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The Impact of Capitalization on Bank Performance in Nigeria 1970 – 2010: An Assessment.

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Abstract

This study examined the effects of capital structure of banks on the performance of commercial banks in Nigeria, (1970 -2010). The choice of the period, 1970 – 2010 is meant to capture the important changes that took place in the banking sector immediately after the cessation of civil hostilities brought about by the civil war in Nigeria, 1967 to January 15th, 1970. Note that during this period, Nigeria had revised of the minimum capital requirements, for banks had established Community Banks, the Peoples Banks and introduced the Structural Adjustment Program (SAP). Capital position of Commercial Banks in Nigeria deteriorated in the late 1980's, many financial institutions suffered from insolvency while many others were technically insolvent. The study captures the performance indicators of banks and employed time series of bank data obtained from the Statistical Bulletin of Central Bank of Nigeria (CBN) and Fact books. The formulated models were estimated using ordinary least square regression methods. The study identified long run positive relationship between capitalization and profitability. This is supported by the results of the research conducted by Ubom (2004), Kwan & Eisenbeis (2005) and Adegbaju & Olokoyo (2008).The result of Granger Causality indicates that the significant relationship between capitalization and profitability is by-directional, implying that increase in capital leads to increase in profitability and vice versa of Commercial banks in Nigeria. The implication of this study, among others, is that improved capital position of Commercial banks in Nigeria will enhance their performance, restore the credibility and confidence of customers in banking operations. We therefore recommend that those strategies that will lead to continuous improvement in the capital position of banks should be embraced.

Key Words: *Bank Capitalization, Bank Soundness, Performance, Profitability, Non-performing Loans, Insolvency and Financial distress.*

Introduction

Bank capital has been a matter of discussion over the decades because of its importance in the banks. In fact many banks go out of their way increase their capital even without the prompting of the Central Bank, Nigeria Apex Bank. Any retained earnings at the end of an accounting year is added to capital as reserve. Central Bank of Nigeria (CBN) often regulates the capital position of banks in order to strengthen them save them from financial distress. History of banking in Nigeria reveals that that CBN has had reasons to shore up the capital base of Nigerian banks since the 1980s. "From a modest value of N10 million naira minimum paid-up capital in 1988, Nigerian commercial banks were required to maintain capital not below N50 in 1991. Between 1991 and 2005 subsequent increases have also been made ranging from N500 million in 1997; N1 billion in 2001; N2 billion in 2002 to N25 billion in 2005" (Onaolapo 2006).

The aims of bank capitalization are to resolve the problem of unsound banking, enhance efficient management in the banking system. Aderinokun (2004) maintain that increasing the capital base of banks in Nigeria would strengthen them and, in the process, deepen activities within the industry, provide better funding for banks lending activities and increase profitability. Improved capital will help to reduce risk, to ensure quality asset management and to put banks in a strong liquid position. Central Bank of Nigeria from time to time introduces reforms which include requirement for increasing banks capital base. Banking in Nigeria embraced the "Lazier faire" principle in which there are virtually no rules guiding the establishment of banks. This philosophy persisted from the early part of 20th century up to the great depression of the 1930s. It was after that great depression that people started insisting that certain guidelines be put in place. As for Nigeria, we were still a colonial territory of the British, and it was not until 1951 through the instrumentality of the British Government that the banking Ordinance of 1952 came into effect.(Isu,2009). The trust of the banking Ordinance was to introduce regulations that governed capitalization in Commercial Banks in Nigeria. Isu, (2009), maintain that most of the banking sector reforms, from inception, were always aimed at addressing peculiar problems in the sector. From Banking Ordinance of 1951 to the recapitalization reform of 2005, the reform were designed to ensure a diversified, strong and reliable banking sector which will ensure the safety of deposits money, play active developmental role in Nigeria economy and be competitive players in the global banking space. These reforms were identified by Okafor (2011): as follows; first (Independence) reform (1960-69); second, the era of indigenization 1970 -1976; third, (Okigbo Committee) reforms (1977-85); fourth, Structural Adjustment Programme (1986); fifth, Bank recapitalization and consolidation (2000- 2011). The aim of these reforms was to improve the effective performance for the banking sector. One of the marks of good performance of every business organization is improved profitability – infact sustained profitability.

