THE IMPACT OF FINANCIAL DEREGULATION ON THE BANKING SYSTEM IN NIGERIA: 1989 - 1996

BY
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BEING A THESIS SUBMITTED TO THE POSTGRADUATE SCHOOL, AHMADU BELLO UNIVERSITY, ZARIA, IN PARTIAL FULFILLMENT OF THE REQUIREMENTS FOR THE AWARD OF MASTER OF SCIENCE DEGREE IN ACCOUNTING AND FINANCE

OCTOBER, 1999

DECLARATION

I, Ahmad Usman Altine hereby declare that this Thesis, entitled 'The Impact of Financial Deregulation on the Banking System in Nigeria: 1989 - 1996' submitted in partial fulfilment of the requirements for the award of MSc. Degree in Accounting and Finance is an original work of mine and not a duplicated one, and that all research materials used have been dully referenced.

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CERTIFICATION

This Thesis entitled 'The Impact of Financial Deregulation on the Banking System in Nigeria: 1989 - 1996' by Ahmad Usman Altine meets the regulations governing the award of the degree of Master of Science in Accounting and Finance of Ahmadu Bello University, Zaria and is approved for its contribution to knowledge and literary presentation.

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Dean, Postgraduate School

DEDICATION

To:

Palestine: A Nation battling the most inhumane form of colonialism.

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ABSTRACT

The banking industry in Nigeria came under the sway of market oriented policies in 1987 via the so-called policy of' Financial Deregulation' . A policy that ushered in a new monetary control regime - an indirect monetary regime. The impact of Deregulation manifested in different forms , some in dramatic fashion . Of great importance was that the policy later triggered shocks that proved devastating for the banking system . There was widespread financial distress which culminated in unprecedented number of bank failures , whose costs to depositors and regulators were estimated in billions of Naira .

What went wrong with Deregulation ? This study examines the impact of the policy on performance of commercial banks using the Model CAMEL (capital, assets , management ,earnings ,and liabilities). A sample was drawn from the list of licensed commercial banks using a stratified random sampling approach. Appropriate ratio proxies were employed to examine aspects spelt out in the model. Behavior practices by the different bank size categories were also examined.

The study reveals that the banking system assumed high credit risk without commensurate returns and consequently accumulated huge non-performing assets, both profitability and operational efficiency were generally low in the period, but there was a tend towards credit expansion especially as the policy triggered shocks. On the overall, the huge non-performing loans proved to be the main cause of the widespread distress that plagued the banking sector.

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CHAPTER ONE

INTRODUCTION

1.1 Background of the Study

The 1980s had been a difficult period for the Nigerian economy. The major indices of economic performance over the period were characterised by dramatic deterioration from year to year. The all-important public sector of the economy was plagued to the point of devastation by wide scale mismanagement. These were to be accompanied by an unprecedented decline in oil revenues (mainstay of the economy) due to plummeting oil prices. As the years pass by, the economy sunk deeper into the doldrums. Infact, the prospects for a turn around were bleak.

Thus, with the economy on the brink of total collapse, the authorities sought in 1986 the assistance and expertise of both the World Bank and the International Monetary Fund (IMF) in efforts to resuscitate the economy. It was no easy task. The response of these key economic institutions was for a total overhaul or restructuring of the Nigeria economy. There could be no better alternative.

The intervention, particularly, of the IMF was to culminate in what came to be known as the 'Structural Adjustment Programme (SAP). The main thrust of the programme was a complete liberalisation of the economy, which entailed strong private sector participation and adoption of market oriented policies. This new economic philosophy was to have an overwhelming -impact on every facet of the Nigeria Economy including both the capital and money markets.

The then blowing wind of change finally caught up with the money market. The year 1987 was to mark a new beginning for the credit market. The market through the policy of "Financial Deregulation" came under the sway of market oriented banking policies. A policy that was to have dramatic effects on both the operations and operators of the credit market. This policy of Financial Deregulation is akin to an indirect monetary monetary control regime. This monetary regime had remained operational ever since, although not without significant modifications and sometimes even outright reversals especially in the years 1991 and 1994.

The status quo ante approach to monetary control (the direct monetary control regime) involved the use of policy instruments such as quantitative ceilings on bank credit, selective credit controls and administered interest and exchange rates. It should be mentioned that both the direct and indirect monetary regimes have the same focus that of influencing the cost and availability of bank credit. But the direct monetary regime in place then has persistently been the object of much criticisms. The main theme of the criticism has been that the approach engenders market distortions that caused inefficiencies in the credit market.

The desire to overcome the inadequacies of the direct monetary regime coupled with the institution of economic liberalisation and market oriented policies in other sectors of the economy provided the much sought after impetus for the change to the indirect monetary regime in 1987. The main components of the regime at its commencement were: The liberalisation of bank licensing requirements, deregulation of the foreign exchange market, the removal of credit ceilings and more important, the deregulation of interest rates. The main argument in favour of this regime was that it will make the credit market dynamic through competition and this will ultimately lead to economic

efficiency in the credit market. Subsequent happenings in the credit market were to confirm the dramatic impacts of this policy of deregulation on the operations of the credit market.

The impact of bank licensing liberalisation manifested itself in the dramatic rise in the number of licensed banks in the first three years of deregulation. From a figure of forty in 1986 (the year before deregulation), the number rose to forty-nine, sixty four and eighty one in 1987, 1988 and 1989, respectively, NIDC Annual Report, (1990). The number was to peak at 120 in 1992. Similarly, the rise in the number of non-bank finance institutions was equally dramatic.

A rise in the number of banks as a benefit of deregulation was intended to engender optimal competition that will ultimately create economic efficiency in the credit market. But the increases in the number of banks were too rapid for the market. Consequently, excessive competition overwhelmed the credit market. This unintended fallout forced the monetary authorities to suspend the licensing of additional new banks in the middle of 1991.

There is little doubt that the single most important component of the market oriented banking policies adopted in 1987 was the deregulation of the interest rates. The first two years of deregulation (1987 and 1988) were characterised by relatively stable interest rates, a good omen for financial stability. However, this relative stability was short-lived. The period stretching through 1989-1990 witnessed an unprecedented and dramatic rises in interest rates. For example, in 1989, the rate rose from an industry average of about 17 to 30 percent p.a within three months. The banking system was then beginning to be plagued by the effects of another unintended fallout. The interest rate nevertheless, continued its upward trend unabated with devastating effects on the banking

system so much that the monetary authorities had to respond with a policy reversal to place a ceiling on interest rate of 21 percent per annum in the 1991 fiscal year.

However, the shocks generated by the high and unstable interest rates persisted through the years 1992 and 1993. In fact, its effect became more acute and manifest. The cut-throat competition for public deposits continued with vigour but with little economic sense. Then crept in the high incidence of inter-bank defaults attributed to the extremely high cost of inter bank funds. At some point, the inter-bank rate stood at 100 percent ! This was to be the last straw that broke the camel's back.. The banking sector began to exhibit the symptoms of financial fragility. At the end of 1994, forty-two licensed banks were officially classified as financially distressed banks, CBN Annual Report and Statement of Accounts, (1994). Additional eight others were also adversely classified in 1995. And in the same year, the regulatory authorities took over the management of nineteen of such banks. A step designed to stave off the contagion effect.

Nevertheless, the worse scenario did set in. The possibility of bank failures become a forgone conclusion. By the end of 1994, four banks had their licences revoked and those of two others suspended. The fiscal year 1996 saw a large number of banks (both commercial and merchant) went under taking with them depositors money estimated in several billions of naira. There could be no worse time for the banking system. It has been brought to the brink of collapse under the era of deregulation. But this is not to say that deregulation did not accomplish a number of positive strides. Far from that. But the shocks generated by deregulation and its attendant consequences to the industry were unprecedented in the history of banking in Nigeria.

It should be mentioned that deregulation as a policy did attract much attention from both bank regulators and management and of course from the public. This is particularly true as the effects of the fallouts of deregulation began to become apparent, especially in terms of costs associated with the bank failures to depositors and owners of the failed bank, cost to the deposit insurance fund and to the diseconomies of scale triggered by such bank failures. An empirical study of the impact of deregulation on the banking system should thus elicit strong interest.

1.2 Statement Of The Research Problem

The policy of Financial Deregulation adopted by the monetary authorities in 1987 undoubtedly marked a significant turning point for the credit market in Nigeria. For prior to the adoption of financial deregulation, this all important sector of the financial system had been characterised by high levels of market distortions and inefficiencies largely attributable to the direct monetary control regime then existent. Thus within the context of a strategy to overcome or correct these market inadequacies, a new monetary control regime was put in place, an indirect monetary control regime. A measure that effectively puts the banking system under the sway of market oriented policies, or deregulation as it is often called.

Financial Deregulation as adopted in 1987 entailed a number of policy elements. The more important ones being the liberalisation of licensing of new banks and the deregulation of the key interest rates. These measures, amongst others, as earlier mentioned were to have dramatic impacts on banking operations. Bank licensing liberalisation was immediately accompanied by a

dramatic rise in the number of new market entrants that included both bank and non-bank finance institutions. This intended benefit of deregulation has made the operations of the credit market more vibrant through some measure of increased competition between the different market participants. A phenomenon, deemed important for the efficient circulation of capital. This was aided further by the deregulation of the key interest rates. The deregulation of the interest rates established the market mechanism as the main tool in the determination of the cost of and availability of bank credit. There are also other less salient benefits that accrued from deregulation.

But on the other hand, this policy of Financial Deregulation had triggered some unprecedented fall-outs or shocks in the banking system. In fact, the shocks were so destabilising that the monetary authorities had to adopt some remedial measures in 1991 and 1994, in what amounted to some milder form of re-regulation of the banking sector. The most important of these shocks were the widespread financial distress in the sector and the subsequent bank failures.

By the end of 1995, a total of fifty licensed banks were officially classified as distressed by the monetary authorities, CBN Annual Report and Statement Accounts, (1995). A figure that amounts to about 43 percent of the number of licensed banks! These banks so classified had exhibited a number of problems that included huge non performing loans, under-capitalisation, poor earnings, illiquidity etc.

The widespread financial distress ultimately culminated in a significant and unprecedented number of bank failures. The costs of both distress and the failures to both depositors and the public were indeed enormous. The figures are in the billions of naira. For example, the CBN in collaboration with the

NDIC had earlier in 1989 organised a rescue package of N2.3 billion to bail out some distress banks and similarly disbursed the sum of N100 million to another problem bank in 1993. In addition the distressed banks' overdrawn position with CBN stood at N17.8 billion as at the end of December, 1996. CBN Briefs, (No.98\11). It couldn't have been worse under deregulation.

But could these fall-outs have been staved-off ? Or are they the inevitable consequences of financial deregulation ? What could have gone wrong ?

1.3 Research Questions

The main focus of the study will be on the following research questions:

I. What were the main causes of the financial distress prevalent in the banking sector ?
II. How did deregulation impact on the liquidity of the banking system ?
III. Did deregulation make bank lending riskier ?
IV. How did deregulation affect the operational efficiency of the banks ?
V. What was the impact of deregulation on bank profitability ?
VI. How did deregulation affect the ability of the banks to absorb shocks and losses ?
VII. What was the effect of deregulation on the availability of bank credit ?
VIII. How did the different bank size categories responded to the deregulatory environment and its shocks ?.

1.4 Objectives Of The Study

The monetary authorities shift from a direct to an indirect approach to monetary control through the policy of Financial Deregulation ever since 1987 and the attendant dramatic events has attracted much and continuos attention from the

public that constitute the main source of bank deposit liabilities. This level of attention underscores not only the paramount role of banks in the financial intermediation process but also their dominance of the financial system in Nigeria. And thus the level of the keen interest in matters pertaining to the banking system.

This policy of Financial Deregulation has being in operation ever since its introduction in 1987. And as earlier mentioned above, the policy has attracted a lot of attention from different stake holders. It is the major objective of this study to examine the impact or effect of the various policy elements of the deregulation on the performance of commercial banks within a framework of the CAMEL (Capital, assets, management, earnings and liabilities) model. In specific terms, this will entail, amongst others, an examination of their effects on commercial banks' profitability, liquidity and solvency.

