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DETERMINANTS OF LENDING PORTFOLIO CONSTRUCTION AMONG NIGERIAN COMMERCIAL BANKS.

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Abstract

Effective lending portfolio construction is one of the most complex problems which the management of financial institutions across the globe has to tackle on a continuous basis. This study investigates the determinants of commercial banks portfolio construction in Nigeria covering a period of 35 years (1977- 2012). Ordinary Least Square (OLS) technique is used to confirm the appropriate relationship between commercial banks' loans and advances (dependent variable) and lending portfolio determinants proxies by volume of commercial banks deposits, loan to deposits, liquidity ratio, lending rate, investment portfolio, inflation and cash reserve ratio. (independent variables). From the result, the study finds that five variables are significant while commercial banks deposits have the greatest impacts on commercial bank lending construction in Nigeria. However, two of the independent variables including inflation and liquidity ratio are not significant. The study among others recommends that, the Central Bank of Nigeria (CBN) should moderate the Monetary Policy Rate (MPR), promote low lending rate, favourable cash reserves, and liquidity of the banks, so as to facilitate investment and price stability in the economy. This is expected to promote credit expansion and invariably returns and profitability of the deposit money banks in Nigeria.

Keywords: Lending, Deposits, Investment, Portfolio, Liquidity, Solvency, Interest rate.

1 INTRODUCTION

Effective lending portfolio construction, a term commonly used to describe the allocation of funds among investment alternatives, is one of the most complex problems which the management of financial institutions across the globe has to tackle on a continuing basis.

Portfolio construction of banks by way of lending practices in the world could be traced to the period of industrial revolution which increases the pace of commercial and production activities thereby bringing about the need for large capital outlays for projects. Many captains of industry at this period were unable to meet up with the sudden upturn in the financial requirements and therefore turn to the banks for assistance (Ajayi, 2007). In Nigeria specifically, several banking enactment stipulates how banks' loans should be directed to preferred sector of the economy in order to enhance economic growth and development. These government objectives are designed through the promulgation of various regulations such as the Bank and Other Financial Act Amendment (BOFIA), various prudential guidelines and circulars issued by the Central Bank of Nigeria (CBN), (Olokoyo, 2011). However, as a result of some micro economic determinants such as the capital base, the deposit base and density of the deposit, commercial banks in Nigeria have always preferred to extend more credit to some selected preferred sectors, thereby distorting the government overall objective of ensuring sound economic development. These actions in the long run can distort government ongoing efforts of achieving her "vision 2020" objectives (Obamuyi, 2013).

In the light of this, this study poses the following questions:

- i) What are the common determinants of commercial banks' lending portfolio construction in Nigeria?
- ii) What effects do the determinants have on commercial banks' lending portfolio construction in Nigeria?
- iii) How does commercial banks' in Nigeria allocate funds to their lending portfolio?

1.1 Structure of the Nigerian Financial System

The Nigerian financial system is broadly dualistic in nature comprising of both an informal and formal sectors. The Informal Financial System (IFS) is made up of the institutions that are not integrated with the Formal Financial System and virtually out of the control of the legal framework. They are poorly developed and limited in reach; they include institutions such as the local moneylenders, rotating savings and cooperative societies. The Formal Financial System (FFS) on the other hand comprises of the banking sector, non-banking sector and the financial markets. Examples are the Commercial banks, Microfinance Banks; Primary Mortgage Institutions; Finance Companies; Bureaus de Change; Development Finance Institutions; Discount Houses; and Insurance Companies etc. They play a key role of uplifting the economic growth of the country and together with the financial banking system, build up and strengthen the financial system of the country (Esisal, 2009).

The rest of the paper is organized into four sections. Section 2 involves the reviews of relevant extant literature; methodology adopted in the study is discussed in section 3 while discussion of findings is presented in section 4. Section 5 provides the concluding remark and provides recommendations based on the findings.

