



Effect of Policy Rates On the Lending Function of Banks (A Case of Selected Branches of First Bank In Ibadan)

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ABSTRACT

This paper examines the impact of policy rates on the lending function of banks. There is an enormous influence of monetary policy on lending function of the country. In this regard variables have been studied to prove the hypotheses. The data which have been used for driving the result was collected from selected branches of First Bank of Nigeria, Oyo State. To determine the relationship between the predictor variables and variable of interest, regression and correlation technique have been used. The study substantiates that interest rate, reserve ratio and liquidity ratio were all statistically significant. The analytical result obtained from the study suggested that policy rate have a significant effect on the lending functions of banks. The study consequently recommended that the monetary policy makers ought to device a steadier and affirmative interest rate and regulate the commercial banks operations since its effect is seen to trickle down to other rates thereby exerting the desired impulse.

Keywords: Liquidity Ratio, Interest Rate, Reserve Ratio, Lending Function, Banks

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1. BACKGROUND TO THE STUDY

Basically banks perform two major functions of deposit taking and lending which makes them into an intermediary between the depositors (surplus unit) and borrowers (deficit unit). With this, banks are able to ease the problems of direct lending where the borrower will have to search for the person that has surplus so as to borrow from him. It is obvious that idle funds contribute little or nothing to the economic growth of a nation. The intermediation function of banks makes idle funds active by giving potential investors the opportunity to borrow and invest (Ramasastrri, & Unnikrishnan, 2006). Lending of course is the major earning assets of banks and since banks are in business to maximize returns on their shareholders' investment, they may be tempted to lend every fund they mobilize to the detriment of liquidity. Without liquidity, public confidence is threatened as banks will not be able to meet their short term debt obligations, like cash withdrawals by their customers. This will bring about lack of confidence and bank run. So both sustainability, which is banks having enough investments in loans, etc and liquidity which is ability of the bank to meet obligations as they fall due are two important opposite sides of the banks; survival.



Due to the position of banks in every economy there is also the fear of too big to fail, so governments will always create apex regulatory bodies like the Central Banks to watch over the activities of banks; to make sure that the banking industry remains stable. In Nigeria for instance the Central bank of Nigeria (CBN) as an apex financial institution has in it, the Monetary Policy Committee (MPC) which is charged with monetary policy formation of the Bank. The monetary policy rates are meant to control the total money supply in the economy so that there is neither excess nor inadequate money in circulation for economic and other activities (CBN 2019). Monetary Policy function seems to be the most difficult function of the Central Bank, as the Committee has to meet periodically to analysis the state of the economy and so determine the policy direction and tools to adopt. To a great extent the suitability of the policies formulated determines the state of growth of the economy.

1.1 Statement of Problem

The policy rates in Nigeria have been faced with frequent changes. In line with the Structural Adjustment Programme of the mid 1980s, the interest rate was deregulated. The belief was that such liberalization will enhance the provision of investible funds so as to promote economic growth. This was reversed in 1994 because to them there was high variability in interest rate occasioned by the deregulation and ceiling for lending rate was fixed at 21%. This ceiling was lifted in 1997 to pave way for the pursuit of flexible interest rate (Omole and Falokuu, 1999).

In March 2019, the CBN set out a benchmark interest rate at 13.5% from 14% (Sunnewsonline, 25 March 2019). This was the first rate cut since 2015. The move being to instigate growth in the economy, the cash reserve ratio was retained at 22.5% while liquidity ratio stood at 30%. Lending rates averaged 14.12% from 1961 until 2019, reaching an all-time high of 37.80% in September 1993 and low of 6% in April 1975. The maximum lending rate moved from 30.48% in January to 30.56 % in February and 30.83% in March 2019.

No doubt interest rate is a major tool in the monetary policy tool box for the control of money supply. The inconsistency in the interest rate regimes in Nigeria has been a thing of concern to the people (Iganiga & Asemota 2013). Recently there is guided deregulation of policy rates that led to high and volatile interest rate and there have been such frequent changes till date. The argument has been on the belief that flexible interest rate leads to high vitality while fix rate does not encourage investment. There is therefore the need for further studies to actually determine how policy rates affect lending function of banks and that is what this research tried to achieve.

