A Comparative Analysis of the Performance of Real Estate and Financial Assets as Security for Mortgage Lending in Nigeria

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Key words: real estate, financial assets, mortgage security, loan default

SUMMARY

Traditionally, financial institutions in the country accept valuable asset (real estate and financial) as security for loans with greater preference for real estate. However, consequent upon rising cases of loan default and bad debt arising from non-performance of security assets and the attendant problems associated with sales of real estate, there is a gradual shift towards financial assets. Against this background, this paper examines the relative performance of real estate and financial assets as security for loans with a view to ascertain whether or not the drift towards financial asset is justified. Using a sample of Forty six transactions involving landed and financial assets and test of difference between two population means, the study reveals that although, the banks still prefer financial asset, however, both real estate and financial assets provided cover for the secured loans but real estate has a superior performance on the long run. In addition, Real estate exhibited higher growth than financial asset over the loan period.

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1. INTRODUCTION

The success of any investment activity rests heavily on the availability of adequate finance which more often than not is beyond investors' current financial resources. This financial insufficiency naturally turns investors to financial institution for possible credit advancement. Mbanefo (2002) observed that the importance of banks in our economy lies in their monopoly of the resources to provide loans for industrial and commercial developments. The provision of this loan however, carries the risk of default in repayment hence the need to take adequate, reliable and appropriate security for the purpose of insulating default risk associated with credit transactions in banks.

Traditionally, financial institutions accept valuable assets as security for loans which include real estate (residential, commercial, industrial, or recreational) and financial assets (Shares, Life Assurance policy, Guarantee, Pledge, Indemnity policy, Special Account, Time deposit, etc). Assets that act as covers for loans are not taken primarily to form the source of loan repayment but it is taken where the primary source(s) of credit repayment fail(s) or instances of willful default of the mortgagor. In this wise, lenders are concerned not only with the value of security at the time of loan origination but also the ease of disposal and the inflation hedging ability of the security asset that will be realized upon default. In credit transaction lenders would require to be compensated for every conceivable difficulty and the potential risk of default. It thus means that the greater the risk of loan default, the greater the need for security and the more stringent the terms of credit transaction. Moreover, loan default has been observed to be on the increase since the 1990s with various difficulties attending loan realization through the security asset which acted as cover for such loan (Momoh, 1990). According to CBN report (1995), out of every ₦1.00 loan granted by Nigerian Banks only 57 kobo were capable of being realized representing 57%. The questions that one should ask are, how suitable is the security asset being taken? Can difficulty in loan realization adduce to poor documentation on the part of lenders be sufficient? In the past, much preference was given to real estate as security for loan in Nigerian Banks because of its ability to preserve wealth against inflation and the fact that its value appreciates on a sustainable basis as confirmed by (Fama et al 1977, Limmack et al 1998, Ajayi 1998, Aluko 2001, Bello and Asaju 2002, Bello 2003). However, there have been a growing shift from real estate to financial assets. Momoh (1990) argued that the shift has been gradual but as it is observed, is gaining momentum in mortgage transaction perhaps because of relatively illiquid nature of real estate. Oloyede (2004) also observed that more liquid assets are important to lenders because of relative ease of loan realization in case of default. There is no doubt that Share as a form of financial assets is gaining ground in credit transaction. Although, it enjoys greatest advantages of marketability and liquidity but its performance is precariously hinged on the general performance of the economy just like any other form of financial asset.

From the foregoing, a number of pertinent questions are to be addressed given the Nigerian present economic realities, which type of real estate is mostly acceptable and less acceptable in credit transactions, which form of financial assets is gaining ground over real estate and why?, and what is the performance of real estate and financial assets in the recent times? Is it safe for financial institutions to continue to secure most of hers loan with financial assets?

In line with the view to provide answers to the above questions, this paper is structured as follows: the next section (section 2), in the form of conceptual underpinnings, examines the characteristics of a good security visa-vis the nature of both share and real estate, this is followed by a discussion on the methodology adopted for the study in section 3. Section 4 deals with data analysis and discussion of results while section 5 deals with the conclusion and recommendation.

2. CHARACTERISTICS OF A GOOD SECURITY

Security is generally referred to as a backup for loan advanced to a borrower which serves as a secondary source of loan repayment (Adewusi 2006). An adequate security interest serves to assure a lender that in the event of default of fulfilling the obligation of repayment, the lender could rely upon the security to recover the debt. In conventional mortgage transaction, loans are primarily repaid from borrower cash flow (Okoror 1995, Oloyede 2000). Security is not taken with intentions of obtaining repayment by its realization; it is however taken in case the normal source of repayment fails. Security is required by lenders more as an insurance against unknown events which may render the proposed loan repayment plan impracticable. Akinfala (2004) enumerated the qualities of a good security as follows :- it must be safe, possesses capability of periodic yield, passes the test of liquidity, capital appreciation, taxation advantage with minimum management responsibility to the lender.

