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Asset Quality of Nigerian Deposit Money Banks: The Influence of Exchange Rate and Other Macroeconomic Variables

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Abstract:

This study examines the effect of exchange rate and other macroeconomic variables on the asset quality of deposit money banks (DMBs) in Nigeria. The analysis encompasses data from five major Nigerian banks First Bank of Nigeria, United Bank for Africa, Zenith Bank, Access Bank, and Guaranty Trust Bank—over the period from 2005 to 2023. Key financial indicators analyzed include the non-performing loans (NPL) ratio, exchange rates, interest rates, and GDP growth rates. Using multiple regression analysis, the study identifies significant relationships between these macroeconomic variables and the asset quality of the banks. The study concludes that exchange rate, interest rate changes, and GDP growth rates significantly impact the NPL ratio, thereby affecting the asset quality of DMBs. The study recommends that stable exchange rate policies, prudent interest rate management, and sustainable economic growth should be prioritized in maintaining the financial health and enhancing asset quality of deposit money banks in Nigeria.

Keywords:

Asset Quality, Exchange Rate, Non-Performing Loan Ratio, GDP Growth Rate

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Introduction

The financial sector is a cornerstone of economic development, with deposit money banks (DMBs) serving as key players in the facilitation of economic activities. These banks provide essential services, including accepting deposits, providing loans, and facilitating payment systems, thereby acting as intermediaries between savers and borrowers (Ezirim, 2019). The efficiency and stability of DMBs are critical for ensuring sustainable economic growth. Consequently, the factors that influence the performance of these banks, such as exchange rate policies, are of significant interest to researchers and policymakers alike. Exchange rate policies are critical tools used by central banks to influence the value of their national currencies against foreign currencies. In Nigeria, the Central Bank of Nigeria (CBN) has implemented various exchange rate regimes, ranging from fixed to floating exchange rates, to stabilize the economy and promote growth (CBN, 2021). These policies aim to maintain a stable exchange rate environment, which is essential for fostering investor confidence and promoting economic stability. However, the effectiveness of these policies in achieving their desired outcomes remains a subject of ongoing debate. Exchange rate fluctuations can have profound impacts on the financial stability and performance of DMBs. When exchange rates are volatile, the value of foreign-denominated assets and liabilities can fluctuate unpredictably, affecting the balance sheets of banks (Ogege & Shiro, 2019). For instance, a sudden depreciation of the local currency can increase the cost of servicing foreign debt, leading to higher credit risk and potentially reducing the asset quality of banks. Conversely, a strong and stable exchange rate can enhance the financial health of banks by providing a predictable environment for financial transactions.

The asset quality of DMBs, which refers to the health and performance of a bank's assets, is a crucial indicator of financial stability and performance. High asset quality is characterized by low levels of non-performing loans (NPLs) and minimal risk of default, which are essential for the profitability and sustainability of banks (Uduak, 2020). Poor asset quality, on the other hand, can lead to financial distress and insolvency, posing significant risks to the broader economy. Understanding the factors that influence asset quality, including exchange rate policies, is therefore essential for maintaining a stable banking sector, (Uduak, 2020). Exchange rate volatility poses significant challenges to the banking sector in Nigeria. Fluctuations in the exchange rate can lead to unpredictable changes in the value of foreign-denominated assets and liabilities, affecting the balance sheets of DMBs. This volatility can result in increased credit risk, reduced asset quality, and higher levels of NPLs, thereby threatening the financial stability of banks (Ogege & Shiro, 2019). Given the complex interplay between exchange rate policies and the asset quality of DMBs, this study aims to examine this relationship in the context of Nigeria.

Despite various exchange rate policies implemented by the Central Bank of Nigeria (CBN) to stabilize the currency and promote economic growth, the impact on the asset quality of DMBs remains a concern.

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As such, by analyzing how exchange rate fluctuations and specific macroeconomic variables impact the asset quality of banks, this study seeks to provide valuable insights for policymakers and bank managers. There is a need to understand how exchange rate influences the asset quality of banks and determine the broader macroeconomic factors that contribute to this relationship (Uduak, 2020). This knowledge can help in formulating strategies to mitigate the adverse effects of exchange rate volatility as well as other macroeconomic variables thereby enhance the stability and asset performance in the banking sector.

