at agreed terms, within a stipulated period of time. However overtime, evidence has shown that in Nigeria, some borrowers or customers may not be willing to comply with the agreed terms, thereby resulting in their inability to honor any aspect of loan repayment as at when due. Attempt to make the borrowers to pay may result in litigation or death. Actually, it was reported that a manager (of a defunct bank) was killed while attempting to make one of the bank debtors to pay the loan granted to him (*Daily Sun*, 2011.). Indeed, the reason why those who borrow money fail to pay is because they are fraudulently minded. Diversion of money to other non-business ventures is fraud (Oghonna, 2011). Besides, it has become very obvious that some people borrow money to do business but instead of doing business, they use the money to build houses. Some use the money to travel to London and America to shop, while some prefer to use the money to increase the number of wives they have or organize great parties."

Qiwei and Binjie (2008), in "identifying potential default in loan applicants", posits that, default in loan application, is due to myopic business attitude, overheated economic growth, failure of real estate profits and the granting of loans to customers with poor or no credit history. In "Borrower Lender distance credit scoring and the performance of small business loan", Robert, Dennis and Nigro (2006) observed that the relationship and distance between the parties and unrealistic or poor credit scoring of clients or customers, contributed to greater defaults. Brownbridge (1998) claimed that the single

biggest contributor to the bad loans of many of the failed local banks was insider lending. He further observed that the second major factor contributing to bank failure were the high interest rates charged to borrowers operating in the high-risk business ventures. The most profound impact of high non-performing loans in banks portfolio is reduction in the bank profitability especially when it comes to disposals. Also, such banks are unable to meet their clients need for fund as and when due, thus prompting the clients to seek alternative sources of fund.

In another development, Agwuegbo (2006), on "Prospects of micro-Finance Banks", advocated that, the CBN should review bank loan policies, grant equal opportunities to assess funds and provide a supervisory framework that will be stringent enough to protect the banks. This may be as a result of the "tradition", observed by the Managing Directors of *Good Neighbor Micro-finance Bank and Meridian Micro-finance Bank* that the average Nigerians wants to take loan without paying back. They went further to report that people who cannot secure loans in commercial banks, makes a u-turn for loans in Micro-finance banks, to boost their businesses, only to divert it for paying their rents, school fees, and other frivolous agenda (Sanusi, 2009)

Loan defaults

A loan is a type of debt like all debt instruments. Typically, a loan may be expected to be paid back in regular installments, partial repayments or full payment. A Loan is generally provided at a cost referred to as *interest* on the debt, which provides an incentive for the lender to engage in lending. Interest is the difference between the amounts of money repaid. In a legal loan, these obligations and restrictions is enforced by contract, which can also place the borrower under additional restrictions known as loan covenants. Acting as a provider of loan is one of the principal tasks of financial institutions.

A secured loan is a loan in which the borrower pledges some assets (e.g. a car or building, share certificates etc) as collateral for the loan, while

unsecured loans are monetary loans that are not secured against a borrower's assets. These may be available from financial institutions under many different guises or marketing packages such as credit card debt, personal loans, bank overdrafts, credit facilities or lines of credit and corporate bonds (Gostineau, 1992)

In finance, default occurs when a debtor has not met his or her legal obligations according to the debt contract. A default is the failure to pay back a loan. Several theoretical explanations may be proposed for creditors failing in their loan repayment obligation to banks. In "Banking capital, monitoring and performance", the theory predicts that higher capital results in better banks. If granting of bank loans is done indiscriminately without an in depth assessment of the borrowers because the lender wants more interest on loans in order to reap in more capital, the wrong choice may be made, granting loans to those who are not credit worthy. "Borrower-Lender Distance, credit scoring and performance" suggest that there will always be a little "grey area" between the lender and the borrower. This means that the lender may not be aware of all the limitations of the borrower and even the little the borrower does not know, may be crucial in determining whether the borrowers will pay back the loan or default. The past records of the borrower may be hidden from the creditor. This imperfect knowledge of the borrower by the creditor is crucial in determining the level of loan defaults (Haffernan, 1996). Usually, the demands for huge sums of money, which the borrower may find difficult to fully repay, may be due to human and/or economic factors which have not taken care of the capacity of the borrower to repay loans. Both the human and the economic factors are inter-related and basically, the economic factors are the consequences of the human factors.

Human Factors

Maslow (1954) in *Human Motivation* noted that human beings would appear to have an insatiable appetite. So they may not easily be satisfied, especially when they are exposed to pleasurable experiences. Then they may want more and more

until they become choked up by their insatiable appetite.

