DEBT MANAGEMENT IN COMMERCIAL BANKS:
A CASE STUDY OF HABIB NIGERIA BANK LIMITED.

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CERTIFICATION

This project entitled "DEBT MANAGEMENT IN COMMERCIAL BANKS: A CASE STUDY OF HABIB NIGERIA BANK LIMITED" by Olonisakin, Comfort Folake, meets the regulation governing the award of the degree of Master of Business Administration (M.B.A.) of Ahmadu Bello University, Zaria, and is approved in its contribution to knowledge and literary presentation.

A. Sala — Sept 30, 1993

Supervisor | Signature | Date

Head of Department | Signature | Date

External Examiner | Signature | Date

20/5/97

Dean, Post-Graduate School | Signature | Date

DECLARATION

I hereby declare that this project titled "Debt Management in Commercial Banks: A Case Study of Habib Nigeria Bank Limited" for the award of Master of Business Administration of the Ahmadu Bello University, Zaria, is the product of my research findings.

All sources of information used for this write up and where applicable other writers views have been duly acknowledged by means of references and I should be held responsible for any error of omission or commission in the project.

Comfort Folake Olonisakin.

DEDICATION

This work is Dedicated to my darling mother, Mrs Julianah S. Olonisakin whose motherly care and support made me attain this height in life.

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ABSTRACT

The increasing competition in the Nigerian banking industry necessitates that banks take on higher degree of risks than they are hitherto accustomed to; but the degree of risk inherent in a bank's lending portfolio has serious implications for the bank's earnings and earning assets, and subsequently for its liquidity, profitability and capital.

The problem with which this study was concerned is that of identifying the causes of bad debts in commercial banks using Habib Nigeria Bank Limited as a case study Effects of factors such as economic recession, non-prudent financial management, natural disaster, prevailing economic situations on debts management were considered.

The objective of the work was to study the process of credit appraisal, identify the major causes of bad and doubtful debts, analyse their effects and offer suggestions on minimization and effective management of bad debts in commercial banks.

Consequently, four hypotheses were stated for testing at 5 per cent level of significance. These are:

1. That the state of the economy does not significantly affect the incidence of bad debts.

2. That prudent financial management does not significantly affect the incidence of bad debts.

3. That the establishment of effective loan policy does not make any significant difference to the occurrence of bad debts.

4. That stall qualifications do not make any significant difference to the occurrence of bad debts.

The study population was made up of fifty officers from the credit departments of the bank from ten branch offices. The instrument used for data collection was the questionnaire, and the data was subjected to chi-square test.

As a result of the analysis of data, the research study discovered that factors such as, Economic recession, Government Monetary policy, Excess gearing, Under Capitalization etc., could cause bad debts in banks.

The implication of these findings for debt management in commercial banks is enormous. It implies that the of the economy, staff qualifications, prudent financial management and establishment of effective loan policy does have a significant effect on the incidence of bad debts.

TABLE OF CONTENTS

CHAPTER FOUR DATA PRESENTATION AND ANALYSIS

CHAPTER FIVE DISCUSSION OF RESULTS, CONCLUSION AND RECOMMENDATIONS

LIST OF TABLES AND APPENDICES.

CHAPTER 1

INTRODUCTION

1.1 An Overview:

Lending is a primary function of banking for two main reasons. First, it is through the lending function that banks act as agents of capital formation (Henderson, R.F; 1980). Bank lending, if channelled into the productive sectors of the economy, promotes the financing of capital formation and thus business development and economic growth.

Secondly, a bank's lending portfolio comprises the bulk of its assets that provide the major sources of its earnings and profits. Adewunmi reports, from a survey based on 1983 annual reports of twelve Nigerian Merchant banks, that interest earned on loans represents between 58% to 94% of individual banks' gross earnings (Adewunmi, 1985).

Commercial banks in an economic system transfer funds from the savings - surplus units to savings - deficit units. The surplus units provide the funds needed by the deficit units for investment purposes. This is essential for economic growth of any country. The commercial banks are the intermediaries between the demand side and the supply side of money.

Banks in the process of performing their roles of financial intermediation between surplus units and deficit units create deposits. When a bank gives out loan to a customer, it debits the loan account and credits the customer's account with the amount involved. The credit to the customer's account has become a new deposit which is available to the bank for further lending to other prospective borrowers. The ability of a commercial bank to grant loans depends on the level of deposits it has generated and the legal reserve requirement(s) imposed by the Central Bank. In Nigeria, money supply in the narrow definition is made up of currency outside banks plus demand deposits. (Adewunmi and Ojo, 1982): The demand deposits in particular are made up of deposits made by customers through current and savings accounts (which include proceeds of loans from other banks) and deposits created from loans granted by the bank to its customers. A bank earns a return for performing the role of mobilising funds. It pays a price, which is the interest, to the supplier of funds as reward for parting with his money, thus abstaining from present consumption. It in turn charges interest to the user of the fund at a price/rate above the cost of the fund, the margin being the gain for performing the role of an intermediary. This process of generating investment has the advantage of creating more employment opportunities, consumption, further savings and further investments. The Saving process is a cyclic one. Accordingly, Adam Smith has referred to money as the "great wheel of the economic system."

1.2 Background to the Study:

The introduction of Prudential Guidelines by CBN in 1990 compels Commercial Banks to be more selective in granting loans and manage their advances properly so as to minimise bad debts and improve on their final performance or results.

If there is doubt concerning the recovery of an account, it is classified doubtful and when several efforts geared toward(s) the recovery are in vain, it is declared a bad account. Several factors affect the decision of the bank management in the classification of the outstanding debts. Among the numerous factors considered are the time factor, the nature of the business of the company involved and its management team; so also is the type of industry into which the company falls and the prevailing economic situation.

Due to numerous reasons which may include the likely death of a borrower, possible illegal diversion of funds, poor state of the economy, not all the loans granted by banks to their customers are repaid when due. Such problem loans are classified as bad and doubtful. McCarty (1982) described loans and advances as the most important as well as the most profitable assets of commercial banks. Of all financial assets of Commercial Banks, loans and advances yield maximum return (Nwankwo, 1975). One of the main objectives of Commercial Banks is to maximise profit. But, this objective can be affected by increasing trend of provision for bad and doubtful debts. This has been a major concern to both management and shareholders.

Bad debts are losses to banks and therefore are capable of reducing the returns to the shareholders and contributions of the banks to economic and social development of the country.

As part of its participation and control exercised on banks, Federal government had instituted a number of measures through the Central Bank of Nigeria (CBN). To this end therefore, both the lending and borrowing rates had been fixed and varied. For the purpose of rapid economic development of the country, the economy itself had been classified into the preferred and the less preferred sectors. While the preferred embraces Manufacturing, Agriculture, Public Utilities and Housing, the less preferred is notably Domestic trade and importation. The preferred sector attracts largest proportion of 75% of the loan. To effect this, a fine is imposed on any bank that exceeds this limit for more than a month. These two sectors are further sub-divided into sub-sectors for which targets are also set (Financial Punch, April 6, 1981).

The banks were also directed to open new branches in the rural areas with the intention of bringing their services closer to the rural dwellers.

Furthermore, the recruitment of experienced personnel from foreign countries had been reduced to the minimum. This has no doubt opened stiff competition fro the very few most promising employees of the existing successful banks. It will also open challenges to these financial institutions, and force them to make greater use of the available training facilities for their manpower. Failure to gear efforts towards this demand would allow for half baked managers to handle these banks, thereby increasing the specific risk of the banking business.

However, directives by the government should not be enough reason for the banks to open branches in rural areas. *They should make proper analysis* and take cognisance of the fact that there is potential market before such branches are opened. It is also imperative to ensure availability of qualified personnel for successful banking business.

1.3 **Statement of the Problem:**

The study is directed to the management of debts in Habib Nigeria Bank Limited. It has been discovered that several factors affect the decision of the bank management for the grouping of the outstanding debts. Some of these factor are, the time factor, the amount involved, the nature of the business of the firm concerned and its management team.

The study concerns itself with the examination of how factors like economic recession, non-prudent financial management, natural disaster, prevailing economic difficulties which have caused many companies to operate below capacity etc, have affected the bad debt situation.

1.4 **Objectives of the Study:**

Effective management of bad and doubtful debts starts from adherence to government fiscal and monetary policies, lending principles, canons of lending, internal policies and recovery procedures of the bank.

The bank, as a business enterprise, aims at maximization of profit, payment of handsome dividends to the shareholders and contributing its quota to the economic growth of the nation. Efforts would be made to show the *effect of* bad debts *on* bank's profitability. Bad debts destroy the assets of the banks, thereby constituting a major constraint on the achievements of their desired objectives. Shareholders are becoming increasingly aware of their rights, they now carefully study the annual reports in preparation to raise questions during annual general meetings on the continued increase in provision for bad and doubtful debts. Days are gone when shareholders were anxious only to receive their dividends through the post. The awareness and inquisitiveness of these shareholders have got to the extent that they, in some cases, request to know the names of the bank officials for appropriate disciplinary action(s) whenever the need arises.

