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**IMPACT OF CREDIT RISK MANAGEMENT ON DEPOSIT
MONEY BANKS PERFORMANCE IN NIGERIA**

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ABSTRACT

This study examined the impact of credit risk management on deposit money banks performance in Nigeria using panel regression model on ten selected banks for the period 2001-2015. The performance proxy Profit after Tax (PAT) was made as function of Non-performing Loan Ratio (NPLR), Loan Loss Provision Ratio (LLPR), Loan to Total Asset Ratio (LTAR), Interest Rate (INTR) and Inflation Rate (INFR). Fixed effect, Random effect and Hausman test was conducted on the variables. The result from the panel analysis indicated that NPLR, LLPR and INTR exhibit a negative relationship while LTAR and INFR depict a positive relationship with deposit money bank performance. Based on this result, the study concluded that despite the various initiatives and reforms carried out by the government and the monetary authorities, high incidence of credit risk resulting from poor management is still prominent among the deposit money banks due to increased default in loans and advances recorded. Based on this findings, the study recommended that deposit money banks in Nigeria should always pay particular attention to their credit risk management policies in order to reduce the occurrence of non-performing loans recorded. Also, ensures compliance with banks' philosophy and set up effective system of internal control to monitor the risk control mechanisms so as to enhance the performance of deposit money banks' in Nigeria.

Keywords: *Profit after Tax, Non-performing Loan Ratio, Loan Loss Provision Ratio, Loan to Total Asset Ratio, Interest Rate, Inflation Rate.*

INTRODUCTION

The health of financial system has important role in the country while its failure can disrupt economic development (Das & Ghosh, 2007). Deposit money banks is like blood arteries of human body in developing economies especially in Nigeria as it accounts for more than 90 percent of their financial assets (Rwayitare, Shukla & Ruhara, 2016). Cohen (1986) aptly stated that these institutions provide the oil that lubricate the wheel of commerce, facilitate an efficient payment system and the main source of liquidity in the financial system. A bank exists not only to accept deposits from the savers but also to grant credit facilities. This intermediation function of banks gives rise to different types of risks with different magnitudes and level of causes on bank performance such as credit risk, liquidity risk, market risk, legal risk, foreign exchange risk, solvency risk and operational risk. Among these risks, credit risk is one of the most common causes of bank failures and the success of their business depends on accurate measurement and efficient management of credit risk more than any other risks (Kolapo, Ayeni & Oke, 2012).

Bank failures in Nigeria and other emerging economies have been attributed to improper lending practices, lack of experience, organizational and informational systems to adequately assess credit risk in the falling economy among others. High incidence of non-performing loans in the balance sheet reduces bank's profitability and thereby affects performance of banks (Uwalomwa, Uwuigbe & Oyewo, 2015; Ogbulu & Eze 2016; Kolapo, Ayeni & Oke, 2012). Bessis (2002) asserted that credit risk management is important to bank management because banks are 'risk machines' they take risks and transform them to banking products and services. Risks are uncertainties due to variations in expected returns. The dictum in finance says that "The higher the risk, the higher the return". Therefore, risk can be opportunity or threat. In order to get higher returns, bank can either take an increased risk or lower operating costs. Thus, managers must evaluate and balance the tradeoffs between risk and returns.

The success of credit risk depends on counterparty issues or borrower performance. Credit extended to borrowers may be at the risk of default such that

banks extend credit on the understanding that borrowers will repay their loans, some borrowers usually default and as a result, banks income decrease. To mitigate this exposure, Credit risk management framework in Nigeria thus become essential for banking system which would enhance the possibility of long term survival and growth. Efficient risk management practices handle risk in such a manner that one type of risk does not get transformed into any other risk. Deposit money banks' performance therefore, largely depend on the effectiveness of their credit management system because these institutions generate most of their income from interest earned on loans extended to small and medium entrepreneurs (Abiola&Olausi, 2014).

Iwedi and Onuegbu (2014) observed that despite creation of risks management department in all the deposits money banks (DMBs), whose responsibility is to manage the banks risk including credit risk, records have it that bad loans (non-performing loans) was as high as 35% in Nigeria deposits banks between 1999 and 2009. The greater level of non-performing loan rate in banks records, poor loan processing, inadequate or absence of loan collateral among other things are linked with poor and ineffective credit risks management that negatively affects banks' performance (Danjuma, Kola, Magaji&Kumshe, 2016).

