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POLICY **BRIEF**

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KEY POINTS

- The measures of financial stability often considered include: Asset quality ratio, Capital adequacy ratio and Income/expense ratios.
- Asset quality ratio measures the quality of assets owned by banks and a major indicator is the ratio of non-performing loans (NPLs) to gross loans
- High level of bad debt are detrimental to banks and can cripple their operation and survival.

Rising Non-Performing Loans of Nigerian Banks: A Threat to Financial Stability

Tracking the soundness of a country's financial institutions is very important. Particularly in response to the global and financial crises in the 1980s and 1990s, national and international institutions started monitoring the soundness of the financial system more intensively. A wide range of instruments is used to assess the financial system stability in analytical practice which provide some ideas of the soundness of the financial sector as a whole.

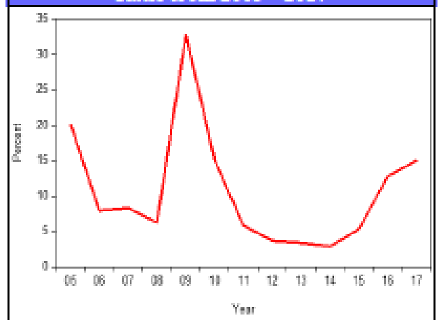
The measures of financial stability often considered include: Asset quality ratio, Capital adequacy ratio and Income/expense ratios. Asset quality ratio measures the quality of assets owned by banks and a major indicator is the ratio of non-performing loans (NPLs) to gross loans. Capital adequacy ratio measures the capital expected to maintain balance with the risks exposure of the financial institution in order to absorb the potential losses and protect the financial institution's debt holders. The ratio of regulatory capital to risk weighted assets is the most common indicator of this measure. Further, Income /expense ratios are used to measure the profitability of the banks. Common operating ratios used to assess banks' profitability include return on assets (ROA) and return on equity (ROE). Return on assets is measured by dividing the annual earnings (profit after tax) by its total assets while return on equity is the ratio of earnings (profit after tax) to total equity.

The Central Bank of Nigeria (CBN) and Nigeria Deposit Insurance Corporation (NDIC) maintain close watch on these indicators of financial stability in Nigeria. Recently, the CBN released the Nigeria's Financial Stability Report for the first half (H1) of 2017. The report shows that the ratio of NPLs to gross loan rose from 12.8 percent in 2016 to 15 percent in H1 2017. Also, ratio of regulatory capital to risk weighted assets decreased from 14.8 percent in 2016 to 11.5 percent in H1 2017. In addition, return on assets increased from 1.3 percent to 2.6 percent in H1 2017.

In the CBN's explanation, the rise in the non-performing loans reflects the deterioration in banks' loan portfolio. Thus, the Apex Bank has proposed a framework for the establishment of private asset restructuring companies that will acquire the non-performing loans. Likewise, the decline in capital adequacy ratio was attributed to the challenges in the oil and gas sector. To this, the Bank promises to intensify its efforts to proactively engage bank operators to effectively manage the associated risks.

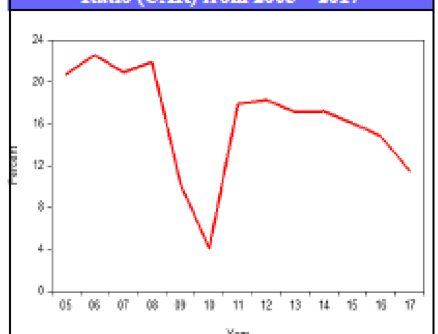
Figures I, II and III depict the trend of non-performing loans, capital adequacy ratio and return on assets respectively. The rising trend of the ratio of non-performing loans to total gross loans peaked at 32.8 percent in the year 2009 resulting from the financial crisis during the period. This resulted in the government opting for a bailout solution through Asset Management Corporation of Nigeria (AMCON) to buy some non-performing loans from banks with an estimated five trillion naira. This helped the ratio dropped between 2011 to 2015 but recently increasing given the recent statistics from the CBN. Also, capital adequacy ratio was relatively stable in the period of 2005 to 2008 until the sharp and lowest decline of 4.06 percent recorded in 2010. The CAR later picked up in 2011 but have been on the downward trend since 2015. Further, return on assets was relatively stable ranging be-tween 2.3 percent and 2.5 percent from the period of 2012 to 2015. However, a decline was recorded in 2016 while the latest figure of 2.6 represents an improvement.

Figure I: Trend of Non-Performing Loans Ratio from 2005—2017



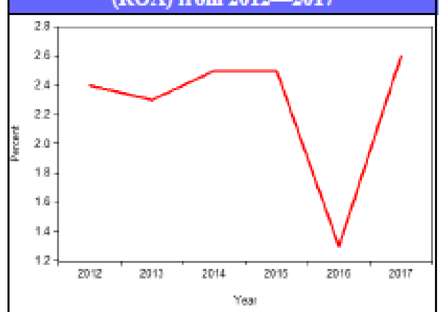
Source: CBN, NDIC
ADSR Research

Figure II: Trend of Capital Adequacy Ratio (CAR) from 2005—2017



Source: CBN, NDIC
ADSR Research

Figure III: Trend of Return on Assets (ROA) from 2012—2017



Source: CBN, NDIC
ADSR Research

High level of bad debt are detrimental to banks and can cripple their operation and survival. This have great implications on the growth of the economy as a whole as non-performing loans grow, thereby causing resource allocation inefficiency. Likewise, lower capital adequacy ratio of banks implies the inability of meet up with short term financial obligations, thereby putting depositors at risk. This bank distress will ultimately make them lose their major source of financing and subsequently become insolvent in the long run. Hence, timely detection and management of these indicators performance is necessary and cannot be underscored.

It will be difficult to isolate the banking system from the rest of the economy. Thus, Nigeria banks are still suffering from the hangover of the recently-exited recession. Guiding against a feedback effect on the rest of the economy therefore, the financial regulator has to intensify its efforts in strengthening the financial system. The proposed private asset restructuring companies should be critically evaluated in terms of how it can actually address some of the limitations of the AMCOM and whether such private arrangement will not constitute a risk later.

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