The main objective of this work therefore is to study the process of credit appraisal, identify the major causes of bad and doubtful debts, analyze their effect(s) and offer suggestions on minimization and effective management of bad debts in Habib Nigeria Bank Limited.

1.5 **Scope of the Study:**

The study will centre on the management of bad and doubtful debts in Habib Nigeria Bank Limited. Loans and advances Department of ten branches of the Habib Nigeria Bank Limited will be selected randomly from Kaduna, Kano, Plateau, Benue, Bauchi, Katsina, Niger and Kwara States. The research will cover the identification, possible avoidance, minimization and management of bad and doubtful debts in the bank from 1987 to 1991.

It is expected that the result from the study will also be useful and relevant to other Commercial banks in the country, since they are all in the same financial market and face similar problems.

1.6 **Justification for The Study:**

Provisions are made for bad and doubtful debts out of the profit of the firm after tax. This goes to reduce the amount which the company could reserve for future investment. In terms of dividend declared to shareholders, there would also be reduction, more so, when the financial institution involved declares dividend as a percentage (%) of the net profit (as a matter of policy). In banking business, the amount reserved for bad and doubtful debts in an annual report is a reflection of the efficiency or otherwise of management team.

This study concerns itself with the examination of these factors that constitute these bad and doubtful debts and the suggestion of ways and means of reducing them.

Since bad debts affect the liquidity of the bank assets, they also affect the bank's ability to create credit, further loans to prospective borrowers are reduced. With investible capital not coming from the banks as expected, the economy contracts, and the problems of recession continue. Profits of most commercial banks have been reduced due to these bad debts which are losses to the banks.

Hence, the study looked into the possibility of effective management of loans as to avoid bad debts and recommendations on effective control of loans were given.

1.7 **Research Hypotheses:**

In trying to study debt management in some selected branches of Habib Nigeria Bank Limited, the research raised four major hypotheses.

1. That the state of the economy does not significantly affect the incidence of bad debts.
2. That prudent financial management does not

significantly affect the incidence of bad debts.

3. That the establishment of effective loan policy does not make any significant difference to the occurrence of bad debts.
4. That staff qualifications do not make any significant differences to the occurrence of bad debts.

1.8 Presentation of the Project:

The rest of this study is organized into four chapters. Chapter two deals with review of related literature. The Concept of Bad Debt, and Procedure for granting loans as well as loan Recovery Strategies will be discussed.

In chapter three the methodology adopted in data collection and analytical tools used in identifying factors responsible for bad debts considered in the study will be discussed.

Chapter four deals with Data Presentation, Analysis and Findings.

The last Chapter contains the summary and Conclusions of the Study as well as Recommendations for improving bad debt Management in Habib Nigeria Bank Limited, and other Commercial Banks.

CHAPTER TWO

LITERATURE REVIEW

2.1 INTRODUCTION:

The purpose of this chapter is to review the literature related to the study. The chapter is organised into two sections. Section one focus on Management of debt in Commercial Banks.

The second section takes a look at Credit Risk Assessment in bank lending. Finally we have the summary of the chapter.

2.2 MANAGEMENT OF DEBT:

The Management of debt in order to avoid or reduce the extent to which loans given by commercial banks become doubtful and bad has been discussed in several theoretical studies.

On avoidance of bad debt, Duesenberry (1964) states that banks should be prepared to meet deposit withdrawal at anytime. Also, they must be prepared to meet minimum cash requirement of the owners at any time. Therefore, a substantial amount of assets which can be readily liquidated must be held. In addition, they must meet legal reserve requirements and hold enough vault cash to accommodate their customer's requests for currency. Once these conditions have been met, banks can invest remainder of their assets in business loans, mortgage loans, instalment loans to customers, or in federal state and local, or corporate bonds.

The limited amount eventually invested in loans can be properly monitored. The proportion of the loan amount that happens to be bad will not have significant effect(s) on the operations of the banks if the above conditions are met before loan agreement are entered into.

Stephen and Charles (1970) states that the length of the credit period tend to increase sales and therefore profits, unless, the sales are offset entirely by increased costs. Collection costs and costs of credit analysis may also increase.

Reduction in the length of the credit period would not only reduce receivables but would also tend to cause some customers to move elsewhere. However, this policy must be used with caution, for a firm's customer might take the credit terms as a fixture and expect consistent treatment.

The marginal revenues (MR) increase, at a declining rate, with the length of the period increases, increased bad debt, carrying costs and so on, more than offset (cross MR) increases in revenues. On commercial bank behaviour, the risk aversion model associated with Parkin (1970), Pyle (1971), Goldfied (1966) and Jaffe (1971) states that the quality of loans is a supply function derived from general portfolio theory. Loan are viewed as a risky asset which banks purchase because of the existence of positive risk premiums over the return on the riskless security. In this view, optimal asset and liability choices are interdependent. Banks use an arbitrage process to exploit the difference in the expected rates of return between deposits and loans which is eventually eliminated by aversion to increased risk. Klein (1971), Sealey and Lindley (1971), Pringle (1973) and Slevin and Sushka (1975, 1983) view market imperfection as the dominant characteristic of banking markets in general and loan markets in particular. Consequently a bank has a degree of monopoly and can act as a price setter in loan and deposit markets while it is a price taker in the securities market. In such a case banks determine an optimal loan rate at the point where a bank extends sufficient loans so that the resulting marginal revenue obtained is equal to the heterogeneous rate on government securities (e.g treasury bills, development loan, stock etc) which is the opportunity cost of lending. This leads to the independence of loan decisions from events in the deposit market.

Banks generally provide avenues for savings to individuals, business organisation, cooperate bodies and government agencies who have funds that are not for immediate use. The bulk of such funds are therefore lent to needy customers, for personal and business concerns in form of loans and advances. The process of such lending is made according to laid-down rules and regulations. Applications of such rules, however, require careful consideration to enable both parties involved derive satisfactory benefits from the exercise. comparing the lending principle with the basic economic laws, Matlor (1972) argued that the rules should not be applied with rigidity. He then concluded that the principles must always be carefully weighed with an open mind. According to him, the three basic principles that serve as guides to bank lending are: safety, suitability and profitability.

2.2.1 **Safety:** The safety of any loan and advances is of paramount importance to the bank. There must be a reasonable assurance that the amount granted can be repaid from the operations of the borrower. The source of the repayment must not be doubtful. Hence, banks place great emphasis on the character, integrity and reliability of the borrower. In support of the requirement, the borrower must be able to provide acceptable security which will serve as a guarantee for repaying the debt in case the expected sources of repayment fails.

2.2.2 **Suitability:** It is necessary for the banker to ensure that the purpose of the loan is not in conflict with economic and monetary policies of the government even when safety requirements have been satisfied.

To achieve this, bank lending in Nigeria is highly regulated and controlled by the Central Bank. This is done through the issuance of annual credit allocation guidelines and the imposition of quantitative and qualitative limitations on bank lending. The guidelines vary from year to year depending on the economic and monetary policies being pursued by the Federal Government. The purpose of an advance and its implications on the economy, are, therefore given due considerations when it is being granted.

2.2.3 **Profitability:** Banks are known to be profit oriented establishments and not charitable organisations. It is therefore important that loan facilities granted yield profits to the bank. Hence every bank tries to confine itself to the profitability of any advance before such an advance is granted.

What determines the amount of profit is the rate of interest charged and the volume of loan issued out. The interest rates are however regulated by the government through the Central Bank. This is necessary so as to protect the interests of both the banks and the customers. Apart from these, other important factors that are considered include the following: amount and value of the loan or advance, the loan period, loan repayment programme, past performance of the loanee, owners' equity, integrity and strength and the liquidity of the security provided for the loan and advance. All these are necessarily considered to safeguard against defaults or bad debts. Credit information on potential borrowers form a vital part of the decision-making process (Ivan, 1972). It is complementary to the historical and investigational information on the borrower which, if well carried out, would reduce the risk element in a lending proposition. However, any competent banker will give careful considerations to the basic talents of lending in order not to load his loans portfolio with potential bad debts arising, basically from poor credit judgement.

2.3 CREDIT AND RISK ASSESSMENT IN BANK LENDING:

In order to protect their capital, ensure profitability, and guarantee liquidity, banks need to limit the risk of their lending portfolios to a level consistent with their returns. There is need therefore, to have a proper appreciation of the level of risk involved in each credit exposure. This would facilitate credit pricing and optimum portfolio management practices. We live in times of greater actual and potential volatility of external factors which increase the degree of credit risks. Today's bankers will therefore need to draw on a combination of old principles, and new techniques and technologies in order to effectively manage credit risk.

