Effect of Non-Performing Loans and Advances on Gross Domestic Product in Nigeria

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Abstract
This study examined the effect of non-performing loans and advances (NPL) on economic growth in Nigeria, using selected banking sector indicator, non-performing loans and advances. As the independent variable while real gross domestic product was used as the dependent variable. The study adopted an ex facto research design, where data were sourced from the CBN Annual Statistical Bulletin 2000–2022. The study adopted the Augmented Dickey-Fuller (ADF) unit root test to test for the stationarity of the variables, multiple regression and Johansen co-integration rank test. The findings showed that non-performing loans and advances exert a negative and significant effect on real gross domestic product (RGDP). The study therefore concluded that the Nigerian banking sector plays a critical role in influencing macroeconomic outcomes. Particularly, the level of non-performing loans is detrimental to economic growth, as it reflects inefficiencies in credit risk management and a fragile lending environment. The researchers' recommended that, banks and regulators must reinforce risk assessment and loan monitoring frameworks to reduce the volume of non-performing loans.

Keywords: *bank distress, economic growth, Nigeria, non-performing loans, real gross domestic product*

Background to the Study

The banking sector plays a critical role in the economic growth and development of any nation by facilitating financial intermediation, mobilizing savings, and allocating credit to productive sectors. According to Osoro (2018), investing in capital, whether from inside or outside the country, needs to use up surpluses in the economy. The economy's financial system creates the conditions for this investment to happen. Similarly, Ibekwe, Ibekwe, and Nnebe (2023) noted that the banking system provides a major institutional mechanism for the mobilization of minuscule and not-so-minuscule resources from surplus units and for channeling it to the deficit units through the extension of loans and advances. Thus, the

efficiency with which this was done greatly influences the savings-investment process and has implications for the management of the economy and the attainment of sustained growth and development. In Nigeria, the banking sector has been central to economic growth by supporting businesses, individuals, and government activities. However, the recurrent issue of bank distress has posed significant challenges to the stability and efficiency of the financial system, thereby affecting the nation's economic growth (Ayodeji and Abolade, 2020).

According to Nkiri and Ofoegbu (2022), banking crises or distress can be triggered by structural weaknesses in the financial system, including persistent illiquidity, insolvency, undercapitalization, high levels of non-performing loans, and weak corporate governance. It typically begins when a bank struggles to meet its financial obligations to stakeholders. In many cases, this leads to large-scale credit recalls and withdrawals by customers, sometimes necessitating liquidity support from the Central Bank of Nigeria. Similarly, Ibekwe et al. (2023) defined bank distress as a situation where a financial institution faces severe liquidity shortages, insolvency, or operational inefficiencies, ultimately rendering it incapable of meeting financial commitments. This often results in a loss of depositor confidence, reduced credit availability, and, in extreme cases, bank failures. Osoro (2018) emphasizes that bank distress refers to a severe downturn in banking operations, leading to significant disruptions and financial strain. This distress can arise from various factors, including inconsistent policies, fraudulent activities, mismanagement of loans and advances, interference from board members, and weak internal controls. The causes of bank distress can be classified into intrinsic factors—such as poor governance and operational inefficiencies and extrinsic factors, including economic instability and regulatory inconsistencies.

Bank distress can be attributed to various internal and external factors, including adverse economic conditions, restrictive policies, poor environmental management, regulatory changes, undercapitalization, non-performing loans, liquidity issues, mismanagement, fraud, inflation, and fluctuating interest rates (Osoro, 2018). These challenges continue to threaten the stability and efficiency of the banking sector. Despite several reforms aimed at improving the Nigerian-banking sector, significant progress remains largely unattained (Soludo, 2004). According to Soludo, these reforms were designed to strengthen financial institutions, ensuring long-term stability, increased shareholder returns, and overall economic growth. However, industry evaluations by the Central Bank of Nigeria (CBN) in 2014 and 2015 suggest that these goals have not been fully met. Interest rates continue to be excessively high, fluctuating between 25% and 30%, while banks exhibit reluctance in extending credit to the real sector. Even when borrowers are willing to accept loans at prevailing rates, stringent lending conditions have hindered productivity and contributed to rising youth unemployment.

