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CAPITAL ADEQUACY AND OPERATIONAL EFFICIENCY OF BANKS IN NIGERIA

By

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B.Sc. (Accounting)

A THESIS SUBMITTED TO THE
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CERTIFICATION

This is to certify that OLAREWAJU ODUNAYO MAGRET carried out this research work under my supervision in the Department of Management and Accounting, Faculty of Administration, Obafemi Awolowo University, Ile-Ife, Nigeria.

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DEDICATION

This thesis is dedicated to GOD ALMIGHTY, the one who bestowed upon me, the grace, wisdom, knowledge and understanding to start and finish this programme.

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Odunayo Magret Olarewaju

August, 2015

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ABSTRACT

This study examined the determinants of banks' capital adequacy; and determined the influence of bank size on operational efficiency of banks for the period 2004-2013. It also evaluated the influence of capital base of banks on the level of operational efficiency of banks in Nigeria. These were with the view to providing information on operational efficiency as a measure of banks' performance using Financial Ratio Analysis.

Data were collected from both primary and secondary sources. Primary data were sourced through administration of structured questionnaire. Purposive Sampling Technique was used to select two managerial members of staff and one executive director from the head office of each of the 15 quoted banks out of the existing 21 consolidated banks and two representatives of Central Bank of Nigeria totalling 47 respondents who were the people that attended the Central Bank of Nigeria Capital Adequacy Ratio panel. Data on variables such as cost to income ratio, equity to total asset ratio, equity to total loan ratio, debt to total equity ratio, core capital ratio, bank size ratio, bank risk ratio, return on asset, return on equity, credit risk, liquidity structure, total asset, gross domestic product, inflation and deposit structure was also sourced from the Annual Reports and Accounts of selected banks and Central Bank of Nigeria Statistical Bulletin covering 2004 - 2013. The data were analysed using descriptive statistics such as mean, median, mode, standard deviation and inferential statistics such as pool ordinary least squares, fixed effect, random effect estimation and dynamic regression techniques.

The results showed that return on asset ($z = 2.95$, $p < 0.05$), return on equity ($z = -2.53$, $p < 0.05$), credit risk ($z = -3.85$, $p < 0.05$), deposit ($z = -6.64$, $p < 0.05$) and liquidity ($z = -4.00$, $p < 0.05$) were significant determinants of capital adequacy in Nigerian money deposit banks. The results also showed that the influence of bank size on operational efficiency was negative and

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insignificant ($t = -0.08$, $p>0.05$) and that debt to total equity ($t= -3.17$, $p< 0.05$), core capital ratio ($t = 4.65$, $p< 0.05$), bank risk ($t = -3.89$, $p< 0.05$) were significant in evaluating the influence of capital adequacy on operational efficiency of the Nigerian money deposit banks. Banks like FCMB Bank ($t= 2.63$, $p< 0.05$), Fidelity Bank ($t = 2.23$, $p< 0.05$) and WEMA Bank ($t = 2.45$, $p< 0.05$), had heterogeneous operational efficiency in the year 2009 ($t = 3.06$, $p< 0.05$) and year 2010 ($t = 3.63$, $p< 0.05$) due to their intrinsic organizational factors such as managerial competence, technological acceptance and timeliness of decision making, towards sustaining operational efficiency.

The study concluded that Financial Ratio Analysis was a better method of measuring bank's operational efficiency.

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CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

The banking sector is crucial to the survival of any economy and in order for the banking industry to achieve its objectives; the industry must be reliable, stable, safe and sound. However, banks all over the World have been undergoing crisis. In Nigeria, for example, the rapid increase in the number of bank failure has reached an unprecedented level. Hence, the regulatory authorities have adopted measures aimed at ensuring the reliability, safety and soundness of the banking industry. In 2004, the Central Bank of Nigeria embarked on banking sector reform which sought, among other things, to strengthen the Nigerian banking system and to improve its operational efficiency. At that time, the Nigerian banks were generally weak and inefficient.