According to Casson (1977), the traditional principles of lending involving the character, capacity, and integrity of the borrower are still as valid as when they were first proposed. However, problems may arise when dealing with faceless corporate entities. Here emphasis must be placed on the evaluation of the management.

2.3.1 Traditional Approaches to Credit Risk Assessment:

The traditional approaches to credit risk assessment are the financial statement analysis and credit information checks. While the financial statement analysis addresses the question of current and future capabilities of the firm, the credit information checks address mostly the question of character and integrity of the borrower.

Sources of credit information include the references provided by the customer, bank sources, trade sources, firm's competitors, credit reporting agencies, agency rating books, press comments, stock exchange opinion, companies' registry search, etc. (Williams; 1966). In Nigeria, the most commonly used sources are the bank references, references provided by customers, the stock exchange opinion. The aim of credit investigation is to build up as complete and reliable a picture as possible of the customer.

According to Ryan (1982), the consideration facing bankers in the assessment of corporate funding proposals can be broken down into two separate, but interrelated categories - credit assessment and risk assessment. These two categories are so related that this division may appear not justified, since the purpose of credit assessment is to determine the degree of credit risk, while the risk assessment of a proposal is to determine its credit worthiness. However, it is convenient to treat the two categories differently. To the above two categories, we add a third one, namely the credit scoring technique - a new tool that provides sound statistical basis for maintaining credit quality (Cambridge Conference, 1988). We shall look at these categories in turn.

2.3.2 **Credit Assessment:**

Credit assessmentis based on a corporation's financial statements and other supporting financial data accompanying the loan proposal. This procedure is often called financial statements analysis. The main statements used are the balance sheet, profit and loss statements, and cash/funds flow statements. These statements could be proforma or/and historical.

In the past, bankers approach to financial analysis especially with regard to balance sheet is to treat the firm as gone-concern (Mather L.C., 1967). However, because bankers are currently being pressurised to lend on medium and long term basis, the emphasis has shifted toward the treatment of firms as "going-concerns." Consequently, the historical accounting statements of balance sheet and income statements are being supplemented with the use of more current, at least up-to-date management accounting information and proforma statements. So the use of sales and profit projection, cash flow projection, budgets, etc is now very popular.

The main tools of financial analysis are financial ratios, statistics, and the analysis of cash/funds flows. By far the most popular is the use of ratios. The logic in financial statements analysis is that past performance of a company provides a cue to future performance.

The analysis of funds flow statement enables the appreciation of the financing and investing activities of the firm. It enables the analyst to know whether cashflow is being generated from operations, long terms financing, or sale of non-current assets. It also gives indications as to what the cash generated is being used for-purchase of long terms assets, retirement of debt, declaration of dividends, or meeting shortfalls from unprofitable operations (Soyade, 1982). According to Hartley (1978), the use of cash flow figures by the banker enables more realistic analysis. For example, substituting the figure of cash generated from operations for profit figures in the calculation of ratios for comparisons would provide more realistic results.

2.3.3 Financial Ratio Analysis to assist credit assessment:

As pointed out earlier that the main tool of balance sheet and income statement analysis is the financial ratio. The analysis of these statements by bankers usually proceeds in a sequential *manner. The information in the* statement is first of all"spread" in such a way that would enable proper assessment of the company's financial and operating position.
The "spreading" allows consistent and standardized approach towards the *financial* analysis, depending on the format used by the bank. The spread is usually prepared in comparative statement format covering at least

the last three years. After "spreading", the analysis would then continue using either of the two main techniques of financial analysis the cross-sectional or the time series technique (Foster, 1978).

The cross-sectional techniques allow the comparison of a firms result to some bench mark e.g a similar firm in the same industry or the industrial standard. This can be done either by reducing the statements to common size or by the use of financial ratios. In common size analysis, the various components of balance sheet are expressed as percentages of total assets, while the income statement items are expressed as percentages of sales.

The series technique, on the other hand, provides insight into prediction of future company performance using trend statements, common size statements or financial ratio analysis.

Since ratio analysis occupies such a significant and integral part of financial analysis process, and has found increasing acceptance as a most valuable aid in assessing a company's financial position and performance, we shall look at the more frequently used ones in bank lending decisions.

Financial ratios express the relationship between two quantities in a firm's financial statement, and is derived by dividing one quantity with the other. In lending decisions, the banker is interested in the firms level and trend of profitability, efficiency, and financing mix. Osayameh (1966) categorizes into six - short term solvency (liquidity), long term financial strength, asset turnover, profitability, gearing and other investment ratios - the number of ratios that should be of interests to bankers.

2.3.4 **Types of Financial Ratios:**

Although any number of ratios can be computed, it is important to ensure that those used are essential, individually significant, provide reasonable conclusions, and reveal trends. Various types of ratios have been suggested for various users of accounting information; see for instance Van Horne (1983:889), Adekanye (1986), and Clohen et al (1987). However, it is generally agreed that four classes of ratios - liquidity, profitability, financial leverage and efficiency - are important in credit analysis. On Glenn Munn's Encyclopedia of Banking and Finance (1983), they are referred to as Credit Barometric.

Liquidity ratios indicate the ability of the firm to pay its current liabilities as they come due. The following forms are commonly used:

$$\text{Current ratio} = \frac{\text{Current Assets}}{\text{Current Liabilities}}$$

$$\text{Quick ratio} = \frac{\text{Current Assets} - \text{Stock}}{\text{Current Liabilities}}$$

It is often stated as a rule of thumb that a 2 to 1 current ratio indicates sound financial situation. This is however inconclusive, as the situation may depend on the firm's nature of business.

The profitability ratios give indications of the company's profitability. The most frequently used forms are :

$$\text{Return on Assets} \ \frac{\text{Net Profit After Tax}}{\text{Total Assets}}$$

$$\text{Return on Equity} = \frac{\text{Net Profit After Tax}}{\text{Owners' Equity}}$$

The financial leverage ratios, sometimes referred to as debt or solvency ratios give indications as to whether the firm has too much or too little debt.

The following forms are used :

$$\text{Debtors} = \frac{\text{Total Debts}}{\text{Total Assets}}$$

$$\text{Capitalization} = \frac{\text{Long term debt}}{\text{Long term debt} + \text{Networth}}$$

$$\text{Interest Coverage} \quad \frac{\text{Profit before Interest and Tax}}{\text{Interest Payments}}$$

$$\text{Burden Coverage} = \frac{\text{Profit before Fixed Charges and Tax}}{\text{Fixed Charges} + \left\{\frac{\text{Principal Payments}}{\text{1- Tax rate.}}\right\}}$$

The efficiency ratios give indication of management efficiency in the usage of assets at their disposal. They are also sometimes called activity ratios or turnover ratios. The following forms are frequently used :

$$\text{Total Asset turnover} = \frac{\text{Net Sales}}{\text{Total Assets}}$$

$$\text{Accounts receivable turnover} = \frac{\text{Net Sales}}{\text{A/C receivables}}$$

$$\text{Days Sales Outstanding} = \frac{\text{A/C receivables}}{\text{Average daily sales}}$$

$$\text{Inventory turnover} = \frac{\text{Net Sales}}{\text{Average Inventory}}$$

It is important to note that inspite of their wide acceptance as analytical tools, ratios have their limitations.

.3.5. Limitations of financial Ratios:

Their most basic limitations is that ratios cannot be more accurate than the financial statements from which they are derived. These statements, by their nature, are already outdated by the time they are available. Also, ratios individually mean nothing, and choosing a basis for comparison may present some problem, since no two firms are exactly the same. Even when firms are alike, differences in accounting methods may result in inaccurate conclusions.

There may also be problems with interpretation of ratios. For example while a high current ratio is generally desirable, it may also mean that a firm is not managing its current assets properly. Also, return on assets may be deceptively low in the case of a fast growing firm. Different ratios must therefore be used together, since no one ratio tells the whole story.

Even when ratios are appropriately derived and do reflect the actual situations, doubts are sometimes raised as to their usefulness in some situations. Goiran (1985) questions the desirability of low gearing ratio by bankers, since according to him, the risk of over gearing only materialises when assets no longer provide sufficient income to meet liabilities. According to Goiran, the return generating ability and the degree of accessibility (liquidity) of a company's assets-base, should be the concern of lending bankers rather than low gearing ratio. The weakness of his argument is the issue of liquidity; since however liquid a company's asset base is, its accessibility to any one lender would be limited to the portion on which no prior claims exists. Again, gearing ratios would be useful in measuring this.

The analysis of ratios may not provide the right answers, but it leads the analyst to the right questions. A lot depends on the interpretation skill of the credit analyst. The recent application of micro-computers in credit analysis to perform the processing of financial information allows the analyst to concentrate on the development of these essential skills of financial analysis and interpretation (Hogan, 1984).

2.3.6 Risk Assessment:

According to Mather (1967), the test of a sound banker is to know when to accept risk, but it is first essential to be able to assess the risk with reasonable accuracy. Risk in credit assessment is associated with the probability of non repayment of loan. Where lending is against future cash flow of a company, a detailed analysis of risk of that particular company is required. This is particularly true in project finance in which case the lender has limited recourse to the sponsor in the event of project failure.