The study will also encompass an examination of the behaviour practices of the different bank size categories in their responses to the new operating environment engendered by deregulation. This will be particularly useful in explaining the competitive behaviour and approaches to risk by the different bank-size categories. As for the accompanying analysis, it should provide a basis for evaluating the effectiveness of the various policy reform elements on the banking system since the adoption of deregulation in 1987.

1.5 Significance of the Study

The concern for a sound banking system cannot be over emphasised. This is particularly true given the paramount role of tanks vis-a-vis financial

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intermediation. Besides, a sound banking system is perceived as an indicator of confidence and soundness of a nation's economy. The task of ensuring a sound banking system rests with the nation's monetary authorities, for they are responsible for the important task of monetary policy formulation and implementation. The findings of this study should be of benefit to them in many ways.

This study is expected to be an empirical report of the effects of deregulation on the banking system. It findings will reveal the effectiveness of the various policy interventions in the credit market by the monetary authorities under the period of the study. The findings will also show the extent of the effectiveness of the different bank-specific regulatory requirements imposed by the bank regulators under deregulation. Then the accompanying analysis of the behaviour practices of the different bank-size categories to environmental changes engendered by deregulation should be of assistance to the bank regulators in their routine of monitoring and supervision of banks, especially under a period of financial turbulence as witnessed under deregulation.

The huge costs associated with the unprecedented number of bank failures witnessed under deregulation underscores the imperative need for regulators to significantly improve their supervision standards and the identification process employed to identify potential problem banks. The costs of such bank failures extend not only to the depositors of the individual banks but to the funds of the Nigeria Deposit Insurance Corporation (NDIC). The study is expected to benefit both the bank regulator (CBN) and the NDIC on selecting efficient bank specific measures that will enable them to monitor a banks probability of failure. It will also provide information to the NDIC on the behaviour to risk by the different bank size categories especially under the period of deregulation.

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The study will also be of interest to bank directors and management. This is much so since they are respectively saddled with the task of bank policy formulation and implementation. The findings particularly in the area of bank-specific variables of portfolio riskiness, earnings and liquidity should provide a basis for directors and management to evaluate the efficiency and effectiveness of their past and future actions under an environment of financial deregulation. This will assist them in overcoming or at least minimise the effects of the fall-outs associated with deregulation.

A study of the impact of deregulation on the banking system should be of interest of financial analysts and researchers. Both groups will find the study useful as an important source of information for either financial analysis or bank research. The period covered by the study is long enough to accomplish either of the purpose.

1.6 Scope of the Study

The study will employ the annual accounts of a sample of commercial banks selected through a proportionate stratified random sampling approach. Thus the study will be limited to only commercial banks. It will therefore be inappropriate to apply the results of the study to other category of banks. The study will cover the period from 1989 to 1996. The unavailability of data did not permit the inclusion of the first two years - 1987 and 1988 - of the commencement of deregulation. Thus the initial impact of the policy in those two years cannot be ascertained.

Reporting practices of the banks did not also permit the measurement of a bank's credit exposure to particular sectors of the economy so as to determine the concentration of a bank's portfolio, say to vulnerable sector(s). This would have provided useful information on sectoral credit risks. The study did not also consider the likely impact of macro-economic factors (e.g. inflation, budget deficit, etc.) on the bank-specific variables employed in the study. It is not unlikely that they might have had some influencing effects.

1.7 Limitations of the Study

The unavailability of relevant literature especially current academic journals and the still-inadequate reporting practices of the banks are some of the main constraints encountered in the course of the research. Nevertheless, every effort was made to overcome the effects of these inadequacies, so as to source the relevant data that will permit the use of the research technique adopted for the study.

It should be mentioned that the results of the study should not be considered as prescriptive. They do not define optimum levels for the bank-specific variables, rather they only indicate the bank specific variables which most influenced the performance of the commercial banks during the period under study.

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1.8 Definition of Terms

Non performing Loans: Those loans that are 90 days or more past due or not accruing interest.

Total Loans: The aggregate total value of all outstanding loans before loan loss charge-off.

Operating Income: The total of all operating revenue reported by a bank.

Inter-Bank Rate: The interest rate that applies to transactions between Banks, mostly for overnight and short term funds.

Bank Failure: A bank that is unable to meet its obligation.

Naira : The national currency of Nigeria

Commercial Bank: A bank licensed to make loans and issue deposits, including deposits against which cheques can be written.

Distressed Bank: A bank with problems relating to illiquidity, poor earnings, non performing assets, and insolvency.

Interest Rates: The rental value paid for the use of money or credit. The rate may be nominal or real.

Lending Rate: The interest rate applied to loans made to customers.

CBN: Central Bank of Nigeria. Nigeria's apex bank.

NDIC:	Nigeria Deposit Insurance Corporation. The agency charged with insuring the deposit liabilities of licensed banks.

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CHAPTER TWO

LITERATURE REVIEW

2.1 Structure of Banking in Nigeria.

The important position of a banking system in an economy derives from the role of banks in facilitating economic development. Banking institutions have become so central to economises that the prospects of a modern and industrial economy without a bank system is beyond imagination. In fact, Schumpeter (1933) identified the banking system as one of the two key agents in the whole process of development. The essential function of the banking systems is that it acts as an intermediary between savers and borrowers. An important feature that distinguished banks from all other financial intermediaries is that they alone apart from government furnish part or all of the means of payment or money supply.

The structure of the banking system in Nigeria may be examined in the light of the different types of banks that comprised the system. Apart from the Central Bank of Nigeria (CBN), the banking system is made up of commercial, merchant (or investment), mortgage, and development banks. In recent years, there have emerged certain specialised types of banks which are more or less like fringe institutions. These are the so-called Peoples Banks and Community Banks. Of all the different bank types, the commercial and merchant banks seem to be the heart of the banking system. Then next in importance are the development banks, followed by the mortgage institutions. The specialised banks completes the tail end of the structure.

2.1.1 Central Bank of Nigeria

The Central Bank was established in 1958. It functions along the usual patterns of any central bank. The bank acts as a banker to other banks and the government. It is the main institution charged with the responsibility for monetary policy. Thus, this establishes the Central Bank as the main government agency controlling the activities of the commercial and merchant banks and by extension plays the role of a lender of last resort for the banking system, so as to stave of crises. The role of a Central Bank in a banking system stems from the need for a higher authority to regulate banks so as to prevent them from reckless credit expansion or to help them overcome crises by lending generously to them, Bagehot (1912) and Goodhart (1988). The Central Bank has increasingly assumed high profile roles in the banking system especially in the aftermath of the adoption of market oriented policies in 1987. The Nigerian Banking System operates a branch type of lending system as against the unit form of banking obtained in say the US.

2.1.2 Commercial Banking

The term commercial banks is used to refer to financial intermediaries with a licence to make loans and issue deposits including deposits against which cheques can be written. The functions of the commercial banks can be perceived as being mainly the money creating function and the service rendering function. The main important function of the commercial banks in the Nigerian economy is that of creating and destroying money supply in the economy through their lending and investment activities. Thus they play a key part in the control of the money stock in the economy.

Commercial Banks in addition to their main function described above, render a number of other services for their customers. These services, amongst others are:

I. Providing paying and receiving stations for hand to hand currency;
II. Providing savings department for their customers;
III. Performing trust services;
IV. Providing facilities for foreign exchange transactions;
V. Offering safekeeping facilities;
VI. Receiving cheques, drafts, notes, etc. for their customers.

The importance and dominance of commercial banks in the economy of Nigeria cannot be overemphasised. These banks constitutes the most important segment of the credit market. Their importance in the Nigerian economy is reflected in Table 2.1 vis-à-vis their lending activities and the value of assets under their control. These figures underscore the importance of the commercial banks to the Nigerian economy. Their numbers stood at fifty-eight as at December 31, 1990.

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Table 2.1: Commercial Banks' Assets and Loans and Advances

Year	No of Banks	Total Assets (NM*)	Net Loans and Advances(NM*)
1986	29	39678	18473
'87	34	49828	21633
'88	44	58027	24464
'89	n.a	64874	28108
'90	58	82958	33451
'91	65	117512	45550
'92	66	181736	52765
'93	66	272285	77578
'94	65	324002	109535
'95	64	463671	165330

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*Millions of Naira.

Source: Major Economic, Financial and Banking Indicators, CBN, April,1996.

2.1.3 Merchant Banking

The merchant banks are next in importance after the commercial banks. Merchant banking, in contrast, to commercial banking has a more recent history in Nigeria. They could be distinguished from commercial banks through the types of activities they either engage in or do not engage in. Merchant banks in Nigeria are essentially wholesale bankers and thus their main clientele are corporate customers. This means that they require few branches to operate. Another important feature that separate them from commercial banks is that they specialise in arranging large loans through the issue of bonds and hence lend mainly on medium and long term basis. Such banks provide a number of other services for their customers. But unlike commercial banks, they do not

create money in the form of demand deposits. Their numbers and business profiles have grown over the years in Nigeria. From a figure of twelve in 1985, their number had risen to forty-eight in 1990.

2.1.4 Development Banks and Others

The development and mortgage banks are essentially development finance institutions established to boost the growth of some specific sectors of the Nigerian economy. The most important of such institutions are the Nigerian Industrial Development Bank (NIDB) and the Federal Mortgage Bank of Nigeria (FMBN). NIDB raises its funds mainly from international development agencies. By 1990 the bank had sanctioned about 63 projects valued at over N1b. FMBN on the other hand mobilises funds for mortgage development mainly from internal sources.

The banking system, in recent years, witnessed the emergence of certain specialised institutions. They are referred to as the Peoples Banks and then the Community Banks. They provide services mainly to rural and low-income groups. They provide services mainly not available in conventional banks or where available difficult to obtain by such low-income groups.

2.2 *Concept and use of Financial Ratios*

The use of ratios in the analysis of financial statements stem from the underlying theory that there exists a relationship between the various items in the profit and loss account and balance sheet and certain other items in the

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profits and loss account or balance sheet. And the relationships establishes a discernible pattern of behaviour. Ratios whether employed as percentages or decimals, have become the basic building block in financial statement analysis. ratios are employed as important benchmarks for the analysis of financial statements. The use of ratios for analysis, can be employed in the form of structural analysis, time-series analysis and cross sectional analysis.

Financial ratios as tools of financial analysis have come a long way in accounting literature. But financial ratios , assumed great importance following the studies of Altman (1968) and Beaver (1968), in which both studies employed financial ratios for the prediction of corporate failure. These two studies added an important dimension to the usage of financial ratios, which had until then been restricted to the normal basics of financial analysis.

The works of Altman and Beaver were closely followed by other works in their footsteps. Meyer and Piper (1970) extended the use of financial ratios to predict the likelihood of failure to commercial banks. They carried out a study of 39 commercial banks that failed in the US between 1948 and 1965. Their conclusion was a step further ,that "...even when failure frequently results from embezzlement and other financial irregularities, financial measures can evaluate the relative strengths of firms". A conclusion that entrenched further the usage of financial ratios as important measures of corporate performance.

Ever since, financial ratios have become important tools in the evaluation and analysis of corporate performance. There have also emerged a number of

different statistical models that ranges from univariate, bivariate to multivariate, that depends on the use of financial ratios for corporate performance evaluation that even includes the detection of potentially problem banks and other firms. For example, the multiple discriminant analysis is a basic statistical model that relies on financial ratios, employed as an early warning model for detecting potentially problem banks. Sinkey (1975) had employed the multiple discriminant model to study the characteristic of problem banks.

Financial ratio also serve other equally important uses. Bank regulators employ financial ratios in their bank examination process for the purpose of enforcing bank prudential regulations. The FDIC for example, employs the so called adjusted capital ratio and the net capital ratio in its bank evaluation process. Other regulatory agencies employ similar identical ratios for bank prudential examination processes.

A search through accounting literature will always reveal how important financial ratios have been in the analysis of financial statements. Financial ratios have come to be employed for many important purposes, especially corporate performance valuation. Researchers have employed them for purposes as forecasting financial failure, determination of corporate success or growth, corporate risk, corporate bond rating, etc.

However, it should be stressed that despite the position of prominence enjoyed by financial ratios in finance literature, they must "be used with caution", is a

well established axiom in financial analysis, for "ratios are not to be regarded as a substitute for judgement; they are merely clues which focuses attention on certain relationship, some of which may be worthy of further investigation", Pitcher (1979).

