



# The Impact of Credit Risk on the Value of Shareholders of Listed Banks in Nigeria

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**Abstract:** Credit risk is the weightiest menace that banks encountered during their operations. Various banking crises have prompted banks to focus more on credit risk management activities, as it is critical for banks to maximize the wealth of their shareholders. The primary goal of businesses is to maximize shareholder wealth, as such DMBs are expected to engage in risk management operations if and only if it adds value to both the firm and the shareholders. Thus, this study seeks to establish the influence of credit risks on the profitability of listed Nigerian DMBs. The ex-post facto method was adopted and the researchers sampled eight (8) out of twenty-four (24) quoted DMBs on the Nigerian Group Exchange. Data was sourced from the audited annual accounts of the sampled DMBs for a period of four years, spanning from 2015–2019. OLS regression techniques revealed that non-performing loans (NPL) have an insignificant influence on the profitability of the sampled DMBs ( $=-0.141$ ;  $p$ , 0.797). This implies that a 1% increase in NPL would lead to a 14% decrease in shareholders' value. Loan and advances (LAD) according to the regression models exert a significant influence on shareholders' value ( $=7.341$ ;  $p$ , 0.004). This implies that an increase in LAD will lead to an increase in the shareholders' value. Nigerian banks should keep their loan and advance portfolios because it makes them more valuable to their shareholders.

**Keywords:** Credit Risk, Shareholders' Value, Non-performing Loans, Loan & Advances, Loan Loss Provisions

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## 1. Introduction

Banks and financial markets are the two key vehicles for allocating funds. Banks facilitate the transfer of funds between savers and investors, commonly referred to as the allocative function. Households can deposit excess funds with banks, which can then lend the money to businesses. It directs or allocates funds available for investment towards the most profitable investment opportunity. Financial intermediation is the term for the process of allocating funds. Some part of the deposits will be distributed to people in need of money through microlending, mortgages, short-term & long-term loans among other options. There is all tendency that DMBs can be exposed to credit risk during the above-mentioned credit activities.

According to Fredrick [12], credit risks are the possibility that bank borrowers or counterparties will fail to satisfy their

financial commitments according to agreed terms. Financial institutions confront numerous challenges around the world as a result of credit risks. Credit risk is viewed as the risk of losing principal and/or benefits/returns as a result of borrowers' failure to comply with contractual obligations. It is extremely difficult for a bank to adequately manage credit risk, despite the fact that it is critical to the bank's success. Loans are the primary source of credit risk for the majority of DMBs. Apart from loans, DMBs face credit risks through a variety of financial instruments such as foreign currency transactions, swaps, and bonds, among others. It's worth noting that, in addition to credit risk, banks face various risks in their operations, the most common of which are market risks, liquidity risks, and operational risks.

Credit risk, as one of the banking industry's associated hazards, poses a direct threat to the banks' solvency (Chijoriga, [8]). Credit risk is not only linked to solvency, but it also has a far higher magnitude and chance of loss than

other bank risks. It could result in significant loan losses, causing financial institutions to fail (Richard, et al., [28]). Credit risk is a financial risk that arises from a borrower's inability to follow contractual agreements, and this failure usually exert a negative effect on firms' value. Due to the increasing variety of counterparties, credit risk has become the most vital issues that need management attention. A high credit risk is sometimes expressed as a non-performing loan ratio, especially when compared to the general industry ratio. Banks that have a lot of credit risk might experience a hard time, especially its lending capacity and may most likely affect its going concern (survival).

According to value maximization theory, corporations should only engage in risk management operations if they add value to both the firm and the shareholders. DMBs have been regarded as being involved in risk management initiatives. Identifying risks, quantifying risk exposures, and ensuring that proper capital forecasts and monitoring programs are in place are all part of risk management. According to Resti and Sironi [27], it is part of the firm's ability to identify, assess, control, and most importantly, value any risks that they incur on and off their balance sheet. Credit risks, capital risks, liquidity risks, market risks, interest rate risks, and operational risks are the main hazards that banks face as identified by the Basel Accords. Due to the liquidness level, credit risk is the weightiest menace that banks encountered during their operations. Various banking crises have prompted banks to focus more on credit risk management activities, as it is critical for banks to maximize the wealth of their shareholders. The primary goal of businesses is to maximize shareholder wealth, and this is also the primary goal of financial management.