In other to find a lasting solution to the recurring of nonperforming loans that bedeviled Nigerian banks, prompted the Federal Government of Nigeria to establish the Asset Management Corporation of Nigeria (AMCON) in July, 2010. Other efforts made by the Central Bank of Nigeria (CBN) to ensure sound and efficient financial institutions' performance are the recapitalization policy of July 2004, issuance of Prudential Guidelines, establishment of Nigeria Deposit Insurance Corporation (NDIC) in 1988 to protect depositors' funds, Fines and Sanctioning of Management, withdrawal of Licenses among others. Considering the importance policy makers and industry practitioners place on credit risk management as a distress prevention strategy, it is crucial to know whether this optimism is truly warranted.

In addition to this, empirical studies that examine the actual impact of credit risk management on bank's financial performance in Nigeria produced mixed results thereby leaving the academia and policy makers in quandary. Some studies on this topic show that credit risk management strategies impact on banks performance, but the impacts are of highly uncertain magnitude and conflicting

direction. The implication that emerges from these studies is that the impacts of credit risk management on banks performance are theoretically ambiguous. For example, researchers like Hamza (2017), Ajayi and Ajayi (2017), Adebawo and Enyi (2014), Ejoh, Okpa and Egbe (2014), Epure and Lafuente (2013) amongst others found evidence that credit risk management does not impact positively on banks profitability. In particular, while Ogbulu and Eze (2016), Abiola and Olausi (2014) found that credit risk management indicators significantly impacted on the performance of deposit money banks. Consequent to the unsettled empirical evidence, it is against this backdrop that the present study set out to empirically ascertain the impact of credit risk management on deposit money banks performance in Nigeria.

REVIEW OF RELATED LITERATURE

Credit Risk Management (CRM)

Lending operations are core banking activities and the most profitable asset of credit institutions. In many markets, banks have to operate in the economic environment that is characterized by the existence of obstacles to good credit management. Where credit is not properly channeled, controlled and administered, it leads to a devastating effect on the banks, reducing its performance, profitability and further into bank distress and failure (Berger & Christa, 2009). Credit risk emanates from a bank's dealing with individuals, corporations, financial institutions or a sovereign. Deposit money banks are exposed to credit risk through their trading, financing and investing activities and in cases where they acts as an intermediary on behalf of customers or other third parties or it issues guarantees. The amount of credit risk exposure in this regard is represented by the carrying amounts of the loans and advances on the balance sheet (Drigă, 2012).

Pânzaru(2011) noted that credit risk include three risks: default risk, exposure risk and recovery risk, while Arunkumar and Kotreshwar (2005) explained that in a bank's loan portfolio, credit risk includes the transaction Risk, intrinsic Risk and concentration Risk. For each of these aggregations, the bank should define appropriate and reasonable portfolio concentrations necessary to mitigate against the exposure. Credit risk management thus serve as a process of identifying, evaluating, monitoring and control of risk arising from the possibility of default in loan repayments by some borrowers and results in decrease in banks income due to the need to establish allowance for these bad debts. Credit risk management arises any time bank funds are extended, committed, invested, or otherwise

exposed through actual or implied contractual agreements, whether reflected on or off the balance sheet (Abiola&Olausi, 2014). Credit risk management incorporates decision-making process; before making the credit decision, follow up of credit commitments is done including all monitoring and reporting process. The credit decision depends on the financial data and judgmental evaluation of the whole market, borrower financial status, management and shareholders. The two distinct dimensions of credit risk management can be identified as *preventive measures* and *curative measures*. *Preventive measures* is ensuring better credit portfolio diversification through providing early warning signals of future defaults, it include risk evaluation, risk measurement and risk pricing. On the other side, the aim of *curativemeasures* is to minimize post-sanction loan losses through steps such as securitization, hedging trading, risk sharing, legal enforcement (Arunkumar&Kotreshwar, 2005; Kithinji, 2010).

