CAPITAL ADEQUACY AND THE BANKING SECTOR CONSOLIDATION IN NIGERIA

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Abstract

The Nigerian banking industry is relatively developed in relation to and compared with Sub - Saharan Africa. This development has not been unconnected with the regulatory regimes affecting capital base for banks in Nigeria, as it has recorded tremendous growth over the years. The sub-sector has undergone experiences and a number of lessons have been learnt concerning the continuous growth trend in the capital base of Nigerian Banks over time. The paper presents a historical analysis of capital base requirements in Nigeria and reviews the period of prudential regulation and control of Banks dating back from 1952. A detailed explanation is given on bank capitalization and recapitalization with adequate consideration given to its objectives and historical profile. Bank capital adequacy measurement and the Basel capital Accord was analyzed touching areas such as its formulation, computation and limitations. The paper concludes that globalization has compelled the current Bank consolidation and that inflationary pressures, rapid Naira exchange rate depreciation, erosion of Bank capital through non-performing credits, and the post SAP increased competition have compelled the incessant increases in Bank capital base in Nigeria.

Introduction

A capital base is very essential to any Bank, as it is among one of the basic requirements for all Banks as a necessary condition for obtaining a license to operate and to remain in business. The Banking and Other Financial Institutions Act (BOFIA) 1991, requires that any person desiring to undertake Banking business in Nigeria, should apply in writing to the Governor for the grant of a license, and shall accompany the application with a deposit, by it's shareholders a sum, equal to the "minimum paid up share capital". The minimum paid up share capital of Banks, or the Bank Capital is usually fixed by the central bank of Nigeria to meet the economic challenges of Nigeria.

The CBN uses the capital base as a means of control over other Banks. The area of controversy as regards the capitalization over the years has been on capital base increments, which most banks cannot easily meet up with in terms of finance and it's statutory requirements. That then leaves us to the question about: (a)what factors actually motivate the incessant increases in capital base of Banks in Nigeria? (b) What effects does the continuous increase in Bank capital have on the Banking industry and the Nigerian economy in general? (c)What options are available for increasing Bank's capital base in Nigeria? (d) How has these options been adopted to increase capital base to meet with the statutory requirement?

The answers to these questions, and so many other questions, provide the frame work for this study and gives an insight into what this study, aims to achieve. The goal is to provide a sound theoretical basis for preparing Banks and other corporate organizations for the challenges that may come in future with respect to capital base and to equally identify problems and obtain solutions in the area of capitalization, through a careful study of how it has been carried out in the past in comparison with the present times, so that Banks will be efficient and effective, thereby, avoiding failures and liquidations.

This discussion presupposes the need for proper understanding of the basic concept of the capital adequacy, examination of the divergent views of numerous authors and schools of thoughts in relation to Bank Capitalization, it's effect on the Banking sub-sector and the economy in general as well as the role of central Bank of Nigeria in Bank capitalization.

Concepts and Components of Bank Capital

The concept and components of Bank capital is the idea behind Bank capitalization and the variables or constituents that are required for Bank capital. Since the adoption of the 1988, Basel Accord, Bank capital has been defined to consist of core-capital (also called primary capital or Tier 1

capital) and supplemented capital (or Tier 2 capital). The CBN rolled out the approved components of Bank capital in Nigeria to include: (A) - Tier 1, capital made up of Paid up share capital and disclosed reserves (statutory and general); (B) Tier 2, capital made up of undisclosed reserves, asset revaluation reserve, general provision/general loan loss reserve, hybrid (debt/equity) capital instruments and subordinated - term debt.

The entries, which form the basis for computing equity capital in Nigeria include: equity capital (shareholder's funds), share capital (called up); statutory reserve, exchange difference reserve, loan stock (debenture), redemption reserve, bonus issue reserve. In some cases, contingent reserve, are included in the computation of a Bank's equity capital. Capital adequacy ratio is arrived at, by taking into cognizance credit risk, market risk and operational risk. The formula for calculating capital adequacy in Nigeria is total capital (primary capital + secondary capital) x Risk weighted Assets for credit risk (market risk + Operational risk) x 12.5.

A Historical Overview of Bank Capitalization in Nigeria

Banks are regulated and supervised by NDIC and CBN through some specified controls. One of these is stipulation of minimum capital. Minimum capital requirements was first stipulated for Banks operating in Nigeria in 1952, after the promulgation of the Banking ordinance, the colonial authorities, realized that inadequate capitalization of the Banks was one of the major reasons for the collapse of a number of Banks in the early 1950's. Since then, various increases have been made in the minimum capital requirement of Banks.

