

INTRODUCTION

1.1 Background Information

There are direct and indirect linkages between the banking system, agricultural and industrial sectors of any economy over time. Vogel, (1999) observes that these linkages are strong in development because they play major roles in agriculture led industrialization process. The recent experiences of global financial crisis suggest that the state of the banking system and developments in real economy are strongly interconnected (Jakubik and Schmieder, 2008). The banking system is the foundation of the key institutional mechanism for financial intermediation. This is because it mobilizes resources from surplus units and channels same to the deficit units by granting loans and advances/credits to agriculture, manufacturing-industrial and other 0.sectors. According to Soludo, (2009) the Nigerian banking system accounts for over (90) ninety percent of the financial sector's assets. The system depends predominantly on the macroeconomic environment which is a vital ingredient for the stability of the financial sector. The system catalyzes the economic growth and development process (Dabwor, 2010). This ushers in improvements in the welfare of the citizens of a country. It follows that the effectiveness of the banking system, to a large extent enhances the realization of the country's economic potentials (Chukwu, 2010).

In any economy such as Nigeria, the banking system plays crucial roles which predominantly include the provision of loans and advances to agriculture, industry, services and external sectors. However, huge proportion of these loans are not repaid as at when due. These non- repayments of loans over a prolonged period ranging from ninety (90) to three hundred and sixty five (365) days and beyond constitute non-performing loans (NPLs) (Badar and Javid 2013; IMF, 2006; CBN, 1991). Some of the major causes of NPLs include: excessive credits creation by the banks, relaxed credit condition and poor loan recovery strategies, insider abuse issues about loan

collections and distributions, (Sanusi, 2010). Others include; business cycles, macroeconomic and bank specific factors. These include: gross domestic products, inflation, interest rate, loans/advances; and liquidity of the banks.

The high proportion of non-performing loans (NPLs) to total loans and advances of the banking system is the main cause of financial crisis both in developing and developed nations and is reported in prints and electronic media as the basic cause of crises in the banking system (Badar and Javid 2013). In Indonesia, over 60 banks collapsed during the 1997 East Asian financial and banking crisis and it affected a large population of Sub-Saharan African nations in the 1990s.

This was followed by a rapid accumulation of NPLs (Fofack 2005). According to Inekwe, (2013) NPLs in Nigerian banking system in 1989 was N2.9 billion while as at August 2009 prior to the CBN intervention, it was N2.508 trillion. He observed that the continuous rise in NPLs with its accompanied effects was unhealthy for the banking system because of the ultimate effect on its intermediation function. This huge existence of NPLs, significantly contributed to the banking crisis in developing and developed nations. (Elegbe, 2013; Hou and Dickson, 2007).

Though the Nigerian banking system attained prominence in its role in granting loan facilities to the economy for production and consumption purposes, yet its biggest challenge is increasing the accumulation of high NPLs which emanate from non-repaid loans and advances granted to various beneficiaries in agriculture, manufacturing-industry, and other sectors. The recent financial crisis in the United States of America is believed to have been caused by high default in subprime mortgage/ loans (Svenssen, 2010). The existence of a sudden or prolonged high level of NPLs is an indication of dismal conditions of the banks. This means that low NPLs suggests a better and sound banking system while high level of NPLs is an indication of poor and unsound banks' performance. According to Badar and Javid, (2013) NPLs have direct effect on liquidity and profitability. These may collectively affect the financial system hence the agricultural and manufacturing sectors. NPLs in banks indicate financial

pollution in the financial system whose continuous existence may cause great harm and damages to economic growth and social welfare (Zeng, 2012).

According to CBN, (2010) NPLs fueled the banking system crises which affected the system from 1979 to 2012. In the mid-1990s, the financial system was at the verge of collapse due to the existence of rising levels of NPLs. For example, in 1992, eight (8) deposit money banks which were declared insolvent had forty five (45) per cent of NPLs. Furthermore, in 1995, Central bank of Nigeria (CBN) classified almost half of the eighty one (81) local banks as terminally distressed. Similarly in 2009, six (6) banks failed and were closed. A greater proportion of the basic conditions of these distressed banks were ascribed to requirements associated with lending to risky sectors with lower credit standards. According to Brownbridge, Harvey, and Fritz (1998), these conditions contributed to high NPLs ratio. The existence of high NPLs constrained the availability of loanable funds for agricultural and manufacturing activities. For example, as at end of December, 2009, the CBN financial stability report showed NPLs to total gross loans ratio as 38.80% (CBN, 2010). The statistics from Nigerian Deposit Insurance Corporation (NDIC) showed that NPLs to total gross loans ratio oscillated from 33.44% in 2004 to 26.77% in 2005; it continued to fall to 10.34% in 2006 and grew to 15.95 in 2007, declined to 6.75% in 2008 and uptrend again to 38.80% in 2009. The significant upward trend in NPLs was a reflection of erosion of the banks' capital which led to credit crunch and economic recession. The existence of high levels of NPLs constituted a major challenge in banks' credit administration in all economies.

