AN ANALYSIS OF CREDIT CREATION AND ADMINISTRATION IN COMMERCIAL BANKS IN NIGERIA

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ABSTRACT

This paper examines credit creation and administration of commercial banks in Nigeria. It defines banking and credit administration as a process, using various tables to illustrate the process of credit creation by commercial banks. It also tries to analyze the post consolidation effects of credit creation and administration in Nigeria. It recommends among others, that commercial banks should evaluate loan proposals and put in place a versatile credit policy and environment to help in minimizing issues of default in repayment of credit by banks customers.

Keywords: *Analysis, Credit, Administration, Banks, Nigeria.*

INTRODUCTION AND BACKGROUND TO THE STUDY

The banking sector plays a vital role in the development of any economy especially the third world economies that requires proper administration of funds and efficient credit creation process which could stimulate growth and development in such feeble economies. This is why Levine (1996) argued that financial intermediaries play crucial roles in the operation of most economies and stated further that the efficacy of financial intermediaries can also affect economic growth.

In the history of development of the Nigerian banking industry, it can be seen that most of the failure experienced in the industry prior to the consolidation era were results of imprudent lending that finally led to bad loans and some other unethical factors (see Job et al, 2008). It is important to note that the consolidation process in the banking sector has, however, assisted in augmenting the capital base of Nigerian banks, and as such, increasing their ability to administer more loans and thus the ability to create more credits for the growth and development of the economy. The sector's ability to fulfill this function is an identified impetus for the Nigerian government in achieving its dream of being among the most developed economies in the world in the year 2020. (UBA 2006)

The role of the banking sector in this regard can therefore not be underemphasized. One of such functions as identified by Ijaiya and Abdulraheem (2000) is the credit creation ability of commercial banks which is the multiple expansions of banks' demand deposits. It is an open secret now that banks advance a major portion of their deposits to the borrowers and keep smaller parts of deposits to the customers on demand. Even then the customers of the banks have full confidence that the deposits lying in the banks are quite safe and can be withdrawn on demand (Blurtit 2007) which is in line with the Banks and Other Financial Institutions Act (BOFIA) 1991. The banks exploit this trust of their clients and expand loans by much more time than the amount of demand deposits possessed by them. This tendency on the part of the commercial banks to expand their demand deposits as a multiple of their excess cash reserve is called banks credit creation process which can further be explained in a more lucid term. It can therefore be established here that a single bank cannot create credit. It is the banking system as a whole that can expand loans by many times of its idle funds. Furthermore, when a loan is advanced to an individual or a business concern, it is not given in cash. The bank opens a deposit account in the name of the borrower and allows him to draw upon the bank as and when required. The loan advanced becomes the gain of deposit by some other bank. Therefore, loans thus make deposits and deposits make loans.

CONCEPTUAL ISSUES

In this paper, some concepts will be examined in broad terms; this is to enable a vivid understanding of this discussion. In this present effort, Ekezie (1997) defined a bank as an institution which accepts deposits from the public and in turn grants loans by creating credit. This is in agreement with Section. 61 of Banks and Other Financial Institutions Act (BOFIA) 1991 that a bank is that licensed under the Act, which can also be compared to Section 31 of 1990 Banking Decree that a bank is any person licensed to on banking business. Furthermore, Section 61 of BOFIA 1991 also describes Banking Business as one includes the acceptance of deposit. See also Section 2(1) of the Bill of Exchange Act (1882) which defines a banker as a body of persons whether incorporated or not who carry on the business of banking, and this includes the ability of banks to execute some other statutory function of credit creation in the economy. This process is also one of the primary functions of the commercial banks i.e. the granting of credit to worthy customers.

On the other hand, credits are means of obtaining resources at a certain period of time with an obligation to repay at a subsequent period in accordance with the terms and conditions of the credit obtained. It is also referred to as the process of lending and borrowing money from financially able bodies e.g. banks, government and individuals (Pearce 1992). Simply put, credit is the availment of resources (money) to household, firms and government with the understanding that repayment will be at a specified period of time. The credit term to be granted to any customer will depend on the norms and practices of the industry (Pandey 2006).

In creating credit, a bank has to know how much of its' deposits is idle after having satisfied the requirements of the regulatory authorities (i.e. the CBN, NDIC). Tools such as the reserve requirements (cash and liquidity ratios), open market operations and stabilization securities are generally used by the authorities to control the amount of credit that is created.