Deposit Money Banks Performance

The financial performance of banks is expressed in terms of profitability and the profitability has no meaning except in the sense of an increase of net asset. Profitability is a company's ability to earn a reasonable profit on the owner's investment. Li and Zou (2014) defined profitability as a gauge of capability of the bank to bear risk and/or raise the capital of bank and it implies effectiveness of the bank and gauges the excellence of management. Deposit Money Banks's performance is ability to generate new resources, from day – to – day operation over a given period of time and being gauged by net income and cash from operation(Aktan&Bulut, 2008).

There are various measures of bank performance and the choice of the specific performance measure depends on the objective of the study. In the literature, the performance measures are: Profit after Tax (PAT), Return on Assets (ROA), Return on Equity (ROE) and cost to income ratio (CIR) and net interest margin (NIM) (Yuga, 2016). Thus, choice of the best measure of performance is tedious task (Ajayi&Ajayi, 2017). Therefore, studying the concept of bank performance sometimes generate different results depending on the nature of the stakeholders which analyze the term. Such multitude of opinions opens new directions in banking performance research, but this study points out single classical performance indicator Profit after Tax (PAT) which expresses the risk taking behaviour of bank management in obtaining the satisfied level of profit.

Empirical Review

Hamza (2017) examined the impact of credit risk management on performance of commercial banks in Pakistan. The pooled regression was adopted to determine the impact of credit risk management on two performance methods. The findings revealed that credit risk management is inversely associated with bank performance. For return on asset (ROA) analysis revealed that capital adequacy ratio (CAR), Loan loss provision ratio (LLPR), liquidity ratio (LR) and Non-performing loan ratio (NPLR) variables have significant impact on return on assets (ROA). The Loan loss provision ratio (LLPR), liquidity ratio (LR) and Non-performing loan ratio (NPLR) have negative while the capital adequacy ratio (CAR), loan and advances (LAR), and SIZE have positive impact on the return on assets. In relation to return on equity, the CAR, LAR and LLPR variables have significant impact on ROE. Therefore concluded that the credit risk management have inverse relationship with bank performance. Thus the management needs to be cautious about nonperforming loans, loan and advances and liquidity ratio because these ratios are severely affecting the profitability of banks. Moreover, capital adequacy contributes positively in bank performance so it should be managed.

Ajayi and Ajayi (2017) examined the effects of credit risk management on the performance of deposit money banks in Nigeria from 2001-2015. The study employed panel regression analysis in which Profit after Tax (PAT) was used as proxy for bank performance while Non-Performing Loan Ratio (NPLR), Loan Loss Provision Ratio (LLPR), Loan to Total Asset Ratio (LTAR) and Cost per Loan Ratio (CPLR) were used as indicators of credit risk management. Fixed effect, random effect and Hausman test were conducted on the variables. This study revealed that banks profitability is negatively influenced by NPLR, LLPR and CPLR. While LTAR influences performance of banks positively. The study therefore concluded that deposit money banks in Nigeria have a high growth rates on loans and advances, with corresponding high rate of non-performing loans by customers. Also, the provisions for loan loss were slightly below the required amount 8% by Basel Accord with high administration costs. The study thus recommended that Nigerian banks should ensure high quality credit management and strict adherence to professional banking ethics. Also, deposit money banks should make adequate effort toward deposit mobilization and reduce credit administrative cost so as to be more efficient and enhance profitability.

Ogbulu and Eze (2016) investigated the impact of credit risk management on the performance of deposit money banks in Nigeria using the ECM and Granger

causality techniques in addition to the IRF and VDC methodology. Data for the study were sourced from the CBN Statistical Bulletin and the Annual Reports and Accounts of the NDIC for the period 1989 to 2013. The findings indicated that the selected credit risk management indicators significantly impacted on the performance of deposit money banks measured as return on equity, return on total assets, and return on shareholders' fund respectively. However, the findings reported no evidence of significant granger causality relationship between the various credit risk management indicators and the various measures of performance except for a uni-directional granger causality relationship from ROE to RNPD and from ROTA to RNPS respectively. Based on the foregoing, the study recommended that deposit money banks in Nigeria should always pay particular attention to their credit risk management policies in order to significantly improve on the performance of these banks.