The Central Bank of Nigeria, has explained over the years, that the various increases in minimum paid up capital, was due to a number of factors, some of which are: Persistent inflationary pressures, need to ensure consistency with international standards, erosion of capital funds of Banks by non-performing credits, Rapid Naira exchange rate depreciation, Post SAP increased competition brought about by deregulation and licensing of new Banks (CBN, 1995). Apart from stipulating minimum capital requirements, other regulatory requirements relating to Bank's capital base include: (i) Capital funds adequacy, which is the ratio of capital funds to total risk weighted assets, effective 1st January 2004, (ii) This is stipulated at 10%, (iii) Ratio of adjusted capital funds to total credits net of provision must not be less than 1:10, (iv) Maintaining a reserve fund out of net profit for each year (after making provision for taxation and before any dividend is declared), (v) specifying single obligor limit in loans and advances in relation to a Bank's shareholder's fund unimpaired by losses, currently, this is stipulated as 30% of shareholder's funds.

The fundamental purposes of regulating Bank's capital are in three - fold: (i) to limit the risk of Bank failures, (ii), to preserve public confidence in Banks, (iii) to limit losses to the monetary authorities arising from deposit insurance claims.

The 1997, Federal Government Budget statement directed that all merchant and Commercial Banks should have paid - up share capital of not less than N500 million by 31st December, 1998. By 2001, the current minimum capital requirement of *₦1* billion for existing Banks, *₦2* billion for New Banks and N3 million for community Banks was required.

The 2004/ 2005, monetary policy guidelines issued by the Central Bank of Nigeria, increased this minimum paid up capital of existing Banks (₦l billion), and that of new Banks (N2 billion) to N25 Billion and this was to be concluded by the end of year 2005. Sobadu, pointed out, the lack of clarity over what the CBN really required between shareholder's funds and paid up share capital. Soludo (2004), pointed out that even the largest Bank in Nigeria has capital base of S240 million, compared to $526 million in Malaysia,—even those that have met the minimum capital requirement which then stood at Nl billion or $7.53 million for existing Banks and N 2 billion or $5.64 million for new banks did not compare with $526.4 million in Malaysia.

The goal of the current increase of Banks' capital base to N25 billion is to consolidate the Nigerian banking system (Soludo, 2004). Considering the wide increase in capital, it is argued that 'capacity' would be a major challenge in the post consolidation era and that consolidation would positively impact on Banking regulation, corporate governance and Bank management. However, product mix and target marketing are equally important, as size is not synonymous with higher profitability. Market forces, on the other hand, can weed out the marginal Banks. Also there were too much fragmentation of small and medium size Banks, hence consolidation became the best option and developments in the system made consolidation the ultimate reality. Orogun (2004), argued that size,

which is the objective of the consolidation programme of the CBN, is not enough condition to guarantee adequate funding to the real sector. He noted that, even with the current capital base, Nigerian Banks have frequently come together to finance big-ticket projects item. It is quite clear that there were many regulatory provisions that the CBN needed to consider rather than over-concentration on consolidation.

What is Adequate Capital and Bank Soundness in Nigeria?

An adequate capital base for a Bank is the level of capital, necessary to ensure the Bank's financial health and soundness (Kolawole, 2004). The minimum capital adequacy ratio as prescribed by the Basle committee of central Banks supervision is 8 percent. This ratio relates capital to credit risk. The 8 percent ratio implies that for every N100 credit, a Bank needs J48 capital. A lesser ratio shows different degrees of under capitalization, such that a ratio that is less than 2 percent, for example, shows critically under capitalized Banks and/or insolvent Banks.

Records from Nigerian Deposit Insurance Corporation shows that the average of capital adequacy ratio is 17 percent, which is 7 basis points above the official requirement of 10 percent. The Basel agreement on Bank capital adequacy ratio is 8 percent of risk - weighted assets.

$$\text{Capital Adequacy Ratio} = \frac{\text{Risk weighted Assets} \quad x \quad 100}{\text{Adjusted capital}}$$

The Basel committee regarded the capital adequacy as indicating the margin of protection available to both depositors and creditors against unanticipated losses that may be experienced by a Bank. Thus, it indicates the Bank's resilience to economic difficulties.

The Nigerian Banking industry's average shareholder's fund has been reported to be N3.27 billion, thus leaving an average gap of N21.73 billion for each of the 89 Banks in the reconsolidation era, to fill. This amounted to ₦1,933.97 billion additional capital funds required to be in place by December 2005. (Obadan, 2004). In consonant with CIBN and some Northern Senators, Obadan suggested that the Banks should be grouped into three with minimum capital as follows: Investment Banks N5.0 billion, Universal Banks N12.5 billion, Mega Banks $420.0 billion and the time suggested was 2004 - 2006, one year longer than the CBN's stipulation.

