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MONITORING ACTIVITIES AND NON-PERFORMING LOANS OF FINANCIAL INSTITUTIONS IN NIGERIA

Keywords: audit quality, board independence, monitoring.

J E L Classification: G21, M41, H81.

Abstract: Recent complexities in the Nigerian financial sector underscore the critical need for effective monitoring activities to mitigate the risks associated with non-performing loans (NPLs). This study investigates how monitoring activities, particularly focusing on board independence and audit quality, affect NPLs in Nigerian financial institutions. Data were obtained from the annual reports of selected financial institutions covering the period from 2010 to 2022. The population includes all eleven categories of financial institutions in Nigeria as of December 31, 2022. However, a purposive sampling approach was employed, focusing on four specific categories, totaling 38 financial institutions. The feasible generalized least squares regression method was used for data analysis to ensure a robust and reliable result. The findings reveal that while board independence negatively impacts NPLs, the effect is not statistically significant.

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Conversely, audit quality shows a negative and significant effect on NPLs. The findings suggest that both board independence and audit quality have the potential to mitigate the incidence of non-performing loans in Nigerian financial institutions. However, the significance of their effects varies. Recommendations include enhancing board members training and development, mandating high-quality audits, and strengthening regulatory oversight to improve monitoring capabilities.

Introduction

The financial institutions in Nigeria indeed play a crucial role in the economic growth, development, and stability of the country. They facilitate the allocation of resources, mobilization of savings, and the funding of businesses and infrastructure projects. However, the persistent issue of non-performing loans (NPLs) within the sector remains a significant threat to its stability in some parts of the world despite the existing regulatory frameworks and monitoring activities. In Africa, Comoros, Kenya, Djibouti, and Zambia perform beyond a threshold of 5%, while in Europe, San Marino, Ukraine, Greece, and Cyprus perform beyond a single digit (World Database, 2020).

According to Ojeka, Adegboye and Dahunsi, (2021), non-performing loans in Nigeria have shown a considerable fluctuation over the years. For instance, NPLs peaked in 2009 with a ratio of 37.25%, marking a period of severe financial distress. The ratio subsequently fell to its lowest point of 2.96% in 2014, indicating a period of recovery and improved asset quality. However, this improvement was not sustained, as the NPL ratio rose again to 12.82% in 2016 and further to 14.81% in 2017. By 2018, the NPL ratio had decreased slightly to 11.67%. In 2021, the rate of NPLs stood at 4.85%, demonstrating a significant improvement from the previous years and suggesting a positive trend towards financial stability. Zhao and Ooi (2023) argue that weak monitoring was at least partly responsible for the elevated levels of NPLs, which ultimately led to distress in the financial sector.

The accumulation of NPLs in Nigeria's financial sector has had severe repercussions, including capital erosion, profit depletion, and the liquidation of numerous financial institutions (Bebeji, 2013). This issue has been persistent, with significant spikes observed at various intervals. For instance, Chijioke (2018) highlighted that weak monitoring activity, including breaches of governance rules and disharmony among board members, contributed to the deterioration of risk asset quality at Diamond Bank Plc. This impairment in asset quality was significant enough that it eventually led to Diamond Bank's takeover by Access Bank Plc in April 2019. Furthermore, Femi and Msugh (2021) identified that the Bank of Agriculture (BoA) faced challenges in recovering over ₦77 billion in loans due to inadequate monitoring activities. This issue was primarily attributed to the lack of an independent board to oversee and monitor the actions of the executive directors.

While there is a substantial literature on the causes and determinants of NPLs, research focusing on the effectiveness of monitoring activities and their impact on NPLs in Nigeria remains scanty and needs further empirical investigation. This gap hinders the development of effective strategies to attenuate the incidences of NPLs. To address the issue of NPLs and improve the stability of Nigeria's financial sector, it is crucial to enhance monitoring activities. This can be effectively achieved through strengthening board independence and improving the quality of audits (Ofei, Owusu & Asante, 2020). The present study aims to evaluate the monitoring activities and the non-performing loans of financial institutions in Nigeria, seeking to fill the gap in previous research that focused exclusively on deposit money banks.