Adebawo and Enyi (2014) examined the impact of credit risk exposure on the market value of Nigerian Banks from 2006 to 2012 using correlation and Ordinary Least Square (OLS). Credit risk exposure model was used to predict the impact of credit risk exposure on the performance of the 18 banks listed on the Nigerian Stock Exchange as at December 31, 2012 including the 3 nationalized banks together with secondary data which were tested statistically. The findings revealed that banks' credit risk exposure did not have a strong influence on their market value and performance at $F = .793$ with P value of $.513$ significance. Conclusively, banks' risk analysis is an indispensable aspect of credit assessment and the credit risk exposure model developed for the study was found to be effective in predicting credit risk exposure for all the banks. The study recommended that banks' management should comply fully with statutory provisions.

Abiola and Olausi (2014) investigated the impact of credit risk management on the performance of commercial banks in Nigeria. Financial reports of seven commercial banking firms were used to analyze for seven years (2005 – 2011). The panel regression model was employed for the estimation of the model. In the model, Return on Equity (ROE) and Return on Asset (ROA) were used as the performance indicators while Non-Performing Loans (NPL) and Capital Adequacy Ratio (CAR) as credit risk management indicators. The findings revealed that credit risk management has a significant impact on the profitability of commercial banks' in Nigeria. The study also revealed that commercial banks with higher capital adequacy ratio can better advance more loans and absorb

credit losses whenever they crop up and therefore record better profitability. Thus recommended that the regulatory authorities should pay more attention to banks' compliance to relevant provisions of the Bank and other Financial Institutions Act 1991 and prudential guidelines.

Ejoh, Okpa and Egbe (2014) investigated the impact of credit risk and liquidity risk management on the profitability of deposit money banks in Nigeria with particular reference to First bank of Nigeria Plc. Descriptive research design was used for the study where questionnaires were administered to a sample size of eighty (80) respondents. The data obtained were presented in tables and analysed using simple percentages. The formulated hypotheses were tested using the Pearson product moment correlation. The results of the study revealed that there is a significant relationship between credit management and bank profitability and there is a significant relationship between bank liquidity and profitability among deposit money banks in Nigeria. Based on the findings, it was recommended that deposit money banks should set up effective system of internal controls to monitor the risk control mechanisms in use in order to ensure complete compliance with bank philosophy. Again, banks should always maintain a balance between deposit-loan ratio in order to avoid asset liabilities mismatch.

Kolapo, Ayeni and Oke (2012) carried out an empirical investigation into the quantitative effect of credit risk on the performance of commercial banks in Nigeria over the period of 11 years (2000-2010). Five commercial banking firms were selected on a cross sectional basis for eleven years. The traditional profit theory was employed to formulate profit, measured by Return on Asset (ROA), as a function of the ratio of Non-performing loan to loan & Advances (NPL/LA), ratio of Total loan & Advances to Total deposit (LA/TD) and the ratio of loan loss provision to classified loans (LLP/CL) as measures of credit risk. Panel model analysis was used to estimate the determinants of the profit function. The results showed that the effect of credit risk on bank performance measured by the Return on Assets of banks is cross-sectional invariant. That is the effect is similar across banks in Nigeria, though the degree to which individual banks are affected is not captured by the method of analysis employed in the study. Based on this findings, the study recommended that banks in Nigeria should enhance their capacity in credit analysis and loan administration while the regulatory authority should pay more attention to banks' compliance to relevant provisions of the Bank and other Financial Institutions Act (1999) and prudential guidelines.

MATERIALS AND METHODS

As at August, 2017, there are 22 banks listed at Nigerian Stock Exchange. By following the above mentioned criteria ten deposit money banks were selected on a cross sectional basis for fifteen years, this constitutes 45 percentage of the total population. The selected banks are First Bank Nigeria PLC, Guarantee Trust Bank PLC, Access Bank PLC, Diamond Bank PLC, United Bank of Africa PLC, Wema Bank PLC, Zenith Bank PLC, Sterling Bank PLC, Fidelity Bank PLC, and Eco Bank PLC. Data collected covers the period 2001–2015 sourced from the financial reports and accounts of the chosen banks.