According to Ryan (1982), the type of considerations which should be taken into account when assessing the risk of a corporate borrower include the nature of the industry, the security offered, whether company premises is owned by the company or leased, the major sales outlets, and "management succession planning" policy of the company.

Das (1983) drew up eight broader categories of risk that must be weighed by the lending banker; these are the resource risk completion risk, cost over-run risk, operating risk, marketing risk, political risk, financial risk and force majeure risk.

Resource risk is the likelihood that the resources (e.g minerals) may not be of sufficient quality or may not be economically recoverable by proposed facilities. This is especially important for natural-resources-based projects.

Completion risk is the probability that the project may not be completed and brought into operation as a result of setbacks in completing the infrastructure, labour difficulties or technical set backs.

Cost over-run risk is associated with risks caused by inflation, and inaccuracies in engineering and design studies. This arises from underestimation of capital requirements of the project. This risk is quite high in Nigeria due to high inflation rate and low level of technical expertise.

Operating risk arises from unexpectedly high operating costs. This may be as a result of inaccurate assessment of the production or recovery process, poor engineering to meet product quality and quantity specifications, low labour productivity, unexpectedly high equipment replacement, inflation, and changes in the parity of currencies for industries with high imported input content. The Structural Adjustment Programme in Nigeria has made operating risk quite high for many industries.

Marketing risk arises as a result of incorrect assessment of outlets, technological obsolescence product, and decreases in selling price or demand. With decreases in real disposable income of Nigerians, this risk is high for many companies presently.

Political risk is high for companies located in foreign countries. They run the risk of nationalisation or outright expropriation. For domestic firms, political risk take the form of government interference in normal market forces, foreign exchange restrictions, currency inconvertibility, imposition of taxes, withdrawal of licences or subsidies, and forced management. Since trade liberalisation is one of the components of SAP, the government's current intention is to lower the political risk of doing business in Nigeria.

Financial risk is related to the ability of the firm to bear significant changes in financing costs due to changes in debt rate or interest rate or movement in exchange rate where foreign finance is involved. With the present deregulation of interest rate and adoption of "floating" exchange rate, firms in Nigeria are highly exposed to this risk. Moreso, many of the firms have high input content of imported materials.

Finally, <u>force majeure</u> risk is associated with intrusion of circumstances beyond the control of either the firm or lender; for example, natural disasters and strikes. In Nigeria, the agricultural sector is particularly amenable to this risk.

An unreasonable exposure of a company to any of the above risk categories may lead to company bankruptcy or failure. Any company that goes bankruptcy would certainly be unable to service its debts. Indeed, insolvency, the inability to meet obligations as they fall due, is shown enroute bankruptcy. Dyer (1981) considered eight factors that may lead to company failure. These are incorrect costing, stagnant management, overtrading, unsatisfactory contract, poor product or demand, poor market research, too much diversification, megalomania and bad labour relations.

Dyer defines megalomania as a situation where a company is operated as if it were a personal possession of its Chairman or Managing Director. Many Nigerian companies may be considered guilty of poor market research, too much diversification and megalomania.

In lending situations it is important that the banker evaluate the above factors. It is obvious that due to the nature of risk creating factors, a fool proof quantitative approach to risk analysis is impossible. A lot would depend on the judgement of the analyst. However, the past performance of companies can be used as a guide to the future. If the problem of risk assessment is approached in this fashion, the above risk creating factors would become automatically integrated into the analysis.

2.3.7 Credit Scoring System:

One of the new tools available as a basis for credit decision is the credit risk scoring technique. The system similar to credit risk rating system, is defined as the evaluation of the credit worthiness of an individual or business concern based on relevant factors including ability and willingness to pay obligations, as well as networth (Glenn G. Munn's 1973).

According to Batt & Fowkes (1972), credit scoring systems are statistically based tools for forecasting the outcome of extending credit to individuals. The systems attempt to distinguish potentially bad from potentially good credit risks. A Credit Scoring System enables a structured approach to spotting potential credit problems early enough and hence institution of appropriate remedial action. Credit Scoring System also provide useful analytical approach to portfolio management.

Batt and Fowkes (1972) gave an illustration of a procedure for credit scoring. Initially, characteristics that best discriminate between bad and good debts are derived statistically using empirical data. These characteristics are then attached weights in terms of maximum score, depending on the degree with which they discriminate between the two groups. Cut-off-point-totals are then established between the potentially bad and good debts. Scoring schemes are usually designed so that high scores indicate high risk of default and low scores indicate low risk of default. The characteristics used for scoring differ from firm to firm and may depend on the type of facility.

2.3.8 **<u>Credit Scoring Techniques:</u>**

The credit scoring techniques have mostly although not exclusively, been applied in consumer credit and personal bank credit decisions. Examples of consumer or personal characteristics used are geographical location of borrower, possession of bank account, occupation status, sex, stability of employment, amount sought, age, etc. The favourable usage of credit scoring system in personal lending rather than corporate lending may be due to the fact that personal characteristics are easier to identify and score. However, since financial ratios have been known to possess high predictive power, there exist the potential for their use in corporate credit risk scoring.

In an empirical study, Wilsted et al (1972) used multiple regression technique to capture the loan policies of some 165 bankers from one hundred banks having provided them with some 24 applicant characteristic cues. He concludes that the mean cue weights used by the 265 bankers in rating fifty loan applications were as follows:

Cues in rank of importance.		Mean regressions weight
1.	Credit rating (from credit report)	0.48
2.	Unencumbered monthly income	0.33
3.	Occupation: Professional	0.29
4.	Occupation: White collar	0.25
5.	Prospects of long-term customer relationship	0.20
6.	Average saving balance	0.18
7.	Occupation: Skilled worker	0.18
8.	Marketability of collateral	0.16

This shows that the greatest weight was attached to credit rating and the disposable monthly income, while the least weight was attached to the marketability of the collateral.

In another work, Gau (1978) developed a quantitative procedure for assessing the relative levels of default risk inherent in residential mortgages. Starting with 64 inter-related variables describing the financial, property, and borrower characteristics, he came up with 6 taxonomic groups with default rates ranging from 8.6 to 45.6%.

Prominent among the financial characteristics is the ratio of loan amount to the appraised value of property.

As mentioned earlier, some potentials were seen for the use of ratios as scoring parameters in corporate credit risk scoring. In practice some banks use a credit risk rating system similar to credit scoring. Although parameters used by these banks are similar to the ones that could be used in a formal credit scoring system, their rating system is more subjective and less structural. Lawson (1987) attempted to device a credit risk scoring system for corporate borrowers using current, quick, and leverage ratios as scoring parameters. However, the empirical validity of the deviced model was not tested.

Batt and Fowkes (1982) contend that credit risk scoring improves the level of a firm's risk management. They argue that the use of the technique leads to decreases in loan default. Also, the system can be used to reduce bad debts in a preferential manner in periods of credit restrictions, simply achieved by lowering the cut-off-point.

According to them, credit scoring also improves profit forecasting, since it is essentially a forecast of what would happen to various classes of loans. Also, the average score of all the applicants over time gives a measure of the quality of these applicants. It therefore, enables the monitoring and evaluation of portfolio quality over time.

Other advantages they point out are the effective control of individual credit officers, arising from the structured approach to credit appraisal; and more economic use of additional credit enquiries, since these enquiries can now be limited to applicants with inconclusive scores. The system also facilitates credit pricing and determination of credit limit reflective of the applicants credit risk class.

Capon (1982) observes that credit scoring systems are amenable to computerisation. Use can be made of computational power of a computer to identify those characteristics that best discriminate between the good and bad debts, and to determine the point values for the various levels of selected characteristics.

2.3.9 Limitations of Credit Scoring Techniques:

Even with the advantages mentioned above, many writers are critical of the credit scoring technique. Shinkel (1977) showed that biased estimates are obtainable with credit scoring.

Nevin and Churchill (1979) are of the view that characteristics frequently employed in credit scoring systems, such as number of dependents, age, occupation and place of residence, are irrelevant, unchangeable and have no merit in case of credit decision. For example, Webb's finding (1982) that personal characteristic of the household head is not significant in determining mortgage loan default, gives an empirical backing to the above view. Webb, however, found some correlations between occupational differences in income trend and sources of income on one hand and loan delinquency on the other hand.

Capon (1982) concludes that individuals should be judged on characteristics that are ultimately related to decision under consideration; that brute force empiricism has no place in decisions of such importance to individual citizens.

The above findings leads to the conclusion that although the characteristics used in credit scoring may be empirically derived and statistically sound, they may have unpleasant social consequences.