It is pertinent that lender is interested only in asset whose ownership is evidenced by document of title and the ownership of which may be transferred. Despite the genuineness of the title document, a lender however should not go to sleep after advancing the loans, monitoring plans should be put in place, review occasionally with necessary follow-up actions to regularly evaluate the state of things. Fortune-Ebie (2002) opined that security asset must over the life of the loans maintain its qualities and value in all its ramifications and must not be interfered with without the consent of the lender. Security acceptable to banks in credit transactions can be classified into two broad assets – real estate and financial assets.

(a) Real estate as security

Real estate is composed of several distinct areas of investment opportunities such as residential, commercial, industrial, agricultural or recreational investment. Traditionally, financial institutions accept Real estate as security for loan perhaps because of its ability to preserve wealth against inflation. When considering real estate for security, Valuer is consulted whose value estimate forms the basis of lender's decision to lend and how much to advance to the borrowers. In this regard, the key consideration is the market value of the property in question. Brueggeman et al (2002) opined that property market value is the basis for lending decision because the property will either be full or partial security for loan. Lenders are concerned with both the initial property value and the pattern of property values overtime. This pattern of property values is expected to exceed the outstanding loan balance for any given property over the term of the loans.

The salient points to note are: Is the property a freehold or leasehold? If leasehold, how many years has the lease to run? When did the property change hand and at what price? It is pertinent however to note that some lenders are in the habit of engaging the services of some professionals other than the Estate Surveyors and Valuers who by training are familiar with economics of landed resources. The value estimates incompetently arrived at could form a wrong basis for lending decision and loan purportedly advanced on such basis is capable of becoming non-performing loan and consequently bad debt. Osayameh (1986) however affirmed that when taking a mortgage over business premise for a large advance, it is prudent to use professional Estate Valuers because of the technical intricacies involved in asset valuation. When real estate is lodged as security for loan, certain elements have to be considered which include, valuation report of the property by a competent Estate Valuer, the question of fire insurance in respect of the building thereon, the title examination and report, the mortgage creation, legal or equitable, the priority of charge required, repayment of loan, remedies available to the mortgagor, is there a second mortgage or sub-mortgage?, and whether the land is registered or not (Onanuga1999). Real estate has some shortcomings as security for loan which include; if poorly located it may be difficult to exercise the right of sale, it has negative publicity for financial institution, the expenses on perfection can be heavy and time consuming, it is also subject to various State and Local laws and rates. Real estate despite these shortcomings is adjudged a better security asset for loan in an economy where things change rapidly.

(b) Shares (financial Asset) as security

When shares are purchased, a small part of the company is purchased. The size and part owned in such a company is determined by the number of shares bought in relation to the total number of issued shares in the company. The return to an investor in shares is referred to as dividend. It is pertinent to note that not all companies' shares are acceptable as security for loans only the quoted company shares are acceptable as banking security. Shares enjoy the highest advantages of liquidity and marketability but its ultimate performance is precariously hinged on the performance of the economic environment. Olawoye et al (1998) opined that lenders should exercise caution when taking security asset whose performance is solely hinged on the happenings in the economy. Talabi (1998) also warned that lenders should bear in mind that apart from the possible changes in trading fortunes of the company concerned, prices can fluctuate according to the impact of political and international events. The spate at which financial institutions accept share as security should be approached with caution because booms and recessions appear to be permanent features of any economy. Our discussion of financial is limited to shares for the fact that it is most common and acceptable in credit transaction in the country.

3. LOAN DEFAULT AND BAD DEBT

Default is described as failure to fulfill a legal obligation to which one has agreed to in the past. Default is anticipated in lending activity. Adewumi (1982) enumerated causes of default to include; poor analysis of financial data, incomplete knowledge of customers activities, bad management of account, inadequate monitoring, misrepresentation and dishonesty of customer, excessive lending on security value, insensitive to economic and environmental trends, diversion of funds and inadequate project funding. The incidence of bad debt can be regarded as occupational hazards in business of a bank. Akinfala (2004) however cautioned that such must be kept within a reasonable and managing level of the total lending portfolio. Adewusi (2006) observed that it is difficult to eliminate bad debt completely in credit transactions but it must be managed to a comfortable level.