2.3 Commercial Bank Performance Ratios

The main parties interested in the financial statement of banks are depositors, regulatory authorities, stockholders and bank management. Although the information needs of each of the parties vary, nevertheless, the financial statements have been tailored to serve the individual needs of the respective parties. Their information needs is usually achieved via the use of financial ratios that are specific to their respective needs. For example, while depositors are interested in measures of solvency of their bank regulatory so as to assure themselves that the operators of bank are being carried on in accordance with relevant laws. Stockholders on the other hand will be more concerned with ratio that serve as indicators of earnings and dividends. As for Management, they have more obligation to fulfil that ranges from meeting the demands of depositors to earning fair returns on the assets and equity of the bank.

Financial ratios employed in the analysis of commercial bank financial statements can be grouped into a number of ratios based on the respective areas of interest to the users of such ratios. And like those of other firms, financial ratios of commercial banks are subject to the usual caveat associated with the analysis of financial statements. There are a number of financial ratios that can be derived from either the profit and loss account or balance sheet, or from both statements. Such derived financial ratios are employed to serve as proxy

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measures for the different areas of interest. It should be said that an area of particular interest may be proxied by two or more different ratios.

The financial ratios produced below are some of the many ratios employed in the analysis or the statements of commercial banks. The classification of the ratios is based on the area of interest to users.

i. Liquidity Ratios

These are ratios that measure a bank's ability to meet customer deposit withdrawals. For banks to meet their obligations to their depositors, the regulatory authorities usually require banks to maintain at least a specified minimum regulatory liquidity ratio. Liquidity of a bank may be measured by any of the following ratios.

i. Ratio of cash and Nigerian government securities to total deposits
ii. Ratio of liquid assets to total deposits
iii. Ratio of liquid assets to total assets.

Although a high value in any of the above ratios depicts a favourable liquid position but may not necessarily represent a favourable position from an income point of view, given the dominance of cash and other low income yielding securities in the portfolio of such a bank.

ii. Profitability Ratios

They measure the ability of a bank to employ its assets and earn a reasonable return for its stock holders and to boost its reserves. The profitability of a bank's operations can be measured by either of these ratios:

i. Ratio of net income to total capital
ii. Ratio of net income to total assets

iii. Capital Adequacy Ratio

They are ratios employed to measure the ability of a bank to absorb shocks and losses. Such ratios are indicators of the degree of safety enjoyed by a bank's depositors. Any of the ratios below can be employed to measure capital adequacy.

i. Ratio of capital to total assets
ii. Ratio of loans to capital plus reserves
iii. Ratio of capital to risk assets

A number of ratios are employed by the different regulatory authorities for capital adequacy purposes.

iv. Revenue Sources

The ratios in this category are employed to measure revenue concentration. Such ratios includes:

i. Ratio of loan income to total revenue

ii. Ratio of interest on Nigerian government securities and treasury bills to total revenue.

iv. Loan value Ratios

They are ratios employed to measure loan volume. The following ratios can employed for this purpose:

a. Ratio of total loan to total assets

b. Ratio of total loans to total deposits

2.4 Bank Prudential Regulation

The key role of banks in the process of financial intermediation in an economy had made them the subject of public regulation. There are a number of economic rationales for bank prudential regulation. This is reflected in the different studies carried out (for example, Meltzer (1967), Jacobs (1964), Posner (1974), Posner (1978), Itzhak (1980)), to examine the justifications for bank prudential regulation. There are two main discernible themes from the different studies. Itzhak (1980) identified the existence of deficiencies in information as to banks' degrees of riskiness and the external diseconomies associated with bank failures, as the justifications for bank prudential regulation. Thus the objectives of effective bank prudential regulation "should be to minimise the social cost of intermediation consistently with safeguarding depositors" and "should ensure that banks do not follow imprudent policies to the extent that their operational viability, or solvency is threatened"

The approaches to bank prudential regulation vary from country to country. This implies that the degree of prudential control and appraisals will differ from one country to another. Thus different countries will employ bank regulations in different ways to achieve their goals. But it should be said that there are more common grounds than are differences, besides the objectives are similar if not same. Capital adequacy regulation, bank examination process and the deposit insurance scheme are some of the ways of achieving bank prudential regulation.

2.4.1 **Capital Adequacy Regulation**

The huge cost often associated with bank failures underscores the importance of the so called capital adequacy problem. Capital adequacy problem is essentially concerned with how much capital (or net worth) should banks maintain for the purpose of absorbing possible losses. The rationale for maintaining adequate capital to cushion the effects of possible losses is meant to protect depositors and thus stave off bank failures.

But how much capital is required for the purpose of cushioning possible losses has remained problematic. For there is a lack of consensus on this matter between bank regulators and bankers. This may not be unconnected to the fact that "what might be adequate for one institution might be quite inappropriate for another. Banks face different risk exposures as a result of differing management strategies", Gardener (1978).

Despite the lack of agreement, the regulatory authorities often put in place a number of regulations that are capital adequacy related for compliance by

banking institutions. The capital adequacy regulation in addition to protecting depositors also serves to stave off bank failures. And where a deposit insurance fund exists, the regulations also protect the fund.

As earlier referred, capital adequacy regulation vary from country to country. But there are number of common provisions in terms of rules and guidelines. The regulatory authorities in Nigeria operates along the tradition of the British Banking Supervision. A style that involves the continuous surveillance through a number of capital ratios. For example, there are regulations that defines the percentage components of banks' capital and of recently the adoption of the 8.0 percent minimum Basle standard of capital to risk weighted assets. There are also portfolio related constraints which restrict the activities of banks and the composition of their portfolios of assets and liabilities.

However, it should be mentioned that bank prudential regulation through the use of capital ratios applied across the board to all banks has inherent drawbacks. It ignores the important fact that "banks face different risk exposures". Besides the limitations of ratios are constraints that cannot be ignored in financial analysis. Usage of prescribed ratios also brought with them the temptation of "window dressing" by the reporting bank management.

It is for the reasons of the inadequacies of the existing system that Revell (1975) has suggested the so called vicarious participation. This entails the regulatory authorities not laying down any inflexible mandatory prescriptions, but "instead they should supervise and monitor that all banks are managed in prudent fashion, undertake certain prudential tests and generally employ a suitable risk management methodology within their overall financial planning

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and control". An approach that links a bank's prudential adequacy to its overall risk management function.

2.4.2 **Bank Examination**

Bank examination by the regulatory authorities is about ensuring safety and soundness in the banking system. This boils down to the fundamental objective of preventing bank failures. A task that is to be achieved through the bank examination process, which entails identifying banks with the highest failure risks, i.e., problem banks. The Federal Deposit Insurance Corporation (FDIC,1973) identified the purposes of bank examination as:

I. to determine asset quality;
II. to determine the nature of liabilities;
III. to ascertain compliance with laws and regulations;
IV. to evaluate controls, procedures, accounting practices, and insurance;
V. to evaluate management and its policies, and
VI. to determine capital adequacy.

The task of ensuring safety and soundness in the banking system is undoubtedly an important one. But the task of problem bank prediction is a difficult one. This is particularly true, given that management dishonesty is the major course of bank failures. For example, Hortvitz (1975) found out that of the 84 banks that failed in US between 1960 and 1976, 45 were essentially due to insider credits, while 25 cases were due to embezzlement or manipulation, and only 14 of the failures were due to managerial weakness in loan portfolio administration.

Although no established study on the major causes of the recent bank failures in Nigeria, the establishment of a "failed banks tribunal" and subsequent prosecution of a large number of bank managers and directors and their associates lends vindication to the assertion that most bank failures are caused by dishonest management. This makes the task of predicting problem banks difficult but not impossible. For Meyer and Pifer (1970) concluded that "...even when failure frequently results from embezzlement and other financial irregularities, financial measures can evaluate the relative strength of firms".

But in such circumstances, the examination process may have to emphasise aspects of fraud detection and evaluation of internal control systems in the banks. This of course its in addition to other measures of prudential regulation. Only then can the important task of predicting bank failure be more meaningful. The recent failure of a large number of small-size -banks less than a decade of their existence is a terrible blow to the bank examination process of the regulatory authorities in Nigeria.

It should be mentioned that bank regulators main indicator of a bank's safety and soundness flows from the loan evaluation process. The FDIC's manual of examination policies states:

> One of the most important aspects of the examination process is the evaluation of loans, for, in large measure, it is the quality of a bank's loans which determine the risk to depositors. To a great extent, conclusions regarding the condition of the bank, the quality of its management and its service to the community are weighted heavily by the examination's findings with regard to loans.

This underlines the importance of loan evaluation in bank prudential regulation.

2.4.3 **Deposit Insurance Fund**

Deposit Insurance Schemes are emerging as important complementary components of bank prudential regulation in many countries. There are currently two types of schemes in operation: The constant rate scheme and the risk related rates scheme . The scheme in operation in Nigeria is fashioned along the US model. It is an across the board scheme that charges constant rate premium on domestic deposits. Deposit insurance was introduced in the US to restore and maintain confidence in the banking system following the great banking relapses of the 1920s and 1930s. Revell (1976) pointed out that deposit insurance "serves to prevent the event that is insured against".

The two main objectives of deposit insurance schemes is first, to protect depositors and second, to prevent destructive runs on deposits i.e., to prevent mass or panic withdrawals of deposits from insolvent or potentially insolvent banks. The scheme in Nigeria introduced in 1988 offers protection to depositors up to a limit of N50,000 on an individual account. Following the recent bank failures and the subsequent liquidation of many of the failed banks, the NDIC compensated the depositors of the liquidated banks up to the maximum limit allowed. This measure should help to restore confidence in the banking system following the unprecedented bank failures witnessed under deregulation.

The across-the-board or constant rate premium scheme is often the object of criticism on equity grounds. It is often argued that the stronger institutions with proven prudential soundness are subsidising the risk exposures of their less prudent brethren. Thus Revell (1976) has proposed the scheme that reflects the individual risk exposure, so as to make the system "realistic and equitable".

But the risk-related scheme has its own difficulties. It is often difficult to assess risk of failure on an accrual basis, Bernett, et al. (1977). Besides the establishment of deposit insurance has the effect of making banks increase their riskiness, Peltzman (1970) and Mingo (1975). Thus whatever type of scheme is adopted the bottom line remains the same, that of protecting depositors and the banking system.

2.5 *Theory and concept of Monetary Policy*

Monetary Policy Formulation and implementation is undoubtedly an important function in an economy vis-a-vis the promotion of both economic development and monetary stability. The importance of monetary policy as a task stems from its role in the difficult task of linking the real sectors-output, employment and prices-and the monetary aggregates to desired or optimal levels. This mammoth task is akin to determining desired levels of output and employment, interest rates, wages and prices by influencing the appropriate variables that links the markets for money, goods and labour. This couldn't be an easy task even in the best of economic times.

The above is particularly true in less developed economies where attempts to influence some of the real sector variables through a manipulation of the monetary variables might be difficult if not impossible due to the existence of large informal real sectors. Thus its obvious that the task of monetary policy is an important one in an economy. Equally obvious is the fact that conducting monetary policy could difficult and even complex. There are a number of issues connected to monetary policy. The concept is a broad one. Its objectives are many and often vary from year to year. And there are different instruments

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employed to attain its objective or goals by different monetary authorities. But there are a number of common elements.

2.5.1 Concept of Monetary Policy

Wilczynski (1978) in his book 'comparative monetary economics: capitalist and socialist monetary systems', provided a broader definition of the concept of monetary policy.

> Monetary policy consists in the application of certain measures by monetary authorities, such as the issue of currency, liquidity ratios, interest rates and other credit terms and direct controls. In its broadest sense monetary policy is aimed at facilitating production and distribution and promoting high levels of economic development consistent with monetary stability.

This definition also highlights the mammoth task that conducting monetary policy could be. It also reveals what monetary policy is essentially all about. It is about measures adopted by the monetary authorities aimed at regulating the supply and cost of money in an economy vis-à-vis some desired level of economic activity.