The above shortcomings notwithstanding, credit scoring systems have proved quite useful. The quantitative approach to credit decision making is surely more objective than the usually subjective rule of thumb methods often employed. The fact that between 20% to 30% of all consumer credit decisions in the United States as at 1979, are made by credit scoring (Credit Card

Redlining, 1979), is a pointer to the acceptability of the system. The users include large credit granters like banks, finance companies, oil companies, retail merchants, and travel and entertainment cards.

In view of the high predictive ability of ratios; see for instance Altman, (1968), Fedel (1977), and Dambolena and Khoury (1980), a more successful application of credit scoring system to corporate lending decisions is foreseen. Also, the scoring characteristics of corporate borrowers would be impersonal and therefore not pose any social problems.

2.3.10 Need for Adherence to Good Lending Policies:

Adherence to good lending principles is essential for the avoidance of bad debts and to achieve this, an effective loan policy and credit administration need be formulated. It was the view of Institute of Bankers 26th International Summer School (July, 1973) that in formulating a loan policy, the general factors to be taken into account by an individual bank should include:

(a) capital and reserve position

(b) desirable balance sheet gearing ratio

(c) structure of deposit and loan maturity profile

(d) earnings requirement

(e) economic conditions

(f) government directives and general monetary and fiscal climate

(g) nature of credit needs of customers

(h) management skills available

(i) competition.

Setting up an efficient administration for loan policies requires provision for formal structure for loan approval e.g limits, adjustment of lending facilities to customer needs and establishment of loan administration offices in the management hierarchy. Credits need routine administration and this can be achieved through a routine review and control programme, supervision to ensure observance of conversant and allocation of responsibility for collection of loans in default. Bad debts destroy the assets of the bank and to avoid or minimize the incidence of bad debts, establishment of effective loan policy and loan administration is of utmost importance.

Black (1975) and Fama (1980) argue that when banking is competitive, the portfolio management and lending activities of banks are the type of pure financing decisions covered by the Modigliani - Miller (1958) theorems. In this view, banks are price takers in efficient financial markets, even in the commercial loan market. Banks bring together demands and suppliers of assets and act as repositories for the securities generated.

2.3.11 **Borrowers' outlook towards bank loans:**

Very often, bank loans are regarded by the borrowers as their own share of the national cake and they have no intention to repay (Nwankwo, 1980). Some recipient of agricultural loan have this misconception that the N100 million agricultural guarantee scheme of the Central Bank was actually money given to commercial banks by government to disburse to farmers. Occasionally, bank customers abscond with their loan and proceed to other banks and start fresh borrowing relationship. Unfortunately, they are protected by bank secrecy, the absence of a central intelligence agency and inadequate records. Costs of administering and recovering bad debts are enormous and increase the overall costs of the banks which affect the banks profitability and level of earnings available to shareholders.

Adewunmi and Osuntogun (1983) concluded that, loans and advances secured from a particular bank can be treated almost like a grant since with the collusion of the staff or through inefficient book-keeping, the bank will not press claims when its advances are due for retirement. Such staff dishonesty in lending results in an increase in the proportion of bad debts that have to be provided for. Honestly, adequate staff training and experience are essential ingredients for minimizing incidence of bad debts. According to Bass (1981), bad debts are often regarded as the most important test of the credit manager's performance. Credit management does not end with taking the decision to grant credit. The lending cycle is complete only when the credit granted has been retired.

In the views of McCarthy (1982), loans and investments provide income for satisfying liabilities of deposits and paying dividends to shareholders. Bank profits depend on a balanced portfolio of lending to credit worthy borrowers. And, useful lending policy is essential for bank solvency. When loans are not repaid as agreed, the bad debts destroy the assets of the banks and the value of liabilities could exceed the assets. If this happens, the bank is said to be insolvent. This type of a situation invariably leads to bank failure.

Safety is the watchword of commercial bank lending (Kent, 1982). Bankers want to be reasonably sure that their loans are repaid and could go to the extent of lowering interest rate charged for better risk lending. This notwithstanding, even a well-managed bank will have some of its loans become uncollectible in whole or in part. However, keeping losses to very small proportions of total loans is always the goal of any bank.

Commenting on the source of repayment of loans, Nowzard (1983) was of the view that the crucial question from the lender's point of view, is not so much whether or not a country or an individual will be able to meet its debt servicing obligations, but on the repayment of both the principal and the interest. The answer to this question in most cases, according to him, is at best difficult and at worst, totally elusive.

2.3.12 ***Need for greater care in Debt Management:***

Debt management is not an easy task. Fratian (1983) believes that debt levels will not be reduced costlessly. He opines that a viable strategy, avoiding the pitfalls of deflation, renewed inflation, bail outs and socialisation of loan losses will require contributions from debtors, lenders, national authorities and international organisations. Most writer on credit management including Nowzard (1983), Rholwin (1984) and McGinnic (1981) are of the view that bad commercial loans can wreck a bank's balance sheet. Therefore, commercial should have foresight of this before lending.

In their own opinion, Stein and Zieglen (1984) state that, high credit losses and increased demand on the credit handling process must lead to a steady development of new steps for operational early warning procedures for credit management.

Falegan (1987) concluded that not only is good administration of a loan portfolio required but management must set its objectives before hand as to how it is going to lend and where. Control must be exercised over a bank total exposure and this must be monitored by management. Neglect of these fundamental principles may amount to bad banking. It is a truism that prevention it better than cure, but it is essential that commercial banks exercise pre-lending controls, once a facility has been agreed to by management. The actions left to a banker in post-lending situation depend to a large extent, on the care with which condition and security have been respected before hand. To minimize bad debt and their effect on banks assets and profitability, there is the need to adhere to pro-and post-lending policies.

2.4 **SUMMARY:**

Efforts have been made in this chapter to place the problem of this study within a theoretical frame work.

The studies reviewed, did not in a sufficient manner tell us that bad debt can be completely eradicated in bank lending. The study enumerated the various criteria for granting loans and credit risk assessment in bank lending. Credit assessment, Risk assessment and credit scoring systems were dealt with in details.

It is however worthy of note that, the minimization of bad debts in commercial Banks depends on the banks adherence to pro and post lending policies.

CHAPTER THREE

RESEARCH METHODOLOGY

3.1 INTRODUCTION:

The main focus of this chapter is the discussion of the research methods used in this study. Attempts have been made to describe the research sample for the study, sampling procedure, research instruments and the procedure used for data analysis.

3.2 THE RESEARCH SAMPLE:

The population consisted of 50 credit officers selected at random from 10 branches of Habib Nigeria Bank Limited from Kano, Kaduna, Niger, Plateau, Bauchi, Katsina, Kwara and Benue States.

3.3 RESEARCH INSTRUMENT USED:

The instrument employed for this research is the questionnaire. The rationale for using only questionnaires is that it allows respondents to freely express their views without any inhibitions as it is the case with interview. In addition, questionnaires ensures anonymity of the respondents.

The instruments was administered personally on the selected subjects and were collected immediately after completion by the participants.

In the branches used, bank managers were contac ted and they helped in the administration of the questionnaires. Assistance was given in the administration and distribution of the questionnaire to the staff in the loans and advance section of the bank. At the end, the questionnaires were collected for scoring.

3.4 **DATA COLLECTION THROUGH RESEARCH QUESTIONNAIRE:**

In constructing the questionnaire used for this study, the researcher made use of experts' contributions on debt management as contained in the theoretical studies reviewed. The questionnaire consisted of two sections.

The first section of the questionnaire required the officers to supply some personal data i.e the age, sex, highest educational qualifications, length of their service in the Bank and their present positions in the Bank. The second section was sub-divided into two parts. The first part was designed for the officers to react to every statement on the possible causes of bad debts in banks, and to give further possible causes of bad debts known to them. The second part required the officers concerned to react to every statement on the items in this second section of the questionnaire on the possible ways of avoiding bad debts. Response to the items in this section was on five point rating scale ranging from strongly agree to strongly disagree. The scoring of the responses to the questionnaire items were based on these ratings: strongly disagree (1 point); disagree (2 points); indifferent (3 points); agree (4 points); strongly agree (5 points). The questionnaire also required the officers to make recommendations on effective credit management and explain procedures taken by their bank in debts recovery.

Furthermore, annual reports and accounts of Habib Nigeria Bank Limited from 1987 to 1991 were carefully studied. This was to get figures for loans and advances given to customers and provisions for bad and doubtful debts made, and the proportion which had been declared bad and written off during the five years under study. Thus, enabling inferences to be drawn from the various reports.

3.5 METHODS OF DATA ANALYSIS:

The data collected through the use of questionnaire were subjected to statistical analysis, using the chi-square test. It is believed that this method would yield good results. It is a rule which has been generally adopted, in the one-degree-of-freedom situation, that the expected frequency in all cells should be equal or greater than 5 (Haber and Runyon, 1977; Hoel, 1960). This general rule had been satisfied before using the chi-square test for the analysis in chapter four. The expected frequency in each of the cell used was calculated to be 10; which is greater than the required minimum of 5. The level of significance was set at 0.05. The chi-square test was to measure discrepencies existing between observed and expected frequencies and it is represented by:

$$\chi_c^2 = \sum_{1=i}^{k} \frac{(0i - Ei)^2}{Ei}$$

where 0i = observed frequencies for cell i

Ei = expected frequencies for cell i

Significance level = 0.05 = X^2 0.95

x = Chi square

k = No of expected calculations.