Sobodu (2004) argued that the capacity of the industry to the required fund put by some estimates at a princely sum of more than N2 trillion, which is even more than the current value of all the stocks on the Nigerian stock exchange.

Functions of Bank Capital

Adequately capitalized Banks that are well managed are better able to withstand losses and to provide credit to consumers and businesses. Generally, capital is required to support business, but the importance of adequate capital in Banking cannot be overemphasized. It is an essential element that enhances confidence and permits a Bank to engage in Banking. A very important function of capital in a Bank is to serve as a means of absorbing losses. It serves as a buffer between operating losses and insolvency. The more capital a Bank has the more losses it can sustain without going bankrupt. Capital thus, provides the measures for the time a Bank has to correct for lapses, internal weaknesses or negative developments. The larger size the capital, the longer the time a bank has before losses completely erode it's capital.

Apart from offering protection against losses, adequate capital confers other benefits such as protection of depositors and creditors in times of failures, strengthening of Banks ability to assume risk, influencing a Bank's ability to attract funds at low cost, forming the basis for measuring financial capability in Banks, and enhances a Bank's liquidity position. The snags however, is that little risk is rewarded with little return in line with the observation in finance theory of a positive linear relationship between risk and return. Thus, while inadequate liquidity will damage a Bank's reputation, excess liquidity will retard earnings. In the light of the above and in view of its significance, the regulatory authorities, consider capital adequacy a primary index for monitoring Banks.

International Standards for Capital Adequacy

The Basel committee established in 1974, represents central banks and financial sector authorities of the G10 countries. Concerned with ensuring the effective supervision of banks on **a** global basis the committee sets and promotes international standards in the area of capital adequacy measurements. In 1988, the " Basel capital Accord" on capital adequacy ratios was issued. This has continued to be the approach for calculating capital adequacy for major international banks. The "Basel Capital Accord" was developed in order to improve capital adequacy measurement and to standardize international practice (BCBS, 2001). The calculation of capital requires some adjustments to be made to the amount of capital shown on the balance sheet before the capital adequacy ratios can be applied on them. Two types of capital are measured, called Tier One Capital (TC|) and Tier Two Capital (TC2) (RBNZ, 2000). TCi is permanently and freely available to absorb losses without the bank being obliged to cease trading. Items here include (i) ordinary share capital (or equity) of the bank; (ii) audited revenue reserves (retained earnings less current year's losses), (iii) future tax benefits, and (iv) intangible assets including goodwill. TCi is important because it safeguards both the survival of the bank and the stability of the financial system.

Cem and Michael (2000), identified that TC_2 generally absorbs losses only in the event of a winding-up of a bank, and so provides a lower level of protection for depositors and other creditors. It comes into play in absorbing losses after the bank has lost TCi. TC_2 is sub-divided into upper and lower TC_2 (BCBS, 2001). Thilo and Peter (2002), showed that, upper TC_2 has no fixed maturity. TC_2 include (i) unaudited retained earnings, (ii) Revaluation reserves, (iii) general provision for bad debt, (iv) perpetual cumulative preference shares, (v) perpetual subordinated debt. Lower tier two class of capital has limited life span, which makes it less effective in providing a buffer against losses by the bank. This class includes (i) subordinated debt with a term of at least 5 years, (ii) Redeemable preference shares which may not be redeemed for at least 5 years. Thus total capital will be the sum of TC| and TC_2 less the following: (i) equity investments in subsidiaries, (ii) shareholdings in other banks that exceed 10 percent of that bank's capital, (iii) unrealized revaluation losses on securities holdings.

Supervisory authorities are encouraged to apply The Basel Capital Accord minimum capital adequacy standards. These include: (i) TCi to risk weighted credit exposures, which should not be less than 4 percent (ii) Total capital (TC) to total risk weighted credit exposures to be not less than 8 percent, (TC = TCi + TC_2 less certain deductions). Some further standards applicable to tier TC_2 include (i) TC_2 may not exceed 100 percent of TC|, (ii) the lower TC_2 may not exceed 50 percent **of** TC,, (iii) lower TC_2 are amortized on a straight-line basis over the last five years of its life. According to the new Basel framework (BCBS, 2001b) tier three capital (TC_3) has been identified and referred to. TC3 consist of short-term subordinated debt. It can be used to provide a buffer against losses caused by market if TCi and TC_2 are insufficient.