Ajayi (2005) maintains that capital is an important tool in the Nigeria banking industry, because a bank with a strong capital base has the ability to absolve losses arising from increasing non-performing loans. In 2004, the Governor of Central Bank of Nigeria, Prof. Charles Soludo, announced a 13-point reform programme for the Nigerian Banks which include increasing the capital requirements of banks to N25b. The capital position of most Commercial banks in Nigeria have marked increased ever since the change came into effect in 2005. The primary objective of a sound capital base is to guarantee an efficient banking system. Lemo (2005) said that solid capital base would enable the banking system to develop the required flexibility to support the economic development of the nation, by efficiently performing its functions as the pivot of the process of financial intermediation. According to Adegbaju and Olokoyo (2008) the primary objective of bank capital was the maintenance of public confidence because confidence was the only collateral any bank would offer to depositors of funds. Capital is a very vital tool for the efficient and effective performance of any business enterprise especially banks because of the nature of their operations. Capital is being referred to in this study as equity share and reserves. This study wishes to determine the relationship between shareholders' fund (Capital) and Profitability. The objectives of this study are essentially:

1. To evaluate the relationship between bank capital and profitability.
2. To determine whether changes in bank capital granger cause changes in bank's profitability.

This paper has five sections. Section 1 is the introduction. Section 2.deals on the review of related literature. Section 3 is research methodology and model specification, section 4 concerns itself with the result of the findings and discussion, while section 5 discusses conclusion and recommendation.

Related Literature Review

Bank Capitalization and Profitability

Profit is the essential prerequisite of a competitive banking institution and the cheapest source of funds. It is not merely a result, but also a necessity for successful banking in a period of growing competition and uncertainty in financial markets. The basic desire of a bank's management is to make profit, as the essential requirement for conducting any business (Bobáková, 2003).

Several studies have examined the link between capital and profitability. For example, Berger (1995) examined the relationship between the return on equity and the capital asset ratio for a sample of US banks

for the 1983-1992 periods. He showed that the return on equity and capital to asset ratio tend to be positively related. In a similar study, Abreu and Mendes (2002) investigated the determinants of bank interest margins and profitability for some European countries. They reported that well-capitalized banks faced lower bankruptcy and funding costs and this advantage translated into better profitability. Naceur (2003) explain that the higher equity-to-asset ratio, the lower the need for external funding and therefore higher profitability. Bobáková (2003), agreeing that capital influences bank profitability, argues that in the arithmetical sense the yield on own capital grows, ceteris paribus, as the capital proportion declines, since a given volume of capital supports a higher volume of assets. Banking business thrives on public confidence. To win and retain such public confidence, a bank must be able to convince the public of its stability and display its readiness to repay customers' deposits and accommodate genuine credit needs of Customers (Anyanwaokoro, 1996). Improved capital helps to accomplish this. A bank with adequate capital will surely gain more public confidence than a poorly capitalized bank. This is why Janson (2005) emphasizes that a financial institution needs to hold capital to attract depositors and also be ready to pay interest on deposit and dividend on shares.

One can say that banks hold capital to help serve as a buffer against unexpected losses such as those suffered in a recession. In accounting, capital is the value that would remain if the bank were sold and its creditors paid (Rubinstein 2012). Many economists and banking experts maintain that capital raised by issuing common stock is often viewed as the strongest type of buffer against losses (Isu, 2009 and Rubinstein, 2012). In the case of Nigeria, banking regulation became very important because of the high incidence of banking failures in the 1930s, 1940s and 1950s, hence the introduction of the Banking Ordinance of the 1952. And infact, regulators mandate capital requirement for banks to ensure that in the event of an unexpected decline in asset value perhaps resulting from a financial down turn, the bank sectors' ability to meet its obligations will not be impaired (Isu, 1991).