As the bulk of the money supply is in the form of bank money, the task of monetary policy is directed at influencing the capacity of banks to extend credit and the cost of credit to borrowers. Through these actions, the monetary authorities expects to influence the levels of investment, output and employment in the economy. It is for this reason that monetary policy is seen to be largely counter cyclical. The CBN is the main government organ saddled with this all-important task of monetary policy formulation and implementation.

2.5.2 **Objectives of Monetary Policy**

The basic objectives of monetary policy in a given economy have often varied from one fiscal year to another. A phenomenon that makes the conduct of monetary policy more difficult. But in spite of this, there are some bottom-lines. But before highlighting the different objectives, it may be especially important to mention that the level of development of a nation's economy strongly determine it monetary policy goals or objectives.

For example, in the well developed economies of Western Europe, monetary policy is aimed towards tackling the most serious weaknesses of the capitalist economy, viz., unemployment, fluctuations and inflation. While in less developed economies its pursued within the overall strategy of speeding up economic and social development.

In Nigeria, the CBN, is the main organ of government saddled with the task of monetary policy formulation and implementation. The key objectives of monetary and credit policies are often spelt out in the annual national budget and then subsequently outlined and highlighted by the CBN in the form of Monetary Policy Circulars for compliance by banks and other financial institutions. Failure to comply often attract some forms of sanctions. The major objectives of monetary policy as outlined by the CBN over the years entails, amongst others:

i. the maintenance of relative stability in domestic prices;
ii. the maintenance of a healthy balance of payment position;
iii. the stimulation of economic development.

The adoption of SAP and the subsequent liberalisation of the money market in 1987 saw the emergence of monetary and credit policies that are largely restrictive. The 1987 budget, for example, spelt out its specific monetary and credit objectives as to:

i. moderate the inflationary pressures associated with SFEM foreign exchange market;
ii. simulate domestic savings;
iii. encourage non-oil exports and foreign capital inflow;
iv. stimulate local production output; and
v. ensure an improvement i the balance of payment position.

There are other major objectives of monetary policy in addition to promoting economic growth, stabilising business cycles and maintenance of full employment or at least high levels of employment. There is also the important objective of maintaining stability in the money and foreign exchange markets. This particular task has proved to be a difficult one for the monetary authorities in Nigeria especially following the deregulation of the foreign exchange market and the money markets.

The nation's currency, the naira, had witnessed massive depreciation against other major currencies and the bank market had been characterised by high and unstable interest rates with devastating effects for the economy. This underscores the difficult task of conducting monetary policy especially in a developing economy adopting market oriented policies. The usual objective of monetary policy vis-a-vis interest rates is to keep them stable at a low rate.

It should be mentioned that despite the desire to accomplish the objectives of monetary policy, the limitation of monetary policy and control often come into play.

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2.5.3 Instruments of Monetary Policy

The instruments of monetary policy are those tools or variables employed by the monetary authorities, normally the Central Bank, to affect the money supply, its allocation and cost in an economy. The main instruments of monetary policy employed to influence the money supply in an economy differed from one economy to the other. This is largely determine by the nature or structure of the financial system.

In the developed economies, where the financial system is well developed, the approach to monetary control is through the market mechanism and thus referred to as an indirect monetary control. In the less developed financial systems, however, a direct means is employed to control the money supply and thus called the direct monetary control approach. But it should be borne in mind that the two approaches essentially have the same focus, that of influencing the cost and availability of the banking system's credit.

The main instruments of monetary control especially employed in the developed economies are: reserve requirements, the discount rate, open market operations, and moral suasion.

i. Reserve Requirements

"A required reserve ratio is a minimum ratio of cash reserves to deposits that the Central Bank requires commercial banks to hold". By altering the reserve ratio upwards or down-words, the central bank can control the supply of credit in the economy and at the same time ensuring the solvency of the banking system.

ii. Discount Rate

"The discount rate is the interest rate that the central bank charges when the commercial banks want to borrow money". Through a manipulation of the discount rate the central bank can induce commercial bank to voluntarily hold additional cash reserves so as not to fall below the minimum safe ratio of cash to deposits.

iii. Open Market Operations

This occurs when the central bank alters the monetary base by buying or selling financial securities in the open market. Unlike the use of reserve requirements and discount rate for monetary control via altering the value of the multiplier the use of open market operations operates by altering the money base. Through the open market sale of financial securities the Central Bank alters not only the monetary base but bank's cash reserves, deposit lending and the money supply.

It should be said that the above instrument of monetary control are not mutually exclusive. Rather, they are employed to compliment each other. This stem from the fact that while the first two tools alter the value of the money multiplier, open market operations alter the monetary base and since the money supply is

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the monetary base multiplied by the money multiplier, they together alter the money supply.

iv. Moral Suasion

This refers to the use of informal channels by the Central Bank to communicate to commercial banks the desired goals or direction of monetary policy and the roles expected of the commercial banks towards accomplishing the desired goals. Thus moral suasion essentially entails the use of persuasion to urge the commercial banks to go along the spelt out objective of monetary policy.

But given the limitation of the above tools coupled with the fact that they are more suited for developed economies, the less developed economies have had to employ other tools of monetary control outside the traditional tools considered above. Such tools includes the use of liquidity reserve ratios to regulate the liquidity structure of bank assets, the use of special deposit balances to curb excess liquidity in the banks and the use of selective credit controls to influence the distribution of credit, say to preferred sectors or industries. In other instances, the central bank directly control the interest rates charged by banks on their loans.

In Nigeria, following the adoption of deregulation in the bank credit market, the monetary authorities shifted to an indirect monetary control regime and thus abolished some of these tools particularly selective credit controls and the regulation of interest rates. A step that marked a new phase in the conduct of monetary policy in Nigeria.

2.6 *Economics of Financial Deregulation*

The debate over regulation and deregulation of financial markets has attracted much attention from both economists and finance specialists. The dividing line has been between advocates of strong regulation and opponents of such regulation of the financial markets. This debate is similar to the one between the keynesian and the monetarists on matters of monetary policy. It is obvious that both proponents and opponents of regulation recognised the special importance of the financial market as the heart of a nation's economy. Thus the debate is narrowed to matters about rules in the financial markets. If regulation is taken to mean literally "laying down of rules", Gowland (1990), then the main sticking point will be about the degree to which the financial markets should be regulated.

A sampling of literature on the economic rationales for regulation will reveal a two-fold objective. For example Keynes in the 1930s argued that monetary regulation was desired in order to maintain economic domestic stability and employment. Galbraith (1958) and Ingham (1984) took a similar line. Gowland (1985), Bellensperger and Dermine (1987), and Gowland (1990), are all agreed on the macro-economic policy rationale for financial market regulation. But they added a second rationale, that of fiduciary regulation, which is aimed at maintaining efficiency and stability of the financial market, so as "to preserve investor confidence and to prevent systemic risk within the system." This latter argument has been employed by regulatory authorities to justify the prudential regulations imposed on say banks given the social costs that might be associated with their failures.

However, in spite of the laudable economic justifications for market regulation advanced by the proponents of market regulation, economists on the other side of the divide have responded with economic theory that shows regulation to be otherwise. They associate regulation with the following inefficiencies:

i. barriers to market entry;
ii. compliance costs of regulation;
iii. regulation benefits producers and not consumers; and
iv. regulation reduces the dynamism of financial market by stifling innovation and competition, Friedman (1962) and Stigler (1971).

Other critics of regulation have equated market regulation to financial repression and thus the so-called "financial repression hypothesis", which is a policy-based explanation of financial market fragmentation that often results from excessive government intervention, which is akin to a regulation of the market. These proponent of the financial repression hypothesis - Mckinnon (1973), and Fry (1982, 1988) have attributed underdeveloped and inefficient financial markets to excessive government intervention that results from policy failures. Thus, the bottom line of arguments against regulation of the financial markets is that regulation is anti-competitive and engenders inefficiency in the market.

For the above reasons, advocates of financial reform have been advocating the removal of direct controls in financial markets including the market for bank credit. The main motivation being the belief that deregulated financial markets allocate capital in the most efficient way possible, Driscoll (1991) and that ultimately leads to improved macro-economic performance. These perceived benefits of deregulated financial markets seemed to have informed the decision of the monetary authorities in Nigeria to adopt a policy of deregulation of its

banking system in 1987. A policy that then entailed a gradual elimination of direct controls in the market for bank credit. The main policy elements adopted are contained in the chapter "Introduction" of the thesis.

However, it should be emphasised that the mere adoption of liberalised market reform does not essentially translate to automatic results in the financial market. This is particularly so when such reforms are not accompanied by requisite improvements in monetary policy formulation and implementation. Kaufman (1977) vividly portrays the likely scenario:

> It seems that the most of those well-intentioned proposals to increase the resiliency of the financial system will actually increase susceptibility of the system to financial crises... Liberated financial markets, which will bring forth the entrepreneurial spirit of participants, may result in increasing competitive struggles, followed by more financial concentration and, in the end, more government intervention...unless the efficiency of monetary policy improves vastly.

The above observation was particularly reflected in the Nigerian situation, when the monetary authorities after adopting market reforms have had to intervene in the market for bank credit with measures that amounted to major policy reversals in 1991,1994 and 1995, after the banking system was plagued to the point of brink by dramatic shocks triggered by deregulation.

Although the liberalised market reforms adopted by the monetary authorities in Nigeria are far from achieving their overall objectives, nevertheless, the financial system especially the banking sector had witnessed a number of significant changes similar to those observed in other liberalised markets by Akhtar (1983). A significant growth in the financial markets especially the money market. Then the changing shape of retail banking and the

diversification of sources of financial services, thanks to the liberalisation of market entry requirements for both banking and non-banking institutions.

2.6.1 **Studies on Deregulation**

Following the pioneering works of Altman (1968) and those of others, to the works of Sinkey (1975) on bank performance analysis and prediction of bank failures and to the more recent works on the subject seem to establish the firm position of financial ratios especially in multivariate statistical models employed for corporate performance analysis. Thus, many other studies relying on ratio analysis were to follow.

The emergence of market liberalisation world-wide saw a rekindled interest in studies pertaining to the effects of liberalisation on financial markets. The adoption of market liberalisation especially in the financial markets in the developing countries mostly at the behest of the IMF further widened interest in matters pertaining to market liberalisation. For example, Sundarajan and Balino (1991) examined current issues relating to banking crises in developing countries. Rojas (1995) on the other hand examined financial market fragilities in Latin America. While the pitfalls of financial liberalisation were examined within the context of the Nordic countries' banking crises by Drees and Pazarbasioglu (1995). Then Gonzalez (1997) employed a model similar to the basic CAMEL model to case study Mexico's banking system fragility, in the aftermath of the crash of the Mexican currency, the Peso.

The above studies pertaining to banking crises and financial market liberalisation have been carried out in economic conditions that are significantly different from those that obtained in Nigeria, this is especially true

given the different macro-economic conditions of the different economies in different periods. Besides the banking crisis in Mexico was the result of a serious crash in the value of its Peso. And many of these studies had relied on models many of whose performance in conditions similar to those of the banking system in Nigeria may be empirically suspect.

Again some of their conclusions may not hold true for the banking system in Nigeria. Then there are other peculiarities associated with the implementation of the liberalisation of the banking system in Nigeria and its for this reason that it was referred to as "guided financial deregulation". It is for these and other practical reasons that a study of the effect of deregulation on the banking system in Nigeria is to be carried out employing a relevant model, in this case, one similar to the basic CAMEL model.

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CHAPTER THREE

RESEARCH METHODOLOGY

3.1 Data Collection

The data employed in computation of the bank specific ratios was obtained from the Annual Accounts - income statements and balance sheet - of the banks in the sample. The Nigeria stock Exchange proved to be an important reservoir of corporate financial information for the study. Their collection of Annual Accounts comprised both quoted and non-quoted companies. Head and Regional offices of the banks in the sample were equally important sources for missing or unavailable Annual Accounts.

There are different approaches to statistical sampling. A researcher determines the technique that suites his situation best. A proportionate stratified random sampling approach was employed in the collection of data for the study. Licensed commercial banks were the population for the study. The stratification of the population was confined to the list of licensed commercial banks as at December 31, 1990. The Central Bank of Nigeria (CBN) drawn list comprised of fifty-eight commercial banks as at that date.

