SAFETY AND SOUNDNESS OF BANKS: A REVIEW OF MONETARY POLICY INFLUENCES IN NIGERIA

Anthonia U. Ubom (Pit. D) and Uduak B. Ubom (Ph. D)

Abstract

Monetary policy is one of the macroeconomic policies used by government to regulate the economy in order to achieve some macroeconomic objectives. This involves the use of monetary policy rate (MPR), interest rate and open market operations, among others. This article examines the influences of monetary policy on the safety and soundness of banks in Nigeria. Depending on the direction and focus of the government, the Central bank changes monetary policy tools from time to time. It is noted in this paper that monetary policy changes occur more frequently in the country. This affects banking operations seriously as inexperienced bank managers find it difficult to follow the trend and adjust their operational strategies effectively for smooth operations. As a result, investment position of the banks is adversely affected. This threatens the ability of the financial institutions to maintain a sufficient level of liquidity and to maximise profits. With weak liquidity position and low profitability, the soundness and stability of the financial institutions are threatened. In order to improve the performance, soundness and the stability in the banking industry in Nigeria, a more consistent and stable monetary policy regime and management strategies, among others have been advocated.

Introduction

Government adopts macroeconomic policies to regulate the economy. The major aim of such regulation is to achieve some macroeconomic objectives such as economic growth, full employment of labour, price stability, equilibrium balance of payments and equitable distribution of income, among others. Monetary policy is one of the macroeconomic policies used by the government in the pursuit of the above objectives. This policy is formulated and implemented by the Central Bank on behalf of the government. In adopting monetary policy, the apex bank intends to influence the volumes, flow and cost of credit within the economy. This is usually achieved by manipulating some variables including the Monetary Policy Rate (MPR), interest rate, cash ratio, liquidity ratio and the use of open market operations and stabilization securities.

When the economy is in boom, the Central Bank adjusts the MPR (i.e. discount rate), interest rate, cash ratio, and liquidity ratio upward in order to contract the economy. It will also sell treasury bills in the open market and compel some banks to buy stabilization securities. These actions reduce the credit base of banks and the ability of the financial institution to extend loans and invest in securities.

However, when the economy is dull, the reverse actions are taken. In other words, the MPR, cash ratio, interest, liquidity ratio are reduced and the Central Bank buys treasury bills from members of the public and redeems stabilization securities. The intent here is to increase the credit base of banks and enable the financial intermediaries to extend credits and expand the economy.

The monetary policy tools and directions as indicated above are subject to change from time to time depending on the objectives and focus of the government. The rate and the frequencies of such changes have serious impacts on banks. It exerts negative influences on the safety and soundness of the financial institutions as many bank managers find it difficult to follow the trend and directions of the Central Bank and make realistic implication of such actions. As a result, some bank managers, mainly the inexperienced ones, find it difficult to follow the trend and monetary policy actions of the government, and interpret same effectively for sound lending and other operational decisions. This exposes most banks to unsafe policy decisions and actions which threaten the stability and soundness of the individual banks and the industry as a whole.

This problem deserves a devoted attention in order to establish the basic approaches to effective and efficient monetary policy capable of ensuring or promoting safety, soundness and stability in the banking industry. This article is designed for this purpose.

Following this introduction are the conceptual review and empirical evaluation. At the end of the evaluation, discussions are made. Thereafter, the work is concluded and recommendations made.

Conceptual Review

Overview of Banking

Banks are business corporations established to maximize profits. Operationally, they are described as financial intermediaries because of the financial intermediation role they play in the economy. Such a role is in terms of deposit mobilization and lending activities within the system.

In order to perform these functions, the financial institutions require adequate stock of capital, good regulatory and supervisory framework and macroeconomic stability. These are the necessary factors which enhance the attainment of the corporate objectives of the banks. These objectives include profit maximization and shareholders' wealth maximization.

The thrust of banking business is mainly on acceptance of deposits, loans and advances and investments, among other functions. Hence, the healthiness strength and the overall performance of banks are measured first and foremost by the volume of deposits raised, amount of credit granted to the economy as well as the efficiency in the management of such assets to minimize defaults and accumulation of bad debts.

In the Nigerian banking industry, the major operators are the deposit money banks and regulatory and supervisory authorities particularly the Central Bank of Nigeria (CBN) and the Nigerian Deposit Insurance Corporation (NDIC). The Central Bank regulates the business of banking in the economy through the use of monetary policy tools. According to Byrns and Stone (1992), these tools include rediscount rates (i.e. monetary policy rate (MPR)), open market operations, interest rates, cash ratio, liquidity ratio, stabilization security and margin requirements among others. The Central Bank raises or reduces these tools depending on the state of the economy and the policy direction of the government. Detailed analysis of the nature and tools of monetary policy is made in the next section.