Previous empirical studies found no sign of the impression of credit risk on shareholder value, and the mainstream of the studies were purely theoretical. Most Nigerian research is clearly focused on credit risks and financial performance (Kolapo, Ayeni, & Oke, [18]; Kargi, [17] 0, or credit risks and capital adequacy (Kolapo et al., [18]; Kargi, [17]; Ogboi & Unuafé, [23]). This study used market capitalization as a proxy for shareholder value. Thus, the principal goal of this study is to determine the impact of credit risks on shareholders' values in Nigerian quoted banks. In specific terms, the study analyzes the influence of non-performing loans, loan and advances, and loan loss provisions on the shareholders' value of the sampled firms.

## 2. Conceptual Clarification

This section defined relevant and related concepts on credit risk, firm's profitability, non-performing loans and loan loss provision.

### 2.1. The Concept of Credit Risk

Credit risk is defined by the Global Risk Management Group [13] as the probability that loans and advances will fail to meet its obligations. Credit risks, according to Coyle [9], are potential losses resulting from debtors' failure to

repay the total amount owing within the specified time frame. Direct borrowing and some events outside the balance sheet, such as letters of credit, guarantees, foreign exchange disparities, forward contracts and derivatives, and asset pledging in the form of debt securities, all contribute to credit risk. The term Credit risk is fundamental to bank's survival since it generates considerable profits from loan interest on risk exposures. Credit risk management is an essential component of banking operations and is critical to the banks' long-term viability. It is generally known that banks' lending policies put them in danger of credit default. Limited institutional capacity, variable interest rates, weak credit rules, low liquidity levels, credit calculation errors, and bad lending practices may all contribute to credit risk (Kithinji, [19]). An increase in bank credit risk eventually leads to financial crises, necessitating the implementation of a robust credit risk management system. In other words, a thorough assessment of credit risk is critical for banks to increase their overall value and ensure their existence. The best way to manage credit risk is to have a good credit risk strategy, a good credit risk structure, a good credit rating scheme, monitoring, and control.

### 2.2. Concept of Shareholders' Value

Competent credit risk management can be an aid to sustainable returns on invested funds. Similarly, a well-designed credit risk policy allows a bank to fulfill its goal of creating shareholder value. From classic accounting indicators to more complex methodologies, the measuring of shareholder value has progressed. Classic accounting measures include return on equity (ROE), earnings per share (EPS), return on assets (ROA), dividend per share (DPS), and market capitalization (Banerjee, [6]). These tests uncovered flaws that prompted the creation of new procedures. Earnings, may not accurately reflect a company's performance since they are heavily influenced by accounting standards such as depreciation procedures and the pooling interest versus purchase method for mergers and acquisitions. Furthermore, it disregards the time value of money. Servén [31] investigated the valuation of stockholders in relation to the stock price. He considers the market price of a common stock to constitute shareholder value. According to Scott [30], "shareholders' value" is another phrase for an enterprise's value of stock or market capitalization. He went on to say that a company's market capitalization is highly transparent and is calculated by multiplying the No. of issued shares X average share price. To put it another way, market capitalization = (No of outstanding shares X market price per share).

### 2.3. Non-performing Loans

Under the framework of the Financial Soundness Indicators (FSIs), the International Monetary Fund (IMF) [15], recommended that loans be classified as non-performing when principal and interest payments are past due by ninety days or more; or interest payments are made for

ninety days or more and have been capitalized (refinanced, re-invested, or rolled over). The ninety-day benchmark is the time span that most financial institutions use to judge whether a loan is functioning or not. Non-performing loans usually have an impact on a bank's liquidity and profitability.

#### **2.4. Loan Loss Provisions**

Loan loss provisions are funds set aside to cover any potential losses resulting from loan defaults. Loan losses are compensated against the banks' earnings in general or on a case-by-case basis. General provisioning is done to account for the likelihood of a loss on the entire loan portfolio, whereas specific provisioning is done to set aside a portion of funds from a loan portfolio that has already been categorized. Loan loss provisions are used to keep track of predicted loan losses and are typically triggered by loan defaults (Hasan & Wall, [14]). While a high amount of loan provisioning is required for significant non-performing loans, banks can also utilize loan loss provisions to gauge their financial soundness (Ahmad, Takeda & Thomas, [3]). Charges against earnings for the period in which they are recorded are represented by a loan loss provision. Increases in loan loss provisions in response to deterioration in loan quality diminish banks' retained earnings, and weaker institutions are under pressure to reduce loan loss provisions (Ford & Weston, [11]).