Literature review

Non-Performing Loans: Nigeria's Perspective

According to the Central Bank of Nigeria (CBN) prudential guidelines (2010), NPLs are defined as loans for which the interest or principal payments have not been made for 90 days or more. Additionally, loans can also be classified as non-performing if the interest payable is equal to 90 days or more and has been rolled over into a new loan. This definition underscores the significance of timely loan repayments and the challenges posed by non-performing loans to the stability and health of financial institutions. The CBN prudential guidelines classify non-performing loans into four categories based on the duration of their delinquency. This classification helps in determining the appropriate provisioning requirements for these loans. The categories are substandard, doubtful, very doubtful, and lost. In the opinion of Wafula, Muli, and Bulla (2023), the accumulation of non-performing loans has significantly contributed to reduced profitability and, in some cases, the collapse of financial institutions. Scholars such as Wafula et al. (2023) and Ogbebor, Osundina and Oyamendan (2020) measured non-performing loans as the amount of loan defaults divided by the total loan outstanding.

Monitoring Activities

The monitoring function is very important to the success of financial institutions. Loans represent one of the riskiest assets being paraded by financial institutions from time to time. With this, management needs to commit reasonable time and energy to monitor their loan portfolio (Oba, 2015). Monitoring in the line of thinking of Ahmed and Ng'anga (2020) includes the assessment of control structure in an organization every time. The objective of monitoring, as enunciated by Umar and Dikko (2018), is to assess if controls put in place by the management are properly adhered to. Thus, monitoring entails the level of supervision carried out by the management to ensure that assets created do not go bad.

Board Independence

As posited by Islam (2020), board independence represents another layer of monitoring activities, as it discourages the opportunistic tendencies of the Management who acts as agents. The role of independent non-executive directors served as a monitoring mechanism for overseeing the performance and activities of executive directors and management. Overall, their presence was essential to enhancing the board's effectiveness (Sanni, Shali & Kanwai, 2019). This structure not only ensures effective management and decision-making but also promotes transparency, accountability, and stakeholder confidence. By maintaining a balanced and well-functioning board, companies can better navigate challenges and achieve sustainable growth and success. Furthermore, Potharla and Kolpula (2023) opine that board independence engenders stable performance. Through independence, interest of the shareholders is adjudged protected and hence mitigates agency theory (Rashid, 2017).

Audit Quality

Illiemena and Okolocha (2019) explain that audit is the systematic examination of the financial accounts by an independent person (auditor) in a bid to express opinion regarding the truth and fairness of the accounting records. What this translates to is that auditors are involved in assurance engagement and emphasis must be placed on audit quality. The pillar of audit quality as explained by Chaari, Belanès and Lajmi (2022) view audit quality from the totality of internal audit, audit committee and external audit. From the perception of Lisa, Orbaningsih and Aditya (2023), audit plays important role in attenuating NPLs through credit assessment and improvement in the processes and procedures. However, there are lots of factors that determine audit quality of a firm. This includes, and is not limited to, qualification experience, independence, audit fees, audit firm rotation, audit firm size, audit committee functions, and audit firm specifics such as competence (Illiemena & Okolocha, 2019). Muotolu and Nwadialor (2019) opine that the big audit firms have high exposure while carrying out audit assignment. As conceptualized in this study, audit quality represents a situation where the financial statements of the financial institutions are being audited by one of the Big 4 audit firms.

Theoretical review

Agency Theory

This theory was propounded by Jensen and Meckling (1976) and has attracted attention from various disciplines, particularly accounting, finance, economics, law, and political science. According to Felix (2017), agency theory highlights the inherent conflicts of interest between business owners and managers and underscores the importance of mechanisms to align their interests. Sanni et al. (2019) reinforces the theory by recognizing the critical role of the board of directors in mitigating these conflicts. Through independent oversight, regular audits, and robust governance structures, the board can effectively suppress opportunistic behaviors of management, thereby protecting the interests of shareholders and ensuring the long-term success of the organization.