Insufficient capital might cause enlightened depositors to restrain from placing their deposits in the bank; and enlightened investors may also refrain from investing in it. This has adverse effects on the bank's profitability. Based on the foregoing arguments, it is widely believed that overall bank returns would be enhanced by increased capital position. The positive correlation between returns and capital has also been demonstrated by Furlong and Keeley (1989), Keeley and Furlong (1990), Berger (1994) and Kwan and Eisenbeis (2005). Bank regulators increase banks' minimum capital requirements in order to increase profitability and minimize risk of distress in the banking sector.
However, contrary to the foregoing arguments of a positive correlation between returns and capital, Hughes and Mester (1997) actually discovered that higher levels of capital are associated with higher variable costs. It has also been argued that whether more capital decreases the risk of bankruptcy depends on what happens to the asset portfolio when new capital is introduced. Adegbaju and Olokoyo (2008) and Lorenz (1986), argue that some capital resulted in increased profitability, and for most, the effect was neutral. Some had negative effects in operational efficiency, profitability improvement and resources maximization. Based on the foregoing review of the existing literature pertaining to the impact of capital in bank profitability, it is clear that the debate regarding the nature and extent of this role remains inconclusive. It has been emphasized that capital is not the only factor that significantly determines the extent of profitability of a bank.

We therefore deem it necessary to investigate the true relationship between capital and bank profitability in Nigeria in order to clearly establish the appropriateness or otherwise of the periodic upward reviews of minimum share capital amount as a means of balancing bank profitability and capital, and, by implication, attempting to minimize bank distress in Nigeria. In this study, profit before tax was used for the analysis and capital was represented by shareholder's fund.

Research Methodology

The study employed secondary data that were obtained from publications of the Central Bank of Nigeria, (CBN), from Fact book – a publication of Security and Exchange Commission of Nigeria and International

Financial Statistics – publication of the International Monetary Fund. Information used cover a period of 40 years. The OLS estimation is obtained from E- view used for the purpose of the analysis. The stationary of the time series is tested using the Augmented Dickey Fuller (ADF) Unit Root Test (as obtained from E-Views) for the variables adopted in the study. Again, the Pair wise Granger Causality Test (GCT), is also used for co-integration test between the variables. The study is based in the hypotheses that (1) there is no significant relationship between bank capital and profitability of Nigerian commercial banks and (2.) changes in the banks' capital do not granger cause changes in bank profitability.

Model Specification

The models take the form of simple equations operating with one independent variable and one dependent variable: PBT=f(SHF)

Where: SHF = Shareholders' Fund. PBT= Profit before Tax

Data Analysis

Table 1: Level Series Regression
Dependent variable PBT, Method Least Squares, Date 05/03/12. Time 12.02, Sample 1970/2010
Included observations 41

Variable	Coefficient	Std. Error	t-Statistic	Prob
C	-11072.72	63512.25	0.1743450	0.8625
SHF	0.262634	0.06983	14.87539	0.0000

R-Square	0.850160	mean dependent var	32.2927.8
Adjusted R-Square	0.8463 18	S.D Dependent Var	97.4469.0
S.E Regression	382014,7	Akaike info criterion	28591.88
Sum squared resid	569E+12	Schwarz criterion	286575.45
Log likelihood	-564.1331	F-statistic	221.2771
Duble Watsons stat	1.853612	Prob.(F-statistic)	0.000000

Source- E View Software Package: Computer Print Out

This table is used to test the short run relationship between capitalization and performance of commercial banks.

Table 2: Augmented Dickey-Fuller Unit Root Test on D(PBT,2)
Source- E View Software Package: Computer Print Out

ADF Test Statistic	-8.373848	1% Critical Value	-3.6171
		5% Critical Value	-2.9422
		10% Critical Value	-2.6092

Mackinnon critical values for rejection of hypothesis of a unit root.