These banks were chosen because in terms of credit score ratings, the banks have moved from stability to the positive credit rating and the banks have a large customer base and are active players on the Nigerian Stock Exchange (NSE). The study used a panel data research method design to determine the said objective of the study. As described by Hamza (2017) the panel data provides the benefit of controlling for the individual heterogeneity, lower multicollinearity in variables and the most suitable tool when the sample comprises cross-sectional and time-series data and the model are of the form:-

$$Y_{it} = (\beta + \beta_i X_{it} + e_{it}) \dots \dots \dots (1)$$

Where the subscript i represents Cross – Sectional dimension and t denotes the time series dimension. Y_{it} represent the deposit money banks performance i.e Profit after Tax while X_{it} stands for the explanatory variables such as Non-performing Loan Ratio, Loan Loss Provision Ratio, Loan to Total Asset Ratio, Interest Rate and Inflation Rate

Model Specification

The model for this study assumes an underlying relationship between impacts of credit risk management on deposit money banks performance in Nigeria. The study follows a similar research method used by Ajayi and Ajayi (2017), Kolapo, Ayeni and Oke (2012). For instance Kolapo, Ayeni and Oke (2012) econometric model are stated as:

$$ROA = f\left(\frac{NPL}{LA}, \frac{LLP}{CL}, \frac{LA}{TD}\right) \dots \dots \dots (2)$$

Where:

- ROA: Return on Assets
- NPL: Non-Performing Loan
- LA: Loan and Advances
- LLP: Loan loss provision

CL: Classified Loan

TD: Total Deposit

Therefore the empirical model aimed at determining the impacts of credit risk management on deposit money banks performance in Nigeria takes non-performing loan ratio, loan loss provision ratio, loan to total asset ratio as internal banks factors and interest rate and inflation rate as external/micro-economic factors. Thus, expressed as:

$$PAT = f(NPLR, LLPR, LTAR, INTR, INFR) \dots \dots \dots (3)$$

This specified model can be written in testable form as follows:

$$PAT_{it} = (NPLR_{it} + LLPR_{it} + LTAR_{it} + INTR_{it} + INFR_{it} + U_{it}) \dots \dots \dots (4)$$

Where:

PAT = Profit after Tax

NPLR = Non-performing Loan Ratio

LLPR = Loan Loss Provision Ratio

LTAR = Loan to Total Asset Ratio

INTR = Interest Rate

INFR = Inflation Rate

μ_{it} = Error terms; $i = 1, \dots N$; $t = 1, \dots T$

A Priori Expectation

The following are the expected relationship between the dependent and explanatory variables in the model. $\delta > 0$, $NPLR < 0$, $LLPR < 0$, $LTAR < 0$, $INTR > 0$, $INFR > 0$

Where: δ = constant parameter

RESULTS AND DISCUSSION OF FINDINGS

Estimates of Parameters for Panel Regression Model

Table 1: Random Effect (RE) and Fixed Effect (FE) Specification Test

Dependent Variable PAT		
Independent Var	Fixed Effects	Random Effects
Constant	27.83895*** (3.759240)	28.04290*** (3.790018)
NPLR	-0.013132 (0.154397)	-0.046822 (0.153595)
LLPR	-0.276399* (0.151346)	-0.278516* (0.150833)

LTAR	0.805907** (0.366353)	0.762309** (0.364318)
INTR	-5.466068*** (1.156563)	-5.434061*** (1.154273)
INFR	0.044018 (0.421646)	0.042922 (0.421510)
No. observations	114	114
R-squared	0.865862	0.349685
Adjusted R ²	0.846893	0.319578
F-statistics	45.64598	11.61467
Prob. (F-Statistics)	0.000000	0.000000
Dubin-Watson	1.075401	0.000000

Note: Standard errors are reported in parentheses. *, **, *** indicate significance at 10%, 5% and 1% level respectively.

Source: *Authors' Computation (2017)*

The result of the fixed effect and random effect estimation in table 1 indicated 0.87 (87%) and 0.35 (35%) of the systematic variation in the dependent variable (PAT) is explained by the five independent variables, computed as non-performing loans ratio, loan loss provision ratio, Loan to total asset ratio, interest rate and inflation rate. The F-statistic value in both estimates are significant at 1% level, which also indicates that there is a linear relationship between deposit money banks performance, that is, profit after tax and the five independent variables. This also indicates the goodness of fit of the estimated model.