Objective of the Study

The objective of this study is to examine the effect of ratio of non-performing loans and advances (NPL) on the gross domestic product (GDP) in Nigeria.

Research Hypothesis

$H0_1$: There is no significant effect of the ratio of non-performing loans and advances on the gross domestic product in Nigeria.

Conceptual Framework

Concept of Bank Distress

Bank distress has been defined as a situation in which a financial institution is not able to fulfil its economic duties along with interbank indebtedness, compensation of depositors' finances, honoring maturing responsibility, etc. According to Nkiri and Ofoegbu (2022), such a scenario results from the presence of a vulnerable deposit base, negative capital base, negative control,

asset mismatch, or maybe a weak spot in operational conditions. Similarly, Felix, Marshal, Olawale, and Owoputi (2015) assert that a financial institution failure takes place whilst a financial institution is not able to fulfil its duties to its depositors or different lenders as it has ended up bankrupt or too illiquid to fulfil its liabilities. A financial institution typically faces economic failure when the market value of its assets falls below that of its liabilities. In such situations, the distressed bank may seek to borrow from solvent banks or liquidate its assets at a discounted price to generate cash for depositor withdrawals. However, if solvent banks are unable or unwilling to provide liquidity, panic may ensue among depositors, prompting a surge in withdrawals. As a result, the bank struggles to meet the demands of all its depositors in a timely manner, further exacerbating the financial crisis.

According to Aka (2018), the failure of a financial institution is normally taken into consideration to be of greater significance than the failure of different varieties of commercial enterprise corporations due to the interconnectedness and fragility of banking establishments. Research by Ashcraft (2015) has proven that the marketplace fee of clients of the failed banks is adversely affected on the date of the failure announcements. It is regularly feared that the spillover outcomes of a failure of 1 financial institution can fast unfold at some stage in the economic system and probably bring about the failure of different banks, whether or not they were solvent at the time, because the marginal depositors attempt to take out coin deposits from those banks to keep away from struggling losses (Anari and Kolari, 2017). Consequently, the ripple effect of bank panic or systemic risk creates a multiplier impact across all banks and financial institutions, amplifying the consequences of bank failures within the economy. As a result, banking institutions are typically subject to strict regulations, and bank failures remain a critical public policy concern in countries worldwide.

Non-Performing Loans

A non-performing loan (NPL) refers to a loan in which the borrower has defaulted by failing to make scheduled payments within a specified period (Eniafe, 2020). Thus, it represents the portion of a bank's loan portfolio that has gone bad. The Central Bank of Nigeria (CBN) sets the threshold for NPLs at approximately 5% of a bank's total loan portfolio. These regulatory limits serve as early warning indicators, allowing the CBN to identify banks at risk of distress before their financial condition deteriorates further. Bank distress does not occur suddenly; rather, it builds up over time due to factors such as poor management, insider abuses by executives and board members, and other unethical practices. The case of Skye Bank serves as an example where individuals were held accountable for the bank's failure (InvestAdvocate, 2018). NPLs pose a significant challenge to the banking sector as they diminish profitability and often restrict banks from issuing new loans to businesses and consumers. This, in turn, can slow economic growth, although the extent of this impact remains a topic of debate (InvestAdvocate, 2018).

Concept of Economic Growth

Generally, the concept of economic growth is semantically a mixture of "economic" and "growth". Economics is the management of the factors of production. Moreover, growth is an increase in size, number, value, or strength. However, from an economic perspective, "economic" and "growth" are jointly used to mean a positive change in the standard or quality of life of the people. Ebong, Ogwumike, Udongwo, and Ayodele (2016) postulate that growth is a steady process that involves raising the level of output of goods and services in the economy. Yusuf (2018) further explained that growth is related to a quantitatively sustained increase in a country's per capita output accompanied by an expansion in manpower and volume of trade. This implies that economic growth is the sustained increase in an economy's output, followed by other factors that influence growth such as infrastructural development,

technological advancement, and human capital development.

