OBAFEMI AWOLOWO UNIVERSITY

COMPETITION AND EFFICIENCY OF COMMERCIAL BANKS IN NIGERIA (1990 – 2008)

BY

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DEDICATION

This thesis is dedicated to Almighty God for being with me throughout the period of the programme and to my kids: Taiwo Oluwaseyi, Kehinde Oluwaseun, Seyefunmi Ayomide, Ifeoluwa Oluwafunbi, Olanrewaju Clement and my lovely wife Olufunke Olukemi Ajisafe.

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ABSTRACT

The study examined the relationship between the degree of competition and the level of efficiency of commercial banks in Nigeria from 1990 to 2008. The study also determines the degree of competition as well as the level of efficiency of commercial banks in the country.

Our study made use of secondary data obtained from the annual reports and financial statements of fifteen individual commercial banks in Nigeria, for the period 1990 – 2008. Both descriptive statistics and econometric techniques were employed in analysing our data. In the descriptive analysis, we made use of tables, charts, ratio and percentages, while in the econometric techniques; we measure competition by the Panzar –Rosse H-statistic, and measure the level of efficiency with the translog cost function of the stochastic frontier approach. The relationship between the degree of competition and the level of efficiency were analysed using the dynamic panel generalised method of moment with fixed effect.

The results showed that the Nigerian commercial bank is characterised by monopolistic competition with the value of H-statistic significantly different from zero for all the periods and sub-sample periods. The value ranges between 0.0925 and 0.1168. For the level of efficiency in the banking sector, the results showed that commercial banks in Nigeria are efficient in the observed sample period with mean efficiency value less than 0.3% The results of the relationship between the degree of competition and the level of efficiency of commercial banks in Nigeria showed that competition is positive and significantly related to efficiency with a t-statistic of 2.4512 and coefficient of 0.1639 at 5% level of significance. This result was corroborated by the panel GMM which equally showed that competition influences efficiency in the Nigerian banking sector with a t-statistic value of 2.1584.

The study concluded that the degree of competition in the Nigerian banking sector is positively related to the level of efficiency, which corroborates the intuitive positive influence of competition on efficiency.

No of words: 320

Key words: competition, Efficiency, commercial banks, stochastic frontier, H-statistic.

CHAPTER ONE

INTRODUCTION

1.1 Background to the Study

The soundness of the financial institutions is an important element in the health of the nation. This is as a result of the key roles they play in the development of the real sector and in the efficient allocation of resources within the economy. The important functions performed by the commercial banks within the economy can be classified into two major categories namely, the deposit creating function, and the service-rendering function. The deposit creating function entails the lending and investing activities of the commercial banks. The service rendering functions include amongst others, provision of facilities for domestic and foreign remittances; collection of cheques, drafts notes, and other obligations for their customers; operation of paying and receiving hand to hand currency (financial intermediation); and provision of facilities for the safekeeping of valuables. All these functions are regarded as the operations of commercial banks which are used as a measure of their efficiency when performed effectively and efficiently.

These functions have been supported by Schumpeter (1911), who argued that financial intermediation through the banking system played a vital role in economic development through efficient allocation of savings, thereby improving productivity, technical change and the rate of economic growth. This was also corroborated by the endogenous growth model postulate that financial development has a positive impact on the growth of the economy. That is, well functioning financial systems are able to mobilize savings, allocate resources, efficiently, diversify risk, and enhance the flow of liquidity.

As a result of the importance of the financial systems and the fact that the ability of the banks to effectively impact on economic development depends largely on their soundness and efficiency, government all over the world, Nigeria inclusive, continue to take various measures to safeguard the banking sector through reforms.

The Nigerian banking system has experienced some fundamental changes since independence which occur as a result of changes in government policies. At independence, the banking markets were dominated by relatively small number of foreign banks. After about three and half decades, the number of banks expanded and the ownership structure diversified. Initially, it was dominated by the public sector banks, and later (1992 to be specific). The private sector banks became the dominant participants. As at this period, the government intervened in the banking markets to control resource allocation and promote the indigenization policy of the economy. The policies of financial repression pursued by the government directed at the Central Bank of Nigeria (CBN) during this period, was to control interest rates, volume and direction of credit in the economy.

By 1970, the federal government had acquired equity stake in all the foreign banks while a number of other banks were set up by the state governments. Also, in the late 1970s, the CBN instructed the commercial banks to establish branches in the rural areas as a result of the initiation of the rural banking scheme. The policy of financial repression and public ownership of the banks pursued by the government had significant consequences for the banking market. First, competition was stifled; it provides some degree of protection to inefficient banks, but the financial performance of the public sector banks was nevertheless poor. The policy of lending loans to the priority sectors in accordance with credit guidelines assisted in building up the non performing loans in the portfolios of the federal and state government banks.

Many of the state government banks were badly managed and served as a source of finance for their owners. However, the larger federal government banks were able to avoid serious financial difficulties, despite their bad debts and high overheads. They retained experienced management, the cost of their deposit base was low and their size enabled them to be well diversified. But extensive bad debts rendered some of the smaller federal government banks and many of the state government banks insolvent.

In spite of the various regulations and close control of the banking system to enhance its stability, the financial system in Nigeria, can, in general, be said to be relatively inefficient with a large number of banks and a small market (Ajayi and Ojo 2006). This inefficiency is partially due to the high rates of inflation, mismanagement and fraud in the public and private sector banks which led to excessive waste of resources. The rating of licensed banks in 2003 shows that 11 banks were sound, 53 were found satisfactory, 14 were found marginal, and 9 were found unsound (Usman, 2005).

Fraud as one of the serious economic crimes being perpetrated in our banking industry today is the use of fraudulent means to obtain money, assets', or other property owned or held by financial institutions or to obtain money from the depositors. The incidences of massive fraud and forgeries pervade the Nigerian banking system and it has contributed significantly to the failure of most banks. It is a plague that has continued to exist despite the increasing surveillance by the monitoring authorities that is responsible for the safety and soundness of the entire banking system. In the Nigerian Deposit Insurance Corporation (NDIC) report of 2009, there were 1764 reported cases of attempted frauds and forgeries involving N41.2 billion that year compared to N53.5 billion in 2007 out of which 10 banks accounted for N37.18 billion, a figure that is higher than the 2008 figure of N34.31 billion. Before this period, cases of fraud reported in commercial banks were about 180 in 1996, 132 in 2002, and 131 in 2003, and the amount involved was N427.13million, N872.3 million and N4870.90million in 1996, 2002 and 2003 respectively (NDIC Annual Reports Statement of Accounts of several Years). The case of fraud reported above, resulted to huge financial losses to banks and their customers, the depletion of the shareholders' funds and banks' capital base as well as loss of confidence in the sector. It has also resulted to the fall of most banks and organizations which eventually led to their closure. Some of the fraud perpetrated was as a result of presentation of forged cheques; posting of fictitious credits, fraudulent transfers and withdrawals, loss of money to armed robbers and lodgment of stolen warrants. Others include; granting of unauthorized credits and perpetration of ATM frauds accounted for the largest proportion.

Following from the above, it could be observed that a number of features characterized the Nigerian banking system. This include capital deficiency and insolvency, high incidence of non-performing loans/poor asset quality, weak management and declining margins, poor corporate governance/non-compliance with regulations, gross insider abuse, over dependence on public sector deposits, government revenue collections, and over reliance on the foreign exchange market for income through "round tripping" of officially sourced foreign exchange. Based on all these, there is the need for further reforms in the banking sector.