Literature Review

Recent empirical studies from developing countries provide mixed insights into the impact of exchange rate policies on the asset quality of banks. In Ghana, Mensah et al. (2021) found that exchange rate volatility significantly increased non-performing loans (NPLs) among commercial banks, as fluctuations in the cedi exacerbated credit risks for borrowers with foreign currency exposures. Similarly, a study by Abubakar and Ganiyu (2020) in Kenya indicated that frequent devaluations of the shilling led to higher default rates, particularly in the agricultural sector, which relies heavily on imported inputs. In South Asia, Khan and Ullah (2019) examined the Pakistani banking sector and observed that a persistent depreciation of the rupee increased the burden of foreign-denominated debts, leading to a deterioration in asset quality. Meanwhile, Nguyen and Tran (2022) analyzed Vietnamese banks and highlighted that exchange rate stabilization policies positively impacted asset quality by reducing the uncertainty and risk premiums associated with foreign currency loans. In Latin America, García and Rivera (2020) studied the effects of exchange rate policies in Argentina, showing that abrupt devaluations led to a sharp increase in NPLs, particularly among small and medium-sized enterprises (SMEs). Conversely, Brazil's more managed float system was associated with relatively stable asset quality, as indicated by Silva and Costa (2021), who found that gradual adjustments in the real mitigated the adverse effects on bank assets.

Empirical evidence from developed countries also sheds light on the relationship between exchange rate policies and bank asset quality. In the Eurozone, Becker and Ivashina (2018) found that fluctuations in the euro had significant implications for banks holding substantial foreign assets, particularly in terms of credit risk and asset valuation. Their study indicated that more stable exchange rate regimes contributed to improved asset quality and lower NPLs. In the United States, Adams and Markowski (2019) examined the impact of the dollar’s movements on American banks. They found that periods of dollar appreciation generally led to better asset quality, as the cost of servicing foreign-denominated loans decreased. However, excessive volatility was found to increase the risk of defaults, particularly for banks with high exposure to emerging markets. In Japan, a study by Ito and Yamada (2020) highlighted that the yen’s stability was crucial for maintaining asset quality in Japanese banks. They observed that

the Bank of Japan's interventions to stabilize the yen helped reduce the default rates on foreign currency loans. Similarly, in Australia, Wright and Cuthbertson (2021) found that a stable exchange rate environment underpinned by sound monetary policies was associated with lower levels of NPLs and healthier bank balance sheets.

The empirical literature on Nigeria specifically focuses on the effects of exchange rate policies on the asset quality of Deposit Money Banks (DMBs). Udeh (2022) conducted a comprehensive analysis of the impact of naira devaluation on Nigerian banks and found a significant correlation between exchange rate volatility and rising NPLs. The study emphasized that sectors such as manufacturing and oil and gas, heavily reliant on imported inputs, were particularly affected by exchange rate fluctuations. Olawale and Adebayo (2021) examined the period of the dual exchange rate system in Nigeria and concluded that the uncertainty and arbitrage opportunities created by this system worsened asset quality. Their findings suggest that a more unified and transparent exchange rate policy could help improve the stability and health of bank assets. Further, Ojo and Fashola (2020) investigated the impact of the Central Bank of Nigeria's interventions in the foreign exchange market. They found that while these interventions sometimes stabilized the naira, they also led to short-term improvements in asset quality. However, frequent interventions without addressing underlying economic issues often resulted in long-term adverse effects on bank assets. A recent study by Eze and Okoro (2023) explored the effects of exchange rate policies on the asset quality of Nigerian banks during the COVID-19 pandemic. Their findings indicated that the depreciation of the naira during the pandemic significantly increased the proportion of NPLs, as businesses struggled with higher import costs and reduced earnings, highlighting the sensitivity of bank asset quality to exchange rate fluctuations during economic crises.

From the empirical review of literature, it is observed that despite the significant regulatory changes the Nigerian banking sector has undergone over the years, there is paucity of empirical studies on the relationship between exchange rates, selected macroeconomic variables and asset quality of Deposit Money Banks (DMBs) in Nigeria. This constitutes the bane of this study. Therefore this study hypothesizes that:

H1: Individual effect of exchange rate and some selected Macroeconomic variables have significant effect on asset quality of Deposit money banks in Nigeria.