2.0 LITERATURE REVIEW

2.1 Conceptual Issues: Management and Determinants of Banks Lending Portfolio.

Portfolio management is the identification of measured risk exposures that are controlled in the context of defined risk tolerance (Compuscan, 2013). It involves managing a portfolio of assets to achieve the best possible mix as distinct from managing individual assets within the portfolio. According to Oloyede and Fapetu (2002), portfolio management is a tool used to minimize aggregate risk problems while achieving or exceeding hurdle returns for risks the lender is willing to accept.

According to Oloyede and Fapetu (2002), four guiding considerations determine the commercial banks' lending portfolio. One is prudence and transaction demand. This largely governs allocation to cash assets such as vault cash or cash due to banks. These are required for working balances to make charge, meet requests, attend to loan demand and provide for various operating expenses. The second consideration is legal. In allocating bank funds to various assets categories, banks are constrained by legal requirement and the need to address satisfy the stipulations of the credit policy guideline. These stipulated required cash and liquidity reserves and proportion of bank funds to be allocated to different asset categories. The third consideration is the need to maintain a high degree of liquidity objective; the banks generally emphasize the real bills or commercial loan doctrine, the shift ability doctrine and the anticipated income approach to the allocation of bank funds. While the fourth consideration, is the need to earn sufficient income from their transactions. Commercial banks are commercial organisations and are therefore obligated to their shareholders to make maximum profit subject to the constraint of liquidity and safety. At the same time, as the suppliers of most of the nation's money stock, the banks owe important obligations to the public. The public must never have reason to question the solvency, liquidity or integrity of the banking system and depositors must be able to maintain full confidences in the ability of the banks repay deposits on demand or as agreed. One can also say that the contribution of commercial banks to the development of the economy is another consideration. To enhance sound banking practices, Abdul, Freeman & Michael (2013) identified the followings as some of the determinants of bank lending portfolio:

I) Deposits:

Deposits forms majority of banks' liabilities and plays an important role in the intermediation activities of banks. The decisions of banks management to lend are greatly influenced by the volume and cost of deposits to the banks. The interest paid on deposits ensures that banks earn return over and above their cost of funds, hence the transformation of these liabilities to loan assets to generate interest income. The larger the volume of bank deposits, the more loan able funds available to the banks, hence the higher likelihood of given out more loans and advances.

ii) Banks Capitalization:

Banks capitalization can affect bank willingness and ability to extend long-term loans in several different ways. Banks with larger capital cushion against credit risks should have higher capacity to extend risky, long-term loans. Therefore increasing banks' capital can enhance the banks' capacity to increase lending.

iii) Income Diversification:

The diversification of banking activities serves to stabilize bank income by focusing other sources of bank income which leads to decreased intermediation activities. This study proxies diversification as the ratio of non-interest income to total income. A negative relationship is expected between diversification and bank lending since diversification ensures that banks use its resources in non-interest generating activities.

iv) Intermediation Spread (Profitability):

The spread between interest income and expense gives an indication of bank profitability. A higher spread means lending is profitable and thus profit driven bank management is more likely to lend more. Therefore, it is expected that higher interest margin will induce banks to give out more loans and advances.

v) Asset Quality (Provisions for loan losses):

The level of non-performing loans in bank's loan is an indication of the profitability of bank lending activities. It requires the provision for write-offs of either portions or all of the loans. The write-offs are losses that the banks absorb with its equity capital, hence the banks reluctance to take new risks and commit new 'loans which is described as the credit crunch'. Lower bank asset quality signals banks as to their risk levels, therefore their reluctance to take on more risk through lending.

2.2 Theoretical Underpinning

In an attempt to provide sound theoretical underpinning for this study, this study adopts the Commercial loan theory in order explain the portfolio construction of banks.

2.2.1 Commercial Loan Theory

The commercial loan theory is the early asset management theory of Adams Smith in "the nature of wealth". The basic point of view of the theory is that Deposit is the main source of bank loanable fund and the deposits may be demanded at any time. So, in order to guarantee fund mobility, commercial banks can only issue short-term loans associated with commercial turnover, and adapting to the production material reserves for loans, but can hardly grant real estate and other long-term loans. This theory has some limitations which include: the characteristics of the loan which cannot meet the economic development needs of the long-term capital bank (Lee and Lee, 2013).