Augmented Dickey-Fuller Test Equation
Dependent Variable: D(PBT,3)
Method: Least Squares
Date: 05/03/12 Time 12:06
Sample (adjusted) 1974 2010
Included observations: after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Probability
D(PBT(-1),2)	-2.646016	0.315986	-8.373848	0.0000
D(PBT(-1),3)	0.804086	0.215460	3.731953	0.0007
C	72637.70	45871.26	45871.26	0.1226
R-squared	0.740657	Mean dependent var		-40818.28
Adjusted R-squared	0.725402	S.D. dependent var		513088.0
S.E. of regression	268868.9	Akaike info criterion		27.91944
Sum squared resid	246E+12	Schwarz criterion		28.05006
Log likelihood	-513.5096	F-statistic		48.55035
Durbin-Walson stat	1.38254	Prob(F-statistic)		0.000000

This table is used to test the stationarity of the data. It shows that the level series data were stationary at the second difference and maximum lag of one.(D(PBT(-1},2)

Table 3: Johansen Cointegration Test

Date: 05/03/12 Time: 11:55
Sample: 1970 2010
Included observations: 39
Test assumption Linear deterministic trend in the data
Series: PBT SHF
Lags interval 1 to 1

Eigenvalue	Likelihood Ratio	5 Percent Critical Value	1 Percent Critical Value	Hypothesized No. of CE(s)
0.961032	134.7330	15.41	20.04	None**
0.189153	8.177352	3.76	6.65	At most 1 **

*(**) denotes rejection of the hypothesis at 5% (1%) significance level
L.R. test indicates 2 cointegrating equation(s) at 5% significance level

Unnormalized Cointegrating Coefficients

PBT	SHF
7.53E-07	1.14E-07
-6.66E-07	2.67E-07

Normalized Cointegrating Coefficients: 1 Cointegrating Equation(s)

This table established the long run relationship that exist between capitalization and profitability of the commercial banks. The alternate hypothesis of at most 1 ** co-integrating equation is accepted. This implies that there are 2 variables are related in the long run.

Table 4: Over Parameterised Result

Dependent Variable D(PBT)
Method: Least Squares
Date: 05/03/12 Time: 12:17
Sample: 1970 2010
Included observations: 38 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Probability
C	6105.397	13283.57	0.459620	0.6490
D(PBT(-1))	0.628447	0.153803	4.086044	0.0003
D(PBT(-2))	1.771847	0.134831	13.14123	0.0000
D(SHF)	-0.213009	0.023347	-9.1235448	0.0000
D(SHF(-1))	0.336205	0.040779	8.244496	0.0000
D(SHF(-2))	-0.113578	0.055866	-2.032939	0.0507
ECMO2(-1)	-0.162526	0.124017	-1.310512	0.1996
R-squared	0.964174	Mean dependent var		113857.4
Adjusted R-squared	0.957240	S.D. dependent var		358857.1
S.E. of regression	74206.59	Akaike info criterion		25.43192
Sum squared resid	1.71E+11	Schwarz criterion		25.73358
Log likelihood	-476.2064	F-statistic		139.0477
Durbin-Walson stat	3.184914	Prob(F-statistic)		0.000000

Source: E-view Software package: computer print out.

The table indicate that variables are appropriately signed with, (R^2) of 96.41% and the adjusted R^2 0.95%.