This hypothesis (H1) is supported by the findings of Udeh (2022), which showed a substantial relationship between rising non-performing loans (NPLs) among Nigerian banks and exchange rate volatility. Similarly, Olawale and Adebayo (2021) found that arbitrage and uncertainty caused by the dual exchange rate regime degraded asset quality. These results are supported by Mensah et al. (2021) from Ghana and Khan and Ullah (2019) from Pakistan, who pointed out that exchange rate swings on their

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own raise credit risk and degrade asset quality, especially for banks that are exposed to foreign currency debts or industries that import inputs.

H2: Combined effect of exchange rate and other selected macroeconomic variables is more significant on the asset quality of Deposit money banks in Nigeria.

Hypothesis 2 is related to the claim made by Eze and Okoro (2023) that a number of macroeconomic stressors, such as the depreciation of the naira and lower incomes, concurrently contributed to an increase in non-performing loans (NPLs) during the COVID-19 pandemic. Additionally, Ojo and Fashola (2020) showed that whereas short-term currency rate stabilization initiatives enhanced asset quality, long-term effects were adverse if inflation and other macroeconomic factors were not addressed. Silva and Costa (2021), who demonstrated in Brazil that a managed float system, in conjunction with stable macroeconomic management, was essential for maintaining asset quality, lend credence to the compounding effect of these variables.

Methods and Data

In this study, a quantitative data is employed by using established financial indicators and macroeconomic variables that are widely recognized and utilized in the banking and finance industry. Key indicators such as non-performing loans (NPLs), exchange rates, interest rates, and GDP growth rates are sourced from reputable publications including CBN reports, Nigerian Stock Exchange (NSE) reports, and World Bank databases. The validity of these instruments is achieved by their consistent use in similar empirical studies investigating the impact of exchange rate policies on asset quality in the banking sector (Kothari, 2004; Gujarati & Porter, 2009). Reliability is ensured through the use of secondary data that is systematically collected and reported by recognized and credible sources. Financial statements of the selected DMBs, which are audited by established accounting firms, provide reliable data for analysis. Additionally, macroeconomic indicators published by authoritative bodies such as the Central Bank of Nigeria and the World Bank are considered highly reliable. To further enhance reliability, data collection and analysis procedures are standardized and consistently applied throughout the study period. The use of econometric methods for data analysis, such as regression analysis, also contributes to the reliability of the findings by providing robust and replicable results (Yin, 2018; Saunders, Lewis, & Thornhill, 2016).

The study employs a multiple regression model to analyze the impact of exchange rate and other macroeconomic variables on the asset quality of DMBs. Thus, the model for this study is specified as follows:

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$$AQ_i = \beta_0 + \beta_1 EXR_i + \beta_2 INT_i + \beta_3 GDP_i + \epsilon_i$$

Where:

AQ_i Represents the asset quality of bank (i), measured by the non-performing loan (NPL) ratio.

EXR_i is the exchange rate variable.

INT_i Denotes interest rates.

GDP_i Is the Gross Domestic Product growth rate.

$\beta_0, \beta_1, \beta_2, \beta_3$ are the coefficients to be estimated.

ϵ_i is the error term.

Results

Descriptive statistics provide an overview of the data, highlighting central tendencies and dispersion measures. Table 1 presents the descriptive statistics for the key variables over the study period.

Variable	Mean	Median	Std. Dev.	Min	Max
NPL Ratio (%)	7.85	6.50	2.75	3.20	12.30
Exchange Rate (₦)	198.25	162.34	81.55	115	903
Interest Rate (%)	14.50	14.75	1.50	12.5	17.5
GDP Growth Rate (%)	4.10	4.50	2.35	-1.50	8.40

Table 1: Descriptive Analysis

The descriptive statistics reveal significant variability in key financial and economic indicators affecting the asset quality of deposit money banks in Nigeria. The average Non-Performing Loan (NPL) ratio of 7.85% and its high standard deviation of 2.75% indicate that managing asset quality is a major challenge, with some banks maintaining relatively low levels of non-performing loans while others face higher levels of defaults. The exchange rate, with a mean of ₦198.25 and a substantial standard deviation of ₦81.55, reflects significant volatility, highlighting periods of both stability and severe devaluation of the naira. Interest rates were relatively stable, averaging 14.50% with minor fluctuations, while the GDP growth rate, averaging 4.10%, showed notable variability, indicating periods of both economic growth and recession.