2.3 Empirical Review of Literature

Many empirical works have been carried out to determine the factors responsible for the lending portfolio construction behaviour of banks in different countries and also specifically in Nigeria.

In Chile, Alejandro and Ugo (2006) observes that state-ownership of banks is correlated with lending behavior over the business cycle. They found out that state-owned banks' lending behaviour is less responsive to macroeconomic shocks than the lending of private banks.

Olokoyo (2011) investigated the determinants of commercial banks' lending behaviour in the Nigerian context. The study aimed to test and confirm the effectiveness of the common determinants of commercial banks' lending behaviour and how it affects the lending behaviour of commercial banks in Nigeria. It was discovered that commercial banks deposits have the greatest impacts on their lending behaviour.

Muhammad, Ammara, Abrar & Fareeha (2012) carried out a study on the economic factors causing non-performing loans in the Pakistani banking sector since 2006. According to the results, Pakistani bankers perceive that Interest Rate, Energy Crisis, Unemployment, Inflation, and Exchange Rate has a significant positive relationship with the non-performing loans of Pakistani banking sector while GDP growth has significant negative relationship with the non-performing loans of Pakistani banking sector.

Kolapo, Ayeni and Oke (2012), carried out an empirical investigation into the quantitative effect of credit risk on the performance of commercial banks in Nigeria over the period of 11 years (2000-2010). Their results showed that the effect of credit risk on bank performance measured by the Return on Assets of banks has a cross-sectional variant. They concluded that the effect is similar across banks in Nigeria.

Abdul, Freeman & Michael (2013) wrote on the persistence of bank asset quality on bank lending behaviour in Ghana. They used a dataset from the Bank of Ghana for 25 Ghanaian banks from 2005 to 2010. They observed that the effect of the deterioration of bank asset quality (high levels of non-performing loans) on bank lending behaviour is persistence and not contemporaneous. In addition, bank deposit mobilization, intermediation spread and equity were also found to influence bank lending behaviour. Finally, some studies revealed that the behaviour of bank's investment portfolios is prevalent on their lending portfolios. Such studies are those of Nwankwo (1980) and Roussakis (1977) specified and estimated four commercial bank equations for Pakistan using annual data from 1955/56-1969/70.

2.4 2011 and 2012 Sectorial Distribution of Credits to Deposit Money Banks in Nigeria.

The banks credit portfolio construction (loan and advanced) to the various sector of the economy is a very major indicator of financial development. It explains the degrees of financial intermediation in an economy because it comprises all the credit given by the banks to the various sectors. This section examines the structure and share of commercial bank credit to the various sectors of the economy as at 31st Dec, 2011 and 2012 as shown in table 1 below.

Table 1: Sectorial Distribution of Credits as at 31st Dec, 2011 and 2012.

Details	Dec 2012		Dec 2011	
	N' Billion	%	N' Billion	%
Oil and Gas	1,912.92	23.47	1,529.84	21.03
Others	1,228.31	15.07	1,197.44	16.47
Manufacturing	1,185.60	14.55	1,108.64	15.24
General	977.20	11.99	854.10	11.74
General Commerce	813.40	9.98	809.20	11.12
Information and Commerce	722.87	8.87	628.14	8.64
Governments	640.06	7.85	542.93	7.46
Real Estate Activities	376.58	4.62	377.33	5.19
Agric, Forestry and Fishing	293.09	3.60	226.13	3.11
Total	8,150.03	100	7,273.75	100

Source: NDIC Report (Banks return), 2012

The figure shows that Commercial banks commonly distribute their lending portfolio among the various sectors. These sectors make up the construction of their various portfolios. The percentages analysis reveals the manner in which banks credits are allocated to the various sectors of the economy.