Nature and Tools of Monetary Policy

Fundamentally, policies are formulated to guide in the conduct and operations of activities of individuals, organizations, governments and their agencies at a given point in time. Monetary policy is formulated to guide monetary operations and management in a given economy. According to McConnell and Brue (2002), it is one of the macroeconomic policies implemented to achieve and maintain price level stability, full employment and economic growth. Such a policy consists of deliberate changes in the money supply, to influence interest rate and the total level of spending in the economy.

As explained by Mishkin (1992), the target of monetary policy is usually on the reserve base of banks. By affecting the reserve base of the financial institutions, the monetary authorities are able to influence and control availability, cost and flow of credits in the system.

In analyzing monetary policy and its applications in Nigeria, Sanusi (2002), observes that the question as to whether monetary policy can or cannot indeed achieve the price stability, full employment and economic growth objectives among others, is at the centre of the controversies between the Monetarist and the Kynesian schools of thought. The arguments between these two schools of thought is not the focus of this article. Rather the point to note is that the monetary policy strategy for the attainment of the said goals in any economy is often influenced by the stage of development of the economy and the financial infrastructure. Expantiating this point further, Sanusi (2002:1), observed that:

> In the early stages of economic development Central Banks typically rely on direct instrument of monetary policy, notably, administrative controls of banks. With these instruments, they attempt to control directly the balance sheets of commercial banks. As the economy develops and the financial system becomes more sophisticated, the Central Bank relies on indirect instruments to influence the level of bank reserves through the financial markets.

To properly put in place the administration of monetary policy, the Central Bank of Nigeria has at its disposal, a number of control mechanisms usually referred to as "tools of monetary policy". These tools are classified as quantitative and qualitative. The quantitative tools are banks rates, open market operations, reserve requirements, discount rate and interest rate. The qualitative tools are special deposits, stabilization securities selective control (Afolabi, 1998).

Bank rate is the rate at which the Central Bank lends money to banks, discount houses and other financial institutions. The lending is done through rediscounting of bills. That is why at times the bank rate is otherwise called the rediscount rate. A point to note is that for deposit money banks to cover cost and make profit, their lending rate is expected to be higher than the bank rate. The bank rate thus helps to ration credit and ensure that the available fund gets to the best users. Hindrance arises when banks have excess liquidity such that they can give out loans at rates lower than the bank rate. In this case the bank rate does not influence other rates in the economy. Where the government is the highest borrower, high bank rate leads to high cost of social services. Constant alteration of the bank rate leads to speculation in the money market and in stability in the economy. Too low a bank rate also leads to capital flight as a result of search for high interest.

Open market operation involves the purchase and sales of government securities. Such securities include treasury bills, treasury certificates, development stocks, government bonds and many others. When there is too much money in the economy, government may decide to reduce the amount of money in circulation. This it does by selling treasury bills in the open market to the public. In this case, the buying public, at most times, civil servants are issued with certificates and their funds are tracted by the government. This singular act by Central Bank reduces the reserves of deposit banks and their ability to create credit. On the other hand, when the economy is too tight, government pumps in money into circulation by buying the securities from the public, thereby increasing the ability of deposit institutions to create credit through increase in their reserves base. The aim of monetary policy formulation and implementation is to regulate the economy to achieve macroeconomic objectives. These objectives are economic growth, price stability, employment generation and equilibrium balance of payments, etc. In order to achieve these objectives, monetary policy must be formulated and implemented effectively and efficiently.

Monetary Policy Formulation and Implementation Strategies

The administration of monetary policy in Nigeria started with the establishment of the Central Bank in 1959. Its policy formulation is in line with macroeconomic policy of the nation. Monetary policy thrust then was maintenance of stability in wages, prices, support for increasing levels of agricultural and industrial output and provision and organization of development finance. During the oil boom, it shifted to draining excess liquidity in the economy and diverting funds to the productive sectors. Due to the relatively under-developed state of the financial system then, most tools could not be used. With the introduction of the Structural Adjustment Programme (SAP) in 1986, monetary policy was aimed at inducing the emergence of a market oriented financial system for effective mobilisation of financial savings.