The Central Bank of Nigeria's surveillance report as at the end of March, 2004 indicated that 62 banks out of 89 were classified as sound/ satisfactory and 14 as marginal. The number of unsound banks had risen from 9 as at the end of December, 2003 to 11 in May, 2004. Based on this, there was serious over-dependence on public sector funds and Central Bank of Nigeria credits as well as income from foreign exchange trading on the part of the banks.

Besides being grossly undercapitalized, the banking industry was characterized by several weaknesses including poor corporate governance, poor asset quality, inaccurate reporting and non-compliance with regulatory requirements, falling ethics and de-marketing of other banks in the industry, gross insider abuses resulting in huge non-performing insider related credits, oligopolistic structure with 10 of the 89 banks controlling more than 50 per cent

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of the industry's assets and liabilities, lack of capacity to support the real sector of the economy and lack of competition by banks in savings mobilization to boost the level of deposits.

The above is an indication that Nigerian banks were not efficient during the period under review. According to Beck, Loayza and Levine (2000), the more efficient a financial system is in resource generation and in its allocation, the greater its contribution to productivity and economic growth. Management of operations has usually been a secondary concern, partly because it has been considered, for some reasons, to be less critical to profitability (Said, 2012). High income may not mean that banks are efficient, more sustainable and cost efficient. Banks generally tend to minimize their cost to generate certain amount of income. So, there is the need for the banks' management to understand the proper operational efficiency required for effective utilization of banks resources.

The banking systems of many developing economies have exhibited poor performance, perhaps, in part, due to excessive government regulations and unfavourable business environment. To address this problem, various financial liberalizations, reforms and restructuring programs have been implemented in an effort to foster banking efficiency and a better allocation of resources (Isik & Hassan, 2003). The impact of these measures on bank efficiency has been widely studied with approximately 95% of these works focusing on banks of industrialized countries. However, only a limited number of these studies have examined the impact of capital adequacy on banks operational efficiency on developing economies (Kwan, 2003).

Studies on the importance of operating efficiency for banks in other economies revealed that the key determinants of operational efficiency were affected by the global financial crisis (Siraj & Pillai, 2011). This reinforces the need to understand the drivers of operational efficiency

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for proper risk management in the Nigerian Deposit Money Banks. The high interest charged by Nigerian banks could be attributed to the inability to push their operational costs downwards despite the increase in capital base of Nigerian banks. This may be due to many challenges in respect of costs and management of risks which banks are exposed to. Operating efficiency is one of the most critical risks faced by financial institutions in the Nigerian environment. For the banking institution to make the best use of their capital base, it is paramount for the sector to operate efficiently. Thus, this study is aimed at critically examining banks' capital adequacy and operational efficiency in Nigeria.

1.2 Statement of the Problem

Deposit Money Banks provide liquid and relatively low risk saving facilities in flexible amount to households, business concerns and government. It also promotes the payment system by providing major forms of exchange such as demand deposit. All these facilities can only be made available if the banks are adequately capitalized. Banks, in performing their intermediary role between the surplus and deficit unit, need to mobilise deposits which will broaden their capital base.

In Nigeria, currently, it is evident that Deposit Money Banks have moved from 'Demand-following' to 'Supply-leading' institutions; all in an attempt to boost their business activities with a view to bringing down the unit cost. It is a general saying that the stronger and bigger a bank is, the better its performance arising from low cost of operations.

Going through the literature, it is evident that many researchers have worked on the impact of capital adequacy on bank performances. Some of these studies include: Berger (1995), Ben Nacuer (2003), Pasiouras (2006), Kosmidou (2008), Mohi-ud and Tabassum (2010), Babalola (2011), Asikhia and Sokefun (2013), Ezike and Oke (2013), Ogboi and Unuafe

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(2013). All these studies considered profitability as the measure of banks' performance and their findings showed that capital adequacy has a positive relationship with banks' profitability. However, in few cases, the impact was not significant.

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