The table shows that the largest portion of the industry total credits went to the Oil & Gas sector in the sum of N1.91 trillion, in 2012 and N1.52 trillion in 2011 representing 23.47% and 21.03% of total credits to the economy respectively. The table also reveals others (Sectors not classified) as the second highest sector with the sum of N1.22 trillion, in 2012 and 1.19 trillion in 2011 representing 15.07% and 16.47% of the total credits to the economy. The third sector is manufacturing with the sum of N1.18 trillion, in 2012 and N1.10 trillion in 2011 representing 14.55% and 15.24% of the total credit to the economy respectively. However, the lowest portion of the industry total credit went to Agriculture, forestry and fishing with the sum of N293.09 billion in 2012 and 226.13 billion in 2011 representing 3.60% and 3.11% of the total credit to the economy respectively.

Overall, this analysis implies that banks are selective in the allocation and construction of their lending portfolios. The table also confirms the fact that banks constructed their portfolio in such a manner to maximizes their return and reduce risk (credit risk). These confirm the fact and general believe that banks do not give lending preference to government preferred sectors such as agriculture which are perceived to be risky.

3.0 METHODOLOGY

3.1 Research Design and Data Analytical Technique

This study empirically investigates the determinants of commercial banks lending portfolio construction in Nigeria covering a period of 35 years. The study consists of all the commercial banks sub sector of the Nigeria financial system licensed and operating in Nigerian economy from 1977-2012. The commercial banks were selected from the banking sector because they have a wider geographical coverage than any other financial institutions in the banking sector. They also control over 70% of assets and liability of the banking sector of Nigeria financial system (Ajayi, 2007). Secondary source of data was used in this research work. The data was obtained from *Central Bank of Nigeria statistical Bulletin and NDIC report 2012 various issues which covered the periods from 1977-2012*. In view of this, the study therefore, adopted a time series research design method.

3.2 Method of Data Analysis

The paper adopted econometric approach to test the degree of relationship between the variables by employing multiple regression analysis of the Ordinary Least Square (OLS) method. Unit Root Test using Augmented Dickey-Fuller (ADF) technique, Serial correlation test and normality test were also conducted to estimate the reliability of the OLS model used in the study. All the techniques were applied using E-Views 7.0 package.

3.3 Empirical Model

In order to examine the determinant of banks portfolio construction proxy via the use of Total Loans, and adopting the time series data analysis, a model was developed based on the modified version of Olokoyo (2011) thus:

$$TLA = F(VD, LED/TD, LQR, LR, INVP, INF, CRR) \dots\dots\dots (1)$$

$$TL = \alpha_0 + \beta_1 VD + \beta_2 LED/TD + \beta_3 LQR + \beta_4 LR + \beta_5 INVP + \beta_6 INF + \beta_7 CRR + \xi \dots\dots (2)$$

When transformed into a log form equation 2 becomes:

$$\text{Log}TL = \alpha_0 + \beta_1 \text{Log}VD + \beta_2 \text{Log}LED/TD + \beta_3 \text{Log}LQR + \beta_4 \text{Log}LR + \beta_5 \text{Log}INVP + \beta_6 \text{Log}INF + \beta_7 \text{Log}CRR + \xi \dots\dots(3)$$

The apriori theoretical expectations for these parameters are as follows:

$$\beta_1 > 0; \beta_2 > 0; \beta_3 > 0; \beta_4 < 0; \beta_5 < 0; \beta_6 < 0; \beta_7 < 0 \dots\dots\dots(4)$$

TLA = Total Loans and Advances

VD = Volume of Deposit

LED/TD = Loan to Deposit Ratio

LQR = Liquidity Ratio

LR = Lending Rate

INVP = Investment Portfolio

INF = Inflation

CRR = Cash Reserve Ratio

The logarithm of the variables was taken so that all observations in each variable will have equal weight so as to avoid serial auto correlation since the data covered a long period of 30 years.