1.2. Objective

The broad objective of this study is to ascertain how significant policy rate has affected the lending function of banks proxied as adequacy of loanable funds; from here three specific objectives were drawn:

1. To determine the significant effect of policy rates proxied as interest rate on the lending function of banks.
2. To ascertain whether policy rate proxied as cash reserve ratio has significantly affected lending function of banks.
3. To determine the significance effect of policy rate proxied as liquidity ratio on the lending function of banks (loan amount)

1.3 Hypotheses

The following hypotheses were drawn from the objectives:

Ho1: There is no significant effect of interest rate on the lending function of banks.

Ho2: Reserve ratio has no significant effect on the lending function of banks.

H03: Liquidity ratio has not significantly affected the lending function of banks.



2. LITERATURE REVIEW

2.1 Conceptual Framework

Monetary Policy

Diptimai (2018) describes monetary policy as policy meant to influence the aggregate spending by varying money supply. According to Sames (2019), it consists of the process of drafting announcing and implementing the plan of action taken by the central bank to determine the scope and impact of the key drives of the economic activities in a country.

Loan

Loan is the lending of money by one or more individuals or organization to other people. The borrower incurs a debt and he is liable to pay interest. Interest serves as an incentive for the lender to lend (Signoriello 1991)

Lending rates (LR)

Lending rate is the rate that usually meets the short-term and medium term financing needs of the private sector. The rates are usually different according to credit worthiness of borrowers (International Monetary Fund (IMF), 2019). Murray (2018) mentioned that lending also known as financing in its most general sense is the temporary giving of money or property to another person with, the expectation that it will be repaid. Lending involves many types of commercial loans.

2.2 Empirical Review

Ofoeze, Odigbe, Ezeabalisi, & Alajekwu (2018), studied on the effect of monetary policy on economic growth of Nigeria, using Ordinary least square, the research established that monetary policy has significant positive effect on economic growth.

Adegbite and Alabi (2013), studied on the impact of monetary policy on the economic growth of Nigeria using multiple regression and the study found out that exchange rate stability keeps inflation low.

Ayub & Maqbool (2015) examined the impact of monetary policy on gross domestic product (GDP) of the state. The study used egression and correlation technique. The finding shows that money supply, interest rate and inflation greatly affect the GDP. Ayub and Maqbool 2015 further discussed how one of the key variables of monetary policy is money supply. First, money supply growth affects the GDP and then hit the inflation in Pakistan. Additionally, Gul, Mughal & Rahim (2012), studied on the linkage between monetary instruments and economic growth using ordinary least square. The result showed positive linkage between monetary instrument and economic growth.

Olaoluwa & Shomade (2017) Appraisal of monetary policies on commercial bank lending behaviour in Nigeria Banking industry 1980-2014 using ordinary least square (OLS). The result showed a positive significant effect.

2.3 Theoretical Framework

This study used the Keynesian economist theory of monetary policy based on the fact that it works through interest rate and an increase in money supply leads to fall in interest rates

3. METHODOLOGY

3.1 The Research Design

The study embraced a survey research design using questionnaire instrument It also makes use of a cross sectional design, where data were collected at one point in time. The data were sourced from two branches of First bank in Ibadan, Oyo State. The correlation/regression output from SPSS was used to identify the type of relationship that exist between interest rate policy and lending function of commercial banks as well as how significant such relationship is.



Also, the study will make use of only primary data gotten from selected bank staffs on their opinion about how Interest rate, reserve ratio and liquidity ratio affect the lending function of banks.

3.2 Model Specification

It is evident that from the review, commercial banks' lending is influenced by several factors both at macro and micro levels. These factors constitute the costs incurred by the banks in extending their services and they vary directly with interest rates (Soludo, 2008). These costs include administrative costs; cash reserve ratio and liquidity ratio requirements. In testing the impact of policy rate on commercial banks' lending function, this study employed a modified model from the one used by Punita and Somaiya (2006). Their model was used to examine the impact of monetary policy on banks' profitability in India and was specified thus:

$$Pt = \beta_0 + \beta_1BR + \beta_2LR + \beta_3CRR + \beta_4SLR + U \dots (5.1)$$

Where: Pt is bank profitability which also serves as the dependent variable. The independent variables include: BR is bank rate (equivalence of MPR), LR is lending rate, CRR is cash reserve ratio and SLR is statutory Liquidity ratio. U represents the stochastic error term.

The dependent variables in (3.1) will be changed to Loan (LO) while the independent variables will include: Interest rate (IR), reserve ratio (RR) and liquidity ratio (LR).