Review of Empirical Studies and Development of Hypotheses

This study examined the effect of monitoring activities on non-performing loans (NPLs) within financial institutions in Nigeria. Key findings are compared with analogous studies conducted in regions such as, e.g., Asia, the US, and other African countries to highlight similarities and differences.

Board Independence and Non-Performing Loans

Studies have shown varying impacts of board independence on non-performing loans (NPLs) across regions. In Indonesia, Kartika, Sulistyyowati, Septiawan and Indriastuti (2022) found a negative but non-significant relationship between board independence and NPLs. In the same region, Ramadhanti, Butar and Pangaribuan (2021) posited that board independence has potentials to dip NPL ratios of banks. Similarly, Ejaz, Aziz and Anam (2021) submitted that board independence significantly diminished NPLs in 129 Islamic banks across 29 OIC member countries, indicating better asset quality. Comparable findings were reported in the United States, where Islam (2020) proved effectiveness of board independence at reducing the incidence of NPLs in financial institutions. In Jordan, Al Zobi, Shubita, Alomari, Almatarneh and Alrawashdeh (2019) concluded that board independence significantly improves asset quality in commercial banks. Hence, these studies underscore the importance of board independence in curbing loans default in their various domains. Though, Ejaz et al.'s findings focus specifically on Islamic banks, contrasting with the broader scope of studies like Kartika et al. and Al Zobi et al. on Indonesian and Jordanian banks. Comparable results were found in the United States, where specific monitoring activity (board independence) in the study conducted by Islam (2020) proved effective in addressing NPLs of financial institutions, suggesting a universal applicability of this mechanism.

Studies in various regions have shown contrasting effects of board independence on non-performing loans (NPLs). In Tunisia, Budetola, Nmari and Towo (2023) claimed that board independence tends to increase NPL levels in commercial banks, indicating a higher impact on loan defaults. Similarly, in Tanzania, Mwambuli and Mbuya (2020) demonstrated a positive relationship between board independence and NPLs, suggesting that board independence does not necessarily guarantee effective oversight in financial institutions. Likewise, in Sri Lanka, Balagobei (2019) concluded that board independence has no significant influence on NPLs, demonstrating its limited effectiveness as a control mechanism in this region. In Ghana, Akwaa-sekyi and Gene (2016) found a positive but statistically insignificant relationship between board independence and NPLs, implying that board independence alone may not have a meaningful impact on performance in the Nigerian context. These studies demonstrate varying effects of board independence on NPLs across regions.

While it often improves asset quality (e.g., in Indonesia, Islamic banks, the US, and Jordan), there are contexts (e.g., Tunisia, Tanzania, Ghana, and Sri Lanka) where the impact is negligible or even counterproductive. This suggests that the effectiveness of board independence depends on factors such as regulatory environments, cultural differences, and institutional structures.

In the light of the above empirical and theoretical bases, the study advanced a hypothetical proposition in a null form as stated below:

H1: Board independence has no significant effect on the non-performing loans of financial institutions in Nigeria.