4. THE RESEARCH METHODOLOGY

The paper aimed at assessing the performance of real estate and financial assets used as security for loans bearing in mind their ability to adequately cover both the principal and loan interest at foreclosure. Data on Forty-six (46) each on real estate and financial asset used as security were collected from selected banks in Lagos.
The following sets of hypothesis were adopted and tested to achieve the objective of the study.

Hypothesis 1

Ho: The mean sales price ($\overline{P_L}$) of real estate used as security is not significantly greater than the amount of loan ($\overline{A_L}$) secured .

H_1: The mean sales price ($\overline{P_L}$) of real estate used as security is significantly greater than the amount ($\overline{A_L}$) of loan secured.

Hypothesis II

H_0: The mean sales price ($\overline{P_N}$) of financial Assets used as security is not significantly greater than the amount ($\overline{A_L}$) of loan secured.

H_1: The mean sales price of financial Assets used as security is significantly greater than the amount ($\overline{A_L}$) of loan secured.

Hypothesis III

H_0: The Mean Sales Price per unit Loan ($\overline{P_L} / \overline{A_L}$) of landed Assets used as security is not significantly greater than the Mean Sale Price per unit Loan ($\overline{P_N} / \overline{A_L}$) of financial Assets

H1: The Mean Sales Price per unit Loan ($\overline{P_L} / \overline{A_L}$) of landed Assets used as security is significantly greater than the Mean Sale Price per unit Loan ($\overline{P_N} / \overline{A_L}$) of financial Assets

The test in this case is that of matched or paired samples. The procedure for the test is to calculate the difference (di) between each pairs of these samples (di = X_2i – X_1i), where X_2i is the Mean Sales Price of Real Estate or Shares and X_1i is the Amount of Loan Secured. These are then treated as a single sample $d_1, d_2, d_3 \ldots\ldots\ldots d_n$.

The test statistics is based on t-distribution, viz;

$$t = \frac{\bar{d} - D_o}{\frac{S_d}{\sqrt{n}}}$$

where

$\bar{d}$ = mean of $d_1, d_2, d_3 \ldots\ldots\ldots d_n$.
S_d = standard deviation of $d_1, d_2, d_3 \ldots\ldots\ldots d_n$.
n = number of samples
v = n-1 = degree of freedom.

5. DATA ANALYSIS AND DISCUSSION OF RESULTS

Acceptable Security and Documentation

Figure 1 shows the proportion of loan secured and unsecured. Majority of the loans advanced were secured by financial assets representing 61%, 19% were secured by real estate and 20% were not secured at all. This indicates that the banks show greater preference for financial Assets. This finding is in line with the opinion expressed by Oloyede (2004) that more liquid assets are important to lenders because of relative ease of loan realization in case of default. However, the proportion of unsecured loan indicates poor documentation on the part of the banks.

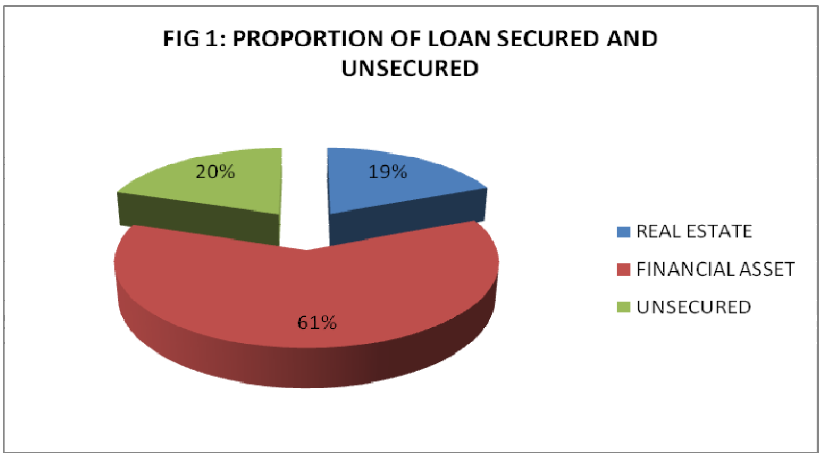
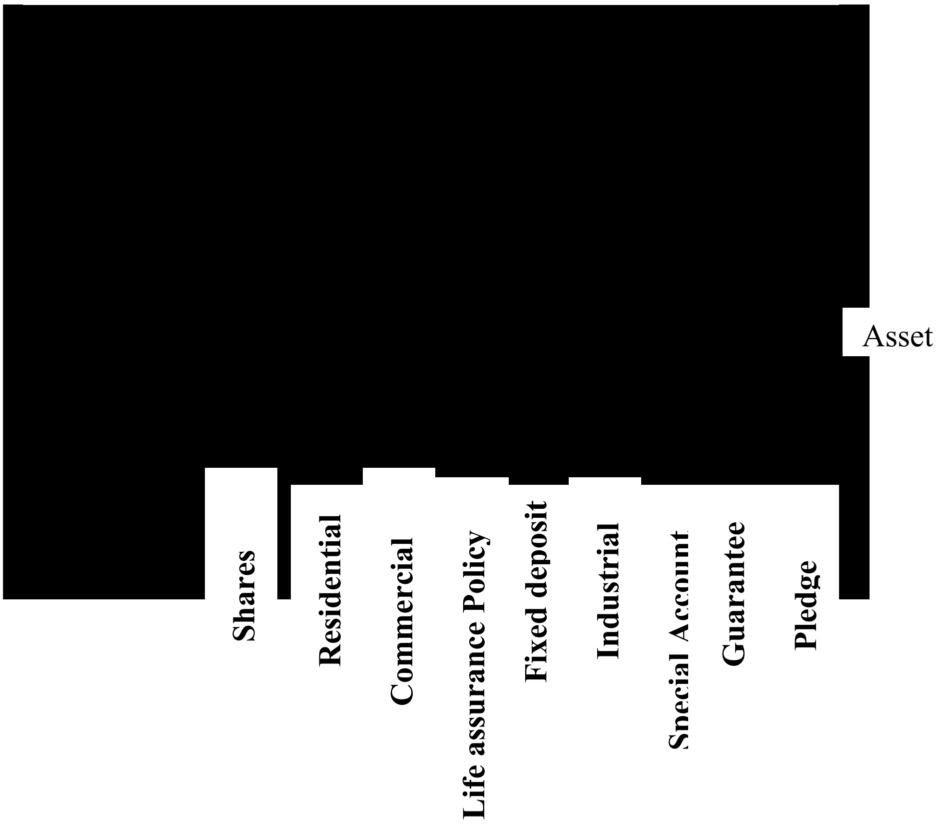