Therefore, the model for assessing the relationship between policy rate and commercial banks' lending function is specified as thus:

$$LO = \beta_0 + \beta_1 IR + \beta_2 RR + \beta_3 LR + U \dots (5.2)$$

3.3 Tools of analysis

The study embraces correlation and regression analysis to explore the nature of relationships and implicit direction of the causation between dependent and independent variables of this study. Correlation coefficient is the square root of coefficient of determination R^2 . Since the coefficient of determination varies between 0.0 and 1.0, it follows that the correlation coefficient must vary between +1 and -1. In regression analysis, the direction of the relationship between variables is made at the beginning, thus the causality is assumed rather than inferred from the model.

4. DATA PRESENTATION

Research instruments (questionnaires) were distributed to the bank staffs. Table 1 gives the regression and correlation summary of their responses.

Table 1: Regression analysis of pooled participant responses

Independent variables	Coefficient	Standard error	t-statistic	Significant
Constant	92.1	0.4910	8.02	0.000
Interest rate	-0.11	0.0012	-5.47	0.001
Reserve ratio	-0.25	0.0461	7.85	0.000
Liquidity ratio	-0.08	0.3211	-4.412	0.000
Dependent variable: Lending Function of Banks				
R = 0.878		R ² = 0.771		
F-statistic = 23.628		F- Sig. Value = 0.014		



From the results in table 1, the regression model can be presented as:

$$LO = 92.1 - 0.11 IR - 0.25 RR - 0.08 LR + U \dots (5.3).$$

This result implies that a unit increase in Interest rate (-0.11), reserve ratio (-0.25) and liquidity ratio (-0.08) will lead to a decrease in banks function as lenders by 11%, 25% and 8% respectively. Also from the table, the R value = 0.878, which shows a strong positive relationship between the predictor variables and the dependent variable while the value of $R^2=0.771$ shows that about 77% of the total variation in commercial banks' lending functions can be explained by the regressing factors. In relation to the stated hypotheses for this study, all the independent variables (IR, RR and LR) were all statistically significant. This is so because their significant values (0.001, 0.000 and 0.000) are less than 0.05, therefore the null hypotheses in the study were all rejected. Collectively, the significant value for the ANOVA statistic also establishes the fact that the relationship between the dependent variable (bank lending function) and the independent variables (Interest rate, reserve ratio and liquidity ratio) are statistically significant.

5. DISCUSSION OF FINDINGS

The analytical result obtained from the study suggested that policy rate have a significant effect on the lending functions of banks. It could also be observed from the result of this study that there is decrease in the lending activities of commercial banks for every unit increase in interest rate, reserve ratio and liquidity ratio.

The findings in this study concurred with the study by Eke, Eke, & Inyang (2015) on "Interest Rate and Commercial Banks' Lending Operations in Nigeria". They concluded that monetary policy rate and the statutory liquidity ratio negatively affected the volumes of banks loans and advances. Moreover, while the later was insignificant, the former was significant ($t=-2.0689$). The implication is that the increasing administrative cost of commercial banks loans exerted an adverse impact on volume of loans. Also, (Enyioko, 2012) found that there is significant relationship between interest rates and bank performance as the t value for the interest rate is 11.565. However the model did show statistical significance with reference to the impact of interest rates policy on the economy because f – statistic is 1.267.

6. CONCLUDING REMARKS

This seeks to assess the effect of policy rates on the lending function of banks by seeking the opinion of bank staffs in selected First bank branches in Ibadan on the various policy rates that may deterred commercial banks in providing loans to members of the public. Three important factors were included in the study which include interest rate, reserve ratio and liquidity ratio. The analysis was done using a modified regression model. The paper has shown that policy rates significantly affect the lending function of banks especially in the area on inconsistent/high interest rate; cash reserve ratio and statutory liquidity ratio.

7. CONTRIBUTIONS TO KNOWLEDGE

In light of the literature review and study evidence, in order to understand the influence of monetary policy on lending function, the following recommendations are suggested. Firstly, the study recommended that the monetary policy makers should device a more stable and favourable interest rate and regulate the commercial banks operations since its effect is seen to trickle down to other rates thereby exerting the desired impulse. Also, commercial banks should devise strategies to attract and retain financial deposit since this will help them improve their lending performances as well as their profitability.



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