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Bank Lending Rate And The Financial Performance Of Selected Deposit Money Banks In Nigeria

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Absstract
This study empirically examined the impact of bank lending rates on the financial performance of deposit money banks in Nigeria over a 14-year period (2010-2023). Specifically, it analyzed the influence of lending rates and the loan-to-deposit ratio on bank performance, using return on shareholder funds (RSF) as a proxy. The study applied the least square econometric method to explore the relationship between bank lending and bank performance in Nigeria. The findings revealed that lending rates have a negative effect on bank performance, while the loan-to-deposit ratio positively affects bank performance. The coefficient of multiple determinations (R2) indicated that approximately 23% of the variations in bank performance (RSF) could be explained by the lending rate and loan-to-deposit ratio, with the remaining 77% attributed to unaccounted factors. Furthermore, the Durbin-Watson test suggested the presence of negative autocorrelation in the model, indicating that around 77% of important variables were missing. The study concluded that the bank lending rate negatively impacts bank performance in Nigeria. Consequently, it is recommended that the Central Bank of Nigeria (CBN) focus on maintaining a low and stable lending rate, ideally in the single digits, to mitigate the adverse effects on RSF. The study also found that a one-unit decrease in the lending rate results in a reduction of 0.397447 units in bank performance, holding other factors constant. Lower lending rates can enhance investment opportunities, boost loan demand, and reduce defaults. Banks are encouraged to find a balance in their loan pricing strategies to cover lending costs while fostering positive relationships with borrowers.

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I. Introduction

According to Adolphus (2011), deposit money banks play a crucial role in savings mobilization and financial resource allocation, making them significant players in economic growth and development. Their ability to mobilize financial resources and allocate them to productive investments directly impacts their performance. Regardless of the source of income or economic policies in a country, deposit money banks are driven to offer loans and advances to their customers while adhering to three key principles: profitability, liquidity, and solvency (Adolphus, 2011).

However, various factors influence a bank's decision to lend, including the prevailing interest rate, the volume of deposits, levels of domestic and foreign investments, the bank's liquidity ratio, its prestige, and public recognition, among others. The history of lending practices dates back to the Industrial Revolution when commercial and production activities surged, creating a need for large capital investments. Many business leaders of that time could not meet these financial demands and sought assistance from banks (Ezirim, 2005).

In Nigeria, the emergence of banks began in 1872 with the founding of the African Banks Corporation (ABC). Other banks followed during the colonial era, marking the beginning of lending practices in Nigeria. However, the colonial banks' lending was often biased and discriminatory, primarily favoring expatriates, which led to the establishment of indigenous banks. Before the introduction of the Structural Adjustment Programme (SAP) in 1986, lending practices in Nigeria were tightly regulated by supervisory bodies. The SAP period saw a relaxation of some of these rules, and the 1998 amendment of the Bank and Other Financial Institutions Act (BOFIA) required banks to report large borrowings to the Central Bank of Nigeria (CBN). The CBN also mandated that loans to any borrower should not exceed 20% of the bank's unimpaired shareholders' funds (Felicia, 2011).

Lending involves granting credit and managing it to ensure it is used appropriately and repaid, with interest, according to the terms of the agreement. Banks must take careful steps to ensure they lend to worthy customers. A major reason for bank failures is non-performing loans, which erode a bank's capital. This was evident in the 2009 banking crisis in Nigeria (Rose, 1996).

Effective credit management is typically guided by a comprehensive loan and credit policy. Without such a policy, loans that were once good can become non-performing (Adewumi, 1983). Lending practices are influenced by various factors such as the economic environment, the experience and expertise of the banker, the

bank's traditions and culture, and the personalities involved (Rose, 1996). Despite these factors, a well-structured lending policy should outline the bank's objectives, lending modalities, and credit analysis guidelines.

Reed, Rose, and Pierson (1980) emphasize that these factors determine a lending officer's confidence in a borrower's ability and willingness to repay the loan as agreed. These factors are often referred to as the "six C's of lending": character, capacity, cash, collateral, conditions, and control. Beyond these core principles, additional factors and guidelines influence how banks manage their lending practices.