#### **2.5. Review of Empirical Studies**

Owing to the importance of credit risk in the production of shareholder value through the preservation of banks' retained earnings, credit risk research has gotten a lot of attention around the world. Several research papers have sought to explain credit risk in terms of shareholder value. However, empirical studies on the impact of credit risk on shareholder value have produced varied outcomes. While some established a negative correlation, others had a pleasant correlation. For example, the relationship between credit risk and shareholder value was examined by Arif, Abrar, and Afzal's findings [4]. The study covers a period of nine years, spanning from 2004 through 2009. The IV (credit risk) was measured by loan loss provisions (LLP), loans and advances (L & A), and capital adequacy ratio (CAR). ROE and ROS were used as proxies for shareholder value as a DV. The New York Stock Exchange 100 Index and GDP were introduced as control variables. ROE exerted a favorable effect on L & A and LLP, while CAR showed a significant effect on ROS of the sampled firms. A thriving economy and stock index show significant impacts on ROS. This explains why a thriving economy allows stockholders to earn more. In the same vein, Adebisi and Oyedijo [1] investigated the impact of credit risk management (CRM) on shareholders' wealth in Nigeria. The research covers a period of five years from 2006 to 2010, and multiple regression and correlation analysis were used to statistically analyze the data. EPS and DPS were used to proxy shareholders' value, whereas ROCE, NPL, and EPS were used to proxy CRM. The findings revealed a substantial positive link between the factors.

Similarly, Kolapo, Ayeni, and Oke [18] evaluated the effect of credit risk on bank performance in Nigeria from 2000–2010. NPL, L & A, and LLP were used as proxies for the independent variables, while ROA was used as a measure of the banks' performance. The sampled Nigerian banks' ROAs were significantly affected by L & A. The result further indicated that NPL and LLP have a significant but negative effect on ROA. This indicated that an increase in LLP and NPL reduces banks' profitability in Nigeria. Aghababaei, Ataei, and Azizkhani [2] found that capital adequacy and the ratio of doubtful loans have a significant negative impact on ROE, while loans, advances, and receivables showed a strong positive impact on ROE of Iranian banks during the period under investigation, from 2005–2010.

Million, Matewos, and Sujata [21] evaluated the credit risks and profitability of Ethiopian listed banks (2003–2014). The research revealed that LLP, adequacy ratio, and NPL exert negative impacts on ROA and ROE of the sampled banks. The effect of non-performing loans on the profitability of Sri Lankan banks from 2009 to 2015 was investigated by Perera & Morawakage [24]. The researchers indicated that credit risk management has a considerable association with shareholder value. The analysis concluded that non-performing loans are the most significant issue affecting the economy. A similar investigation was conducted on UK banks by Zahid and Saeed [33]. The study found that bank size, growth, leverage, net-charge-off, and non-performing loans had a favorable impact on ROE and ROE of the sampled banks. Mwaurah, Muturi & Waititu [22]. revealed that non-performing loans have a considerable negative influence on stock returns, but loan loss provisions have a significant and favorable impact on the stock returns of quoted Nairobi banks.

#### **2.6. Theoretical Framework**

This section reviewed relevant and related theories on the subject under study. The following theories guided this study: credit risk theory and liquidity preference theory.

##### **2.6.1. Credit Risk Theory**

Desrochers and Prefontaine [10] posited that the credit risk theory is the first existing portfolio theory for appraising the risk of credit. Although individuals have been facing the risk of credit since their early years, it has not been extensively studied until these years. Early studies on credit used ordinary actuarial techniques to calculate credit risk, and their major difficulty lies in their reliance on local data. The credit risk approach enables corporations to harmonize the risks across the entire organizations and also provides a report of value-at-risk as a result of risks caused by downgrades, upgrades, and defaults. The credit risk model is useful to all firms that are exposed to credit risk in the course of their businesses. The theory postulates that financial organizations are encouraged to come up with a method of qualifying and calculating credit risk across a wide range of instruments.

### 2.6.2. Liquidity Preference Theory (LPT)

The LPT emphasizes that the premium paid for parting with cash rises as the time it takes to acquire the money reduces. This notion is articulated in financial trade as forward rates should exceed future spot rates (Scott, [30]). Investors seek a premium for securities with shorter maturities because they would rather have cash, which carries less risk. The easier it is to sell a security quickly and at full value, the more liquid it is (Schroeck, [32]). According to Keynes, liquidity is determined by three motives. For various reasons, individuals prefer to hold cash in order to undertake certain transactions as their earnings are not always accessible. The volume of liquidity needed is estimated by the degree of an individual's earnings. The greater the earnings, the more cash is required to execute the greater expenditure. The precautionary motives, individuals choose to hold cash to overcome unexpected social emergencies. The amount of cash needed for this purpose rises as earnings rise. For speculative motives, individuals hold cash to predict that security rates may drop. When there is a fall in the rate of interest, individuals demand more cash to retain until it rises. This would force down the price of existing securities to stay in line with the current rate of interest. Therefore, the higher the interest rate, the lower the

cash demand is and vice versa.