This subsequently led to interest rate deregulation in 1987. The results were devastating and in 1991 the Central Bank re-introduced controls. The ceiling of interest rate at 21% was however, removed in 1992 and full deregulation took place in 1996.

By this time, there had been a shift by the federal government towards the techniques of indirect money control and the promulgation of CBN Decree No. 24 of 1991 and BOFI Decree No. 24 of 1991 to replace CBN Act of 1958 and the Banking Act of 1969. These decrees which have been repealed, enhanced bank's power in designing and conducting monetary policy and also addressed the problems of loopholes by bringing the non-bank financial intermediaries under the control of the Central Bank of Nigeria. Efforts were also made to increase the number of instruments and operations in the money market for efficient functioning of open market operations.

The Central Bank formulates monetary policy which may be tight or expansionary. However, actual implementation of this policy is through banks. The alterations in these policy tools exert influences on the performance, safety and soundness of banks. In the section that follows, the performance of bank is assessed in relation to the movements of monetary policy tools in Nigeria.

Empirical Evaluation

This section is therefore carved out to examine the effect of monetary policy on bank performance by establishing relationships between movements in the tools of monetary policy and measures of bank performance. The yardsticks for measuring bank performance for this purpose are total credit of banks and bank's investment. The data relating to these are presented in Table 1.

Table I
Monetary Policy Tools and the Performance of Banks in Nigeria
(1990-2005)

Period	Monetary Policy Rates (%)	Treasury Bill Rates (%)	Interest Rates (%)	Total Credit of Banks (Wm)	Banks Investments (14'm)	Ratio of non-Performing Credit to Total Credit (%)
1990	18.50	17.50	22.10	26.083.9	10.067.8	44.10
1991	14.50	15.00	20.10	31,762.4	7,453.5	39.00
1992	17.50	21.00	22.10 .	41,810.0	6,767.0	45.00
1993	26.00	26.90	23.99	48,056.0	31,192.0	41.00
1994	13.50	12.50	15.00	92,624.0	40,444.0	43.00
1995	13.50	12.50	13.96	141,146.0	22,695.0	32.90
1996	13.50	12.25	13.43	169,242.0	49,751.0	33.90
1997	13.50	12.00	7.46	230,600,0	42,861.5	25.81

1998	14.31	12.95	9.98	272,895.5	52,993.8	19.35
1999	18.00	17.00	12.59	353,081.1	193,412.9	-
2000	13.50	12.00	10.67	508,302.2	285,294.4	21.5
2001	14.31	12.95	9.98	796,164.8	192,731.8	16.9
2002	19.00	18.88	16.66	954,628.8	435,601.0	21.3
2003	15.75	15.02	11.99	1,210,033.1	434,299.0	21.6
2004	15.00	14.21	12.61	1,519,242.7	677,957.4	23.08
2005	13.00	7.00	10.62	1,847,822.5	94,939.6	-

Source: CBN Statistical Bulletin, 2005
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The data in Table 1, indicate that monetary policy rate (MPR), treasury bill and interest rates fluctuated throughout the period under review. For instance, monetary policy rates (MPR), treasury bill rate and interest rate rose from 18.5%, 17.5% and 22.10% in 1990 to 26.0%, 26.9% and 23.99% respectively in 1993. While the volume of credit granted by the banks to the economy rose sharply from ^26,083.9 million in 1990 to £W8,056.0 million in 1993, banks investment jumped from W 0,067.8 million to &31,192.0 million in the same year.

The following year, monetary policy rates, treasury bill and interest rates declined to 13.5%, 12.5% and 15.0% respectively. This was a liberal monetary policy regime as the volume of loans granted by the banks rose to 1^92,624.0 million as compared to M48,056.0 million in 1993. The volume of investment also increased as ^40,444.0 million was recorded for it. The monetary policy, treasury and interest rates remained fairly stable at not more than 13.5%, 12.5% and 15.00% respectively from 1994 to 1995 to 1996.

However, in 1999, monetary policy rate had risen to 18.0% from 13.5% in 1993. It increased to 19.0% in 2002 and as at 2005 it was 13.0%. The other rates also followed and decreased from 18.88% and 16.66% in 2002 to 7.0% and 10.62% respectively for treasury bill and interest rates.

While total credit granted by banks to the economy kept on increasing throughout the period, total investment fluctuated seriously. For instance, in 1994, the value of bank investment stood at ££40,444.0 million. By 1995, it had decreased to ^22,695.5 and rose to W49,751.0 million, EH93. 412 million and N677,957.4 million in 1996, 1999 and 2004. In 2005, the amount invested by the banks had declined to ££94,939.6 million.