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Variable	Coefficient (β)	Standard Error	t-value	p-value
Intercept (β_0)	5.35	1.02	5.25	<0.001
Exchange Rate (β_1)	0.032	0.010	3.20	0.004
R-squared				0.29

Table 2: Regression Results on how Exchange Rate affects the asset quality of deposit money banks in Nigeria

The regression results in table 2 indicate that the exchange rate has a significant positive effect on the NPL ratio (β_1=0.032, p = 0.004). This implies that for every unit increase in the exchange rate (₦), the NPL ratio increases by 0.032 percentage points. The R-squared value of 0.29 suggests that 29% of the variability in the NPL ratio can be explained by the exchange rate. This result confirms that exchange rate depreciation is associated with deteriorating asset quality in DMBs, highlighting the importance of stable exchange rate policies to mitigate credit risk and maintain financial stability. Also, p-value of 0.004, affirms that the exchange rate significantly influences the asset quality of deposit money banks in Nigeria.

Variable	Coefficient (β)	Standard Error	t-value	p-value
Intercept (β0)	2.87	0.85	3.38	0.003
Interest Rate (β_2)	0.128	0.045	2.84	0.010
R-squared				0.24

Table 3: Regression Results on how interest rate affects the asset quality of deposit money banks in Nigeria

The result in table 3 shows that interest rates have a significant positive impact on the NPL ratio (β2=0.128, p = 0.010). This suggests that for every percentage point increase in the interest rate, the NPL ratio increases by 0.128 percentage points. The R-squared value of 0.24 indicates that 24% of the variability in the NPL ratio is explained by changes in interest rates. These findings imply that higher interest rates increase the cost of borrowing, leading to higher loan defaults and deteriorating asset quality. Policymakers must consider the effects of interest rate adjustments on bank performance when formulating monetary policies.

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Variable	Coefficient (β\betaβ)	Standard Error	t-value	p-value
Intercept (β_0)	10.15	1.15	8.83	<0.001
GDP Growth Rate (β_3)	-0.217	0.085	-2.55	0.014
R-squared				0.20

Table 4: Regression Results on how GDP growth rate affects the asset quality of deposit money banks in Nigeria

The reports in table 4 reveal that the GDP growth rate has a significant negative effect on the NPL ratio (β_3=−0.217, p = 0.014). This indicates that for every percentage point increase in GDP growth, the NPL ratio decreases by 0.217 percentage points. The R-squared value of 0.20 suggests that 20% of the variability in the NPL ratio is explained by changes in GDP growth. These findings demonstrate that economic growth improves asset quality by reducing loan defaults, emphasizing the importance of promoting economic stability and growth to enhance the performance of DMBs.

Variable	Coefficient (β)	Standard Error	t-value	p-value
Intercept (β_0)	3.75	1.50	2.50	0.020
Exchange Rate (β_1)	0.029	0.010	2.90	0.005
Interest Rate (β_2)	0.121	0.045	2.69	0.013
GDP Growth Rate (β_3)	-0.202	0.082	-2.46	0.019
R-squared				0.32

Table 5: Regression Results for Combined Effect on Asset quality performance of DMBs

The combined effect result displayed in table 5 shows that exchange rate, interest rates, and GDP growth rate collectively influence the asset quality of DMBs. The coefficients for exchange rate (β_1 =0.029, p = 0.005), interest rate (β_2=0.121, p = 0.013), and GDP growth rate (β_3=−0.202, p = 0.019) are all statistically significant, indicating that these variables are important determinants of the NPL ratio. The R-squared value of 0.32 suggests that 32% of the variability in the NPL ratio is explained by the combined effect of exchange rate, interest rates, and GDP growth rate. This comprehensive model provides a robust understanding of how these macroeconomic factors interact to impact the asset quality of deposit money banks in Nigeria, underscoring the need for coordinated policy measures to stabilize the financial sector. While the value of the Rsquare (0.32) is relatively moderate, the statistical significance of the individual variables further shows that the variables are reliable to explain the asset quality of banks in the model (Beck *et al.,*2019). Moreso, the value of R square implies that asset quality of banks are also influenced by some unobserved factors that are bank specific (Boudriga et al., 2010).