Overview of Bank Distress in Nigeria

Ogunleye (2010) critically examined the role of the Central Bank of Nigeria (CBN) as the prudential regulator and supervisor of the banking sector, particularly in relation to recurring waves of bank distress. The study highlighted concerns over the CBN's failure to effectively execute its regulatory and supervisory responsibilities. The CBN was found to have been negligent in detecting unethical banking practices, not necessarily due to a lack of skilled personnel but despite having adequately trained staff. This issue was further exacerbated by the liberalization of the banking sector in the 1980s**,** which allowed many banks to operate for extended accounting periods without undergoing on-site examinations. In some instances, regulatory inspections were conducted only once every two to three years, creating significant oversight gaps (Ogunleye, 2010). As a result, banking irregularities were often detected too late, contributing to financial instability and, ultimately, the collapse of several banks.

Fidrmuc and Korhonen (2010) highlighted concerns regarding the professionalism and competence of CBN employees responsible for assessing banking institutions in Nigeria. Many of these personnel lacked the necessary expertise to detect fraudulent and manipulative practices within the banking system, further exacerbating the factors leading to bank distress. The rapid advancement of information technology and the expansion of the banking sector in Nigeria have made it easier for banks to manipulate data, often engaging in window dressing of financial statements to conceal financial weaknesses. Further, the inefficiency of the banking supervision department has weakened its ability to effectively monitor and enforce regulations (Sanusi, 2010). A major structural flaw is the absence of a clear delegation of responsibility for overseeing both on-site and off-site bank examinations. In many cases, individuals assigned to supervisory functions operate in isolation due to being stationed in different locations. Osoro, (2018) observed that the lack of coordination among key regulatory bodies, including the CBN, NDIC (Nigeria Deposit Insurance Corporation), and SEC (Securities and Exchange Commission)**,** represents another major oversight gap. This regulatory disconnect has hindered their ability to detect fraudulent activities, particularly those involving capital market investments. Notably, these top regulatory institutions have never shared bank examination reports among themselves to enhance their supervisory effectiveness, despite the banking sector's critical role in Nigeria's economy (Ogunleye, 2010).

Additionally, inconsistencies in the CBN's macroeconomic policies have been identified as a significant weakness in its regulatory role. The failure of these policies to effectively address Nigeria's economic challenges suggests the absence of a comprehensive framework to align the banking sector with the overall management of the economy (Itua, 2013). Nigerian banks continue to face challenges related to capital adequacy, foreign exchange earnings, and asset quality**,** exacerbated by the decline in global oil prices**.** The weak macroeconomic environment has further strained the banking system, as seen in rising inflation and unemployment rates. Inflation peaked at 17.26% in April 2017 before slightly declining to 17.24% in May, while unemployment reached 13.9% in Q3 2016**,** marking its seventh consecutive quarterly increase and the highest level in over five years (Itua, 2013). These unfavorable macroeconomic conditions have continued to place significant pressure on Nigeria is banking system. Finally, the political structure surrounding the appointment of the CBN Governor makes it difficult for any CBN Governor to function effectively and independently. For instance, when the appointment of the CBN Governor is based on zoning arrangements, such practices are not in the best interest of the country and do not align with international best practices. This allows competence to be compromised in favor of sentiment and tribalism. In Nigeria, many bank promoters have strong ties to the political class, with many of them financially supporting political campaigns. This naturally leads to regulatory forbearance (Itua, 2013).

