

Recapitalization Reform and Banks' Performance - Empirical Evidence from Nigeria

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Abstract

The banks recapitalization reform which took place in Nigerian banking industry in 2005 was driven by the need to strengthen the banking sector and reposition the banks to become strong enough to meet up with the on-going financial and business globalization best practices. The exercise was deemed necessary owing to the fact that a bank with a strong capital base has the ability to absorb losses arising from non performing loans and advances. The study uses an Ex-post-facto research design which employs the use of secondary data obtained from the banks' annual report and accounts. The work studied 17 banks out of the 25 banks that emerged out of the 89 banks that were in operation in 2004 before the reform. The study covers a ten year-period (2002-2012) to see the significance of the reform. Ratio analysis techniques were used to measure the banks' performances as seen in the work of Rose and Hudgins (2005). The study found that there was significant difference in the performance of banks before and after the reforms as evidenced by improved yields in the ratios used as performance measures. The ratios used as performance indicators in this work showcased higher yields in the post-recapitalization as against the lower yields before the reform. The implication of this is that the CBN's decision is a welcome stance as it has changed the market structures of banks by increasing the operational efficiency and raising their earnings potentials. The paper recommends among other things that banks should opt for optimum dividend payout ratio that would focus on the maximization of the market values of the banks' shares, hence higher dividend per share with the resultant increased earnings per share. Again, banks should be encouraged to embark on effective intermediation drive that would bring all the small savers to the purview of the banking system rather than setting target for their staffs especially young girls. Bringing such funds into the banking system through effective intermediation strategy would provide a cheap source of fund for the banks which they can use to generate more interest income which would improve their profitability, hence increased returns on investment in form of increased banks value and stability.

Keywords: Banks, Recapitalization, Reform, Performance, liquidity, Earnings, profitability.

Introduction

The recent economic adjustments in Nigeria have focused more on structural and institutional reforms of the banking industry to bring it to the expected ends of meeting the objectives of its inception. As a matter of facts, the capital base of commercial banks that were operating in Nigeria then was nothing to go by. In as much as the minimum capital base for banks was ₦2 billion, many banks then depended on deposits from the public sector. Worst still, many of them appeared to have abandoned their essential intermediation roles of mobilizing savings and inculcating banking habits unto un-bankable households and micro enterprises, (Akinbola 2006). The implications were that the resources base of some of the banks became weak and volatile, rendering their operations highly vulnerable to the swings in the government revenue arising from fluctuations in the international price of oil. As a result, the number of distressed banks had risen to about 62 banks in 2004, (Uche 2006). To show how bad the situation was, Balogun, (2007) stated that the development in the banking sector then indicated a mixed trend in the performances of banks using the CAMELS Criteria. The result of his study revealed that banks satisfactory rating has been on the decline since 2001 to 2004, from 63 to 51 banks respectively. During that period, the number of banks categorized as "sound" had exhibited a mixed trends, while the number of marginal banks and unsound banks has been on the increase. To support this report, Uchendu (2005) noted that as at end of June, 2004, there were 89 commercial banks operating in the country, comprising banks of various sizes with little degrees of soundness as their shareholders funds were inadequate. Structurally, in Nigeria the sector is highly concentrated, as the ten largest banks accounted for about 50% of the industry's total assets/liabilities and most of them have a capital base of less than \$10 million far below what was obtainable in South Africa and in other developing countries. The small size of most of our banks with expensive headquarters separate investment in software and hardware, oil and gas and other projects that involve heavy fixed costs and operating expenses. Some of them have bunches of branches in few commercial centers and this had led to very high average cost for the industry. This in turn has implications for the cost of intermediation and the spread between deposit and lending rates has put undue pressures on banks to engage in sharp practices as means of survival.