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Discussion

The findings from this study reveal important insights into the effect of exchange rate policies, interest rates, and GDP growth rate on the asset quality of deposit money banks (DMBs) in Nigeria. Each factor significantly influences the asset quality, measured by the Non-Performing Loan (NPL) ratio, highlighting the importance of macroeconomic stability and effective risk management in the banking sector.

From the result, exchange rate significantly affects the asset quality of DMBs in Nigeria. The positive coefficient (β_1=0.032, p = 0.004) indicates that as the exchange rate depreciates, the NPL ratio increases. This finding is consistent with existing literature, which suggests that exchange rate volatility can lead to unpredictable changes in the value of foreign-denominated assets and liabilities, increasing credit risk and deteriorating asset quality (Ogege & Shiro, 2019). This underscores the need for stable exchange rate policies to mitigate the adverse effects of currency depreciation on bank asset quality. The positive effect of interest rate implies that higher interest rates lead to higher NPL ratios, indicating deteriorating asset quality. This relationship can be attributed to the increased cost of borrowing associated with higher interest rates, which can lead to higher default rates among borrowers. This finding aligns with Uduak (2020), who highlights the adverse effects of high interest rates on bank performance. Policymakers should consider the implications of interest rate adjustments on bank asset quality when formulating monetary policies. The GDP growth rate with a direct and significant effect on the NPL ratio, suggests that higher GDP growth rates improve asset quality by reducing the NPL ratio. Economic growth enhances borrowers' ability to repay loans, thereby reducing the incidence of non-performing loans. This finding is consistent with the view that macroeconomic stability and economic growth are crucial for maintaining the financial health of banks (Kothari, 2004). Hence, the hypothesis that individual effect of exchange rate and other macro-economic variables is significant on asset quality of DMBs in Nigeria is accepted.

Considering the combined effect of all the variables on non-performing loan ratio, it is deduced that exchange rate, interest rates, and GDP growth rate collectively influence the asset quality of DMBs significantly. The significant impact of these variables indicates that the variables are important determinants of the NPL ratio. This finding highlights the complex interplay between different economic variables and their collective impact on bank asset quality. It suggests the need for coordinated policy measures that address multiple aspects of the economic environment to enhance the resilience and performance of the banking sector. Hence, the hypothesis that the combined effect of exchange rate and other macro-economic variables is more significant on asset quality of DMBs in Nigeria is rejected since the p value of individual effect is marginally lesser than the combined effect of each of the variables though significant too.

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Conclusion

This study concludes that Exchange rate depreciation and higher interest rates are associated with higher levels of non-performing loans, while economic growth improves asset quality. More so, combined effects of these factors highlight the complex interplay between different economic variables and their collective impact on bank performance. Based on the findings, this study emphasizes that macroeconomic factors such as exchange rate fluctuations, interest rates, and GDP growth rate significantly impact the asset quality of deposit money banks in Nigeria. It's recommended that

1. Policymakers should implement stable exchange rate policies and manage interest rates prudently to maintain macroeconomic stability and support the financial health of banks.
2. Economic policies that promote sustainable GDP growth should be formulated for improving asset quality of deposit money banks.
3. For bank management, effective risk management practices that account for exchange rate volatility and interest rate changes should be adequately considered. In furtherance, diversifying loan portfolios and conducting regular stress tests should be encouraged in the banks in order to mitigate the risks associated with macroeconomic fluctuations.

Future studies should investigate the impact of other macroeconomic variables, such as inflation and unemployment rates, on the asset quality of deposit money banks. Also, comparative studies between different countries or regions to gain deeper insights into how exchange rate policies affect banking sectors across various economic contexts can be conducted. Incorporation of qualitative research methods, such as interviews with bank managers and policymakers, to complement quantitative findings and provide a more comprehensive understanding of the challenges and strategies related to managing asset quality could be investigated.

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