4.0 RESULTS AND DISCUSSION OF FINDINGS

According to Engle and Granger, (1987) most ordinary least squares (OLS) regressions that are not stationary at level are mostly not reliable, because of the likelihood of short run disequilibrium among the variables. In view of this, testing for stationarity of variables to obtain a more reliable result cannot be over emphasized. This paper carried out stationarity test on the variables using Augmented Dickey-Fuller (ADF) as reported in Table 2 below. The result showed that all the variables were stationary at first difference, implying that OLS regression technique can be adopted.

Table 2. Augmented Dickey-Fuller (ADF) Unit Root Test

Variables	t.- statistic	Order of Integration
LOA = LLOA ***	-2.117210	I (1)
VD = LVD**	-4.644321	I (1)
INP = LINP***	-7.854615	1(1)
INF***	-5.802581	1(1)
LED/TD **	-3.793913	1(1)
LR***	-6.657064	1(1)
LQR***	-6.494433	1(1)
CRR**	-2201663	1(1)

Source: Authors' Computation, 2013

Note: ***Significant at 1 per cent level of significance
 **Significant at 5 per cent level of significance

In order to authenticate the reliability of our result, serial correlation test and normality test were conducted and the results presented in tables 3 and 4 respectively. The Jarque-Bera statistics is 0.025196. The result is not significant at 5% level of significance implying that the error term of the regression analysis is normally distributed (see Table 4).

Table 3. Breusch-Godfrey Serial Correlation LM Test

F-statistic	1.305348	Prob. F(2,26)	0.2883
Obs*R-squared	3.284961	Prob. Chi-Square(2)	0.1935

Source: Authors' Computation, 2013

In addition, the R^2 is also less than the Durbin-Watson statistic meaning that OLS model is good. In addition to these, the serial correlation test on (see table 3) also indicated that the error term is also not serially correlated. Overall, the stability of the parameters from the OLS is remarkable, considering the great number of economical reforms implemented during the analyzed period. This indicated that the events capable to create structural breaks were incorporated very well in the model.

Table 4. Normality Tests of Residual

Jarque Bera	Probability
0.025196	0.987481

Source: Authors' Computation, 2013

4.1 Ordinary Least Square Estimation

The study adopted ordinary least square (OLS) for the estimation. The method was adopted because it would be able to capture the essence of the work effectively in addition to its high level of simplicity and global acceptability.

Table 5: Regression analysis on the Determinants of Bank portfolio Construction

Variables	Coefficient	Std. Error	t-Statistic	Prob.
VOLUME_OF_DEPOSIT	1.144132	0.036231	31.57915	0.0000***
LOAN_TO_DEPOSIT_RATIO	0.008942	0.002703	3.308148	0.0026***
LIQUIDITY_RATIO	-0.004867	0.002483	-1.959875	0.0600*
LENDING_RATES	-0.012372	0.005405	-2.289087	0.0298**
INVEST_PORT	-0.081766	0.028609	-2.858022	0.0080***
INFLATION	-0.002889	0.001525	-1.893756	0.0686*
CASH_RESERVE_RATIO	0.025432	0.006492	3.917259	0.0005***
C	-0.872278	0.306552	-2.845448	0.0082**
R-squared	F-statistic	Prob. (F-statistic)		Durbin-Watson
0.8980	2029.556	0.0000		1.91415

Source: Authors' Computation, 2013

Note: ***, **, * indicates significance at 1%, 5%, and 10% levels respectively

4.2 Discussion of Findings

Table 5 provides the summary statistics and the results of the data analyzed. The Durbin-Watson statistics is 1.91 which is close to 2, implying the absence of first order autocorrelation in the regression model., the coefficient of multiple determinations - R-squared is 0.898033 which showed that 89% of the variation in the bank lending portfolio as proxied by LOA was caused by the variations in the explanatory variables as explained by the model. This showed that only 11 percent changes in the dependent variable was caused by other variables not found in the equation but measured by the error term. The F-statistics of 2029.556 is significant at 1 percent level of significance; hence the model is of good fit. The results therefore, revealed that the first null hypothesis of no functional relationship between the Loans and Advances (LOA) and the independent variables is rejected and the alternative hypothesis is accepted.