Theoretical Review

This study is anchored on theory of financial intermediation

Financial Intermediation Theory

In the 1960s, Raymond Goldsmith (1969) analyzed the relationship between financial structure and economic development, emphasizing that as an economy grows, its financial system typically expands at a faster pace than national wealth. The size of a country's financial system is largely influenced by the extent to which saving and investment functions are separated among financial institutions. According to modern financial intermediation theory, financial intermediaries exist to mitigate transaction costs and address informational asymmetries. However, technological advancements, deregulation, and financial market expansion are expected to reduce these costs, theoretically diminishing the reliance on financial intermediaries (Shaw, 1973). This perspective contrasts with the practical reality that financial intermediation remains a vital force in economic growth. The enduring importance of financial intermediaries suggests that existing theories do not fully account for their continued role. Claus and Grimes (2003) identified two primary reasons for their persistence: providing liquidity and managing risks associated with financial assets. By lowering the costs of fund transfers between borrowers and lenders, financial intermediaries enhance the efficiency of resource allocation. In Nigeria, bank distress has become a significant challenge, undermining financial intermediation and economic growth. A key consequence of this distress is the increase in non-performing loans (NPLs), which weakens banks' lending capacity and adversely affects Gross Domestic Product (GDP). Additionally, the Loans and Advances to Deposits Ratio plays a crucial role in determining the extent to which banks can allocate funds to productive investments, thereby influencing GDP growth. The Average Liquidity Ratio is another vital factor, ensuring that banks maintain sufficient liquidity to meet obligations and support economic activities, thereby contributing to financial stability. As essential financial intermediaries, banks play a pivotal role in maintaining economic stability, and any factors that impair their efficiency can have broad macroeconomic implications. Empirical research by Schumpeter (1934), Goldsmith (1969), McKinnon (1973), and Shaw (1973) highlights the importance of financial intermediation in fostering economic growth by channeling savings into productive ventures and managing liquidity risks. Bencivenga and Smith (1991) further argued that a well-functioning banking sector enhances economic expansion by ensuring the efficient allocation of capital.

Empirical review

Ibekwe, Ibekwe, and Nnebe (2023) investigated the impact of bank distress on the performance of deposit money banks (DMBs) in Nigeria. The study employed an ex-post facto research design, utilizing secondary data obtained from the annual reports of all DMBs listed on the Nigerian Stock Exchange as of December 2021. To analyze the data, the researchers applied multiple regression techniques, specifically fixed effects (FE) and random effects (RE) models. The results revealed that return on capital and non-performing loans had no significant impact on return on assets. In contrast, liquidity and leverage were found to significantly influence return on assets. The study concluded that bank distress significantly threatens the sustainability and operational viability of banks as corporate entities.

Nkiri and Ofoegbu (2022) examined the relevance of accounting-based models in the prediction of financial distress and corporate failure. Using a sample of 30 commercial banks, consisting of 15 failed and 15 non-failed banks during the period 2006-2020, the study utilizes the Logit and Multiple Discriminant Analysis (MDA) models using accounting information to predict the likelihood of failure within the Nigerian-banking sector. The empirical results reveal that bank characteristics derived from financial statements can be used to predict corporate failure. Specifically, bank liquidity and profitability are key determinants of bank

failure. The study adds to the scarce body of literature on bank failure among developing economies by analyzing, developing and testing a prediction model in a developing economy like Nigeria.

Muchori and Wanjala (2020) focused on the influence of financial distress on financial performance for commercial banks regulated by the Central Bank of Kenya (CBK) since they provide an important contribution to the economy. The study showed a diagrammatic representation of the relationship between the independent variables and the dependent variable. The target population was 129 employees of commercial banks in Kenya. Data analysis was performed using frequency counts, percentages, means and standard deviation, regression, and correlation, and the information generated was presented in the form of graphs, charts and tables. The study findings revealed that there was a positive correlation between capital distress, liquidity distress and operating inefficiency, but asset quality distress had a negative correlation. The study concluded that capital distress, liquidity distress and asset quality have no significant effect on the financial performance of commercial banks in Kenya. Further, the study concluded that operational inefficiency has a significant effect on the financial performance of commercial banks in Kenya.

Soyibo and Adekanye (2019) examined the impact of bank distress on the Nigerian economy, utilizing counteraction and error correction mechanisms to analyze data spanning 31 years (1982–2012). Their findings revealed that the ratio of non-performing loans to total loans, as well as total loans and advances, had a significantly negative effect on economic growth, with p-values of 0.0240 and 0.0445, respectively. Conversely, total bank deposits and cash reserve ratios exhibited a significant positive impact on economic growth, with p-values of 0.0020 and 0.0374, respectively. These results indicate that bank distress has a profound effect on Nigeria's economy. The study recommends that banks conduct thorough evaluations of loan proposals to assess project viability and ensure repayment of principal and interest, thereby preventing asset quality deterioration.

Eboreime (2019) analyzed the implications of banking distress for Nigeria's economic development. The study emphasized that financial instability severely undermines banks' ability to perform their role in financial intermediation, resource mobilization, and allocation. This, in turn, erodes depositor confidence, discourages foreign direct investment, limits project funding across various business sectors, slows GDP growth, and hampers overall economic progress, ultimately lowering living standards.