The population of the banks was stratified into three based on their paid-up equity capital as at December 31, 1990. The three strata categories are reflected in Table 3.1 as corresponding to Tiers. Tier 1 is essentially the small-sized banks (i.e., 75 percent of commercial bank population), Tiers II, III are medium and large sized banks. Sample sizes were drawn randomly after the

stratification of the population into the three tier categories. The sample size of each tier was proportionate to the size of its stratum. But any sample with an extreme performance was replaced so as not to bias the entire sample.

Table 3.1 Population Stratification.

TIER	PAID UP EQUITY N* MILLION	NO.OF BANKS IN STRATUM	SAMPLE SIZE
I	0-25	43	03
II	25-50	10	02
III	50-100	05	01

*Naira

A stratified random approach to sampling was adopted so as to ensure that the characteristics of each segment or stratum of the population is reflected in the study, i.e., to ensure representativeness. On the overall the entire sample size (about 10 percent of the population) was large enough to offset statistical bias likely to result from ratio estimates. The period covered was also deemed long enough to even-out any unusual or extraordinary performances. The years 1987 and 1988 were eliminated due to lack of complete data for many of the banks in the sample. The accounts were also adjusted for exceptional items of loss and extraordinary income, i.e., for unusual items in the normal course of business activity.

Personal interviews were conducted with some top bank management and officials of the Banking Supervision Dept. of CBN, for clarification purposes.

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Although, over the years, annual accounts of banks reveal significant improvement in their reporting practices, many still exhibit a number of arithmetical inaccuracies that often warrant corrections especially for research purposes.

3.2 *Methods of Data Analysis*

The study had relied on the use of 'the ratio' as an important tool of financial analysis. The 'ratio' as a tool for financial analysis assumed importance in financial literature following the work of Altman (1968) that employed financial ratios to establish corporate performance trends and then extended it to the prediction of the likelihood of corporate failure. Ever since, the 'ratio' had come to be employed as a tool for financial analysis in different financial models that ranges from univariate to multivariate ones.

The study employed a cross-section time - series analysis approach. The use of such an approach was meant to overcome the usual weaknesses often associated with the before-and-after analysis approach. In addition, the cross-section time-series approach allows for a consideration of a longer time span enough to even-out the effects of unusual performances.

The study used bank-specific data derived from the bank -by-bank balance sheet and income statements. These were used as the basic inputs for the bank-specific variables employed in the study. The bank-specific variables were similar to those employed in the basic model of the CAMEL type (that is, evaluating capital adequacy, asset quality, management , earnings and liquidity). Appropriate ratio-proxies were then established for the respective

bank-specific variables. These were then grouped into six main bank ratio categories that corresponds to the different areas of interest. The six main categories are: Credit Risk, Profitability, Capital Adequacy, Loan Volume, Liquidity and Efficiency.

Measures of central tendency and dispersion were computed each year for each of the six ratio categories. The measure of central tendency computed is the Mean and that of dispersion is the more widely used Standard Deviation. These two important measures were thus employed as tools of data analysis in the study.

Given that there exists one or more types of proxies for apparently all the ratio categories, those employed in the study are contained in Tabled 3.2.

Table 3.2 Bank Financial Ratios Used.

AREA OF INTEREST	RATIO-PROXY
Credit Risk	Non-performing Loans / Total Loans
Profitability	Net Income / Total Assets
Capital Adequacy	Total Capital / Total Assets
Loan Volume	Loans / Deposits
Liquidity	Liquid Assets / Total Assets
Efficiency	Operating Expenses / Operating Income

It should be mentioned that, where relevant for the purpose of establishing behaviour patterns specific to the different bank sizes, those grouped under Tier I (i.e., small-sized banks) had been compared with those grouped as Tiers II, III (i.e., medium- large-sized banks), Table 3.1.

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CHAPTER FOUR

DATA PRESENTATION AND ANALYSIS

4.1 Data Presentation

This segment presents the computations of the various ratios that were employed to proxy the different variables that were the subject of empirical study. The bank - by - bank data formed the basic inputs for the various ratio-proxies. The variables as earlier mentioned includes credit risk, profitability, capital adequacy, loan volume, liquidity and efficiency. Computation of each ratio -proxy is presented at a turn.

4.1.1 **Credit Risk**

The measure of credit risk had been proxied by the Ratio of non- performing loans to total loans and was computed for the period of 1989 - 1996. The computations are reflected in Table 4.1. The bank-by-bank data input for the computation of the ratio is contained in Appendix A.

Table 4.1: Ratio of Non performing Loans to Total Loans

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.30	0.59	0.61	0.54	0.54	0.4	0.29	0.27
Habib Bank Ltd	0.07	0.13	0.23	0.13	0.16	0.09	0.08	0.09
Wema Bank Plc	0.40	0.46	0.31	0.20	0.19	0.21	0.22	0.11
Owena Bank Plc	0.37	0.46	0.31	0.27	0.57	0.49	0.57	0.42
Trade Bank Plc	0.38	0.20	0.20	0.19	0.35	0.35	0.39	0.46
Lion Bank Plc	0.28	0.30	0.26	0.16	0.32	0.29	0.26	0.30
Means (X)	0.30	0.357	0.32	0.248	0.355	0.305	0.302	0.275
Std. Deviation (Q)	0.122	0.161	0.136	0.137	0.157	0.130	0.151	0.140

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.1.2 **Profitability**

Profitability was proxied by a measure of return on assets, i.e., the Ratio of net income to total assets. The ratio was computed for the period 1989 - 1996. The bank-specific data used in computing the ratio is contained in Appendix A.

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Table 4.2: Ratio of Net Income to Total Assets

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.02	(0.02)	(0.003	0.02	0.04	0.03	0.02	0.02
Habib Bank Ltd	0.07	0.03	0.04	0.08	0.10	0.03	0.0.016	00.15
Wema Bank Plc	0.02	0.03	0.03	0.03	0.05	0.06	0.03	00.02
Owena Bank Plc	0.03	0.003	0.002	0.02	(0.20)	0.04	0.03	00.02
Trade Bank Plc	0.05	0.02	0.02	0.03	0.03	0.02	0.02	0.01
Lion Bank Plc	0.02	0.04	0.01	0.03	0.01	0.02	0.01	0.01
Means (X)	0.035	0.024	0.017	0.035	0.005	0.033	045.	0.03
Std. Deviation (Q)	0.019	0.017	0.015	0.021	0.096	00.014	0.052	0.058

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.1.3 **Capital Adequacy**

There are a number of ratios that could be employed to measure capital adequacy. But for the purpose of this study, it had been proxied by the Ratio of total capital (i.e., equity plus reserves) to total assets. The ratio covered the period 1989 -1996. Bank-specific data is contained in Appendix A.

Table 4.3: Ratio of Total Capital to Total Assets

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.06	0.04	0.03	0.04	0.04	0.04	0.06	0.06
Habib Bank Ltd	0.07	0.06	0.08	0.07	0.09	0.08	0.08	0.09
Wema Bank Plc	0.08	0.07	0.07	0.08	0.07	0.08	0.06	0.08
Owena Bank Plc	0.07	0.06	0.05	0.06	(0.19)	(0.09)	(0.03)	(0.01)
Trade Bank Plc	0.12	0.09	0.07	0.08	0.08	0.06	0.09	0.08
Lion Bank Plc	0.04	0.06	0.07	0.06	0.09	0.09	0.07	0.03
Means (x)	0.073	0.063	0.060	0.065	0.030	0.043	0.055	0.055
Std. Deviation(Q)	0.024	0.015	0.018	0.014	0.10	0.062	0.039	0.035

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.1.4 **Loan Volume**

The Ratio of total loans to total deposits was used as a proxy to measure the volume of credit extended by the banking system over the period covered by the study, i.e., 1989 - 1996. The bank-specific data employed is found in Appendix A.

Table 4.4: Ratio of Total Loans to Total Deposits

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.62	0.58	0.50	0.44	0.41	0.43	0.41	0.04
Habib Bank Ltd	0.51	0.33	0.28	0.27	0.28	0.41	0.63	0.58
Wema Bank Plc	0.40	0.43	0.38	0.62	0.51	0.31	0.29	0.43
Owena Bank Plc	0.82	0.70	0.54	0.49	0.87	1.12	0.79	0.82
Trade Bank Plc	0.45	0.72	0.43	0.49	0.65	0.55	0.60	0.63
Lion Bank Plc	0.29	0.31	0.20	0.23	0.22	0.36	0.28	0.50
Means (x)	0.515	0.512	0.398	0.423	0.492	0.53	0.50	0.56
Std. Deviation(Q)	0.169	0.165	0.118	0.135	0.219	0.274	0.188	0.141

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.1.5 **Liquidity**

The Ratio of liquid assets to total assets was employed to measure liquidity of the banking system over the period1989 - 1996. Bank -specific data employed in computing the ratio are contained in Appendix A.

Table 4.5: Ratio of Liquid Assets to Total Assets

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.47	0.54	0.63	0.67	0.72	0.66	0.64	0.65
Habib Bank Ltd	0.62	0.72	0.71	0.65	0.63	0.58	0.44	0.43
Wema Bank Plc	0.71	0.66	0.68	0.51	0.51	0.73	0.75	0.56
Owena Bank Plc	0.31	0.43	0.44	0.48	0.34	0.29	0.45	0.34
Trade Bank Plc	0.66	0.47	0.56	0.59	0.53	0.52	0.47	0.49
Lion Bank Plc	0.76	0.86	0.72	0.76	0.54	0.53	0.57	0.39
Means (x)	0.588	0.613	0.623	0.61	0.545	0.552	0.553	0.477
Std. Deviation(Q)	0.154	0.149	0.098	0.096	0.116	0.138	0.113	0.105

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.1.6 **Efficiency**

Operational efficiency was measured by the Ratio of operating expenses to operating income. The ratio had been computed for the period of 1989 -1996. The bank-specific data used as the basic input for the ratio is contained in Appendix A.

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Table 4.6: Ratio of Operating Expenses to Operating Income

Bank	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
First Bank Plc	0.86	1.14	1.02	0.86	0.78	0.84	0.88	0.88
Habib Bank Ltd	0.57	0.77	0.75	0.57	0.57	0.83	0.74	0.78
Wema Bank Plc	0.79	0.79	0.83	0.84	0.73	0.63	0.73	0.83
Owena Bank Plc	0.84	0.80	0.79	0.92	1.65	0.82	0.87	0.89
Trade Bank Plc	0.64	0.87	0.92	0.87	0.92	0.91	0.92	0.94
Lion Bank Plc	0.72	0.76	0.93	0.83	0.89	0.91	0.96	1.25
Means (x)	0.737	0.855	0.873	0.815	0.923	0.823	0.85	0.928
Std.Deviation(Q)	0.105	0.132	0.092	0.113	0.344	0.094	0.086	0.152

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.2 Data Analysis

The part of the thesis that contained the analyses and interpretations of the various ratio categories employed as proxies for the respective variables that were the subject of the empirical study. Computations of the different ratio-proxies are contained in the earlier part of the chapter, i.e., 4.2. Measures of central tendency and dispersion, Means and Standard Deviations, respectively, of the different ratios were the main research tools employed for the analyses and interpretations of the data. The analyses and interpretations of each of the ratio-proxy was done at a turn.

4.2.1 Credit Risk

The risk associated with the banking system's loan portfolio was estimated by the proportion of loans that are non performing. By this measure over the period of the study, the riskiness of bank loans on the average rose and remained considerably high (Table 4.7). As a result, banks accumulated a substantially high amounts of non-performing assets during the period. The figures ranged from a highest of 35.7 percent in 1990 to a lowest of 24.8 percent in 1992. And an average figure of 31.0 percent for the entire period of the study, a figure that underscores the fragility of the banking system during the period of the deregulation.

The above phenomenon can be attributed to the high rate of defaults on both interest payments and principal repayments by potentially risky borrowers. Though partly compounded by adverse macro-economic factors and the attendant high lending rates charged by banks as a result of the deregulation of the interest rate.

Employing the proportion of non-performing loans as a measure of risk reveals that bank lending was generally risky business under the period of deregulation. The economic importance of such huge non performing loans is that they seriously constrained the banks' capacity to generate income on their main source of earnings, i.e., their loan portfolios. Thus a key factor among the many causes of financial distress then prevalent in the banking sector.