Table 5: Parsimonious Error Correction Result

Dependent Variable D(PBT)
Method: Least Squares
Date: 05/03/12 Time: 12:17
Sample: 1970 2010
Included observations: 38 after adjusting endpoints

Variable	Coefficient	Std. Error	t-Statistic	Probability
C	12623.26	16099.99	0.784054	0.4388
D(PBT(-2))	2.015807	0.147591	13.65809	0.0000
D(SHF)	-0.2658240	.023737	-11.19896	0.0000
D(SHF(-1))	0.471776	0.028945	16.29908	0.0000
ECMO2(-1)	0.278646	0.075619	3.656281	0.0009
D(SHF(-2))	-0.079619	0.036334	2.191295	0.0358
ECMO2(-1)	-0.276486	0.075619	3.656281	0.0009
R-squared	0.944879	Mean dependent var		113857.4
Adjusted R-squared	0.936266	S.D. dependent var		358857.1
S.E. of regression	90595.65	Akaike info criterion		25.81014
Sum squared resid	2.63E+11	Schwarz criterion		26.06871
Log likelihood	0.079619	F-statistic		109.7074
Durbin-Walson stat	2.350045	Prob(F-statistic)		0.000000

The table indicate that variables are appropriately signed with, (R^2) of 94.48% and the adjusted R^2 93.62%

From Table (1) , (R^2) is 0.861 (86.1%) while the adjusted R^2 is 0.8463(84.63%) showing that at least 86% of the variation in the dependent variable (Profitability) was explained by changes in the explanatory Variable (Capital). In order words, the change that occurred in the dependent variable was explained by its association with the explanatory variable. The signs and sizes are in consonance with theoretical expectation. Again, the overall fit of the model is considered very good given an F- statistic of 221.227(P – value = 0.00000).

However , the D-W statistic of 1.8536 which is higher than 84.63% the adjusted R and lies between the critical value of 1 and 2 suggesting the presence of some degree of auto correlation in the level series. This shows that there may be some degree of dependence in the level series which could lead to spurious regression results, suggesting the need for more rigorous analysis of the stationarity properties of the level series data.

Using the ADF, (see table 2) the variable is integrated of order 1(2) and second difference ser indicating that data which is largely time dependent and non- stationary can be made stationary at the second difference and maximum lag one. Applying Johansen con-integration test, we find that null hypothesis of no integration is rejected and we conclude that the variables are co-integrated in the long run. In order to determine the number of co-integrating equations, we employ the Johasen (1991) test for con-integrating variables in a system. The result is presented in table 3, the hypothesis of at most 2 co-integrating equations is rejected at the 5% level of significance.

The over-parameterised result in (table 4) is employed to capture the short run deviation of the parameters from the long-run relationship between bank performance and capitalization. The result of the parsimonious error correction model in (table 5) indicates a positive long run relationship between bank capitalization and performance with R^2 of 0.944878 (94.48%) and adjusted R^2 of 0.936266 (93.62%) , meaning that the model explains 94.48% of the variation in bank performance. The D.W statistic is approximately 2.00 and shows absence of autocorrelation. The null hypothesis that there is no significant relationship between capitalization and profitability is therefore rejected.

Hypothesis Two

Ho2: Changes In Capitalization Do Not Granger Cause Changes In Profitability.

Table 6: Pairwise Granger Causality Tests

Pairwise Granger Causality Tests Date 5/03/12 Time 13:11 Lags 21			
Null Hypothesis	Obs	F-statistic	Probability
SHF(Cap.) does not Granger cause PBT PBT does not Granger cause SHF(Cap)	39	29.9408 22.5276	3.2E-08 5.9E-07

Pair Wise Granger causality test was run on the model with at an optimal lag of 1. The result is presented in (Table 6) above. The interest of the researcher here is to establish the direction of causality bank capitalization and performance. The result show that F-statistic for null hypothesis of the causality test is 29.9408 from SHF to PBT and P-value is 3.2E-08, and from PBT to SHF, F-statistic is 22.5276 and P-value 5.9E-07 indicating the presence of causality at 5% significant level. It demonstrates vividly that a by-directional causality runs from shareholders' fund to profit before tax. This means that any increase in bank capital will result in increase in profitability and vice versa. The null hypothesis is therefore rejected.