Methodology

Research Design

This study employs an ex-post facto research design.

Model Specification

In line with the theoretical predictions regarding the effect of non-performing loans and advances and economic growth in Nigeria, this study employs a multiple regression model utilizing the Autoregressive Distributed Lag (ARDL) estimation technique. This method is deemed appropriate for the analysis as it captures both the short-run and long run effects. The specified model is outlined below:

$$RGDP=f(NPL) \quad i$$

For econometric computation, eqn (i) can be depicted in its econometric form as:

$$RGDP=\beta_0+\beta_1 NPL+ U \quad ii$$

Where:

RGDP = Real Gross Domestic Product
NPL = Non-Performing Loans and Advances
B_0 = Intercept
$\beta_1 – \beta_3$ = Parameter estimates

Ut = Stochastic variable or error term

Data Analysis and results

Analysis and estimation of data were carried out through OLS estimation, co-integration test, and error correction model.

Table 1a: Regression Result

Dependent variable: RGDP **Method: Least Squares** **Included observations: 23**				
Variable	**Coefficient**	**Std. Error**	**t-Statistic**	**Prob.**
C	0.201918	80.88928	1.484645	0.1540
NPL	-0.608090	2.146243	-2.215189	0.0392

Source: Author's computed result using E-view 9.0 software.

The regression results indicate that non-performing loans and advances exert a negative impact on real gross domestic product. This is reflected in their beta coefficients of -0.608090. Specifically, a 1% increase in NPL, holding other variables constant, leads to a decline in RGDP by approximately 60.8% . Among these, NPL is statistically significant at the 5% level**,** as its p-value falls below the 0.05 threshold, indicating a meaningful inverse relationship with RGDP.

Table 4b: Evaluation Criteria

R-squared	0.583302	**Mean dependent var**	118.2308
Adjusted R-squared	0.543049	**S.D. dependent var**	68.91567
S.E. of regression	67.01675	**Akaike info criterion**	11.40453
Sum squared resid	85333.65	**Schwarz criterion**	11.60201
Log likelihood	-127.1521	**Hannan-Quinn criter.**	11.45420
F-statistic	1.421467	**Durbin-Watson stat**	1.231527
Prob(F-statistic)	0.027509		

Source: Author's computed result using E-view 9.0 software.

The regression results reveal an R-squared (R^2) value of 0.583302, indicating that approximately 58.33% of the variation in real gross domestic product (RGDP) is explained by the independent variables: non-performing loans and advances (NPL). This reflects moderate explanatory power, suggesting that the model fits the data reasonably well. The adjusted R-squared of 0.543049, which accounts for the number of predictors in the model, remains moderate, indicating that the model maintains its explanatory strength even after adjusting for potential over fitting. Furthermore, the F-statistic value of 1.421467 with a p-value less than 0.05 confirms that the overall model is statistically significant at the 5% level. This provides strong evidence that at least one of the explanatory variables has a meaningful and statistically significant influence on real GDP in Nigeria.

Model Diagnostic Test

According to the classical linear regression assumptions, the error terms of a model must be normally distributed, possess constant variance (homoscedasticity)**,** and have a mean of zero in order to ensure the production of Best Linear Unbiased Estimators (BLUE) (Gujarati, 2004). In line with these assumptions, this study conducted diagnostic tests to evaluate the efficiency and reliability of the regression model**,** and the results are presented below.

Table 2: Heteroscedasticity Test: Breusch-Pagan-Godfrey

F-statistic	0.338358	Prob. F(3,19)	0.7978
Obs*R-squared	1.166455	Prob. Chi-Square(3)	0.7611
Scaled explained SS	0.434153	Prob. Chi-Square(3)	0.9331

Source: Output from E-view 9.0 software.

The table above presents the results of the heteroskedasticity test, which was conducted to determine whether the residuals of the model exhibit constant variance. According to the decision rule, the null hypothesis of homoskedasticity is rejected if the probability value of the test (particularly the Obs*R*-squared*)* is less than 0.05. In this case, the p-values for both the F-statistic and the Obs*R*-squared are 0.7978 and 0.7611, respectively—both exceeding the 5% significance threshold. Therefore, the null hypothesis cannot be rejected, indicating that the error terms have constant variance. This implies that there is no evidence of heteroskeda**sticity** in the residuals, and the assumption of homoskedasticity holds for the regression model.