Moreover, the result displayed in table 1, showed that the regression coefficient of non-performing loan ratio in fixed and random effect estimates are -0.013132 and -0.046822 units respectively with their corresponding probability greater than 5%. This implies that non-performing loan ratio has a negative and insignificant relationship on deposit money banks performance in Nigeria. This result is consistent with the *a priori* expectation stated early and also consistent with the findings of Ajayi and Ajayi (2017), Hamza (2017), Ogboi and Unuafe (2013), but the result negate the work of Abiola and Olausi (2014) Taiwo, Ucheaga, Achugamonu, Adetiloye, Okoye and Agwu (2017). The negative relationship between non-performing loans and deposit money banks indicates that, non-performing loans reduces profitability of deposit money banks in Nigeria. The

result also indicated the inability of the deposit money banks to effectively manage their credit risk. An increase in non-performing loans also may be seen as a signal of lower profitability due to greater amounts of cash given to borrowers relative to those received from depositors.

The regression coefficient of loan loss provision ratio in both estimates stood at -0.276399 and -0.278516 units respectively with their corresponding probability greater than 5%. Meaning that using fixed and random effect loan loss provision ratio depicts an insignificant relationship with deposit money banks performance in Nigeria. This results support the *a priori* expectation stated early and also support the work of Hamza (2017)

In addition, loan to total asset ratio was found to be positive and significantly related to deposit money banks performance with a value of 0.805907 and 0.762309 units respectively for fixed and random effect model. The significant relationship of this variable implies that deposit money banks' exposure to credit risk in terms of this variable is high. Meaning that banks with higher loan to total asset ratio have high exposure to credit risk. Also, from table 1, interest rate depict a negative and significant relationship in both fixed and random effect results with a value of -5.466068 and -5.434061 units respectively. The implication of this result is that the changing of higher rates is likely to discourage microenterprises from accessing loans from deposit money banks. Those who are able to take up such loans may also find it very difficult to repay because of the exorbitant interest rates. This situation has the tendency of creating '*loan-losses high-interest cycle*' phenomenon. This result is consistent with the work of Abiola and Olausi (2014). The regression coefficient of inflation rate stood at 0.044018 and 0.042922 units for both estimation regression model. This implies that a unit increase in inflation rate will lead to 0.044018 and 0.042922 units increase in deposit money banks performance in both fixed and random effect model. The implication of this result is that, higher inflation makes debt servicing easier by reducing the real value of outstanding loans.

Table 2: Result of Hausman Test

Correlated Random Effects - Hausman Test			
Test Summary	Chi-Sq. Statistic	Chi-Sq. d.f.	Prob.
Cross-section random	10.960551	5	0.0522

Source: *Authors' Computation (2017)*

From the result in table 2 the chi-square value is 10.96 alongside a probability value of 0.0522. Thus, the Hausman test result indicated that there is no enough evidence to reject the null hypothesis of no substantial difference between fixed effect estimates and random effect estimates. Meaning that there is no correlation between the random effect incorporated into the composite error term and the other regressor. Thus, rejection of the null hypothesis implies that error component model (random effect estimator) is not appropriate because the random effects are probably corrected with one or more regressors. From the foregoing, it thus stands that among the two estimators (fixed effect and random effect) used for analysis in this study, random effect estimator is most efficient and consistent estimator that can track the true nature of the impact of credit risk management on deposit money banks performance in Nigeria.

CONCLUSION AND RECOMMENDATIONS

In this fast economic world the banks are considered as backbone for the acceleration of economic activities because they play pivotal role but banks have to face several types of risks because risk is inherited to banking operations and the most severe one is credit risk. The continuity of business of the banks is only possible if the business of the bank is not damaged by the negative winds of credit risk. Thus, this study examine the impact of credit risk management on deposit money banks performance in Nigeria. The findings demonstrate succinctly, that the selected credit risk management indicators under study affect the performance of deposit money banks in Nigeria. The findings also indicates that the sampled have poor credit risk management practices; hence the high levels of the non-performing loans in their loans portfolios.

Based on this result, the study concluded that despite the various initiatives and reforms carriedout by the government and the monetary authorities, high incidence of credit risk resulting from poor management is still prominent among the deposit money banks due to increased default in loan and advances recorded. Based on this findings, the study recommended that deposit money banks in Nigeria should always pay particular attention to their credit risk management policies in order to reduce the occurrence of non-performing loans recorded. Also, ensures compliance with banks' philosophy and set up effective system of internal control to monitor the risk control mechanisms so as to enhance the performance of deposit money banks' in Nigeria.

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