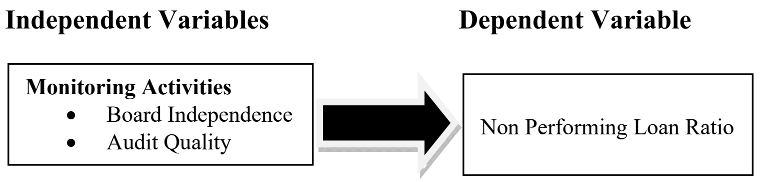
Audit Quality and Non-Performing Loans

Various studies have shown convergent and divergent views on how audit quality, through the use of Big 4 audit firms affects non-performing loans of financial institutions. For instance, Handajani, Akram and Sakarina (2024) in a study conducted in Indonesia submitted that audit quality significantly reduced NPLs of banks. Additionally, Sen, Abedin, Hossain and Ghosh (2022) found in Bangladesh that audit quality has a negative and significant effect on non-performing loans of banks in the region; Monametsi and Agasha (2020) in Botswana and Uganda found a negative and non-significant effect on audit quality and NPLs. In the study conducted in Tunisia among the commercial banks by Zgarni, Fedhila and Gaied (2018), the results showed that audit quality had a negative and not significant effect on asset quality, as measured by discretionary provisions. All these results suggest that audit quality has capacity to improve the assets quality of banks across regions.

However, Koutoupis and Malisiovas (2023) in Vietnam and the United States found a positive and significant relationship between audit quality and credit risks, thereby highlighting regional differences in the impact of audit quality which could be attributed to factors such as economic environment, cultural factors, firms' characteristics, and institutional trusts. Thus, drawing from existing empirical submissions, the current study equally proposed in a null form that:

H2: Audit quality has no significant effect on the non non-performing loans of financial institutions in Nigeria.

Figure 1. Conceptual Framework Schema



Source: authors' compilation.

Methodology

The study is a longitudinal analysis of non-performing loans in financial institutions in Nigeria, utilizing data obtained from secondary sources, specifically from annual reports spanning the period 2010 to 2022. The base year was significant for the Nigerian financial sector, which saw continued banking reforms and recapitalization efforts aimed at ensuring stability and boosting confidence within the industry (Nwosu, Okedighba & Anih, 2020). The sample frame of the study includes all eleven categories of financial institutions in Nigeria as of December 31, 2022. These categories are deposit money banks, development financial institutions, non-interest banks, and merchant banks. However, the study focuses purposively on four specific categories of these financial institutions, comprising a total of 38 elements based on their distinctive financial characteristics and roles within the Nigerian financial sector.

Analyses were conducted using descriptive and inferential statistics, particularly the feasible generalized least squares regression method, to address heteroscedasticity and autocorrelation in the pooled data. The model was adapted from Afolabi, Ogunleye, and Olukoya (2020), who studied the impact of internal control systems on the financial performance of deposit money banks in Osun State, Nigeria, suggesting a tailored theoretical framework for this study. The model is as follows:

$$NPLR_{it} = \beta_0 + \beta_1 BI_{it} + \beta_2 AQ_{it} + e_{it} \tag{1}$$

Where:

$NPLR_{it}$ = Non-Performing Loans Ratio (NPLR) of bank i at time t, as dependent variable

BI_{it} = Board Independence of bank i at time t, as independent variable
AQ_{it} = Audit Quality of bank i at time t, as independent variable
$it_{2010–2022}$ = Annual time series of the pooled data
β_0 = Constant Parameter
β_1 = Parameter Estimate (Board Independence)
β_2 = Parameter Estimate (Audit Quality)
e_{it} = Stochastic error time

Table 1. Measurement of Variables

Variables	Proxies/Notation	Description	Measurement	Source
		Dependent Variables		
Non-performing Loan	Non-performing Loan Ratio (NPLR)	Loans that are classified in line with the CBN prudential guidelines.	Non-performing Loan divided by Total loans	Pham (2021)
		Independent Variables		
Monitoring	Board Independence (BI)	Scenario whereby outsider directors dominate the board structure	Ratio of non- executive directors / total directors.	Abdulazeez et al. (2019)
	Audit Quality (AQ)	External auditors belonging to Big 4	Dummy variables of 1 for the use of Big 4 audit firms and 0 if not.	Ado et al. (2020)

Source: authors' collection.