Over the years, a lot of the existing macroeconomics and banking policies were reformed in order to mitigate the effects of high NPLs. The major banking policy reform regimes in the country were the pre-consolidation (1979-2004), and post-consolidation regimes (2005-2012). The pre-consolidation banking policy reforms regime was mostly characterized with guided regulations with some relaxed credit control measures, liberalization banking policy and universal banking model; and later

deregulated economic policy instruments were adopted to reflect market forces as to determine values for economic activities. The main focus of the consolidation reform regime was on recapitalization of banks and other financial institutions. This was aimed at ensuring stability and soundness which would transcend to increased credit flow in the economy. The post-consolidation banking reforms regime which was aimed at addressing the instability in the banking system witnessed the hallmark of huge NPLs in Nigerian banks. Macro-prudential policies were strictly institutionalized in the financial service sector (CBN, 2010; CBN 2009). There were other arrays of credit policies which stimulated increased credit supply to agriculture and manufacturing sectors (Akpan, Vincent, Edet, and Etim, 2012; Manyong, Ikpi, Olayemi, Yusuf, and Idachaba, 2003; Olaitan, 1997).

Agriculture and manufacturing- industry are priority sectors for the realization of national goal of increased productivity and income that would enhance improvement in welfare of the citizens. Agriculture is not only a dominant sector but a major source of livelihood among a vast number of the population. The sector dominates the economic landscape. It accounts for 38.22 per cent of the total gross domestic product and 40 per cent of employment respectively (NBS, 2012). Other vital roles ascribed to the sector include: provision of food for the teeming population, raw materials to the manufacturing industries, and earnings of foreign exchange from the export of agricultural commodities.

Aside from the agricultural sector, manufacturing sub-sector is the heart of the national economy as it drives the industrialization process and also contributes significantly to economic growth and development over time (CBN, 2011; CBN, 2003) According to Mkpado, (2013) the manufacturing sub-sector's share of the nation's gross domestic products declined since 1991 from 8.5% to 5.9% in 1998; and 4.16% in 2011. These performances appeared poor in comparison with the amount of foreign exchange and other resources channeled into the sub-sector for importation of capital goods. The productivity in agricultural and manufacturing sectors might be crucial to the growth

and development process of the economy and could be influenced by the availability of loans and advances from the banking system. The dismal performances of these sectors were believed to be linked with poor performance of the banking system as evidenced by the existence of high NPLs (Dipak and Ata, 2003; CBN, 2003; and Elegbe, 2013).

There seemed to be a general consensus in literature that increased agricultural and manufacturing productivity were essential ingredients for enhanced economic growth and development. Various studies of agricultural and manufacturing-industrial sectors were of the view that increased productivity and improvement in income could be influenced by the injection of improved factors of production needed for intensive via extensive land and infrastructural development. (Umoren, Akpan, and Udoh, 2014; and Akpan, Obot, and Essien, 2012). Among these major factors of production, loans from the banking system were regarded as panacea for increased production/productivity in these sectors. Bank loan constituted a major source of business capital and its availability increased efficiency of production while its inadequacy or non-availability hampered productivity in these sectors.

The existence of high NPLs ignited deep interest with diverse views among scholars in different parts of the globe, yet in Nigeria, not many studies had been conducted as regards evaluating NPLs and their effects on agricultural and manufacturing sectors. More so, some of the studies on NPLs conducted used static techniques for their analyses which did not provide sufficient time path for robust inferences, prediction and reliable empirical findings. For instance, studies by Bebeji (2013); Inekwe (2013) and Udegbumam (2001) adopted static analytical techniques as regards banks' loan performances. However, the novelty in the current study is the adoption of dynamic approach in evaluating the incidence of existence of high NPLs in the banking system and their relationships with macroeconomic as well as banks' specific variables.

1.2 Statement of the Problem

One of the major challenges of the banking system in many economies since the

1990s is the existence of high levels of non-performing loans (NPLs). In Nigeria, NPLs adversely affected lending to various economic agents in agriculture and manufacturing industrial sectors (Elegbe, 2013; Inekwe, 2013; Hou and Dickson, 2007). In fact, Nanita, Anu, Baljeet, (2011) maintained that the high levels of NPLs remained an area of great concern.