Ukeje, Agu and Onyeukwu (2006) lamented that instead of engaging in strict diversifiable banking products and fund savings intermediation the banks became petty traders trading in foreign exchange,

government short term securities such as treasury bills and treasury certificates, etc. Worst still, so many of them were engaging in direct importation of goods through phony companies and this was not healthy for the economy, hence the move to recapitalize the banks as to be able to finance big projects and compete favorably with foreign ones. The economy needs banks that can stand tall and compete favorably with foreign banks amidst the on-going financial and business globalization. This calls for increased shareholders funds of the banks. Sequel to this, in 2004, the then Governor of CBN, Professor Chukwuma Charles Soludo announced a 13-point reform agenda for the Nigerian Banks. The reforms were designed to enable the banking system develop the required flexibility to support the economic development of the nation by efficiently performing its functions as the pivot of financial intermediation, (Nwude, 2005).

The concept of recapitalization refers to the move by which CBN compelled all the commercial banks operating in Nigeria to raise their capital base from ₦2 billion to ₦25 billion on or before 31st December 2005. According to Soludo (2004), the idea was to ensure a diversified, strong and reliable banking industry where there is safety of depositors' funds and re-assurance of the banks' continual playing of the active intermediation role in the economy. This would equally help Nigerian banks compete favorably on the on-going globalization of financial institutions. This can be achieved by globalizing Nigerian banks through setting up of subsidiaries in London and encouraging them to successfully get listed on the London Stock Exchange in United Kingdom and NYSE in New York. The exercise has made some of the banks to consider Merger and Acquisition as survival strategies. The exercise has since been completed, leaving the number of banks in operation from 89 banks that were in existence at the end of 2004 to 25 banks at the end of the exercise and presently to 17 banks.

The remaining 14 banks which had negative shareholders' funds and could not merger or get acquired went under and their licenses of operations were revoked. Six banks survived as stand-alone entities as they were able to re-capitalize single-handedly. These banks include; two Nigerian banks Zenith Bank Plc and Guaranty Trust Bank (GTB) Plc and all four foreign banks-Standard Chartered, NIB, Stanbic and Ecobank. The successful banks in all accounted for about 94% of aggregate deposit liabilities. The idea is that with this increased capital for banks, the recapitalized banks can improve their total asset turnover and diversify in such a way that they can generate more income on their assets, (Umoh, 2005). Though, this has generated so much controversy especially among the stakeholders and the banking public as regards to its relevancy. The controversy centers much on whether such a move can impact positively on the performance of banks. Other outcomes of the reform include; Nigerian banks going regional and global, enhanced liquidity and capitalization of the stock market as well as more effective supervision as regulators can now focus on fewer banks rather than on larger mostly sick banks, (Adebaju and Olokoyo 2008).

Now that all these have been in place, it is worthwhile to examine how well the banks fared seven years after the recapitalization exercise. Against this backdrop, the broad aim of this paper is to clearly identify on the basis of empirical evidence, if there is positive correlation between bank recapitalization and bank performance in Nigeria using liquidity as proxied by loan to deposit ratio, dividend per share, operational efficiency and earnings per share as performance measures.

Statement of the Problem

The impact of consolidation on banks' performance - a synergistic effect has previously been studied and the findings are embodied in Enyi (2007). In the main, this paper is motivated by the fact that out of 25 banks that emerged from the concluded recapitalization exercise that took place in Nigeria in 2005, we now have only 17 banks still in operation. What happened to the rest? Does it mean that the exercise was a wrong step at a wrong time? To what extent are the differences in the performance of the recapitalized/consolidated banks as regards to their values and their stabilities? Answers to these questions are vital for knowing the relevancy or the irrelevancy of the reform. Hence, this study fills the gap.

Objectives of the study

The main objective of this paper is to assess the relevance or irrelevance of the recapitalization reform in the performance of Nigerian commercial banks.

Specifically, the researcher aims that this study achieves the following objectives:

1. To assess the effect of the reform on the liquidity positions of the banks
2. To examine the influence of the reform on operational efficiency of the banks
3. To determine the impact of the reform on the dividend per share of the banks
4. To find the relationship between the shareholders' fund and the earnings per share of the banks.