The ratio of non-performing loans to total credit was on the decrease when 44.1% was recorded in 1990, by 1998, it stood at 19.35%. However, it increased to 23.08% in 2004. This came as a result of banks[1] improvements in credit management strategies and relative stability in the macroeconomic environment.

Generally, the movement of the monetary policy tools as analysed above affects bank loans and investments. But the impacts of monetary tools adjustments have more serious effects on investment portfolio of the banks. The value of investment fluctuated seriously due to frequent changes in the monetary policy tools which forced the banks to transfer from investment accounts to cash account to satisfy liquidity needs.

Discussions, Recommendations and Conclusion

Monetary policy is one of the macroeconomic policies formulated and implanted by the Central Bank to regulate and control the economy in order to achieve some macroeconomic objectives. These objectives as noted above include: economic growth, full employment of labour, price stability and equilibrium balance of payment, among others. The tools available for this exercise are the monetary policy rate (MPRJ, interest rate, open market operation (OMO), cash ratio and liquidity ratio. Others include stabilization security and margin requirement.

Two important characteristics of monetary policy deserve mentioning here. These are the expansionary and contractionary features.

The expansionary feature arises when the Central Bank reduces the monetary policy rate, interest rate, cash reserve ratio and liquidity ratio as well as purchasing treasury bills from the public. These actions aim at increasing the reserve base of banks and their ability to extend credit to the economy; thereby expanding and increasing the tempo of economic activities in the nation.

Conversely, when the economy is in boom, and excess liquidity threatens, the apex financial institution jacks up minimum rediscount rate, interest rate, cash ratio and liquidity ratio and sells treasury bills to members of the public. The position of the Central Bank in this case is to contract the economy by reducing the reserve base of banks and their ability to extend credit to the economy.

It should be noted that although monetary policy is formulated by the Central Bank, the actual implementation is carried out by banks. When the Central Banks changes monetary policy direction, the tools selected would be changed and/or adjusted. Banks also adjust their operational strategies to suit the requirements of the prevailing monetary policy regime and specifications. Confusions always set in mainly when inexperienced bank managers are involved (when more frequent changes in monetary policy direction and tools are made). The inexperienced bank managers find it difficult to follow the trend and interpret the policy implications of the government in order to take effective and efficient decisions.

This affects the loan and investment portfolios of the banks adversely. It would-also affect their cash positions and volume of deposits mobilised. For instance, as observed by Ubom and Ubom (2004), the frequent changes in monetary policy tools caused serious fluctuations in the volume of investments held by banks in Nigeria as well as their ability to make profits. This view is reflected in the trend of banks' total investment in the country from 1990 to 2005, as indicated in Table 1. The observed fluctuations were due to the banks' transfers from investment account to cash account to satisfy monetary policy specifications and to meet other operational needs. In most cases, the transfer is made prematurely with the bank losing the interest income. This reduces the profit margin of the affected banks.

Another dimension of the problem comes from the inability of the bank to mobilize sufficient pool of deposits, since the monetary policy changes may affect consumption and saving pattern of the public. The inability to mobilize adequate volume of deposits hinders bank's credit extension or reduces the potentials of loan beneficiaries to repay. In other words, it increases loan defaults rate which accounted for the high ratio of non-performing loans in the country within the period under review.

Banks with low deposit volumes, high default rates and high ratio of non-performing credits are exposed to serious weaknesses and overall poor performance. In other words, the problem of imsoundness, instability and low level of performance in Nigerian banks is not unconnected with monetary policy inefficiencies, inconsistencies and twists in the country. Although other factors contribute as well, it is concluded in this paper that poor monetary policy management has the highest potency and intensity in this direction.

To this end, the following recommendations became pertinent:

a. A more consistent and stable monetary policy regime and management strategies should be adopted by the Central Bank. This could be done by choosing and maintaining a particular rate pattern for a reasonable period of time.
b. Bank managers should carefully study the trend and direction of monetary policy tools and interpret the implications on the operations of the banks before taking major decisions.
c. Emphasis should be placed on higher level of experience and skill in the appointment of bank managers and assignment of managerial responsibilities.
d. There is the need for the alignment of monetary policy with banking policies as well as the entire policy framework in the finance industry.
e. Monetary authorities should always give banks adequate orientation and sensitization on any proposed monetary policy adjustments or change in monetary policy directions. This is to enable the banks have first hand information and to prepare in advance for possible adjustment of their operational strategies.

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