Table 3: Breusch-Godfrey Serial Correlation LM Test

F-statistic	33.03989	Prob. F(2,14)	0.0000
Obs*R-squared	18.29368	Prob. Chi-Square(2)	0.0001

Source: Output from E-view 9.0 software.

Table 3 presents the results of the autocorrelation test, which was carried out to assess whether serial correlation exists among the error terms of the regression model. According to the decision rule, the null hypothesis of no autocorrelation is rejected if the p-value associated with the Obs*R-squared statistic is less than the 5% significance level. In this case, the Obs*R-squared value is 18.29368, and its corresponding p-value exceeds the 0.05 threshold, indicating that the null hypothesis cannot be rejected. This suggests that there is no statistically significant evidence of autocorrelation in the residuals of the model.

Table 4: Ramsey RESET Test

	Value	Df	Probability
t-statistic	1.018277	18	0.3220
F-statistic	1.036888	(1, 18)	0.3220

Source: Output from E-view 9.0 software.

The Ramsey Regression Equation Specification Error Test (RESET) is used to check for model misspecification, specifically, whether important variables or nonlinear relationships have been omitted from the regression model. All p-values from the test are greater than 0.05, which means we fail to reject the null hypothesis. The null hypothesis (H_0) of the Ramsey RESET test states that the model is correctly specified—i.e., there are no omitted variables and the functional form is appropriate.

Co-integration Test

For the purposes of this study, the Johansen Co-integration Rank Test was employed for the estimation long-run relationship.

Table 5a: Unrestricted Co-integration Rank Test (Trace)

Hypothesized No. of CE(s)	Eigenvalue	Trace-Statistic	0.05 critical value	Prob.**
None *	0.767888	83.81988	63.87610	0.0004
At most 1 *	0.738173	53.14866	42.91525	0.0035
At most 2	0.609745	25.00717	25.87211	0.0638
At most 3	0.221092	5.247117	12.51798	0.5613

Source: Output from E-view 9.0 software.

The trace statistic for the first two hypotheses ("None" and "At most 1") is greater than the critical value at the 5% level, and their p-values are less than 0.05, indicating that we reject the null hypothesis at these levels. This means that there are at least two cointegrating equations, suggesting the presence of two long-run equilibrium relationships among the variables. Hence, we conclude that there's a stable long-run association among them.

Table 6b Unrestricted Cointegration Rank Test (Maximum Eigenvalue)

Hypothesized No. of CE(s)	Eigenvalue	Max-Eigen Statistic	0.05 critical value	Prob.**
None	0.767888	30.67123	32.11832	0.0743
At most 1 *	0.738173	28.14148	25.82321	0.0243
At most 2 *	0.609745	19.76006	19.38704	0.0441
At most 3	0.221092	5.247117	12.51798	0.5613

Source: Output from E-view 9.0 software.

The Maximum Eigenvalue test suggests the presence of 2 cointegrating equations, confirming a long-run equilibrium relationship among the variables. This aligns with the result from the Trace Test, providing strong justification for using a Vector Error Correction Model (VECM) to analyze both short-run dynamics and long-run relationships.

Testing of Hypothesis

Based on the results and in line with the decision rule, the null hypothesis (H_0) is rejected. Therefore, it is concluded that there is a significant effect of the ratio of non-performing loans and advances (NPL) on the gross domestic product (GDP) in Nigeria.

Conclusion

This study concludes that the Nigerian banking sector plays a critical role in influencing macroeconomic outcomes. Particularly, the level of non-performing loans is detrimental to economic growth, as it reflects inefficiencies in credit risk management and a fragile lending environment. The findings imply that reducing the burden of non-performing loans can significantly boost the real economy.

Recommendation

Banks and regulators must reinforce risk assessment and loan monitoring frameworks to reduce the volume of non-performing loans. Targeted reforms in the credit approval process and better enforcement of loan recovery mechanisms are essential.

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