Research Questions

Based on the above research objectives which this study aims to achieve, the following research questions were extracted:

1. How does the reform affect the liquidity position of banks
2. How does the reform influence the operational efficiency of the banks?
3. What impact has the reform on the dividend per share of the banks?
4. Is there any significant difference between the shareholders' funds and the earnings per share of the banks?

Research Method

We first and foremost showed our main empirical model and variables for testing the effects of recapitalization reform on bank performance as measured by financial ratios. We tested the effects of the reform on bank performance using data from audited accounts of 17 banks out of 25 consolidated banks in Nigeria in 2000s. The four financial ratios used in this work as seen in the work of Rose and Hudgins (2005) are; operational efficiency, liquidity, dividend per share and earnings per share ratios. The study clearly highlights the pre and post reform periods for the above ratios as performance indicators for banks performances in Nigeria following seven years after the 2005 banks' recapitalization reform.

Operational Efficiency: A good measure of operational efficiency is the ratio of expenditure to income. The formula as seen in the work of Rose and Hudgins (2005) is shown thus:

$$\text{Operational Efficiency} = \frac{\text{Operating Expenses}}{\text{Income}} \dots\dots\dots 1.1$$

In this study, the operational efficiency has been proxied by Capital Expenditures to Gross Earnings of the banks as seen in the work of Jackson (2001). Hence, the formula is shown thus:

$$\text{Operational efficiency} = \frac{\text{Capital Expenditure}}{\text{Gross Earnings}} \dots\dots\dots 1.2$$

Liquidity ratio: In this work, liquidity ratio is defined as the total loans and advances to total current liabilities of banks. The best and most effective measure of a bank's liquidity is the loan-to-deposit ratio. Loan-to-deposit ratio is defined as the ratio of total loans and advances to total current liabilities. It measures the percentage of total current liabilities that has been given out as loans to fund users. Hunter and Helen (2002) expressed that loans are the most illiquid assets and as such, a rise in the percentage of current liabilities that goes to loans indicates that the bank is heading towards illiquidity while a reverse signals an improvement in bank's liquidity position. The formula for this is shown thus:

$$\text{Loan-to-deposit ratio} = \frac{\text{Total Loans and Advances}}{\text{Total Current liabilities}} \dots\dots\dots 1.3$$

Dividend per share- This is the stipulated maximum amount that banks have to pay out to shareholders as dividends out of the net profit made. Dividends on ordinary shares are recognized in equity in the period in which they are approved by the Bank's Board. Dividend is normally paid to shareholders less withholding tax of 10% for most of the banks. This is calculated thus:

$$\frac{\text{Dividend pay out}}{\text{Total shares outstanding}} \dots\dots\dots 1.4$$

Earnings per share- This measures the amount of earnings attributed to one share of the bank on an after tax basis. Basic earnings per share is calculated by dividing the net profit attributed to equity holders of the bank by the weighted average number of ordinary shares issued during the year. The calculation is shown as:

$$\text{EPS} = \frac{\text{Profit After Tax}}{\text{WANOSO}} \dots\dots\dots 1.5$$

Where:

WANOSO = Weighted Average Number of Ordinary Shares Outstanding.

Results and Discussion

Tab.1 Performance Evaluation Ratios for Nigerian Banks before and after 2005 Recapitalization Reform

Types of Ratio	Before Recapitalization				After Recapitalization						
	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012
Liquidity (%)	55.32	55.21	60.24	61.22	60.22	58.23	56.02	54.42	54.01	53.21	52.04
Dividend per share (₦)	26k	28k	36k	34k	32k	35k	42k	65k	₦1.00	98k	₦1.02
Operational Efficiency (%)	48.06	47.28	50.68	78.65	60.44	56.58	54.52	52.02	51.34	50.89	50.24
Earnings per share (₦)	0.82	0.78	0.86	0.98	1.65	1.75	1.82	1.87	1.91	1.93	1.99