As highlighted earlier, credit is created when a commercial bank decides to lend some of the depositors money which are lying idle in its' vault to credit worthy customers. The granting of such credits assists in the growth of the economy as resources are pooled from surplus areas to needy areas. This process is also one of the avenues used by the banks to make profit as the interest rate at which the loans are granted is usually higher than the rates paid on the deposits by banks. The difference between the interest rate is the profit for the bank.

ANALYZING THE CREDIT CREATION PROCESS

In the view of Ekezie (1997), banks are legally required to keep a fixed percentage of their deposits in cash and then, lend or invest the remaining amount. It is the amount lent that actually leads to the credit creation process.

Jhingan (2002) identified the following assumptions as a means of explaining the process of credit creation

- There exists more than a bank in the system.
- 30% is the reserve ratio.
- Loans given out are the limit set by law and this is done before additional cash is injected into the system.
- The banks have credit worthy customers who are interested in borrowing and the banks are willing to give them.
- There is an initial deposit of N100,000 into the system.
- There is no cash drain or leakage in the banking system.
- The loans are withdrawn by borrowers and is spent and re-deposited by recipient in the same or another bank.

This process is further illustrated in the table below.

TABLE 1: A Hypothetical Example of Credit Creation

DEPOSIT =N=	RESERVE (30%) =N=	LOAN ADVANCED (70%) =N=
100,000	30,000	70,000
70,000	21,000	49,000
49,000	14,700	34,300
34,300	10,290	24,010
24,010	7,203	16,807
16,807	5,042	11,765
11,765	3,529	8,235
8,235	2,471	5,765
5,765	1,729	4,035
4,035	1,211	2,825
2,825	847	1,977
1,977	593	1,384

1,384	415	969
969	291	678
678	203	475
475	142	332
332	100	233
233	70	163
163	49	114
114	34	80
80	24	56
56	17	39
39	12	27
27	8	19
19	6	13
13	4	9
9	3	7
7	2	5
5	1	3
3	1	2
2	1	2
2	0	1
1	0	1
1	0	1
1	0	0

Source: Authors' Computation (2008)

CLASSIFYING CREDIT

Having discussed the term credit, it is pertinent to consider the credit and it's various form. In this regard, credit may be classified into the following categories:

i. **Short term**: The short term credit is usually repayable within a year and is most times in the form of an overdraft.

ii. **Medium / long term**: This refers to a credit that is payable over a period of more than a year. A medium term facility could be between one to five years whereas long term credit falls within ten years and above. An example of this class of credit is a mortgage loan.

iii. **Contingent:** Contingent credit is that arising as a result of the occurrence of certain events whose certainty cannot be guaranteed. A bank guarantee is therefore an example of a contingent credit.

iv. **Special credit**: This is a type of credit that is customized to meet specific needs of bank clientele. The consumer loan being packaged by the banks is a good example of this type of credit. Under this, we have asset finance, share purchase etc.

The credit administration function is basically a back office activity that supports and controls the extension and maintenance of credit. A typical credit administration unit performs the functions of credit documentation, monitoring and maintenance of credit files, collateral and security documents as well as ensuring that loan disbursement and repayment conform to laid down policies. Thus, credit administration is the follow up on the credit created to ensure that loans so advanced are serviced and paid back at the right time so that when the depositors of the money needs it, they can have access to it. Hence credit administration can be said to be a fall out of credit creation.

In this regard, several factors are considered in the credit approval process but the most important ones are usually referred to as the seven (7) canons of lending. These are (see Adekanye, 1986 and Jhingan, 2002).

- Character – this refers to whether the customer can be trusted enough to keep to the terms and conditions of the loan covenant as at times, some people will have the capacity to pay back but the character makes the person unwilling to pay even though there is financial capacity to do so.
- Capacity – this refers to the ability of the borrower to repay the loan. i.e. whether the customer generates enough fund from his business to service the loan. In determining the customer's capacity, the books of accounts of the company if corporate are properly scrutinized. If the person is an individual customer, credit checks are made from his employer to ascertain that he makes enough money to pay back the loan.

- Capital – In Basil, capital is the equity that a firm has which upon liquidation of the firm will be available for debt repayment if all other means fail. It equally represents the borrower's stake in the company. Consideration is given to whether the company is sufficiently capitalized for the business it is doing and for which the loan is being requested.
- Collateral – this acts as the back up plan if the first source of repayment fails to pay back the loan. Normally, banks do not wish to exploit this option as it usually involves a lot of paper and legal work. The collateral could be in the form of landed property, stocks and shares in blue chip companies and any other source that is acceptable to the bank.
- Condition – this refers to the environment under which the business operates. Economic conditions affect the ability of the borrower to repay financial obligations. These economic conditions are beyond the control of the borrower and the banker.
- Cash flow – Under cash flow, consideration is given to projected cash inflow and outflow of the customer. Is the business able to generate adequate inflow after outflows are taken care of to repay the loan?
- Considerations – this refers to other factors that are likely to prop up during the credit approval process. Factors such as obligor's limit, composition of the lending banks portfolio, etc, come under other consideration.