Discussion of Findings

Simple regression analysis was used in estimating the impact of capital on profitability of Commercial banks in Nigeria. F-statistic, and their related probabilities, coefficient of determination (R^2), Durbin Watson (DW) were employed to test the significance, validity and reliability of the results.
The result of the stated hypothesis in table (1): the F- statistic of the null hypothesis that there is no significant long run relationship between capital and profitability of Commercial banks in Nigeria is significant because the value of the probability is less than 0.01. The Error Correction Model shows the existence of positive long run relationship between Bank capital and performance. This conforms to an apriori expectation that profitability is positively affected by capital and improved profitability further leads to improved capital The positive correlation between profit and capital has also been confirmed by Furlong and Keeley (1989), Keeley and Furlong (1990), Berger (1994) and Kwan and Eisenbeis (2005). Also the result of the research conducted by Berger (1995) shows that capital and profitability are positively related. However, Hughes and Mester (1997) argue that high capital results in high cost and low profit. It is however widely believed that overall bank Profit would be enhanced by increased capital requirement, from a majority of researched results.
The result of Granger Causality (Table 6) indicate that the significant relationship between capital and profitability is by-directional. This means that improved profitability results in increased capital.

Conclusion and Recommendations

This study has explored the relationship between bank capital and profitability in the Nigerian banking industry, in general and commercial banks in particular. The essence of this study is to ascertain how bank capital in Nigeria, can provoke performance by banks in the area of profit generation. Our overall observations emanating from the statistical results, suggest that capital is of vital importance to banks in terms of realizing corporate objectives, notably profit maximization and increasing the wealth of the shareholders.
From our tested hypotheses employing simple regression analysis, of E-view software package, the results of the various tests carried out under this study reject the Null Hypotheses which indicates that there is no significant relationship between capital and profitability of any bank and that changes in bank capital do not granger cause changes in profitability. It was discovered that when there are increases in the capital bases of banks, profit performance also tends to increase. We also discovered evidence of bi-directional relationship between Capital and profitability. (Refer to Table 6). This means that improved profitability leads to increased capital. The Apex bank efforts to review the capital base of the banking sector are aimed at maintaining stability and improving the profitability of the banks.
It should be noted from some of the reviewed literature that strong capital base strengthened the ability of banks to face the challenges and shocks in the global financial market and also to face the competitive banking environments.

Recommendation

Considering the fragile nature of Nigeria's banking sector which has also been affected by global financial meltdown in recent times, there is need to increase the capital positions of banks to restore the credibility and confidence in Nigeria's banking sector. Again, in trying to proffer solutions to the perennial banking sector problems, it is important to place in perspective some historical antecedence.

1. The Apex institution regulator (Central Bank of Nigeria) has to reinforce, the regulatory provisions of its mandate, to insist that banks that go contrary to the laws regulating banking must be seriously sanctioned;
2. Banks must not be allowed to re-introduce the era of "Laizier faire" banking which allowed banks to act in contravention of a public interest;
3. Government and the Apex bank (CBN) must resist the temptation to interfere in the day to day running of banks. For example, in the not too distant past the Federal Government of Nigeria directed banks to

grant a certain percentage (%) of their overall credit to the agricultural sector. They also compelled banks to open rural banks branches even where no businesses exist. These actions led to astronomical increases in non-performing loans leading to the high incidence of banking distress witnessed in the1980s and 1990.

4. There must be synchronization of policies by the Executive arm of Government and Apex Bankng institution (CBN) with particular reference to the maintenance of price stability and sustainable economic growth. For example if the Apex bank introduces a contractionary monetary policy, it will be counter productivity for the Executive arm of Government to embrace an expansion of any fiscal policy. The performance of economy will be greatly distorted and the banking sector will be worse off;
5. Management should adequately mobilize and allocate the financial resources in the banking industry in order to achieve the desired growth in the economy which is the outcome of any profitable venture and.
6. Increase in capital base means availability of more funds for expansion and viable investments. Management should adequately mobilize and allocate the financial resources in the banking industry in order to achieve the desired growth in the economy which is the outcome of any profitable venture.

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