Source: Banks' Annual Report and Accounts of various issues

Interpretations:

For the liquidity ratio which in this work is defined as the total loans and advances to total current liabilities of banks, the result showed that there has been a kind of rising and falling in the liquidity positions of both pre-and post- recapitalization periods. In other words, it has been fluctuating around 55.32% in 2002, 55.21% in 2003, 60.24% in 2004, 61.22% in 2005 during the pre-consolidation periods. We used 2006 as our base year. It has a highest increase between the year 2004 (60.24%) and the year 2005 (61.22%).

The reason for this increase in the liquidity of the banks is not far-fetched. It can be correctly linked to the resultant effects of recapitalization exercise that started in the year 2004 and was concluded on December 31st 2005. Since a rise in the ratio signifies signs of illiquidity and a fall indicates the reverse, the results showed that the banks were uncomfortably illiquid in the pre-recapitalization periods. The situation was like that because banks were in tight corner as per replica effect of raising their capital base to the tune of ₦25 billion. Good enough, the rate began to decline after the exercise, to 60.22 in 2006, 58.23 in 2007, 56.02% in 2008, 54.42% in 2009, 54.01% in 2010, 53.21% in 2011 down to 52.04% in 2012. This decrease was an indicative of a normalized situation. The development is a welcome stance as a rise in the percentage of current liabilities that goes to loans indicates that the bank is heading towards illiquidity while a decrease signals an improvement in bank's liquidity position vis-à-vis loan-to-deposit ratio. Hence, our results revealed that recapitalization has positive significant effect on banks' liquidity.

For the dividend per share which measures the rate of returns available to shareholders as dividends, it was quite low in the pre- recapitalization periods, falling sharply from 36k in 2004 to 34k in 2005 and 32k per share in 2006. Though, it later picked again and increased to 35k per share in 2007. There was yet a remarkable improvement as showcased by a sharp rise in the dividends to 42k, 65k, and 98k, ₦1.00, and ₦1.02 per share in, 2008, 2009, 2010, 2011 and 2012 respectively. This indicated that the shareholders received higher dividend in the pre-consolidation periods, very low at the immediate-post-consolidation eras but sharp/fat increase after the recapitalization. This is not surprising as most banks raised their funds through equity shares which then increased the equity and the profit after tax has improved substantially, hence higher dividend to compensate the shareholders who added additional funds by purchasing additional shares to finance the reform saga.

For the Operational efficiency, the result revealed that the percentage cost for funding expenses jumped from 50.68% in 2004 to 78.65% in 2005, and later dropped to 60.44% in 2007, 56.58% in 2008, 54.52% in 2008, 52.02% in 2009, 51.34% in 2010 and further dropped to 50.89% and 50.24% for 2011 and 2012 respectively. This was quite understandable as it is expected of every major reform exercise to attract high cost of funding. This was so as all the banks were all out to meet the deadline of raising their capital base to the required amount. By so doing, expenses were increased as results of cost of sourcing the funds from the capital market and borrowing from other financial institutions, coupled with other logistics. However, the result showed that there was a sharp decline in the figure as it tapered off between 2008 and 2012 and was consistent with the industry average even before the exercise. From the result we deduced that the reform has positively influenced the operational efficiency of the consolidated banks as indicated by a sharp drop in the percentage costs incurred.

For the earnings per share which measures the amount of earnings attributable to one share of the bank, the result on **table 1** revealed that the amount increased sharply after the 2005 recapitalization reform from 0.88k in 2005 to 1.99 in 2012. From the table, it can be seen that the increase has been in a continuous progressive

dimension.