Available data from International Monetary Fund Global Stability Report, (2012) showed that NPLs in various banking system of some advanced economies such as United States of America, United Kingdom, France, Germany and others were declining whereas NPLs in some developing economies such as Ghana, Togo, India, Nigeria and others were increasing. Nigerian banking system had a large amount of NPLs valued at N1.143 trillion in 2010 (CBN, 2010). In the same year, the ratio of NPLs to gross loans and advances granted by the banking system was about 32.80 per cent. High levels of NPLs continued to oscillate during the period of the study. It was too high from the regulatory benchmark of 5 per cent. The ratio of NPLs to total loans and advances indicates the quality of assets and capital adequacy of the banks and their capacities to finance diverse sectors customers' loan demands that drive economic activities over time. Nigerian economy had a downward trend in manufacturing output growth and contribution to gross domestic products (Anyanwu, 2000). Banks incurred high NPLs due to low output of the real sectors of agriculture and manufacturing especially during periods of economic downturn. Increasing levels of NPLs seemed to pose adverse effects on economic activities. (Siraj and Pillai, 2012; Adebola, Yusoff, and Dahalan.,2011; Dash and Kabra, 2010; NDIC, 2010; Becoff, Juliana; Giovanni and Grimard, 2002).

The problem of declining agricultural and manufacturing activities (CBN, 2003) which persisted in economies of many Subs-Saharan countries, including Nigeria, in the 1990s was documented by Fofack, (2005). He maintained that these declining agricultural and manufacturing activities had negative effects on these economies. The collapse and shutting down of many large farms, agro-allied industries as well as

manufacturing industries in 1990-2007 were believed to be associated with the existence of increasing NPLs trend which created unavailability of funds in the banks (Dipak and Ata, 2003; CBN, 2003). According to Hou and Dickson, (2007) higher level of NPLs reduced banks' aspiration to increase lending. Consequently, these banks could no longer effectively grant adequate credits to these sectors whose major sources of finances were loans and advances.(Dipak and Ata, 2003; CBN, 2003).This seemed to constrain financial intermediation and strangulated economic activities in the real sectors of agriculture and manufacturing.

Saba, Kouser, and Azeem,, (2012) documented the vital roles of credit in a bank-centered economy especially private sector driven as in Nigeria. They maintained that the growth rate of credits influenced NPLs of banks. There had been arrays of credit policies which had stimulated increased credit supply to agriculture and manufacturing sectors (Olaitan, 1997; and Manyong *et al.*, 2003). However, a lot of these loan repayments were in default (Akpan *et al.*, 2012). These later degenerated into high levels of NPLs. The distribution of these NPLs in the banks seemed to reflect the major banking policies reform regimes and credit policies of the CBN. The pre- and post- consolidation banking policies reform regimes which were aimed at addressing the instability in the banking system also witnessed another increasing NPLs levels. These fluctuations in the NPLs trend tended to follow the developments generated by the major policies reform regimes in bank specific as well as macroeconomic environment (Dash and Kabra, 2010). In spite of the adoption of some policy instruments yet their ability to curb high NPLs in the banks seemed fruitless. Study's findings by Vogiazas and Niklaidou, (2011) maintained that bank specific and macroeconomic variables may offer necessary explanation to the root cause of NPLs. The major issues associated with the increased accumulation of high NPLs in Nigeria, seemed to have continued to remain elusive despite concerted efforts by the monetary authority in reforming various policies of the banking system as to achieve sustainable financial stability. Therefore, minimization of high NPLs may be a necessary condition

to improve the agricultural and manufacturing activities. In view of the above, it becomes necessary to conduct a study to evaluate and quantify the effects of NPLs on agriculture and manufacturing sectors in Nigeria from 1979-2012.

1.3 Research Question.

To this end, the questions which the study intends to address are:

What extent did the banking policy reform regimes affect the distributions of NPLs from 1979-2012?

What extent did the banking policy reform regimes affect the growth of NPLs?

How has NPLs changed over the years in the face of changing macroeconomic and banking policies?

What is the relationship between NPLs and lending to Agriculture sectors?

What is the relationship between NPLs and lending to Manufacturing sectors?

What is the relationship between NPLs and productivity in Agriculture?

What is the relationship between NPLs and productivity in manufacturing?

What extent are the changes in NPLs associated with changes in specific macroeconomic and banks variables?

The specific macroeconomic variable is gross domestic product while the banks' variables are interest rate, liquidity ratio, loans and advances to agriculture.

Given the prevailing trend, how will NPLs grow in the next ten years? (2013-2022).

1.4 Objectives of the Study

The broad objective of the study was to evaluate NPLs in the Nigerian banking system in order to investigate, estimate and analyze their effects on the real sectors of Agriculture and Manufacturing.

The specific objectives of the study included the following:

To examine the distribution of NPLs in banks according to the major banking policy reform regimes namely: pre-consolidation (1979-2004); and post-consolidation (2005-2012). Jide, (2010); Akpaeti, Bassey, Okoro, and Nkeme, (2014) grouped Nigerian banking reform regimes into two (2) major regimes namely: pre and post-

consolidation regimes. As time series data were used; and to achieve the objectives of the study, it became necessary to adopt the two major banking reform regimes to ensure efficient results.