From such viewpoints, human beings are potential defaulters of money (or material things) because they could "bite more than what they could chew" (e.g. borrow more money than what they could repay). The fact that human beings may have limited knowledge of how their environment, even their neighbor or business partners and even family members could affect their businesses shows the prospect for loan defaults everywhere, anytime. For example, the loans received by one person or group, may be granted as loans to others, who may be fraudsters.

Ideally, there are supposed to be rules, regulations, guidelines and principles which the operators of banks need to follow before granting loans irrespective of who is in charge without being biased. When this is weak, there is the potential loophole for managers and other operators to manipulate. This could backfire, leading to the inability to meet up with the obligations and subsequently become bad debts. Indeed, negative attitude in the form of negligence, or even the intentional act of aiding and abetting frauds, could derail loans agreements between the lender and the borrower.

Misplaced values, get-rich-quick mentality and flamboyant lifestyle in the society could prompt or tempt the agents of banks and companies or even individuals or government agents to be involved in certain sharp practices that could lead to loan defaults. Also, the general background of the parties in the negotiation could contribute to loan defaults. A person with criminal intention may be predisposed to cheating. Certainly, this could affect the fulfillment of his obligations under any loan agreement. Greed is another canker worm, potentially responsible for the incidence of loan defaults in banks. This is so because the operators could grant loans to persons or institutions with poor or bad credit records by receiving kickbacks from them without following laid down procedures. Some could even grant loans to themselves or their relatives through

manipulations and falsification of documents (e.g. loans through proxies).

The CBN, saddled with the responsibility of supervising the banks to ensure adequate compliance to banking legislations, quite often, may be outmaneuvered, due to the "characters of the officers" involved and their hidden agenda. Indeed, human beings under pressure "from above" may short-circuit the processing of loan papers, which the lender may capitalize on using the legal system not to repay the loan. More importantly, "behavioral misconduct" or outright tendency to cheat, deceive the lenders, by pretending to be bankrupt after borrowing funds from the banks, in the attempt to defraud the banks, is an option, too familiar to be ignored (Sanusi, 2009).

Yet, *window dressing* is another instrument that could be applied for loan defaults in banks. For examples, fake documents could be presented to fool the gullible lenders. Financial statements and budgets on sales etc. could be manipulated or window-dressed. Some borrowers may lie with statistical, accounting, economic and personal information. These statements may be packaged to deceive the banks, or could be encouraged by the bank officials, who are interested in getting a part of the loans they want to give out and directly encourage the lender to defraud the banks (Haffernan, 1996).

Indeed, *unhealthy competition* is another source of loan defaults. For example, some borrowers (businessmen and corporate bodies) could borrow huge sums of money to prosecute a business they do not actually understand or to challenge their fellow competitors, without adequate strength or feasible projects that could yield enough cash flow to meet up with their loan obligations as at when due. Insider dealings may be the worst transaction that is being perpetrated by officers or managers of banks who reveal *official secrets* of the banks or company to the customers and collaborate with them to circumvent the standards of the banks and sometimes tamper with the available records that contain the agreement on loans. Lack of

incentives to borrowers for repayment of loans, and prohibitive cost of borrowing, could create a lot of problems between the banks and their debtors. The need for a "balancing act", between the granting of loans by banks and the repayment of the loans, as at when due, is not a task for banks alone, but the responsibility of everyone in a civilized society. Some management strategies, to aid this process, are focused upon.

Implication of loan default on the Nigerian economy

The Nigerian banking sector is unarguably very important in the political economic system because it serves as the provider of the necessary lubricants that keep the wheel of the economy turning. The sector not only provides the fund needed for investment but allocates these funds as efficiently as possible to those projects that offers the best returns to fund owners. The health of the sector thus determines the well being of the economy (Osaze, 2007). This means that the role of bank remains central in financing economic activity and its effectiveness could exert positive impact on overall economy as a sound and profitable banking sector is better able to withstand negative shocks and contribute to the stability of the financial system (Athanasoglou, Brissimis and Delis, 2005). When users of fund default in their loan repayment obligation, it poses serious health problems for the banking sector, and when the sector is weak, the economy suffers tremendously.

It is also interesting to know that it is money and technical/managerial competencies that drive any economy and the banking sector not only provides the much needed money for building both managerial and technical capacities but also funds viable growth creating and development oriented investments (Osaze, 2007). When fund users therefore default in their loan repayment obligations, the above objectives will not be realized, and this of course leads to a depressed economy.