Figure 2: Security assets Acceptable to Banks



Shares certificate topped the list of security assets acceptable to financial institutions and this was followed by residential property (Fig. 2). What is discovered here is that majority of the loans advanced are short and medium terms (Fig 3). This is in tune with the findings of Akinfala (2004) that financial assets were mostly taken as security for short and medium term loans while long term loans were being secured by real estates.

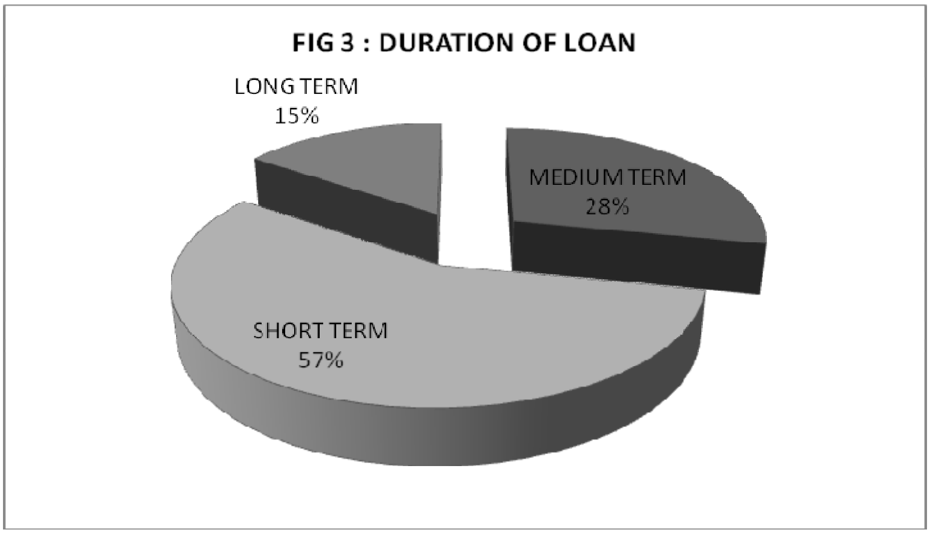


FIG 3 : DURATION OF LOAN

Adequacy of Security

Tables I and II show the pair sample statistics and t-test result. Table I reveals that the real estate (estac) has a mean price of ₦ 8449032.07 which is greater than ₦ 2,280,189.13, the amount of loan secured (loanb) by ₦ 6, 168, 842.94. The mean of the share price (shareb) ₦ 6242648.15 is also greater than the amount of loan secured (loanc) ₦ 2280189.13 by ₦ 3,962,459.02. The mean price of real estate is also greater than the mean share price by ₦ 2,206,383.92.