Results and Discussions

Descriptive Statistics

As indicated in Table 2, the descriptive analysis showed that, on average, the non-performing loan ratio among the chosen Nigerian financial institutions hovers at approximately 10% over the period under review. This level is considered high compared to the best international practices, which typically recommend an NPL rate of approximately 5% (CBN, 2010). The average mean score of 58% in Board Independence (BI) suggests a dominance of non-executive members in the board composition, which is beneficial for the sampled financial institutions. The smallest observation was 0%, indicating an absence of non-executive members on the board, while the highest was 94%.

Audit Quality (AQ) has a mean value of approximately 0.88, implying that 88% of the financial institutions under review use one of the Big 4 firms for audit engagement. The minimum value of 0 suggests that some financial institutions do not engage a Big 4 audit firm, while the maximum value of 1 indicates those that do. The mean value of 24 years for Firm Age (FA) signifies that financial institutions in Nigeria have been listed on the Nigeria Stock Exchange for over two decades. The minimum value of one year implies that some financial institutions have just been listed, while the maximum value of 53 years suggests that some banks in the sample have been listed for five decades. In addition, all variables have positive kurtosis, which implies a distribution with more extreme values than the normal distribution. This indicates the presence of outliers or data points that are significantly higher or lower than the mean, suggesting greater variability in the dataset.

Table 2. Results of Descriptive Statistics

Variables	Mean	Std. Dev.	Minimum	Maximum	Skewness	Kurtosis
NPLR	0.10	0.16	0	1.07	3.01	12.65
BI	0.58	0.21	0	0.93	-1.32	4.82
AQ	0.87	0.32	0	1	-2.29	6.25

Source: authors' computation.

Post-Estimation Test

The result from the Breusch-Pagan/Cook-Weisberg test, in Table 3 indicates the presence of heteroscedasticity in the regression model. The test result shows that the reported statistics have a p-value of 0.0000, which is less than the significance level of 0.05 (indicated by "< 0.005"). Similarly, the autocorrelation test conducted through Breusch-Godfrey LM test manifests serial autocorrelation with the reported statistics < 5%. Given the presence of heteroscedasticity and serial autocorrelation, the study recommends the use of feasible generalized least squares for regression analysis because it provides more efficient and reliable estimates of the regression coefficients and their covariance matrix under heteroscedastic conditions (Popoola, Ishaya & Aisha, 2021).

Table 3. Diagnostic Test

Diagnostic Test	Test Method	Test Statistic	P-Value
Heteroskedastic	Breusch-Pagan	Chi2(1) = 98.49	0.0000
Autocorrelation AR(1)	Breusch-Godfrey LM	Chi2 = 36.90	0.0000

Source: author's computation.

To investigate the effect of monitoring activities on the non-performing loans of financial institutions in Nigeria, the study employs the use of FGLS results to achieve the objective. From the result in Table 4, coefficient for board independence is -0.0005 with a p-value of 0.971. This indicates that board independence has a negative but not significant effect on the NPLs of financial institutions in Nigeria. The high p-value suggests that the relationship is not statistically significant. The coefficient for audit quality is -0.0888 with a p-value of 0.000. This indicates that audit quality has a negative and significant effect on the NPLs of financial institutions in Nigeria. The low p-value indicates that this relationship is statistically significant, suggesting that higher audit quality is associated with lower NPLs. The statistical outcome indicates that the null hypothesis, which states that monitoring does not have a significant effect on the NPL, is rejected. This conclusion is based on the Wald statistic, which are 42.91 with a p-value of 0.0000. The Wald statistic of 42.91 is significantly high, and the p-value of 0.0000 indicates that the probability of observing such a result under the null hypothesis is virtually zero. Therefore, we have strong evidence to conclude that monitoring does indeed have a significant effect on the NPL.

Table 4. Regression Analysis of Monitoring Activities on NPLs

NPLR	Coef.	Std. Err.	P> |z|	[95% Conf. Interval]	
BI	-.0005	.0142	0.971	-.0284	.0274
AQ	-.0888	.0136	0.000	-.1155	-.0621
_cons	.1445	. .0152	0.000	.1147	.1744
		Wald Chi2(2) =	42.91		

Prob. > chi2 =	0.0000

Source: authors' computation.