Problems/Limitations of Capital Adequacy Regulations

An adequate bank capital as set out by the Basel Capital Accord may be, on a general basis, teemed as desirable. However, certain shortcomings have been identified. These include (i) its risk measurement framework does not generate a capital advantage for banks that have well-diversified portfolios, even though finance theory indicates that they should be treated as less risky than banks with concentrated portfolios (RBNZ, 2000), (ii) Its system of four risk " brackets" (of 0, 20, 50 and 100 percent respectively) is too crude and not accurate (Cem and Michael 2000), (iii) Basel Accord is concerned primarily with large internationally active banks (Jeffrey, 2000), (iv) Regulatory and supervisory standards may bring about idle capital funds. In this regard, Pandey (1990), asserts that, from a bank's perspective, holding idle capital is an expensive safeguard against risk because the banks shareholders demand a return on their investment and idle capital provides no such return, (v) the minimum capital ratio (8 percent, for instance) has is arbitrary and it may give a false sense of certainty and security, especially as the capitalization of most banking system worldwide surpassed the 8 percent minimum (Cem & Michael, 2000). For instance, a bank with a nominally high capital ratio of 12 percent normally would be characterized as "well-capitalized", given the Basel minimum capital adequacy ratio of 8 percent. Yet, a 12 percent ratio may be inadequate for the bank's operating environment and risk profile that may warrant or require a capital ratio of 20 or 25% in the economy's sense.

Conclusions

The importance of adequate capital in Banking cannot be overemphasized. Apparently, the concept of capitalization remains one of the most important processes for Banks in considering an adequate, efficient and effective capital base. The reality of global experience is that consolidated activities driven by the imperative of growth are increasing. The necessity to relate the Nigerian Banking industry with that of other countries of the World has led to the N25 billion increase with a view to meeting global standards and the current trend in the Universal Banking industry. However, a huge capital base is necessary but not a sufficient condition for a Bank's continued state of good health since an irresponsible and fraudulent management can squander the huge capital, and the Bank fails (Obadan, 2004).

The increases in Bank capital overtime has positively affected the Nigerian economy, by increasing the number of jobs, providing security against depositor's funds, making Banking accessible to all through increase in the number of branches of existing Banks and finally, reducing the number of distressed Banks amongst others.

Key determinants for the incessant increases of the Bank capital in Nigeria include inflation, which is attributed to government fiscal indiscipline and the adoption of a market determined exchange rate. Uncontrolled inflation ensured that the minimum capital base requirement was further raised (Uche, 1998). Similarly, the CBN (2004), also asserted that the various increases in minimum paid up capital, was due to persistent inflationary pressures, the need to ensure consistency with international standards, rapid Naira exchange rate depreciation, erosion of capital funds of Banks by non performing credits, and post SAP increased competition brought about by deregulation and licensing of new Banks amongst other reasons.

Recommendations

The above conclusions present the following mandate upon the Banks and the regulatory authorities for achieving sustainable stability and survival of the Nigerian banking sector:

(1) There is an urgent need for leadership to be demonstrated at all times in style and action, and also a commitment to enthroning the private sector as the engine of growth and development. This presupposes that private sector operators will be fully consulted whenever major policy reforms are contemplated.

(2) There is strong need to seriously consider other Banks' financial health determinants like Liquidity, Management quality, Profitability, Strict Internal Control and Asset quality that ensure that the proportion of non-performing loans to total loans is pot above the tolerable limit.

(3) No doubt, adequate capital is important, but in order to ensure stability, the major lesson is the need to tackle other fundamental factors that cause ill health and unsoundness in Banks. The major variables to focus on are adverse internal and external shocks, unstable economic policies and adverse economic conditions, unguarded liberalization of entry into the Banking industry, deficiencies within the board of directors, inept management, fraudulent and corrupt practices of Bank owners, political interference in the management of Banks, poor asset/liability management, reckless use of depositors funds, and inadequate supervision and enforcement of prudential regulations.

(4) To ensure the general or overall soundness of a Bank, Government first of all, must adhere to lay down provisions that will help to ensure the attainment of the policy objective of monetary stability. The Board of directors, management and shareholders of the Banks should ensure that fraudulent and corrupt practices are discouraged always; competent hands are employed at all levels to ensure corporate governance and professionalism.

(5) Also, a good cash flow system should be adopted to ensure that there is no persistent recording of losses which signals crisis in the Bank. Liquidity and profitability should be promoted always in the Bank, and the, organizational culture and values of the Banks, should be sound, efficient and effective, to ensure the stability of the Bank financially, other wise and in all ramifications, the consolidation exercise would be a facade.

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