A financial organization that lends credit to borrowers may run into liquidity issues, particularly if the borrowers are unable to repay their loans within the agreed-upon time frame. This may deter businesses from investing in profitable ventures with better long-term profits. According to this principle, a company should keep more money in reserve for investment. As a result, it is critical for the company to reduce credit risk by ensuring that borrowers are creditworthy before extending credit to them (Saunders & Cornett, [29]). Taking the major purpose of this study into consideration, which is aimed at examining the influence of credit risks on shareholders' value of quoted banks in Nigeria, the liquidity preference theory is the best theory to explain the findings of the current study.

## 3. Methodology

The study adopted an ex-post facto research design. The data was derived from the financial reports of the sampled seven (7) Nigerian banks from 2015–2019. To gauge the effect of the variables under investigation, ordinary Least Square (OLS) models were introduced. The sample comprises.

(Access Bank Plc, Fidelity Bank Plc., First Bank Plc., First City Monument Bank Plc.,  
Guranty Trust Bank Plc., Union Bank of Nigeria Plc., United Bank of Africa Plc.,  
Zenith Bank Plc.,

### 3.1. Variables Measurement

The list of the dependent variables, independent variables and their measurements are depicted in Table 1.

**Table 1.** Summary of the Variables of the Study and their Measurements.

Variable Indication	Description	Variable Measurement	Source
Dependent Variable: SHV	Market Capitalization	Natural Logarithm of Market Capitalization	Arif, Abrar, and Afzal's findings [4]
Independent Variables: NPL	Non-performing loans	$\frac{\text{Non - performing Loans}}{\text{total loans and advances}}$	Million, Matewos & Sujata [21]
LAD	Loan and Advances	$\frac{\text{total assets}}{\text{total Loans and advances}}$	Mwaurah, Muturi & Waititu [22].
LLP	Loan loss provisions	$\frac{\text{Loan loss provision}}{\text{total loans and advances}}$	Ogboi & Unuafe [23]

Source: Researcher's Computation, (2022).

### 3.2. Model Specification

In order to evaluate the influence of credit risks on shareholders' value among the quoted banks in Nigeria, the study adapted with little modifications the model used by Mwaurah, Muturi & Waititu [22]. The model was modified as follows. However, the general multiple regression models which the study adopted are provided below:

$$FPM = f(CRM) \quad (1)$$

$$FPM = \alpha_0 - \alpha_1 CRM + \mu_{it} \quad (2)$$

$$FPM = SHV \quad (3)$$

$$SHV = f(NPL, LAD, LLP) \quad (4)$$

$$y = \alpha + \beta_1 X\beta_{it} + \beta_2 X\beta_{it} + \beta_3 X\beta_{it} + \varepsilon \quad (5)$$

$$SHV_{it} = \beta_0 + \beta_1 NPL_{it} + \beta_2 LAD_{it} + \beta_3 LLP_{it} + \mu_{it} \quad (6)$$

where:

$y$  = shareholders value

$\alpha$  = constant value

$X_1$  = Non – performing Loans

$X_2$  = Loans and advances

$X_3$  = Loans Loss Provision

$\varepsilon$  = error term

## 4. Results and Discussion

This section provides a summary statistic of the data gathered on the dependent and explanatory variables of the

study. Table 2 depicted the mean, standard deviation, min & max values of the variables under study.

**Table 2.** Descriptive Statistics.

Variables	Obs.	Mean	Std. Dev	Min	Max
SHV	40	116.6598	204.2594	6.248865	785.2864
NPL	40	21.57879	67.00148	-18.64726	303.9602
LAD	40	1.420008	1.630008	0.7768664	5.990098
LLP	40	1.720007	1.440007	-0.8189800	5.280087

Source: Stata 16.0 Output, (2022).