Summary of findings

The following findings were made:

1. There was a significant positive effect of the reform on the liquidity positions of the banks as showcased in the increased loan-to-deposit ratio.
2. The reform has strong negative influence on the operational efficiency of the banks as the percentage cost for funding expenses increased drastically.
3. The reform impacted positively on the dividend per share of the banks as indicated by a sharp rise in the dividend payout ratio of the banks after the exercise.
4. There was a significant positive relationship between the shareholders' funds and the earnings per share of the banks

Discussion

The results of this study showed that there is significant positive effect of the recapitalization reform on the liquidity positions of the bank. The finding is in line with the result of earlier studies carried out by Nwude (2005) which found that a rise in the percentage of current liabilities that goes to loans indicates that the bank is heading towards illiquidity while a decrease signals an improvement in bank's liquidity position vis-à-vis loan-to-deposit ratio. This is an indicative that there is a significant relationship between a bank's liquidity and its loan-to-deposit ratio.

Our result which revealed that the reform have strong negative influence on the operational efficiency of the recapitalized banks is in complete disagreement with the observation of Hunter, and Helen (2002) who maintained that the better the banks' levels of operational efficiency in terms of their abilities to reduce the level of operating costs, the better the overall performances of the banks, hence higher profits.

However, the perceived significant positive impact of the reform on the dividend per share of the banks agreed completely with the result in the work of Enyi, (2007) in which he found out that there is a positive relationship between the dividend per share which measures the rate of returns available to shareholders as dividends and the shareholders' funds. In our study, the result revealed that the shareholders received higher dividend after recapitalization than before the reform exercise.

Equally our findings revealed that there is a significant positive relationship between the shareholders' fund and the earnings per share of banks. Banks earned more income on earning assets after the recapitalization than before; the reform encouraged more yields on earnings assets. This finding is in line with other similar works on impact of shareholders funds on the earnings per share of banks done by Umoh (2005) and Abrime (2005) but do not agree with the findings of Balogun (2007) who found that recapitalization of banks does not necessarily grantee higher earnings per share. They further added that in most cases the increased shareholders' funds can push some banks into wreck-less lending that can result into bad and doubtful debts, hence irreparable loss that can lead to distress or outright closure.

Conclusion

In conclusion, without doubt, there was plausible empirical evidence which showed that recapitalization reform which took place in the Nigerian banking industry in 2005 has significant positive relationships with the performance of banks. There was yet a remarkable improvement in the performance of the recapitalized banks especially in the area of maximizing the market values of the banks' shares through higher dividend per share. The shareholders received high dividend in the pre-recapitalization periods, higher at the immediate-post-recapitalization period yet fatter increase after the recapitalization. This is not surprising as most banks raised their funds through equity shares which then increased the equity position of the banks and the profit after tax has improved substantially, hence higher dividend to compensate the shareholders who added additional funds by purchasing additional shares to finance the reform saga.

Recommendations

To continually enjoy a continuous maximization of the dividends of the reform, the following recommendations are hereby proposed.

The regulators of the Nigerian banking industry should consider the option of making recapitalization/consolidation a five-year-interval affair with adequate timing and a 100% increase in the banks' capital base.

Again, banks should opt for optimum dividend payout ratio that would focus on the maximization of the market values of the banks' shares, hence higher dividend per share.

Furthermore, banks should be encouraged to embark on effective intermediation drive that would bring all the small savers to the purview of the banking system rather than setting target for their staffs especially the

young girls. To confirm this, CBN has lamented over time that most of the money in circulation is in the informal service sector which the banks have neglected over the years. Bringing this fund into the banking system through effective intermediation drive would provide a cheap source of funds for the banks which they can use to generate more interest income which would improve their profitability, hence increased return on equity.

Finally, the CBN should embark on the full implementation of the “Code of Corporate Governance” for consolidated banks in Nigeria as suggested by the former CBN Chief. The full implementation of this would help sanitize and re-position our banks for greater values. This would equally help in the restoration of both domestic and international confidence of the depositors which is a necessary ingredient for the survival of any bank.

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