Also, to determine when an item was agreed upon by the generality of the respondents as to the avoidance of bad debts, each score was multiplied by the number of respondents accepting it and the percentage of each rating (5,4,3,2,1) was calculated. Measures to be taken to avoid bad debts were then categorised as follows:

Less than 50% strongly agree and disagree = factor

Above 60% strongly agree and disagree = Not a factor.

3.6 <u>SUMMARY</u>:

In this chapter, the population and sampling procedure have been specified. The method of analysis as well as research instruments employed have been described.

CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1 INTRODUCTION:

This chapter presents the analysis of data and summary of findings. Four hypotheses were formulated and data collected from 50 Officers in the loans and advances section of the bank and from various annual reports and accounts for 5 years were used to resolve them. section three of the chapter talks on the debt recovery policy of Habib Nigeria Bank Limited. The chapter concludes with a summary of results.

4.2 PRESENTATION AND ANALYSIS OF DATA:

This section deals with the hypotheses. Four hypotheses were tested in the study, they were as follows:-

1. That the state of the economy does not significantly affect the incidence of bad debts.
2. That prudent financial management does not significantly affect the incidence of bad debts.
3. That the establishment of effective loan policy does not make any significant difference to the occurrence of bad debts.

4. That staff qualifications do not make any significant difference to the occurrence of bad debts.

Chi-square was used in analyzing the results from the questionnaire.

4.2.1 **TEST OF HYPOTHESES:**

a) **Hypothesis one:**

Hypothesis one states that the state of the economy does not significantly affect the incidence of bad debts. Two items of the questionnaire dealt with this hypothesis. They are item 1 and 2. To test this hypothesis, chi-square was used.

TABLE I:

	Strongly Agree (5)	Agree (4)	Indiffe-rent (3)	Disagree (2)	Strongly Disagree(1)
Observed	16	24	9	2	2
Expected	10	10	10	10	10

$$\chi^2_c = \sum_{i=1} \frac{(Oi - Ei)^2}{Ei}$$

Where Oi = Observed frequency for cell i
Ei = Expected frequency for cell i

$$\frac{(16 - 10)^2}{10} + \frac{(24 - 10)^2}{10} + \frac{(9 - 10)^2}{10} + \frac{(2 - 10)^2}{10} + \frac{(2-10)^2}{10}$$

3.6 + 19.6 + 0.1 + 6.4 + 6.4

X^2_c = 36.1

From the table $X^2 0.95$ = 9.49

Source: Analysis of responses to Questionaire (See appendices 1 & II).

The chi-square shows that the state of the economy does affect the incidence of bad debts. Since 9.49 36.1 i.e value of chi-square from the table. Is less than the value of chi-square calculated. Hence, we reject the null hypothesis and accept the alternative hypothesis which states that the state of the economy does affect the incidence of bad debts significantly.

b) **Hypothesis two:**

Hypothesis two states that prudent financial management does not significantly affect the incidence of bad debts. Three items of the questionnaire dealt with this hypothesis. They were all considered in testing the hypothesis. They are items 3, 5 and 6. To test this hypothesis, chi-square test was used.

TABLE II

	Strongly Agree (5)	Agree (4)	Indiffe-rent (3)	Strongly Disagree (2)	Disagree (1)
Observed	17	17	6	7	4
Expected	10	10	10	10	10

$$X^2_c = \frac{(Oi - Ei)^2}{Ei}$$

$$\frac{(17-10)^2}{10} + \frac{(17-10)^2}{10} + \frac{(6-10)^2}{10} + \frac{(7-10)^2}{10} + \frac{(4-10)^2}{10}$$

$$4.9 + 4.9 + 1.6 + 0.9 + 3.6$$

$$X^2 = 15.9$$

From the table $X^2 0.95 = 9.49$

Source: Analysis of responses to Questionnaire (See Appendices I & II).

The chi-square shows that prudent financial management affects significantly the incidence of bad debts. Since 9.49 15.9 i.e. value of calculated chi-square is greater than the value of chi-square from the table. Thus, we reject the null hypothesis and accept the alternative hypothesis which states that prudent financial management does significantly affect the incidence of bad debts.

c) **Hypothesis three:**

This hypothesis states that the establishment of effective loan policy does not make any significant difference to the occurrence of bad debts. Three items of the questionnaire dealt with this particular hypothesis. All these items were considered in testing the hypothesis.

They are items 4, 7 and 8. In testing the hypothesis, chi-square test was used.

	Strongly Agree (5)	Agree (4)	Indiffe- rent (3)	Strongly Disagree (2)	Disagree (1)
Observed	16	20	6	5	3
Expected	10	10	10	10	10

$$X_c^2 = \sum \frac{(Oi - Ei)^2}{Ei}$$

$$\frac{(16-10)^2}{10} + \frac{(20-10)^2}{10} + \frac{(6-10)^2}{10} + \frac{(5-10)^2}{10} + \frac{(3-10)^2}{10}$$

$$3.6 + 10 + 1.6 + 2.5 + 4.9$$

$$X^2_c = 22.6$$

From the table X^2 0.95 = 9.49

Source: Analysis of responses to Questionnaire (See Appendices I & II)

The chi-square shows that the establishment of effective loan policy affects the occurrence of bad debts.

Since 9.49< 22.6 i.e value of chi-square from the table is less than the value of chi-square calculated. Hence, we reject the null hypotheses which states that the establishment of effective loan policy does make any significant difference to the occurrence of bad debts.

d) **Hypothesis four:**

Hypothesis four states that staff qualifications do not make any significant difference to the occurrence of bad debts. Only item 9 of the questionnaire dealt with this hypothesis. To test this hypothesis, chi-square test was used.

	Strongly Agree(5)	Agree (4)	Indiffe- rent (3)	Disagree (2)	Strongly Disagree (1)
Observed	17	22	6	3	2
Expected	10	10	10	10	10

$$\chi^2_c = \sum \frac{(Oi-Ei)^2}{E_i}$$

$$\frac{(17-10)^2}{10} + \frac{(22-10)^2}{10} + \frac{(6-10)^2}{10} + \frac{(3-10)^2}{10} + \frac{(2-10)^2}{10}$$

$$4.9 + 14.4 + 1.6 + 4.9 + 6.4$$

$$X^2_c = 32.2.$$

Chi-square from the table ($X^2 0.95$) = 9.49

Source: Analysis of responses to Questionnaire (See Appendices I & II)

The chi-square indicates that staff qualifications contribute significantly to the occurrence of bad debts. Since 32.2 > 9.49 i.e. the calculated chi-square is greater than the value of chi-square from the table. Thus, we reject the null hypothesis which states that staff qualifications do not make any significant difference to the occurrence of bad debts.

4.2.2 **Other likely causes of bad debts:**

The following other causes of bad debts were discovered from the study as indicated in the questionnaire by the respondents.

a) Inadequate cash flow forecast of proposals.

b) In-experienced credit officers used for credit appraisal.

c) Diversion of funds to other projects on the part of customers.

d) Unplanned expansion by borrower.

e) Poor project conception, operational constraints, mis-management and over-capitalization.

f) Inadequate monitoring of projects after disbursement of funds.

g) Sudden death of prime movers of business.

h) Government monetary policies e.g. the prevailing high interest rate on loans and overdraft, making it difficult for customers to meet interest and principal repayment.

i) Improper costing of projects from the on set.

j) Excess gearing, under capitalization, in-frequent monitoring visits by bankers to project site etc.

4.2.3 **Possible Measures for Avoidance of bad debt:**

Moreover, the table below was used to find out some of the measures that can be taken by banks to avoid bad debts. Items 11 to 18 of the questionnaire dealt with these measures.

TABLE V

Percentage of Responses from Respondents to be used for measures to be taken for Avoidance of Bad Debt

Avoidance of bad debts	5	4	3	2	1
11. Bad debts can be avoided if banks are ready to meet deposit withdrawals at any time	38%	18%	16%	8%	20%
12. Honesty, adequate staff training and experience are essential ingredients of minimizing incidents	34%	52%	2%	4%	8%
13. All the well established principles of lending must be observed e.g. safety, suitability and profit- ability	43%	36	16%	2%	4%
14. Objectives set before hand as to how the bank is going to lend and where	28%	44%	16%	8%	4%
15. Banks should meet legal reserve requirements	38%	28%	6%	8%	10%
16. Establishment of effective loan policy and administration	42%	42%	12%	2%	2%
17. Banks should hold enough vault cash to accommodate their customers request for currency	38%	24%	16%	6%	16%
18. There should be control over banks' total exposure	32%	54%	6%	4%	4%

Where: 5 represents strongly agree

4 represent agree

3 represent indifference

2 represent disagree

1 represent strongly disagree

Source: Questionnaire administered to Bank Staff (See Appendix)

The table above shows that all the eight items connected with possible ways of avoiding bad debts can be regarded as factors to be considered in ensuring reduction or possible avoidance of incidence of bad debts. The reason is the percentage of strongly disagree (1) and disagree (2) of each item is less than 50%.