Discussion of the findings

Effect of Monitoring Activities on Non-Performing Loans

Statistical inferences from Table 4 indicate that Board Independence (BI) has a negative but not significant effect on NPLs of financial institutions in Nigeria. This suggests that an increase in board independence is associated with a reduction in NPLs, although the relationship is not statistically significant. This finding resonates with the studies of Kartika et al. (2022), Ramadhanti et al. (2021) conducted in Indonesia, Motaz et al. (2019) in Jordan, Islam (2020) in the United States, and Ejaz et al. (2021). However, notable differences were observed when comparing this study's result with those of Budetola et al. (2023) in Tunisia, Mwambuli and Mbuya (2020) in Tanzania, and Balagobei (2019) in Sri Lanka, showing that board independence tends to increase NPL levels in financial institutions, which indicates a higher impact on loan defaults. This divergence may stem from potential reason, such as differences in economic conditions, regulatory frameworks, cultural attitudes toward risk management and institutional characteristics.

The information presented in Table 4 further highlights the effects of audit quality on Non-Performing Loans in Nigerian financial institutions. The result showed that the use of Big 4 audit firms has a negative and significant effect on NPLs. This suggests that employing Big 4 auditors can lead to a reduction in the incidence of NPLs. In tandem with this outcome were the studies of Handajani et al. (2024) in a study conducted in Indonesia, Sen et al. (2022) in Bangladesh, Monametsi and Agasha (2020) in Botswana and Uganda, including Zgarni et al. (2018) in Tunisia. The underlying reason is that audits by these firms provide a high level of assurance regarding compliance with effective control mechanisms. However, Chaari et al. (2022), notes that Big 4 audit firms possess extensive exposure, experience, and superior human resources, enabling them to handle complex audits more effectively. At variance with the result of this study were Koutoupis and Malisiovas (2023) in the study conducted in Vietnam and the United States that found a positive and significant relationship between audit quality and credit risks.

In summary, the effectiveness of audit quality at reducing non-performing loans is occasioned by its direct role in enhancing the accuracy of financial reporting, strengthening internal controls, and identifying the potential risk areas. Board independence, though crucial for overall governance, does not have the same immediate impact on credit risk management because they are not directly involved in the day to day risk assessment and credit decision process.

The mechanisms underscoring audit quality's stronger role are embedded in its direct impact on financial reporting accuracy, internal controls, risk assessment, and regulatory compliance. These factors make audit quality a more effective tool in managing credit risk and attenuating non-performing loans in financial institutions.

Conclusion and Recommendations

The objective of the study was to investigate the effect of monitoring activities on the non-performing loans of financial institutions in Nigeria using board independence and audit quality as proxies of investigation. The results obtained through the use of the FGLS method suggest that the increase in board independence might be linked to the reduction in NPLs. However, the effect is not strong enough to be statistically significant. Similarly, audit quality, on the other hand, was found to have a negative and significant effect on NPLs. This indicates that higher quality audits are effective in reducing the incidence of NPLs, highlighting the importance of rigorous and high-standard auditing practices in financial institutions.

The implication of the findings highlights the importance of robust monitoring mechanisms in maintaining the health of the financial sector. By improving board independence and audit quality, financial institutions can better manage risks associated with non-performing loans. These measures will not only enhance financial stability but also bolster investor confidence in the Nigerian financial sector. In view of this, the study recommends strengthening of monitoring capabilities through training and development for board members to improve their effectiveness, as independence alone does not show significant impact. In addition, policy makers should mandate the use of high quality audits and strengthening of regulatory oversights. By adopting these recommendations, financial institutions, regulators can work together to enhance quality of monitoring leading to reduction of non-performing loans. Future research should consider including a broader range of financial institutions such as microfinance banks, insurance companies, and non-bank financial institutions to see if the findings hold across different segments of the financial sector.

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