This ratio if employed as a measure of the quality of bank management, then such huge non-performing loans are a clearly indication of poor quality of bank management particularly on loan administration. This is the justification for the

Prudential Guidelines issued in 1990, i.e., to stave - of excessive risk taking by bank management especially in granting credit which is likely to go bad.

Table 4.7 further revealed that the year 1993 witnessed the most dramatic rise on the riskiness of bank portfolios. A rise of about 10.7 percentage points (i.e., an increase of 43.0 percent) above the 1992 level. This is not unexpected given that the year 1993 coincided with the banking systems most troubling year since the commencement of deregulation. Besides, the year coincided with Nigeria's most politically troubling moment since the post civil war years.

Table 4.7: Ratio of Non-performing Loans to Total Loans

(Means and standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-96
Means (%)	30.0	35.7	32.0	24.8	35.5	30.5	30.2	27.5	31.0
Std.Deviations(%)	12.2	16.1	13.6	13.7	15.7	13.0	15.1	14.0	-

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

The high values of the Standard Deviations (i.e., dispersion) over the years in Table 4.7 vis-a- vis the Means is a reflection of the high degree of variability in practices between the different strata that make up the sample. Nevertheless, the dispersion figures maintained a semblance of stability over the period, recording a minimum of about 12 percent and a maximum of about 16 percent.

Table 4.8 depicts the variability in the practices between banks grouped under Tier I (i.e., small-sized banks) and those under Tier II, III (i.e., medium - large - sized banks).

Table 4.8: Ratio of Non performing Loans to Total Loans

(Means (%) for Tiers II,III versus Tier I)

Tiers	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-96
II, III*25.7	39.3	38.3	29	29.7	23.3	19.7	15.7	27.5	
I**	34.3	32.0	25.7	20.7	41.3	37.7	40.7	39.3	34.0

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

* Medium-large sized banks

** Small-sized banks.

The period 1990-1992 saw the medium -large -sized banks with exceedingly high proportion of non performing loans compared to the small-small-sized banks. On the other hand, the small-sized banks accumulated substantially higher non performing loans in the period 1993-1996, with their figures for 1995 -1996 about twice or more than those of the medium-large-sized banks.

This high increase in riskiness of loan portfolios exhibited by the small-sized category of banks in the mentioned period is a reflection of their increased aggressiveness in loan policies designed to attract additional returns from loans in their desperate drive to survive the shocks that were generated by the most turbulent period of the deregulation. Thus, on balance, the small-sized banks in tier I category assumed proportionally more riskier loans than the medium-large-sized banks in Tie II, III category, by about 6.5 percentage points during the period covered by the study. An unenviable position that strongly constrained their revenue generating capacity on their loan portfolios.

4.2.2 **Profitability**

Profitability was measured by a ratio akin to the return on assets (ROA). By the ROA measure, banking trended towards low profits (Table 4.9) particularly when compared to other industries. During the period covered, the minimum and peak points of the ROA ratio stood at 0.50 percent and 4.5 percent respectively. The 0.50 percent figure confirmed the year 1993 as the banking system's nightmare. On the average for the entire period, the mean ROA is 2.8 percent. The low ROA figures can largely be attributed to the huge non-performing loan portfolios accumulated by the banks as indicated in Table 4.7 earlier.

The huge non-performing loans impaired the banking system's revenue generating abilities. Thus in spite of the high risk assumed by the banks during the period, the low ROA figures indicated there was no corresponding returns from their loan portfolios to compensate them for the high level of risk they assumed, i.e they did not benefit from the so-called risk-return trade-off. The effect of competition from unregulated non bank institutions as a result of deregulation eroded bank earnings from traditional banking activities thereby also contributing to the low ROA figures.

The low ROA figures characteristic of the period with an average of 2.8 percent for the entire period underscores the low profitability of banking under deregulation. And this is in spite of the high level of risk assumed by the banks as reflected in the huge non-performing loans acquired by the banking system.

Such low level of profitability associated with the period made both growth and ability to boost reserves extremely difficult if not impossible. It is therefore, not surprising that a large number of the banks were extremely susceptible to the shocks triggered by deregulation. A situation much more pronounced with the small-sized banks. Therefore, the low profitability associated with poor earnings can be counted among the major causes of financial distress in the banking industry.

Table 4.9: Ratio of Net-Income to Total Assets

(Means and Standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-96
Means (%)	3.5	2.4	1.7	3.5	0.50	3.3	4.5	3.0	2.8
Std.Deviations(%)	1.9	1.7	1.5	2.1	9.60	1.4	5.2	5.8	

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

The high dispersion figures (Table 4.9) associated with the period came about as a result of the variability in profit practices between the different bank strata. Table 4.10 showed that the small-sized banks categorised as Tier I posted significantly lesser profit figures than the medium-large-sized banks in Tier II,III. The lower profits recorded by the small-sized banks was the direct result of their accumulation of huge non-performing loans especially during the 1993-1996 period (as contained in Table 4.8), which impaired their revenue generating capacity.

Table 4.10: Ratio of Net-Income to Total Assets

(Means (%) for Tiers II,III versus Tier I)

Tiers	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-96
II, III*	3.7	1.3	2.4	4.3	6.3	4.0	7.07	6.3	4.42
I**	3.3	2.1	1.1	2.7	(5.3)	2.7	2.07	(0.33)	1.04

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

* Medium-large sized banks

** Small-sized banks.

4.2.3 **Capital Adequacy**

The banking system's capital adequacy had been estimated via the proxy ratio of total capital to total assets. A ratio that serves as an indicator of the ability of the banks to absorb shocks and losses. The ratio was fairly stable in the period 1989-1992, but witnessed a dramatic deterioration in the period 1993-1994 before trending upwards in the period 1995-1996 (Table 4.11). However, the most striking feature of the period lies in the low values of the capital adequacy ratio. The low values of the ratio especially in the period 1993-1996 is not unconnected with the low profit figures posted by the banking system during the period.

The low bank profits resulting from their accumulation of large non-performing loan portfolios meant little surplus funds are available to banks so as to boost their capital strength. The erosion of their capital strength was compounded further by the banks' image desire to be seen as consistent in making annual dividend pay-outs. It is worth mentioning that the values of the capital

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adequacy ratio is not only low in all the years but it was less than the 8.0 percent Bank for International Settlements' minimum standard, adopted by the monetary authorities in 1990.

The effect of low profits has a direct bearing on the ability of the banks to create reserves that will boost their capital strength and hence their ability to withstand shocks and absorb losses. The ability of the banks to do so was generally weak as depicted by the capital adequacy ratio. In fact, for all the years, the capital adequacy ratio did not measure up to the prescribed minimum of 8.0 per cent Basle Standard.

Thus the large number of banks failures witness during the period is an indication of under- capitalisation in the banking system. And since the deregulatory environment generated a number of shock, the banks were in weak capital position to withstand the effects of shocks. Therefore, capital inadequacy also helps to explain the large number of bank failures witnessed under deregulation.

The high dispersion figures (Table 4.11) particularly in the period 1993-1996 was as a result of the financial turbulence associated with that period of deregulation which hard hit most the small-sized banks in Tier I category and thus the cause of the variability.

Table 4.11: Ratio of Total capital to Total Assets

(Means and Standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	'89-96
Means (%)	7.3	6.3	6.0	6.5	3.0	4.3	5.5	5.5	5.6
Std.Deviations(%)	2.4	1.5	1.8	1.4	10.0.	6.2	3.9	3.5	

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.2.4 **Loan Volume.**

The single most important activity of banks is to collect deposits and to extend some of the deposits as loans. This important function of banks referred to as intermediation had been proxied by the ratio of loans to deposits. Employing this measure except for the sudden drop-off in the period 1991-1992, the banking system trended towards credit expansion (Table 4.12).

The main cause of credit expansion associated with the period was the efforts of banks to maximise returns on loans so as to over-come the disturbances generated by deregulation. The contraction of bank lending associated with the 1991-1992 period was mainly due to a credit crunch that resulted from perceived weakness in borrower quality during that period. The significant reduction in the proportion of non-performing loans recorded in the period as reflected in earlier Table 4.7 is a confirmation of the credit crunch hypothesis.

On the overall, the deregulatory environment generated a credit boom as banks expand credit so as to maximise returns on loans so as to overcome the impact

of fall-outs of deregulation. For example, the small size banks hard hit most by the effects of deregulation adopted a too-liberal credit policy as a strategy for survival in an extremely competitive environment engendered by deregulation.

Table 4.12: Ratio of Loans to Deposits

(Means and Standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	'89-96
Means (%)	51.5	51.2	39.8.	42.3	49.2	53.0	50.0	56.0	49.1
Std.Deviations(%)	16.9	16.5	11.9	13.5	21.0	27.4	18.8	14.1	

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

The ratio recorded high dispersion values particularly in the 1993-1995 period (Table 4.12). These figures are an indication of the strong diversity in loan policy practices between the different bank strata in the sample. Figures produced in Table 4.13 below clearly revealed the diversity in loan policy practices between the different strata.

Table 4.13: Ratio of Loans to Deposit

(Means (%) for Tiers II,III versus Tier I)

Tiers	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	'89-96
II, III*	51.0	44.7	38.7	44.3	40.0	38.3	44.5	47.0	43.6
I**	52.0	57.7	39.0	40.3	58.3	67.7	55.7	65.0	54.5

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

* Medium-large sized banks

* * Small-sized banks.

Except for 1992, on the average, the small-sized banks categorised as Tier I extended significantly higher credit as a proportion of their deposits than the medium-large-sized banks categorised as Tier II, III. This is more so in the period 1993 - 1996, a period of deregulation characterised by strong turbulence. It seemed while the medium-large-sized banks adopted some form of contractionary credit policies by extending credit largely to higher borrower quality customers, the small-sized banks adopted liberal credit policies and thus accelerated their credit expansion in effort to overcome the shock generated by deregulation ("the gamble for resurrection").

This sort of a 'too-liberal' credit policy usually carried with it the risk of high default rates and seemed logically to have been the main factor in the accumulation of the huge non-performing loans by the banking system, especially by the small-sized banks in the period 1993-1996 (Table 4.8).

4.2.5 **Liquidity**

Liquidity, measured by the ratio of liquid assets to total assets. The higher the value of the ratio the greater the liquidity of the banking system and thus the ability of the banks to meet huge unexpected withdrawals. It should be said that both the amount of liquidity and the components of liquid assets are often largely influenced by regulatory requirements. This ratio trended very high in almost all the years but particularly so in the early years of deregulation, 1989-1992 (Table 4.14).

This period coincided with the dominance of the credit market by low-income earning government securities, treasury bills and certificates and the subsequent introduction and persistent use of the so-called stabilisation securities by the monetary authorities.

The year 1993, however, marked the beginning of a period of sudden drop-off in the value of the ratio, by 6.5 percentage points (a decline in liquidity of 10.7 percent) and by 1996 it had plummeted by 13.3 percentage points (a 22 percent decline in liquidity) over the 1992 level. A trend that reflects the banking system's aggressive acquisition of risk-assets particularly loans in a drive to maximise bank income that had been significantly eroded by the unintended fall-outs of the process of deregulation.

Then of course is the intensified usage of the stabilisation securities which were then followed by the commencement in 1993 of weekly open market operations (OMO) in treasury securities, within the over all strategy to diminish the excess

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liquidity in the banking system. The success of the strategy explains the plummeting of the ratio in the period 1993 -1996. Therefore, on the over all the deregulatory environment engendered high liquidity in the banking system with the ratio of liquid assets to total assets averaging about 57 percent for the period 1989-96.

The small dispersions relative to the mean values of the ratio tends to support homogeinity in liquidity practices between the different bank strata over the period of the study.

Table 4.14: Ratio of Liquid Assets to Total Assets

(Means and Standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-96
Means (%)	58.8	61.3	62.3	61.0	54.5	55.2	55.3	47.7	57.01
Std.Deviations(%)	15.5	14.9	9.8	9.6	11.6	13.8	11.3	10.5	-

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

4.2.6 **Efficiency**

The ratio of operating expenses to operating income was employed as a measure of operating efficiency, i.e., the ability of a bank to generate revenue from its normal operations and to control total expenses in an efficient manner. This ratio could also be employed as a proxy for the quality of bank management.