The regression results as presented in table 5 shows that the estimated coefficient of Volume of Deposit (VD) Loan to Deposit Ratio and Cash Reserve Ratio are positive. The positive sign on the coefficient establishes that each of these variables are positively related to loans and advances at 1% level of significance indicating that for every 1% increase in Volume of Deposit, Loan to Deposit Ratio and Cash Reserve Ratio will cause loan and advances of the commercial banks in Nigeria to increase by 114%, 0.0089% and 0.25% respectively. This result is therefore consistent with our a priori condition. Thus, the result is consistent with commercial loan theory which views deposit as the main source of bank loanable funds.

The regression estimates also show a negative relationship between lending rate and loans and advances at 1% level of significance. The implication of the result is that lending rate charged by commercial banks in Nigeria has negative effect on commercial banks portfolio construction decision. Although monetary policy instrument of liquidity requirement is not significant at 5% level of significance, cash requirement ratio however, has a significance impact on commercial banks portfolio construction in Nigeria. Therefore, commercial banks should always ensure compliance with these policies. Also, investment portfolio is negatively significant at 1% meaning that investment in Treasury bill and other investments by banks' have a negative impact on banks portfolio construction in Nigeria. This corroborate the works of Nwankwo (1980) and Roussakis, (1977) that posit that the behaviour of bank's investment portfolios are prevalent and impact on lending portfolios. Finally, it is worthy to note that, the coefficient of Volume of deposit (VD) from the result has the highest effect on commercial banks portfolio construction in Nigeria with 114%. This result also, corroborates the work of Olokoyo, (2011).

In addition, Liquidity ratio and inflation show an insignificant relationship with loans and advances implying that these variables have no relationship with bank portfolio construction in Nigeria. Overall, the regression estimates show that five variables are statistically significant out of all the explanatory variables used in the model. i.e. Volume of Deposit, Loan to Deposit Ratio, Lending Rate, Investment Portfolio, and Cash Reserve Ratio.

5.0 CONCLUSION AND RECOMMENDATIONS

In conclusion, available statistics have shown that banks' need to understand how to construct their portfolio so as to maximize their performance in terms of profitability. Bank lending constitutes the core of banking activities and is responsible for a sizeable proportion of bank revenue. It is generally believed that high lending portfolio is positively correlated to profitability which also has a positive correlation to nonperforming loans.

This study has shown that there is a significant relationship between banks lending portfolio construction (sectorial allocation) and determinants such as investment portfolio, lending rate, Volume of deposit, and Cash reserve ratio. The result also revealed that higher percentage lending portfolio construction is majorly attributed to huge deposits of the commercial banks in Nigeria. However, the commercial loan theory disagree with the use of deposit for creating long term loan and maintained that deposit should only be used for generating short term loan. This implied that commercial banks in Nigeria cannot at present grant long term loan which is important for economic development. Although, future research work in this area of study could investigate the effects of recapitalization, priority sector lending, non-performing loans and other microeconomic variables on banks portfolio construction in Nigeria.

5.1 Recommendations

In the light of the above, the following are hereby recommended in line with the result generated from the work:

- Central Bank of Nigeria (CBN) should moderate the Monetary Policy Rate (MPR), promote low lending rate, favourable cash reserves, and liquidity of the banks, so as to facilitate investment and price stability in the economy. This is expected to promote credit expansion and invariably returns and profitability of the deposit money banks in Nigeria.
- For effective and efficient portfolio construction, it is essential for commercial banks to build system and skills in liquidity management, assets and liability management, investment management as well as priority lending strategies.
- The findings from this study reveals that deposit mobilization is the main determinant of Commercial banks lending portfolio construction. Thus, banks should improve their marketing strategize to attract and retain more deposits, exploring strategies that could reduce operational cost of deposit attraction as well as diversifying the various sources of deposits. However, CBN should ensure that customers' deposits in Nigerian deposit money banks are fully insured with the NDIC so as to guarantee that no depositor suffers any losses in case of any sudden bank distress.

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