Further measures as given by the respondents are as follows:-

1. Preparation and adherence to realistic management accounts.
2. Frequent monitoring of account-physical inspection and examination of account.
3. Proper matching of credit taken with investment.
4. Moderate gearing and steady growth.

5. Proper appraisal of projects/requests before credit is given.
6. The initial cash flow projection should be studied and implemented to enable targets to be met.
7. Periodic review of credit policies by banks and government.
8. Debit and Credit turnover on customers account should be strictly monitored.
9. Banks should ensure that customers complete all legal documents before disbursement.
10. Adequate pricing of loans and perfection of security.
11. Banks should ensure good quality investment.
12. Banks should give advisory services to clients.

4.2.4 Monetary Policy measures taken by CBN and its effecton Habib Bank:

It is obvious that the Structural Adjustment Programme (SAP), has been having its own effect on the economy. The observation of the measures contained in the 1988 monetary policy circular to direct to high priority sectors of agriculture and manufacturing in order to increase production capacity and encourage backward integration, the long lead-time from bidding for foreign exchange to transforming the relevant raw materials and spare parts to cash, the impact of the deregulation of interest rates, and the licensing of more banks have led to a lack of liquidity in the Banking System (Ogwuma, 1989). The cost of money to customers is high and a credit ceiling growth of 13.2% in 1991 has made it difficult for the banking industry to satisfy customers' requirements for loan and overdraft facilities. Inspite of these constraints, Habib (Nigeria) Bank has been recording an all round growth in the provisions of loans and advances to customers as shown in table six.

4.3 DEBT RECOVERY POLICY OF HABIB NIGERIA BANK LIMITED

Habib Nigeria Bank Limited was incorporated in November 1982 and started operation in May 1983. The Legal Department of the bank is charged with the responsibility of streamline actions towards recovery of debts previously considered doubtful and bad.

As part of the department's efforts in recovering bad debts, supplementary facility may be granted where necessary or part of the interest accrued may be waived so as to encourage the debtor to settle has debt.

The bank's approach to debt recovery is based on the belief that there must be some underlying reasons for a customer's failure. This may involve re-scheduling the customer's liabilities and the appointment of receivers or receiver/manager to manage the business and keep people in employment while the Bank gradually recovers the debt. Management of the business reverts to its owner(s) upon the restoration of operational nolmacy. Security realization and the institution of legal action are often considered only as a last resort.

As part of its credit management operations, the bank's Operations Departments are responsible for:

(a) Appraising all advances proposals received from Branch and Area Offices.

(b) Obtaining the approval of the General Management or the Board to proposals. Alternatively, advising General management why a proposal should be declined.

(c) Controlling and Monitoring Advances through regular reporting systems to ensure that there are no deviations from the conditions stipulated in the original covenants.

(d) Perfecting security documentation with the assistance of Head Office Legal Department.

4.4 SUMMARY OF FINDINGS:

After the analysis of the data collected, the research study discovered that the following factors could cause bad debts in banks.

1. Economic recession which has made many companies to operate below capacity could cause bad debts.
2. Government monetary policy e.g. the prevailing high interest rate on loans and overdraft, which makes it difficult for borrowers to meet interest and principal repayment.
3. Lending to less credit worthy borrowers is more risky as it makes the money borrowed to become bad debts with time.
4. Some borrowers deliberately refusing to pay because of the feeling that it pays to go bankrupt.
5. Bad judgement at the time loan was made.
6. Inadequate monitoring of projects after disbursement of funds.
7. Excess gearing; under capitalization, infrequent monitoring visit by bankers to project site etc.
8. The use of inexperienced credit officers in credit appraisal and inadequate cash flow forecast of proposals.

Consequently, the respondents used for this study suggested that the following measures, if taken, would help in avoiding the incidence of bad debts in banks.

1. Honesty, adequate staff training and experience are necessary ingredients of minimizing the incidence of bad debts.
2. Establishment of effective loan policy and adminstration by banks.
3. All the well-established principles of lending must be observed.
4. Establishment of Debt Recovery Team at branch level and Debt Recovery Department at Head office to oversee the activities of the Branch Recovery Team.
5. Banks should ensure the employment of competent managers and credit controllers.
6. There should be thorough credit analysis, supervised disbursement and monitoring of customers' accounts after disbursement.

CHAPTER FIVE

DISCUSSION OF RESULTS, CONCLUSION AND RECOMMENDATIONS:

5.1 INTRODUCTION:

This chapter summarises the entire study on debt management in Commercial Banks: A case study of Habib (Nigeria) Bank Limited. It discusses the results as well as conclusion. In addition, it presents limitations of the study and recommendations on the study.

5.2 DISCUSSION OF RESULTS:

Four non-directional hypotheses were tested. In testing the first hypothesis which states that the state of the economy does not significantly affect the incidence of bad debts, the data connected with state of the economy were collected and tabulated in table I. It reveals that there is a significant difference between state of the economy and incidence of bad debts. This finding is similar to the view of Schweitzer (1980) which opines that one of the reasons for borrowers default is the state of the economy and asserted that during recession, more businesses fail thus increasing the bad debts of the banks. Thus, loan losses reduce bank profitability. The study also coincides with the study of Stephen (1981) that the volume of debt owed to banks by countries experiencing economic recession has been growing increasingly. That the large debt service burdens of such countries will lead to sizable write-offs in the loan portfolios of those banks.

Hypothesis two states that prudent financial management does not significantly affect the incidence of bad debts. This finding seems to have proved Duesenberry (1964) right that prudent financial management would go a long way to reduce the incidence to bad debts. This involves banks preparation to meet deposit withdrawal at anytime. In addition, they must meet legal reserve requirements and hold enough cash to meet customer's requests for cash. Bass (1980) also stressed that credit management does not end with taking the decision to grant credit. That the lending cycle is complete only when the credit granted has been retired.

On hypothesis three which states that the establishment of effective loan policy does not make any significant difference to the occurrence of bad debts, the findings reveal that poor and ineffective credit/loan policy could cause loans to be bad with time. This coincides with the view of institute of Bankers 26th International Banking Summer School (1973) that good lending principles are essential of avoidance for bad debts and to achieve this, an effective loan policy and credit administration need to be formulated. McCarty (1982) also supports this view by saying that profits depend on a balanced portfolio of lending to credit worthy borrowers and careful lending policy is essential for bank solvency. This result is also similar to the concession of Falegan (1987) that to avoid or minimize bad debts and their effects on the bank's assets and profitability, pro-and post-lending principles must be adhered to.

Furthermore, hypothesis four reveals that there is significant relationship between bankers' honesty and qualification and incidence of bad debts. This result has proved Osuntogun and Adewunmi (1983) right that loans and advances secured from a bank can be treated as grants. The staff can aid the non-payment of grants, by conniving with customers through inefficient book-keeping. Thus, the bank will not press its claims when the advances are due to retire. Honesty, adequate staff training and experience are essential ingredients for minimizing incidence of bad debts. Also, according to Bass (1981), bad debts are often regarded as the most important test of the credit manager's performance.

5.3 CONCLUSION:

Banks should realise their role in the process of failure through the component of leverage. Leverage is essentially the key to failure and the Bank Manager is having the key. Excess trading which had been enumerated as a contributing factor to bad debts causes bad debts only when the leverage of the borrowing company has become very high. Bankers should hence continue to assist their customers not only by lending but also by advice and guidance at the right time. Though it is hazy if any customer had ever acknowledged any disapproval for lending even when the reason by the Banker/creditor had been to guard him against the resulting failure. The banker's usual advice therefore is that it is better to look else where than to lose the fund. Most of the failures, as investigated into in Boston in (1931), were found to be a consequence of an unjustifiable entrance into business aided in many cases by indiscriminate and careless granting of credit to the bankrupts by various creditors.

Undoubtedly, the prime need is for basic banking principles to be observed when lending as treated under the advances and the control of advances. The need to involve all staff in repayment and recovery action cannot be over-emphasised. An important factor to remember is the speed in appreciating when a facility is beginning to look doubtful, in reaching a conclusion as to the action necessary and then in executing such an action.

It has been proved that adherence to Government monetary policy on control of credit, the bank's loan policy and control, prudent financial management etc. would go a long way minimize the size of bad debts in banks. Due to the sophistication and dynamic nature of banking business, we saw that proper analysis of credit proposal was necessary to reduce bad debts. This however can be well done through well trained, experienced and motivated employees. Fake names may be used by dubious staff to grant loans to himself which may not be defrayed.