The significantly high values of the ratio over the 1990-1996 period of the deregulation was an indication of the very low operational efficiency of the

banking system (Table 4.15). The year 1989 enjoyed some strong measure of operational efficiency with the value of the ratio at 73.7 percent, a reflection of the relative stability of the early period of the deregulation largely due to the effective management of the interest rates in that period of the deregulation.

Table 4.15: Ratio of Operating Expenses to Operating Income

(Means and Standard Deviations)

Measure	Year								
	1989	'90	'91	'92	'93	'94	'95	'96	89-86
Means (%)	73.7	85.5	87.3	81.5	92.3	82.3	85.0	92.8	85.05
Std.Deviations(%)	10.5	13.2	9.2	11.3	34.4	9.4	8.6	15.2	

Source: Computed From Bank-by-Bank Annual Accounts (1989-1996).

The low operational efficiency of the banking system as contained in Table 4.15 resulted from factors that had negative impacts on both the numerator and denominator of the ratio. The years 1990 and 1991 witnessed the most dramatic rise in the value of the ratio, a rise of 11.8 and 13.6 percentage points respectively, over the 1989 level. A deterioration in operational efficiency of 16.0 and 18.5 percents in 1990 and 1991 respectively.

A trend engendered partly by the poor management of the interest rates on both savings and time deposits, re-regulation of the lending rate in 1991 to a maximum of 21.0 percent, thus resulting in declining interest margins, and then by the resulted increases in operational expenses due to loan loss provision increases and loan charge-off, that emanated partly from the adoption of the requirements of the 1990 "Prudential Guidelines" on loan loss provision and of course the effect of the huge non-performing loans associated with those years (Table 4.7).

The ratio, on the overall, trended extremely high during the period reaching a speak of 92.8 in 1996. An important feature exhibited by the ratio was its

dramatic rises and sudden drop-offs from year to year. A pattern that reflects the turbulence surrounding the management of the interest rates and policy inconsistency that characterised the period of the deregulation.

It should be said in a nutshell that the generally low level of operational efficiency associated with the period was essentially due to either squeeze on interest margins (the result of poor interest rates management) or increase in loan loss provisions and loan charge-off, or a combination of all these factors in varying degrees. The ratio, however, did not exhibit any significant dispersion vis-à-vis the means and thus no significant variability in operational efficiency was revealed by the different bank strata categories.

4.3 Summary of Findings

The impact of the policy of deregulation on the banking system in Nigeria had been examined in the light of the effects of the policy on commercial banks over the period 1989-1996. It entailed specifically the examination of its impact on the level of credit risk, bank profitability, capital adequacy, loan volume, liquidity and operational efficiency. These items of empirical interest were measured by ratio proxies that were computed from bank-specific data. The main findings are contained underneath.

The risk associated with credit rose and remained considerably high during the period of the deregulation. This is reflected in the size of the proportion of non-performing loans (Table 4.7) which stood at an average of 31.0

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percent during the period. Thus by this measure, the riskiness of bank portfolios trended high under the deregulation period. The huge non-performing loans impacted negatively on the banking system by severely stifling the income generating capacity of the banks. The size of non-performing loans also indicated poor lending policies on the part of bank management. Hence, an important factor in the many causes of financial distress in the banking industry.

The small-size banks, however, assumed greater risks than the medium-large-sized banks especially in the turbulent period of 1993-1996 as a result of their aggressive efforts to weather the shocks triggered by deregulation. This ratio proved to be an important determinant of banking fragility during the period due to its direct bearing on bank earnings and ultimately on capital strength.

Profitability of the banking system trended low, with an average of 2.8 percent (Table 4.9) for the period as measured by ROA. This trend was in spite of the high level of credit risk assumed by the banks. The anticipated commensurate earnings from risk-return trade-off did not materialise. The small sized banks on the average posted far lesser profits due to their huge non-performing loans vis-à-vis the medium-large-sized banks. Such low level of bank profit is a reflection of a weak or fragile banking system.

The banking system's ability to absorb shocks and losses remained low throughout the period of the study, in fact, below the 8.0 percent minimum Basle standard. This was mainly the result of the low profits posted by the banks which meant little or no new capital can be generated from profits to

boost capital strength. The capital-adequacy position of the small-sized banks was more precarious during the period. A fact that underscores the under-capitalisation of the banking system over the period of the study. By extension the soundness of the banking system.

The banking system on the overall trended towards credit expansion under deregulation. A trend that reflected the banks' efforts to maximise returns on loans so as to weather the financial storms generated by deregulation. The small-sized banks in search for higher earnings adopted a "too-liberal" credit policy and thus extended significantly higher proportion of their deposits to credit customers (Table 4.13), particularly in the turbulent period of 1993-1996. The aftermath of which was the huge non-performing loan portfolios accumulated by the small-sized banks (Table 4.8).

The entire period of the deregulation (particularly in 1989-1992) was characterised by high liquidity. This was partly due to the dominance of the credit market by low-income earning government securities and the emergence of the so called stabilisation securities. But a significant decline in liquidity was witnessed in the period 1993-1996 due to the banking system's increased acquisition of risk-assets especially loans. The then prevailing macro economic factors may have also contributed to the high or excess liquidity in the period.

Low operational efficiency characterised the period. The main exception was the year 1989 (Table 4.15) which was the result of the effective management of the interest rates in the early years of the deregulation. The low operational efficiency characteristic of the period was the product of the

ineffective management of the interest rates, reduced interest margins due to policy in-consistencies and increased operational expenses due to increased loan loss provisions and loan charge-off. The low operational efficiency trend was characteristic of all the bank strata categories in the sample. This level of operational performance constitute a minus for bank management vis-à-vis effectiveness in controlling operational costs.

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CHAPTER FIVE

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS

5.1 Summary

The thesis has been arranged in five chapters. Chapter One is 'Introduction'. It provides a background for the study by highlighting the economic factors that prompted the monetary authorities to adopt the policy of 'Financial Deregulation' and the different components that made-up the policy. A general overview of the effects of the policy implementation was also provided. Chapter 1.2 'Statement of the Research Problem' captures the problem that is the subject of this study. Chapter One also includes 'Research Questions', which are essentially investigative in nature for the purpose of studying the underlying problem.

Chapter Two 'Literature Review' contains a general review of works appertaining the subject of 'financial deregulation'. The chapter reviewed, amongst others, the structure of the banking system in Nigeria, i.e. the different bank categories that make-up the banking industry and their economic significance or impact. A review of commercial bank ratios and their uses was also provided. This chapter also highlighted the major components of bank prudential regulation, such as capital adequacy regulation, bank examination, deposit insurance fund ,etc.

The difficult task of monetary policy formation and implementation, was also captured under this chapter. The main arguments for and against

both regulation and deregulation by both economists and finance specialists were examined under chapter 2.6 'Economics of Financial Deregulation'.

Chapter Three 'Research Methodology' is divided into two main parts : '3.1 Data Collection' and '3.2 Methods of Data Analysis'. The first part dealt with the sources and techniques employed for data collection including the sampling technique adopted and the justification for the method employed. The second part of the chapter contains information on the different ratio proxies used for measuring variables like credit risk, profitability, capital adequacy, etc. and the statistical tools employed for data analysis.

Chapter Four 'Data Presentation and Analysis' divided into three parts: '4.1 Data Presentation' , '4.2 Data Analysis' and '4.3 Summary of Findings'. The data presentation segment contains the bank-by-bank data employed for the computation of the means and standard deviations of the different ratio proxies used to measure such areas of interest as credit risk, profitability, capital adequacy, loan volume, liquidity and efficiency.

The data analysis part deals with analysis and interpretation of each of the ratio-proxy employed for the measuring the areas of interest mentioned above. In addition, this sub chapter captures information on the behavioural practices of the different bank size categories. The last part of the chapter contains the main summary of the findings as deduced from the analysis and interpretation under sub chapter 4.2.

The final part of the thesis, i.e., Chapter Five deals with the main conclusions drawn in line with the major findings of the study. It also contains a part titled 'Suggestion for Further Research' which is essentially suggestions made to further improve the study especially by employing models that will include additional variables not included in the current study. The last part of the chapter contains 'Recommendations', and as the name suggests, it is a number of suggestions meant to ameliorate some of the problems associated with the banking system following deregulation.

5.2 Conclusions

The study resulted in some important findings. It is the view of this study that the single most important factor that caused the widespread financial distress that culminated in the number of bank failures witnessed during the period of deregulation, was the huge size of the non-performing loans acquired by the banks during the period. Such huge non-performing loans stifled the banks ability to generate sufficient earnings from their loan portfolios and this had a direct effect on their profits and ultimately on their ability to absorb shocks and losses triggered by deregulation. This finding should have important implications for both bank management and supervisors.

Attitudes to risk was significantly different among the various bank size categories. The small-size banks assumed far greater risks than the medium-large size banks as measured by the size of their respective proportion of non-performing loans. And without the anticipated commensurate returns, they became more vulnerable to the effect of the shocks of deregulation. This explains why they make up the largest proportion of the banks that failed

during the period. This should have important implications for the bank supervision process of both CBN and NDIC.

5.3 Recommendations

The indispensable role of an effective monetary policy in the quest for a sound and stable financial system cannot be overstated. This is more so in a period of financial liberalisation when monetary policy formulation and implementation cannot be more tasking. The Central Bank of Nigeria is the main institution saddled with this all-important function of formulation and implementation of monetary policy. Its ability to effectively discharge this all- important task is largely dependent upon its measure of autonomy.

Recent events in the world economy had shown that countries with complete autonomy for their central bank had a better control of the usual macro economic variables, particularly inflation and unemployment. A feat they had achieved thanks to their central banks' effective management of the interest rate through the policy of non-interference engendered by complete autonomy for their central banks. An important lesson, indeed, for the monetary authorities.

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This study had established that in a period of financial disturbance, the small-sized banks are often worse off. For in effort to whether the financial storm, they often resort to high risk lending that often culminate in their acquisition of large non-performing loan portfolios, and thereby eroding further their earning capacity and ultimately their capital strength. This consequently makes them more susceptible to shocks and fragility.

A solution to this problem lies in the monetary authorities strict supervision of the lending activities of such category of banks during the periods of financial turbulence. The need for such banks to tighten their credit standards, at least, in periods of turbulence will not be out of place. This will help to stave off the type of bank failures witnessed in the past years of the deregulation period especially by small sized banks.

Consistency in monetary policy formulation and more important, its implementation is a requisite for an efficiency and stable money market. The wholesale deregulation of interest rates and market entry requirements in the early years, only to be accompanied by the fixing of lending rates in 1991, and 1994 seemed to have generated its own pattern of shocks (policy induced) that may have further plunged the credit market into turbulence.

The low operational efficiency of the banks during the period was also partly due to the policy inconsistencies. Thus, the urgent need to significantly improve the formulation and implementation of monetary policy becomes more imperative especially in a period of deregulation. In fact, it is the harbinger of financial stability.

The huge costs of bank failures to stake holders and particularly the loss of confidence in the banking system underscores the need for the bank regulator (CBN) and the operator of the deposit insurance fund (NDIC) to significantly improve their supervision standards and the identification process employed to identify potential problem banks.

This study has established the measure of credit risk and followed by that of earnings as the two bank-specific variables that most influence the

performance of the banks under deregulation. Usage of these two particular variables in combination with other criteria for bank supervision and problem identification by both CBN and NDIC should yield beneficial results that will enhance the effectiveness of their supervision and identification process. In other words, the two variables can form a major part of an early warning system.

The monetary authorities can significantly improve the competitiveness of the banking system by adopting reforms towards some form of universal banking especially by breaking the wall of separation between commercial and investment banking that currently exist.

Findings of the study revealed a low level of operational efficiency in the banking system. This underscores the need for banks to adopt some cost saving measures. This can be accomplished by the banks through a trimming of their overlapping bureaucratic structure, for example eliminating their so called Area and Regional Offices. For such offices have outlived their original purpose, especially in this era of information technology where major branches are connected directly to their Head Office and thus branch reporting and head office activities of monitoring and controlling are possible up to the minute. Other similar overlapping costs may also have to be done away with as part of the measures to improve operational efficiency.