Lending, whether short, medium, or long-term, is a key service offered by deposit money banks. Banks provide loans and advances to individuals, businesses, and governments, enabling them to engage in investment and development activities, which, in turn, foster individual growth and contribute to the broader economic development of a nation (Felicia, 2011).

II. Literature And Empirical Reviews

As noted by Ndungu and Ngugi (2000), lending rates are influenced by macroeconomic instability, which in turn affects the performance of the banking sector. They explained that the macroeconomic environment is both a cause and a consequence of fluctuations in lending rates. The chain reaction triggered by macroeconomic instability heightens uncertainty, which negatively affects borrowers' creditworthiness, leading to higher risk premiums charged by banks. This environment also impacts the banking sector's performance by affecting loan repayment abilities, demand for loans, the unpredictable returns on investments, and the quality of collateral. These factors determine the risk premium and the cost of borrowed funds for investors. In times of economic instability and slow growth, investors face uncertainty about returns, which results in higher lending rates. Ngugi (2001) pointed out that lending rates are important because they reflect the potential loss of value over time of the borrowed funds. The interest rate represents the price paid for the use of borrowed assets and reflects market expectations regarding inflation and changes in purchasing power. Financial institutions play a vital role in mobilizing savings, diversifying risk, and allocating resources. Since the timing of deposits and loans often doesn't align, financial intermediaries like banks incur certain costs (Ngugi, 2001). As a result, banks charge fees for intermediation services under uncertain conditions and set interest rates for both deposits and loans accordingly.

Empirical studies, such as Akinwale (2018), analyzed the relationship between bank lending and economic growth in Nigeria from 1980 to 2016. Data from the Central Bank of Nigeria Statistical Bulletin were analyzed using the Dynamic Ordinary Least Squares technique, with stationary and co-integration tests. The unit root test revealed that most variables were integrated at order I(0), except for bank lending rates, inflation, and the real exchange rate, which were integrated at I(1). The co-integration results showed a long-run relationship among these variables. The findings indicated that a 1% reduction in bank lending rates could lead to a 118% increase in economic growth. Furthermore, the study confirmed that lower lending rates are statistically associated with higher economic growth, as suggested by the Greenwood and Jovanovich Hypothesis. The study concluded that lower lending rates foster economic growth in Nigeria during the study period.

Felicia (2011) used regression analysis to investigate the factors that determine commercial banks' lending behavior in Nigeria. The study found that commercial bank deposits have the most significant impact on their lending activities. Mamman and Hashim (2014) explored the relationship between bank lending and economic growth in Nigeria between 1987 and 2012, using annual time series data from the CBN Statistical Bulletin. Their findings revealed a relationship between bank lending and economic growth; however, this relationship was both negative and statistically insignificant. In contrast, bank assets were found to have a significant positive effect on economic growth in Nigeria.

Ayieyo (2016) examined the factors influencing lending behavior in selected commercial banks in Kenya between 2002 and 2011, using secondary data on loans, deposits, and interest rates. The study found that higher lending interest rates were negatively related to the total loans advanced to the private sector. Additionally, the volume of deposits had a significant positive effect on loans advanced to the private sector in Kenya.

Adzis, Sheng, and Abu-Bakar (2018) assessed macroeconomic and bank-specific factors influencing commercial bank lending in Malaysia from 2005 to 2014, using panel regression and data from 27 banks. The study found that bank size and deposit volume positively affected lending, while liquidity had a negative impact. However, no conclusive evidence was found to support the influence of GDP, lending rates, or cash reserve requirements on commercial bank lending activities. The study also noted that the macro prudential policy introduced in 2010 to address high household indebtedness did not significantly affect lending during the study period.

Khat and Bathia (1993) used a non-parametric method to analyze the relationship between interest rates and other macroeconomic variables like savings and investment. They grouped 64 developing countries, including Nigeria, based on the level of their real interest rates and found that real interest rates had no significant impact on savings, income, or investment for these countries.

Adofu and Audu (2010) used ordinary least squares to assess the effects of interest rate deregulation on

agricultural productivity in Nigeria. The study concluded that interest rates significantly influence economic activities, and monetary authorities should determine appropriate interest rate levels that balance the interests of savers and investors. Rasheed (2010) applied the error correction model (ECM) to investigate the determination of interest rates in Nigeria and found that as Nigeria's financial sector becomes more integrated with global markets, returns on foreign assets will significantly influence domestic interest rate determination.