From Table 2, it can be seen that a total of 40 observations were recorded. The result showed that the shareholders' value (natural log of market capitalization) of the sampled quoted banks has an average value of 116.66, with min and max values of 6.25 and 785.29, respectively. This signifies that there is wide dispersion in shareholders' value of the sampled quoted banks, as portrayed by the standard deviation of 204.26. This means that, the sampled quoted banks in Nigeria are highly varied in terms of shareholders' value. That is to say, some of the sampled banks pay higher attention to shareholders' value than others.

Non-performing loans have an average value of 21.58. With a standard deviation of 67.00, the non-performing loan

deviates 45.42 points from the mean value. The min value is -18.65 and the max value is 303.96. Loans and advances have a mean value of 1.42 with a standard deviation of 1.63, which indicates that loans and advances deviate from the mean value by 0.21. The min and max values are 0.78 and 5.99, respectively. The mean value of loan loss provisions is 1.72, with a standard deviation of 1.44, which implies that loan loss provisions deviate from the mean value by 0.28. The min and max values are -0.82 and 5.28, respectively.

From Table 3, it is seen that the association between non-performing loans and the shareholders' value of the sampled quoted banks is weak and negative, while that of loans and advances is moderate and positive and that of loan loss provisions is moderate and negative, with correlation coefficient values of -0.1376, -0.5621, and -0.4138, respectively.

**Tables 3.** Correlation Matrix.

Variables	SV	NPL	LA	LLP
SHV	1.0000			
NPL	-0.1376	1.0000		
LAD	0.5621	-0.2192	1.0000	
LLP	-0.4138	-0.0805	0.0722	1.0000

Source: Stata 16.0 Output, (2022).

**Table 4.** Ordinary Least Square (OLS) Regression.

SHV	Coef.	Std. Err.	T	P> t	95% Conf.	Interval
NPL	-0.141341	0.539241	-0.26	0.797	-1.284482	1.001799
LAD	7.341007	2.222007	3.31	0.004	2.6422007	1.201006
LLP	-6.51106	2.452006	-2.66	0.017	-0.000012	1.320206
-CONS	127.374	64.41057	1.98	0.065	-9.170446	263.9182
Number of Observations		=40				
F (3,16)		=5.91				
Prob>F		=0.0065				
R-squared		=0.5256				
Adjusted R-Squared		=0.4366				
Root MSE		=153.32				

Source: Stata 16.0 Output, (2022).

Table 4 presents the OLS regression result. The result showed that the adjusted  $R^2$  coef. of determination was 0.4366. This implies that 44% of the variations in the shareholders' value (SV) are caused by explanatory variables, while 56% of the variations are explicated by other features not covered by the study. Also, the probability of an F-value of 0.0065 implies that the model is fit and significant at a 5% level of significance and that the variables are appropriately selected.

The result of OLS indicated that NPL (*Non-performing loans*) exert a negative insignificant impact on the shareholders' value of the sampled quoted banks in Nigeria (*coef.* -0.141, *p.* 0.797). This implies that an increase in NPL (*Non-performing loans*) leads to a decrease in shareholders' value. The result is consistent with that of Million, Matewos, & Sujata [21] but contradicts the work of Perera & Morawakage [24]. Loans and Advances, according to the analyses, have a significant positive impact on the shareholders' value of the sampled quoted banks in

Nigeria (*coef.* -7.341, *p.* 0.004). This implies that an increase in LAD (*loans and advances*) leads to an increase in the shareholders' value. This outcome is in support of the results of Kargi [17] but different from the findings of Arif, Abrar, and Afzal's findings [4]. Furthermore, with a *coefficient and p-values* of (*coef.* -6.511, *p.* 0.017), the results revealed that LLP (*Loan loss provision*) exerts a negative significant impact on the shareholders' value of the tested Nigerian banks. This means that increasing the loan loss provision lowers the value of the company's stock. This agrees with Arif, Abrar, and Afzal's findings [4].

## 5. Conclusions

According to the findings, loans and advances are perhaps the most important elements influencing the value of listed banks in Nigeria. Suggesting that the increase in bank loans and advances is proportional to the increase in the enterprise value of Nigeria's listed banks. The fact that loan loss

provisions have a big negative impact on profitability is a sign that the value of Nigeria's listed banks is going down a lot because of more loan loss provisions.

## 6. Recommendations

Based on the report, the board is recommended to preserve loan and advance portfolios as it increases the value of their shareholders. The research also encourages strategic managers to come up with loan strategies that would ultimately eliminate or decrease loan losses, which certainly will decrease loan loss provisions. Provisions are the amount of profit that is supposed to be given to shareholders but is set aside in the event that some loans are not recovered.

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