To analyze NPLs trend and growth rate.

To investigate the causality relationship between:

- (a) NPLs and lending to Agriculture ;
- (b) NPLs and lending to Manufacturing;
- (c) NPLs and productivity in Agriculture; and.
- (d) NPLs and productivity in Manufacturing.

To evaluate the relationships among NPLs and gross domestic product, interest rates, liquidity ratios, loans/advances granted to Agriculture.

To forecast NPLs ratio for the period (2013-2022).

1.5 Statement of Hypotheses

The various specific objectives of the study were synthesized into the following null hypotheses.

H0: There exists no significant growth trend in NPLs in Nigeria from 1979-2012.

H0: There exists no significant causality relationship between NPLs and lending to Agriculture.

H0: There exists no significant causality relationship between NPLs and lending to Manufacturing

H0: There exists no significant causality relationship between NPLs and productivity in Agriculture.

H0: There exists no significant causality relationship between NPLs and productivity in Manufacturing.

H0: There exists no significant relationship between NPLs and gross domestic product,

interest rates, liquidity ratios, loans/advances granted to agriculture.

1.6 Significance of the Study

It is expected that the study would provide a threshold for regulatory intervention via a systematic approach to solve the problem of NPLs of the banking system in Nigeria. The study is essential for catalyzing national financial stability that would spur rapid growth and development in agricultural and manufacturing industrial sectors. The rising stiff competition due to consolidation among banks coupled with globalization and liberalization as well as continuous innovations to provide efficient and acceptable banking services have generated considerable interests among all stakeholders hence the imperative for detailed evaluations of NPLs. Commercial farmers, agricultural processors, manufacturers, depositors, investors, managers and regulators of the banking system, academicians and other stakeholders have impelling needs for evaluating NPLs. Evaluating NPLs provides signals to commercial farmers and industrial investors as well as banks' depositors on strategic decisions. The managers of the economy want to know the outcome of banks' agricultural and manufacturing loan performances to improve either loan service or deposit service. Being responsible for the safety and soundness of the banking system, the regulators are interested in evaluating NPLs so as to monitor banks' exposures to agricultural and manufacturing credit risk in order to forestall instability in the financial sector. The study of NPLs is very vital to the economy. This is because non-performing loans have become contemporary issues which have tended to challenge the survival of the banking system in all economies. Financial crises and bank failures are associated with accumulated high levels of NPLs. Hence, the study addressed the challenging issues which these institutions and sectors are facing and may continue to confront in future. Policy makers will be better informed and they can also provide prudent judgments in formulating minimization policy for NPLs. The report will serve as a veritable reference material for policy makers in agriculture and manufacturing, development economists and researchers. It will also be of

considerable help to agricultural-industrial banking professionals as it will enhance their understanding, control and minimization of the virulent, toxic and cannibalistic influences of non-performing loans on the economy.

1.7 Definition of Key Concepts

Non-Performing Loans (NPLs)

Hou and Dickson, (2007) define NPLs as loans that no longer produce income for the banks that own them. Non-performing loan ratio is obtained by dividing the NPLs by the gross loans and advances in a given time. (Mohammad, Chandra and Mannan,2008;Berge and Boye, 207; Amediku,, 2006; Gavin and Hausman,1996). Definitions of NPLs are varied. This has resulted to changes in NPLs levels within individual countries rather than a group. A loan facility is said to be non-performing when a borrower is 30, 60, or 90 days delinquent in making a payment (CBN, 1991; CBN, 2010). Therefore, NPLs in the banking system are the total outstanding value of loans/advances not repaid as agreed between the lenders and the borrowers over the prudential prescribed period of time.

Gross Domestic Product (GDP)

Gross domestic product is defined as the market value of all final goods and services produced in a given country during a given period of time usually one year.(Badar and Javid, 2013).

It is the sum of production within a geographical area over a defined period of time. GDP is the market value of all goods and services produced in an economy within a calendar year (Eichengreen, 2003).

Interest Rate

Interest rate is defined as the actual cost of capital in an economy. It is also the reward for embarking on investments. Interest rate measures the price at which borrowers of funds are willing to pay to the owners of capital while at the same time it measures the price at which lenders are willing to lend their money to enterprise in exchange for fund consumption.

Liquidity Ratio/Loan- to- Deposit Ratio: (LTDR)

This is defined as the banking system's capacity to mobilize deposits to meet credit needs of the customers. Loan- to- deposits ratio is usually utilized by the banking system in assessing its liquidity. It is obtained by dividing the total loans and advances by the total deposits.

Loans/Advances to Agriculture (ALAD)

Loans/advances to agriculture are defined as total value of credit granted by the banking system to agricultural sector for agricultural activities over a period of time.

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