III. Methodology

For ease of analysis, this study employs the Ordinary Least Squares (OLS) method of multiple regression analysis. The OLS method is chosen because it possesses several desirable properties that other estimation techniques may lack. These properties include Best, Linearity, Unbiasedness, and Efficiency (commonly referred to as BLUE). These desirable attributes are summarized in the BLUE properties of OLS.

The model for this study is as follows:

RSF = f (LR, LDR) ..... (3.1)

The econometric form of the model is:

RSF = β0 + β1LR + β2LDR + μ ..... (3.2)

Where:

- **RSF** represents the dependent variable (the financial performance of deposit money banks).
- **LR** refers to the Lending Rate.
- **LDR** stands for the Loan to Deposit Ratio.
- **β0** is the intercept term.
- **β1** and **β2** are the coefficients for the lending rate and loan to deposit ratio, respectively.
- **μ** is the error term, accounting for unobserved factors.

IV. Results And Discussion Regression Analysis Results:

Variables	Coefficient	Standard Error	t-Statistic	Probability
C	-7.123150	5.053364	-1.409586	0.1863
LNLR	-0.397447	1.030604	-0.385644	0.7071
LNLDR	1.812217	1.013653	1.787809	0.1014
R^2	0.236128			
Adj R^2	0.097242			
D.W.	2.213300			
N	14			
F-stat	1.700159			0.227307

Source: Eview 9.0

The regression results indicate that the lending rate (LR) is negatively but insignificantly related to the financial performance (RSF) of Nigerian deposit money banks, with a coefficient of - 0.397447 and a p-value of 0.7071. This suggests that a one-unit decrease in the lending rate would lead to a decrease in financial performance (RSF) by 0.397447 units, assuming other factors remain constant.

On the other hand, the loan to deposit ratio (LDR) is positively and significantly related to the financial performance (RSF), with a coefficient of 1.812217 and a p-value of 0.1014. This indicates that an increase in the loan to deposit ratio by one unit would lead to a 1.812217 unit increase in the financial performance (RSF), holding other factors constant.

The coefficient of determination (R^2) shows that approximately 23% of the variations in the financial performance of deposit money banks can be explained by the lending rate (LR) and loan to deposit ratio (LDR). The remaining 77% is attributable to other unaccounted factors. The Durbin-Watson statistic of 2.213300 suggests that there is negative autocorrelation in the model, indicating that approximately 23% of the variables influencing financial performance are missing from the model.

V. Findings

The study finds that the bank lending rate is negatively and insignificantly related to the financial performance (RSF) of Nigerian deposit money banks (LR, $\beta = -0.397447$, $p = 0.7071$). These results align with the findings of Mamman and Hashim (2014), who observed a negative correlation between lending rates and bank financial performance. Similarly, Ayieyo (2016) and Adzis, Sheng, and Abu-Bakar (2018) also found that lending rates have a negative relationship with commercial banks' financial performance.

VI. Recommendations

Based on the study's findings, it is recommended that the Central Bank of Nigeria (CBN) maintain a low and stable lending rate (preferably in the single digits). This could mitigate the negative effects of high lending rates on financial performance (RSF). The study showed that a decrease in lending rates by one unit leads to a decline in financial performance by 0.397447 units, holding other factors constant. Lowering the lending rates may create more investment opportunities, boost loan demand, and reduce defaults. Banks should strive to find a balance in their loan pricing decisions to cover the costs of lending while maintaining good relationships with their borrowers.

VII. Conclusion

The study concludes that the bank lending rate has a negative but insignificant relationship with the financial performance (RSF) of Nigerian deposit money banks. A decrease in lending rates by one unit is shown to lead to a decrease in financial performance by 0.397447 units, assuming other factors are constant. Lowering lending rates could stimulate loan demand and reduce defaults, but it also presents potential risks to the financial performance of banks. Therefore, a careful balance should be maintained in adjusting lending rates to optimize both growth opportunities and risk management.

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