Since cost-cutting is just one way to improve efficiency banks may have to adopt marketing strategies that will enhance their revenue base. For example, through the introduction of new products and improved customer oriented services. Equally important is for bank management to re-inculcate in their employees the culture of enhanced efficiency through dedication, achievable by

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offering the employees incentives commensurate with their responsibilities and the overall performance of their organisation.

The last by no means the least is for the bank regulators CBN and NDIC to encourage some form of mergers between the banks. This will assist the banks to consolidate their balance sheet and also facilitates greater cost efficiencies through a restructuring of their branch networks.

5.4 Suggestions for Further Research

Further research could employ additional variables other than the bank specific variables to improve the results of this study. Of specific interest will be the inclusion of macro economic variables, such as the level of inflation and exchange rate depreciation and possibly employ a statistically more advanced techniques so as to improve the performance of the model and the results.

A further research employing this framework but applied to failed banks during the period will likely provide useful insights that will confirm and improve the findings of this study. A related suggestion for further research would be to consider the effects of variables measuring non-financial characteristics on the performance of commercial banks during the period. A study that also includes variables that could measure policy induced shocks might be found useful.

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APPENDICES

APPENDIX A: BANK SPECIFIC DATA

First Bank of Nigeria Plc

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	8492	8482	11319	16986	23552	33955	59821	72819
Risk Assets	4537	3932	4205	1570	16603	11423	21649	25770
Liquid Assets	3955	4550	1714	11316	16949	22532	38172	47049
Total Loans	3182	3474	4068	5188	6665	9932	16678	21913
Non-Performing Loans	955	2039	2495	2786	3567	3952	4860	5894
Total Capital	535	300	301	625	1047	1382	3396	4014
Total Deposits	5172	6230	8098	11696	16074	22916	40401	54567
Net Income	163	(205)	(31)	366	932	874	1000	1155
Operating Income	1151	1433	1575	2689	4309	5355	8271	10030
Operating Expenses	988	1638	1609	2323	3377	4481	7271	8875

*Millions of Naira

Source: Annual Report and Statement of Accounts (1989-1996).

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Habib Bank Ltd

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	637	981	1143	2075	3525	4094	5618	6784
Risk Assets	240	276	327	725	1303	1715	3152	3849
Liquid Assets	397	705	816	1350	2222	2379	2466	2935
Total Loans	171	197	223	339	625	1248	2323	2694
Non-PerformingLoans	12	26	52	43	101	111	176	230
Total Capital	43	55	87	1 49	311	332	394	470
Total Deposits	335	604	797	1264	2203	3008	3659	4613
Net Income	45	34	45	164	364	103	238	227
Operating Income	105	147	183	383	847	600	926	1043
Operating Expenses	60	113	138	218	483	497	688	816

*Millions of Naira

Source: Annual Report and Statement of Accounts (1989-1996).

Wema Bank Plc

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	890	1006	1402	1705	3146	6084	10097	10812
Risk Assets	262	345	480	829	1535	1633	2566	4748
Liquid Assets	628	661	922	876	1611	4451	7531	6064
Total Loans	250	305	381	738	1149	1240	1829	3376
Non-Performing Loans	101	140	119	147	223	255	394	367
Total Capital	67	69	92	142	226	474	672	821
Total Deposits	623	715	1067	1182	2337	3999	6223	7783
Net Income	22	28	38	44	142	375	303	249
Operating Income	105	134	218	267	527	1004	1141	1505
Operating Expenses	83	106	180	223	385	629	838	1256

*Millions of Naira

Source: Annual Report and Statement of Accounts (1989-1996).

Owena Bank Plc

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	472	626	839	1010	807	1127	1825	2166
Risk Assets	327	354	468	528	533	801	1020	1427
Liquid Assets	145	272	371	482	274	326	837	739
Total Loans	196	251	295	328	638	914	1019	1402
Non-PerformingLoans	73	116	91	89	362	449	584	584
Total Capital	35	38	40	65	(153)	(106)	(59)	(11)
Total Deposits	238	360	548	689	735	819	1297	1714
Net Income	13	02	02	17	(159)	49	50	50
Operating Income	80	95	131	221	245	267	371	457
Operating Expenses	67	93	129	204	404	218	321	407

*Millions of Naira

Source: Annual Report and Statement of Accounts (1989-1996).

Trade Bank Plc

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	211	275	397	852	1096	1616	2007	2697
Risk Assets	71	145	174	348	518	768	1065	1372
Liquid Assets	140	130	223	504	579	848	942	1326
Total Loans	40	120	125	277	498	650	977	1277
Non-Performing Loans	15	24	25	53	172	227	378	593
Total Capital	25	25	28	65	83	98	184	216
Total Deposits	88	167	290	560	771	1175	1632	2036
Net Income	10	06	07	22	33	35	36	38
Operating Income	28	45	86	193	395	398	473	589
Operating Expenses	18	39	79	171	362	363	437	551

*Millions of Naira

Source: Annual Report and Statement of Accounts.

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Lion Bank Plc

Data Element	Year							
	1989	'90	'91	'92	'93	'94	'95	'96
	NM*	NM	NM	NM	NM	NM	NM	NM
Total Assets	232	329	393	548	955	1141	1481	1485
Risk Assets	81	45	109	131	436	536	640	899
Liquid Assets	251	284	284	417	519	605	841	586
Total Loans	62	67	58	83	122	212	238	436
Non-Performing Loans	17	20	15	13	39	61	61	132
Total Capital	14	21	29	34	67	105	107	46
Total Deposits	216	216	292	356	527	583	840	880
Net Income	07	13	04	16	14	18	07	(58)
Operating Income	25	54	60	92	130	200	176	229
Operating Expenses	18	41	56	76	116	182	169	287

*Millions of Naira

Source: Annual Report and Statement of Accounts (1989-1996).

APPENDIX B: LICENCED COMMERCIAL BANKS AND THEIR EQUITY CAPITAL AS AT DECEMBER 31,1990

BANK	EQUITY (N'M)
.Access Bank (Nig) Ltd	21.6
Afri-Bank Ltd	137.5
African Continental Bank Ltd	60.0
Allied Bank of Nig.Ltd	25.0
All State Trust Bank Ltd	22.7
Bank of Credit & Commerce International Ltd	100.0
Bank of The North Ltd	50.01
Broad Bank Ltd	20.0
Chartered Bank Ltd	26.1
Citizen International Bank Ltd	20.0
Commerce Bank Ltd	38.7
Commercial Bank (Credit Lyonnais) Ltd	30.0
Commercial Bank Africa Ltd	20.0
Commercial Trust Bank Ltd	10.0
Co-operative and Commerce Bank Plc	20.7
Co-operative Bank Ltd	26.0
Co-operative Development Bank Ltd	20.8
Credite Bank Nig.Ltd	20.0
Crystal Bank Ltd	20.0
Eco-Bank Nig.Plc	25.0
Eko International Bank Plc	30.8
Equitorial Trust Bank Plc	20.0
First Bank of Nigeria Plc*	80.7
Gamji Bank Ltd	21.2

Gateway Bank Ltd	27.1
Guaranty Trust Bank Ltd	25.0
Golf Bank Ltd	20.0
Habib Bank Ltd*	28.0
Highland Bank of Nig.Plc	20.0
Inland Bank Ltd	20.0
Intercity Bank Ltd	20.0
Lobi bank Ltd	20.0
Lion Bank Plc*	20.2
Mercantile Bank Ltd	16.3
Meridien Equity Bank Ltd	20.0
National Bank of Nig.Ltd	20.9
New Nigerian Bank Ltd	30.9
Nigeria Arab Bank Ltd	20.0
Nigerian International Bank Ltd	20.0
Nigeria Universal Bank Ltd	20.0
North South Bank Ltd	20.0
Oceanic Bank Ltd	20.0
Orient Bank of Nig.Ltd	20.0
Owena Bank Plc*	20.6
Pan-African Bank Ltd	91.3
Premier Commercial Bank Ltd	20.0
Progress Bank Nig.Plc	25.0
Republic Bank Ltd	20.0
Savannah Bank Plc	34.9
Societe Generale Bank Ltd	28.9
Trade-Bank Plc*	20.1
Trans International Bank Plc	20.0

Tropical Commercial Bank Ltd	20.3
Union Bank of Nigeria Plc	63.5
United Bank for Africa Plc	100.0
Universal Trust Bank Ltd	20.0
Wema Bank Plc*	40.0
Zenith International Bank Ltd	24.8

* Banks employed in the study.

Source: NDIC Annual Report and Statement of Accounts,1990.

APPENDIX C: SAMPLE OF QUESTIONNAIRES

EMPLOYED TO INTERVIEW BANK MANAGEMENT

1. The deregulation of the banking industry and the subsequent happening in the industry has attracted keen interest among the key participants in the market, what is your overall impression of the policy?
2. Bank licensing liberalisation adopted under deregulation ushered into the market a large number of new banks, to what extent did this affect the performance of your bank?
3. There was also the dramatic rise in the number of non-bank financial institutions, how has this affected banking activities?
4. Ever since the commencement of deregulation, what seemed to have posed the greatest threat to the banking industry?
5. Financial distress in the banking industry was once much talked about. In your opinion, what were the main factors that could have precipitated the distress?
6. Has your bank at anytime been classified as distressed by the monetary authorities?
7. What was the nature of the distress that plagued your bank?
8. How did your bank overcome the distress?
9. **Has your bank experienced any of the following in recent years?**

a. Suspension from the clearing house

b. Suspension from foreign exchange bidding

c. Restriction on credit activities

d. Removal of directors from office

10. What was the greatest challenge that your bank grappled with in recent years?
11. How will you rate your bank some three years ago in terms of:

a. asset quality;
b. earnings;
c. liquidity; and
d. capital adequacy?

12. Has your bank re-capitalised in recent years? If yes, under what circumstances and how many times?
13. What has been the impact of the following on the liquidity of your bank

a. stabilisation securities
b. Open market operation (OMO)
c. Others (Specify)?

14. How will you rate CBN's management of the key interest rates under deregulation?
15. In what manner has the monetary authorities handling of the key interest rates affected the performance of your bank?
16. It was a widely held view that bank management abused their position vis-à-vis loan administration under deregulation, do you agree?
17. In attempt to boost their earning, given the keen competition and shocks generated by deregulation, banks were deemed reckless or excessive in risk-taking, do you agree?
18. How much of a serious business was bank examination and supervision under deregulation, especially in the period before the widespread distress?
19. What is your assessment of the 'Prudential Guidelines' vis-à-vis loan administration?

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20. What was the impact of the Failed Bank (Recovery of Debts) and Financial Malpractices in Banks Decree 1994 has on banks in terms of loans administration and recovery of debts?

EMPLOYED TO INTERVIEW CBN'S BANK EXAMINERS

1. Bank examination and supervision being the responsibility of your Dept, what are the main activities of your Dept. vis-à-vis commercial bank?
2. In what manner has deregulation of the banking sector shaped the activities of your Dept?
3. What are the key criteria employed by your Dept to determine the soundness of a bank?
4. In recent years, the banking sector has been plagued by the so-called distress, from a bank examiner's view point, what are the inadequacies of such banks referred to as being distressed?
5. Employing commercial banks as our point of reference and using size as a basis of stratification, which banks were more prone to the inadequacies earlier described?
6. How will you rate the medium and large sized commercial banks based on the following criteria?

a. asset quality;

b. earnings;

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c. liquidity, and

d. capital adequacy.

7. Provide an assessment of the small size banks in term of:

a. asset quality,

b. earnings;

c. liquidity, and

d. capital adequacy.

8. To what extent will one ascribe the inadequacies exhibited by the banks to:

a. rapid competition

b. monetary policy formulation and implementation

c. quality of bank management

d. quality of supervision by the relevant agencies?

9. What will be your assessment of banks in terms of:

a. Accounting system;

b. record-keeping and

c. bank management?

10. To what extent has the deregulatory environment engendered the high incidence of infringement of the provision of BOFI Decree and CBN's Monetary Policy Circulars by banks?