Table I: Paired Samples Statistics

		Mean	N	Std. Deviation	Std. Error Mean
Pair 1	estac	8449032.07	46	10970846.46	1617563.06
	loanb	2280189.13	46	2928963.38	431852.09
Pair 2	shareb	6242648.15	46	7960817.30	1173758.47
	loanc	2280189.13	46	2928963.38	431852.09
Pair 3	estac	8449032.07	46	10970846.46	1617563.06
	shareb	6242648.15	46	7960817.30	1173758.47

Source: Analysis of Surveyed Data, 2008.

Table II: Paired Samples Test

		Paired Differences					t	df	Sig. (2-tailed)
		Mean	Std. Deviation	Std. Error Mean	95% Confidence Interval of the Difference				
					Lower	Upper			
Pair 1	estac – loanb	6168842.93	9993419.53	1473449.32	3201163.66	9136522.21	4.187	45	.000
Pair 2	shareb – loanc	3962459.02	8203781.91	1209581.65	1526236.52	6398681.53	3.276	45	.002
Pair 3	estac – shareb	2206383.91	8974089.00	1323157.23	-458591.56	4871359.39	1.668	45	.102

Source: Analysis of Surveyed Data, 2008.

From table II, the pairs of real estate and the amount of loan secured (pair 1); and the pairs of mean share price and the amount of loan secured (pair 2) have their confidence intervals entirely above 0.00, which implies that the two assets provided adequate cover for the amount of loan secured. Since the confidence interval of the pair of real estate and share have the lower limit of the confident interval below 0.00 and the upper limit above 0.00 we cannot infer that the performance of one is better than the other.

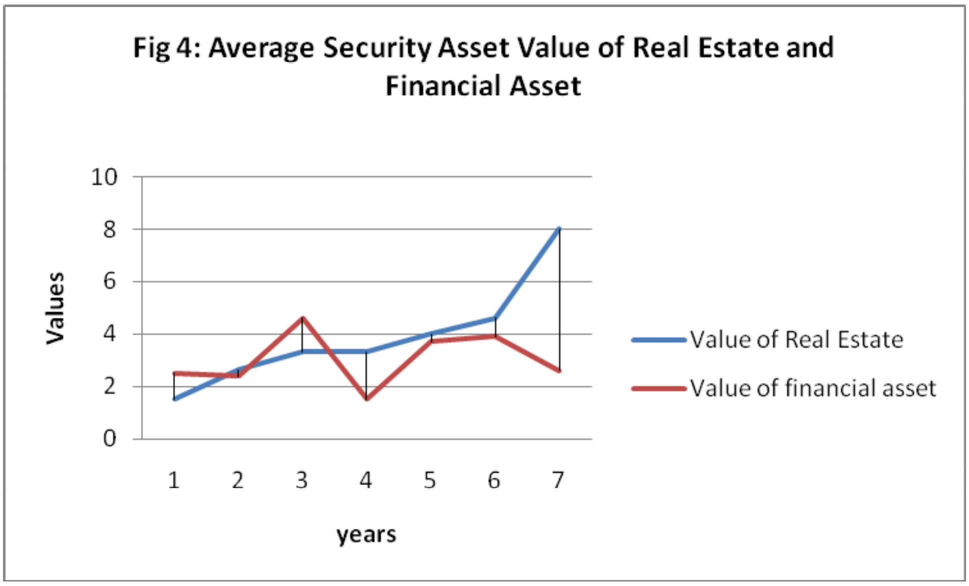
The results of the hypotheses 1 and 2 revealed that real estate and financial assets provided adequate cover but hypothesis 3 did not show that real estate performed better as security. This is contrary to the opinion expressed by Olawoye et al (1998) that shares performed better than landed Asset.

Table III reveals the average security assets value in millions between years 2000 and 2006. The value of real estate steadily increased over the period and financial asset fluctuated in value over the same period (figure 4). There by making real estate a better asset in securing a long term loan.

Table III: Average Security Asset Value Before Foreclosure

Year	Value of Real Estate	Value of financial asset
2000	1.5	2.5
2001	2.6	2.4
2002	3.3	4.6
2003	3.3	1.5
2004	4.0	3.7
2005	4.6	3.9
2006	8.0	2.6

Source: Analysis of Surveyed Data, 2008.



6. CONCLUSION

In this paper, it has been discovered that most sampled banks preferred financial assets as security than real estate but the results of the tested hypotheses revealed that both assets proved adequate but real estate appreciated steadily over the period and has a better performance on the long run. Therefore, financial institutions are enjoined to properly consider the suitability and appropriateness of each of the assets bearing in mind the challenging inflationary trend in Nigerian economy.

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BIOGRAPHICAL NOTES

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