A careful and thorough analysis of the above assists a banker when he is considering whether to approve a credit or not. It is also essential for the lending bank to be knowledgeable about the customer's business.

After approval, it is necessary to keep a close follow up / monitoring of the loan to ensure proper utilization for the purpose it was granted and that the terms and conditions under which the loan is granted are strictly adhered to.

Having taken a look at the credit creation process and how credit is classified, this paper continues by analyzing the effect of the consolidation exercise of 2006 on credit creation using statistics obtained from the audited financial statement of the United Bank for Africa plc over a five year period.

POST CONSOLIDATION EFFECT ON CREDIT CREATION AND ADMINISTRATION

The consolidation of the banking system in 2005 which required commercial banks to increase their capital base from two billion naira (N2b) to twenty five billion naira (N25b) saw the emergence of twenty five (25) mega banks in the country, which later reduced to twenty four (24) in the year 2008 as a result of the merger of *IBTC Chartered and Stanbic bank*. The implication of this capital injection into the banking system was that apart from making the banks stronger capital wise, the banks had a lot of funds to play around with and this in turn led to an increase in the number of credits granted to both the formal and informal sectors, thus could compete relatively at the global level. A corresponding increase was also recorded in the profit after tax. This can be seen from the table below.

Table 2: An Extract from the United Bank for Africa Plc 5-year Financial Summary Showing a Comparative Analysis of its Shareholders Fund, Loan and Advances and Profit after Tax

	Financial Year ended 30 Sept 2007 N' million	**Financial Year ended 30 Sept 2006 N' million**	**Financial Year ended 31 March 2005 N' million**	**Financial Year ended 31 March 2004 N' million**	**Financial Year ended 31 March 2003 N' million**
Shareholders Fund	167,719	48,535	19,443	19,533	14,901
Loans and advances	320,229	107,194	67,610	56, 136	46,076
Profit after tax	19,831	11,468	4,653	4,185	2,989

***Source:* (U.B.A 2007 Annual Report).**

A look at the above table above shows that the loans and advances made by the bank increased by 595% from =N=46,076 (Y/E 31/03/2003 pre-consolidation) to =N=320,229 (Y/E 30/07/2007 post consolidation) while a corresponding increase of 563% was recorded in the profit after tax in the same period. Similarly the shareholders fund grew by 782% within the same period. This implies that an increase in the capital base of the bank as a result of the consolidation exercise led to an increase in both the loans and advances and profit after tax. It will be recalled that the post consolidation United Bank for Africa is a result of the merger of the defunct Standard Trust Bank and Continental Trust Bank with United Bank for Africa Plc.

The increase in the credits granted also led to the banks developing various types of loans structured towards the credit needs of it's customers with an easy repayment plan and a wider reach which will enable those of its customers who hitherto had been unable to have access to credit, now have the liberty to it.

Thus the concept of consumer loans was introduced which had the characteristic of an easy and convenient repayment method. This guaranteed the repayment to the bank as the source of repayment was primarily from the salary payments of the customers.

CONCLUSION AND RECOMMENDATION

Having established that an increase in the capital base led to an increase in credit creation and administration, it is recommended that the bank put in place, a strong credit policy and environment to help in minimizing the default in repayment as done with the consumer credit. This should also be extended to commercial credits in order to grow the other sectors of the economy.

The government through the regulatory authorities is also advised to put in place a sound macro economic environment that will have a positive effect on the amount of credit created since policies have an effect on credit creation.

In summary, Obajemu (2007) advised that Banks should have credit risk management procedures that are holistic. At the minimum, they should cover formulation of overall credit strategy, credit creation, administration, analysis, measurement and control. He also advised that the bank should include the risk review process and procedures for managing problem credits. Credit origination banks must operate within a sound and well-defined criteria for new credits as well as the expansion of existing credits. Credits should also be extended within the target markets and lending strategy of the institution. Identifying the key feature of credit origination to be the assessment of the risk profile of the customer/transaction, banks should develop procedures that adequately capture salient issues regarding the borrower's industry; macro economic factors; purpose of the credit; source of repayment; track record and repayment history of the borrower; repayment capacity of the borrower; the proposed terms and conditions and covenants; adequacy and enforceability of collaterals; and appropriate authorization for the borrowing.

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