The banking industry has achieved great prominence in the Nigerian economic environment and its influence play predominant role in granting credit facilities. However the biggest risk facing banking and financial intermediaries is the risk of customers or counter party default. The probability of incurring losses resulting from non-payment of loans or other

forms of credit by debtors known as credit risks are mostly encountered in the financial sector particularly by institutions such as banks. During the 1990s, as the number of players in banking sector increased substantially in the Nigerian economy and banks witnessed rising non-performing credit portfolios. This significantly contributed to financial distress in the banking sector and the economy generally. Of notable interest is the existence of predatory debtor in the banking system whose modus operandi involves the abandonment of their debt obligations in some banks only to contract new debts in other banks (Ogbonna, 2011).

Credit creation is the main income generating activity for the banks. But this activity involves huge risks to both the lender and the borrower. The risk of a trading partner not fulfilling his or her obligation as per the contract on due date or anytime thereafter can greatly jeopardize the smooth functioning of bank's business. On the other hand, a bank with high credit risk has high bankruptcy risk that puts the depositors in jeopardy. In a bid to survive and maintain adequate profit level in this highly competitive environment, banks have tended to take excessive risks. But then the increasing tendency for greater risk taking has resulted in insolvency and failure of a large number of the banks thereby disrupting the operational efficiency and effectiveness of the bank which in turn exerts a negative effect on the economy.

It has also been observed that banks are increasingly facing credit risk (or counterparty risk) in various financial instruments other than loans, including acceptances, interbank transactions, trade financing foreign exchange transactions, financial futures, swaps, bonds, equities, options, and in the extension of commitments and guarantees, and the settlement of transaction. All these have implications on the operational efficiencies of the economy (Anthony, 1997). The most profound impact of high non-performing loans in banks portfolio is reduction in the bank profitability especially when it comes to disposals.

A high level of financial leverage is usually associated with high risk. This can easily be seen in a situation where adverse rumors, whether founded or precipitated financial panic and by extension a run on a bank. According to Umoh (2002) and Felix (2008) few banks are able to withstand a persistent run, even in the presence of a good lender of last resort. As depositors take out their funds, the bank runs out of cash and in the

absence of liquidity support, the bank is forced eventually to close its doors. Thus, the risks faced by banks are endogenous, associated with the nature of banking business itself, whilst others are exogenous to the banking system.

The Basel Committee on Banking Supervision (1999) asserts that loans are the largest and most obvious source of credit risk, while others are found on the various activities that the bank involved itself with. Therefore, it is a requirement for every bank worldwide to be aware of the need to identify measure, monitor and control credit risk while also determining how credit risks could be lowered. This means that a bank should hold adequate capital against these risks and that they are adequately compensated for risks incurred. This is stipulated in Basel II, which regulates banks about how much capital they need to put aside to guide against these types of financial and operational risks they face.

In response to this, commercial banks have almost universally embarked upon an upgrading of their risk management and control systems. Also, it is in the realization of the consequence of deteriorating loan quality on profitability of the banking sector and the economy at large that this research work is motivated.

Management Strategies

The Government should establish a commission, saddled with the responsibilities of carrying out "Personality Profile Assessment" (PPA) of every person or companies applying for loans before they are granted. Banks and financial institutions, as lenders of funds, should monitor firms and/or screen individual customers to whom credits will be granted, to minimize the problem of selecting those who are likely to default in payment of loans. Indeed, banks ought to maintain a good relationship with firms after extending credit by monitoring their performance to ensure that the loans are used as per the agreed proposal and to see to the success of the projects.

Bridging the distance between the lender and the borrower could be enhanced by an objective assessment/credit scoring of customers. The CBN should review the policy for supervisory frameworks that will be stringent enough to survive the banks. The code of corporate governance should be strictly adhered to and Nigerians banks should engage the services of

trained and experienced credit risk officers who should report directly to the board through the MD/CEO. Their role should include the personality profiling of those who apply for bank loans to find out if they are habitual loan defaulters, moving from one bank to another. Banks willing to survive in a constantly changing environment, should be willing to restructure their targets to reduce unnecessary risk taking by giving out loans to those who are credit worthy.

Documents or statements presented by borrowers revealing their performance and financial position at a particular time should be properly verified before being relied upon. If possible, the auditors should be consulted to re-affirm the truth and fairness of the information contained in such statements. Consultants, lawyers and private investigators, estate agents, debt collectors etc. could be engaged to make sure that the documents on which banks base their lending decisions are not fake.