5.4 LIMITATIONS OF THE STUDY:

In carrying out this study, the researcher encountered some problems. The main constraint of the study has been inadequate comprehensive data on the subject. With the inception of economic recession, resulting in an increase in provisions for bad debts, shareholders are becoming more increasing aware of their rights to critically analyse the annual reports and demand to know why huge amounts of loans are becoming bad. The only information often made available to the public is the annual reports of the banks which contain limited information about the details of bad debts.

Another major limitation is the secrecy surrounding the banker/customer relationship. The relationship is a confidential one and the banks are always unwilling to disclose information pertaining to individual customer's account unless by due force of law. These constraints make it difficult for accurate data to be available for research on bad debts of banks.

Other encountered hindrances are basically finance and short period of time available for carrying out the study.

5.5 **RECOMMENDATIONS:**

On the basis of the findings of the study, the following recommendations are made. It is hoped that these recommendation would assist in better debt management by commercial banks:

1. Proper management of the investment in receivables implies the existence of a collection function. A collection department takes over the responsibility of receivables management after the credit has been granted. The collection departments objective is to ensure the earliest possible payment on receivables without any customer losses through ill will.
2. Prompt collection or payment tends to reduce the rate of losses in accounts receivable investment. The longer a receivable remains outstanding, the

longer the financial manager exposes the bank to possible loss from non-collection. Ideally, any collection pressure from the collection department should be gentle and subtle enough to prevent any loss of customers. On the other-hand, it must be firm. It should be noted that as larger expenditures are made to collect receivables, both carrying costs and bad debts expenses decline.

3. Furthermore, credit insurance may be secured to guard against the possibility of unusual losses in accounts receivables. Banks may require such credit insurance before agreeing to grant a loan. The credit insurer customarily limits the coverage on individual accounts according to the credit rating of the client. If at some later time, a bad debt were collected, the funds would be distributed pro-rata to the insurance company and to the proportion of their losses.

Also, there has to be some relationship between the size and profitability of a customer's balance and the size of the loan he can expect to get. Of course, a customer who keeps an average balance of N10,000 cannot expect to borrow a million naira. Consumer instalment loans have proved particularly profitable to many banks. But, subject to the size of the loan, and when the customer's financial prospects justify the loan, banks should give first priority to the loan requests of good deposit customers in allocating their funds.

Moreover, since a loan must first be approved before it could go bad, it is essential that the officers involved in appraisal and approval process must be trained and have vast experience. Professional/academic qualifications in relevant discipline, in addition to in-house and external course, are necessary because once a mistake is made from the onset, it might be difficult to rectify. The study reminds the bank of the need to ensure that only well trained and capable hands should be involved in granting of loans.

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APPENDIX I

QUESTIONNAIRE

The study is to investigate into management of debts in banks. You are required to please fill the questionnaire as honestly as you can. You need not indicate your name. Information so supplied will be used for research purposes only.

SECTION A: **Personal Data:**

1. Age
2. Sex
3. Highest Educational Qualification
4. Extent of your service in the Bank
5. Cadre in the Bank

SECTION B:

The following questions intend to elicit some information about management of debts in your bank. Kindly rate each of them according to how important you think they are.

Rate each item following the format.

5 - Strongly agree

4 - Agree

3 - Indifferent

2 - Disagree

1 - Strongly disagree

Please tick (X) against the number that expresses your level of feelings.

POSSIBLE CAUSES OF DEBTS	5	4	3	2	1
1. Economic recession which has made many companies go bankrupt could cause bad debts.					
2. Prevailing economic difficulties which have caused many companies to operate below capacity could increase the incidence of bad debts.					
3. Attitudes of an enterprise management may endanger the banker's exposure; hence it is a key fact in loan repayment assessment.					
4 Lending to less credit worthy borrowers is more risky as it makes the loans borrowed to be bad debts with time.					
6. Bad management of account resulting to constant excess over limits agreed and failure to examine account and its workings.					
7. Incomplete knowledge of customer activities i.e. true nature and purpose of the borrowing not known.					

8. Excess lending on securing values e.g. over inflation of the value of mortgaged property.						
9. Bad judgement at the time loan was made could cause bad debts.						
10. From experience, what are the other causes:						
a)						
b)						
c)						
d)						

AVOIDANCE OF BAD DEBTS

11. Bad debts can be avoided if banks are ready to meet deposit withdrawals at any time.

12. Honesty, adequate staff training and experience are essential ingredients of minimizing incidents of bad debts.

13. All the well established principles of lending must be observed e.g. safety, suitability and profitability.

14. Objectives set before hand as to how the bank is going to lend and where.

15. Banks should meet legal reserve requirements.

16. Establishment of effective loan policy and administration.

17. Banks should hold enough vault cash to accommodate their

customers' request for currency.

18. There should be control over bank's total exposure.

19. What are your recommendations on effective credit management.

a)

b)

c)

d)

20. What procedures does your bank employ in recovering debts.

a)

b)

c)

Appendix II

Details of the Analysis

Responses to the questionnaire items

Items	Strongly Agree (5)	Agree (4)	Indifferent (3)	Disagree (2)	Strongly Disagree (1)
1	19	21	5	2	3
2	12	27	8	2	1
3	20	17	7	4	2
4	25	15	4	5	1
5	13	14	6	11	6
6	17	20	4	6	3
7	16	23	6	3	2
8	8	22	8	6	6
9	17	22	6	3	2
11	19	9	8	4	10
12	17	26	1	2	4
13	21	18	8	1	2
14	14	22	8	4	2
15	19	14	8	4	5
16	21	21	6	1	1
17	19	12	8	3	8
18	16	27	3	2	2

Hypothesis 1: State of the Economy

Items 1 and 2 of the questionnaire.

	5	4	3	2	1
O	16	24	9	2	2
E	10	10	10	10	10
O-E	6	14	-1	-8	-8
$(O-E)^2$	36	196	1	64	64
$\frac{(O-E)^2}{E}$	3.6	19.6	0.1	6.4	6.4

$= X^2c = 36.1$

Hypothesis II: Prudent financial Management

Items 3,5, and 6 of the questionnaire

	5	4	3	2	1
O	17	17	6	/	4
E	10	10	10	10	10
O-E	7	7	- 4	- 3.	- 6
$(O-E)^2$	49	49	16	9	36
$\frac{(O-E)^2}{E}$	4.9	4.9	1.6	0.9	3.6

$X^2c = 15.9$

Hypothesis III: Effective loan policy

Items 4,7 and 8 of the questionnaire

	5	4	3	2	1
O	16	20	6	5	3
E	10	10	10	10	10
O-E	6	10	-4	-5	-7
$(O-E)^2$	36	100	16	25	49
$\frac{(O-E)^2}{E}$	3.6	10	1.6	2.5	4.9

X^2c =22.6

Hypothesis IV: Staff experience/qualification

Item 9 of the questionnaire

	5	4	3	2	1
O	17	22	6	3	2
E	10	10	10	10	10
O-E	7	12	-4	-7	-8
$(O-E)^2$	49	144	16	49	64
$\frac{(O-E)^2}{E}$	4.9	14.4	1.6	4.9	6.4

X^2c = 32.2

Table V

Item	Strongly Agree (5)	Agree (4)	Indifferent (3)	Disagree (2)	Strongly Disagree (1)
11	19 (38%)	9 (18%)	8 (16%)	4 (8%)	10 (20%)
12	17 (34%)	26 (52%)	1 (2%)	2 (4%)	4 (3%)
13	21 (42%)	18 (36%)	8 (16%)	1 (2%)	2 (4%)
14	14 (28%)	22 (44%)	8 (16%)	4 (8%)	2 (4%)
15	19 (38%)	14 (28%)	8 (12%)	4 (8%)	5 (10%)
16	21 (42%)	21 (42%)	6 (12%)	1 (2%)	1 (2%)
17	19 (38%)	12 (24%)	8 (16%)	3 (6%)	8 (16%)
18	16 (32%)	27 (54%)	3 (6%)	2 (4%)	2 (4%)

TABLE VI

LOANS AND ADVANCE PROVISION FOR BAD AND DOUBTFUL DEBTS FROM 1987 - 1991.

	1987	1988	1989	1990	1991
	N'000	N'000	N'000	N'000	N'000
Total Assets	530,544	777,806	636,916	981,280	1,151,342
Deposits	297,923	427.457	335.231	604.255	796.580
Loans and Advances	98,742	162.161	168,596	180,063	223,006
Provision for bad & doubtful debt	1,142	1,636	2,895	17,067	29,916
Percentage of Provision for bad & doubtful debts to loans and advances	1.16%	1.01%	1.72%	9.48%	13.42%
Bad debts written of	406	494	1,356	14,263	13,636

Source: Compiled from annual reports and accounts of Habib Nigeria Bank Ltd.