The government should strengthen the existing laws by creating a framework by which loan defaulters could be dealt with. An example of such is the bankruptcy/insolvency laws of enforcement of contract. This includes providing a legal platform to punish bank loan defaulters, especially corporate organizations. The courts should be adequately equipped with computerized document processing system and modern facilities to enable them deal with cases arising from defaults in payment. The attempt being made by the Economic and Financial Crimes Commission (EFCC) in Nigeria, to pursue loan defaulters, as individual or corporate body, is useful and should be more constitutional. And the "press war" against bank loan defaulters (whose activities could cripple the national economy), should be stepped up because their efforts in educating the society about the activities of loan defaulters and fraudsters suggest that, there is little or no hiding place, for those who are on the wrong side of the law.

Regulatory bodies should monitor banks loans portfolio more frequently and not deal only with

the financial records or loans portfolio, at the headquarters of banks, but should also visit the branches. Management may need a complete overhaul. Top management who are not firm and skillful in making loan decisions should be disciplined or even removed to make room for a more purposeful and dynamic one. Indeed, one central data bank, for all those who borrow money from banks; fully computerized, in an interactive system, could be useful in monitoring professional loan defaulters, across the banking halls. A new lending code to overhaul the conditionality for the granting of loans, by banks need to be put in place. Attempt being made in this direction by the Chief Executives of leading financial institutions in Nigeria is useful. The objective of the new lending principle is to ensure that "bank credit is given to the right people in business and not those who would not utilize such facilities for profitable ventures" (Ogbonna, 2011). With the new code, it will no longer be business as usual for loan applicants as they would now be thoroughly screened to determine the feasibility of their projects before approval will be given.

Recommendations

Due to the conclusion that human factors are largely responsible for loan default in Nigerian Banks, it is therefore recommended that management need to be cautious in setting up a credit policy that will not negatively affect profitability. They also need to know how credit policy affects the operation of their banks to ensure judicious utilization of deposits and maximization of profit. Improper credit risk management reduce the bank profitability, affects the quality of its assets and increase loan losses and non-performing loan which may eventually lead to financial distress. CBN for policy purposes should regularly assess the lending attitudes of financial institutions. One direct way is to assess the degree of credit crunch by isolating the impact of supply side of loan from the demand side taking into account the opinion of the firms about banks' lending attitude. Finally, strengthening the securities market will have a positive impact on the overall development of the banking sector by

increasing competitiveness in the financial sector. When the range of portfolio selection is wide people can compare the return and security of their investment among the banks and the securities market operators. As a result banks remain under some pressure to improve their financial soundness.

Conclusion

The *quality* (integrity, intelligence, educational background, family background, social status, behavioral conduct and experience) affects the personalities involved in the transactions between the banks and their customers. *Human behavior* is the key issue from the beginning to the end, in determining who will give out loans, who will receive, who will repay loans and who will default. We need more vigorous research and psycho-analytic studies, funded by banks to deal with the human, environmental and spiritual forces (the flight of conscience) behind loan defaulting. Certain people who appear to be chronic debtors because there is something in their nature or in their psyche (mind), which makes them comfortable owing others and showing no sense of remorse when the repayment is due. Even if they are threatened with court sanctions or imprisonment, some may still be adamant, refusing to repay the loan they collected through voluntary agreement and could even use force on their creditors. Research should be ongoing in this area to know the biometrics of those who are likely to default in bank loans so that we could educate, counsel and encourage them, to change their bad habits.

Studies from other countries on loan defaulting could be useful in dealing with loan defaulters. After all, there is hardly any society where people do not borrow money. In fact, there is nothing wrong in borrowing, what is wrong is for those who borrow money refusing to repay the loans. Steps being taken and/or being advocated in one country to deal with loan defaulters to make them honour their loan obligations, could be useful in another country, although there may be a need to modify such steps to suit the environment of each country. Therefore, the problems identified and

the solutions proposed in this paper, could form the basis, in part or in whole for studies on loan defaulting, in other contexts. Turning to those who are timely in the repayment of bank loans, they should be commended for their honesty of purpose and be used as good examples of bank customers. They should be credited for contributing to development. Through the prompt repayment of loans, the banks would be able to contribute more meaningfully to the growth of the society in which they belong, granting more loans generously to individuals, groups, corporate organizations, government institutions, cognate others and especially investors, to enable them create wealth and share prosperity.

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