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# The Effect of Recapitalization on Bank Performance in Nigeria

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**Abstract**

This study evaluates the effect of mergers and acquisitions on bank recapitalization in Nigeria with emphasis on the impact of the strategy on economy development. The study makes use of data from the foremost eight banks in Nigeria that account for over 60% of the banking transaction in the country.

The research work was evaluated through regression analysis of secondary data covering ten years (2002-2011) from the sampled banks. The research entails a study of the pre-recapitalization and post-recapitalization periods hence the sample period was divided into two. This approach assists to capture the actual effect of the latest recapitalization policy of the government during the period.

The result suggests that the effect of the latest recapitalization policy was positive on the operational capability of the Nigeria banking system. There are lot of economies of scale derived from the exercise. Harnessing of resources through mergers and acquisition gave the banks the much required funds to intermediate more effectively within the financial system.

**Keywords:** Recapitalization, Bank performance, Nigeria

## 1. Introduction

Banks as agent for financial intermediation that allows mobilisation of surplus funds to the deficit sector of the economy attaches great importance to the activities within the economy. It is therefore globally accepted that a well functioning financial system is crucial to the development of the economy. Thus Imala (2005) opined that the banking system serves to promote stability and provide grounds for sustained economic growth. In view of this, government and regulatory agencies ensure proper policies that enhance optimum performance of banking activities. The financial system in Nigeria, the situation is not different from what is described above, more so that the government views the sector as fragile and needs adequate principles to aid their operations. Soludo (2004), stated that the Nigerian banking system is fragile and marginal because of the challenges that they face; which if not addressed could result in crisis. He was of the opinion that there is need to synergise so as to benefit from economies of scale and be positioned to attract cheaper funds into the economy. This could be achieved through recapitalization of the entire system.

Recapitalization policy is not a new concept in the Nigeria banking system. Several of such had taken place in previous times since 1952. For instance, between 1952 and 2005, there were ten (10) different phases of recapitalization within the sector as detailed in the table below.

Table 1.

| YEAR | TYPE OF BANKS | AMOUNT |
|---|---|---|
| 1958 | Commercial | £400,000:00 |
| 1969 | Foreign & Indigenous | ₦1.5Million & ₦0.6 Million |
| 1979* | Commercial | ₦2.0Million |
| 1988 - February | Commercial & Merchant | ₦5.0Million & ₦3.0Million |
| 1988 - October | Commercial & Merchant | ₦10.0Million & ₦6.0Million |
| 1989 | Commercial & Merchant | ₦20.0Million& ₦12.0Million |
| 1990 | Commercial & Merchant | ₦50.0M & ₦40.0M |
| 1997 | Commercial & Merchant | ₦500.0M for all banks |
| 2001 | Existing & New | ₦1.0Billion & ₦2.0Billion |
| 2006 | Commercial | ₦25.0Billion |

In July, 2004; the Central bank announced a policy of restructuring that stipulated a minimum capital base of N25 billion for banks within the country, effective from 1st January, 2006.This policy generated a lot of controversies because most of the key players in the sector see the time schedule within which to meet the requirement as unrealistic. Banks that do not have the stated minimum capital are expected to accomplish it through mergers and acquisitions. It is anticipated that the reform strategy will assist to reposition the sector in terms of improved financial efficiency, strong capital base and sound global competitiveness. Mergers and acquisitions is a global business term used in achieving business survival, growth and expansion. Merger can be described as the process of coming together of two or more firms to become one big firm while acquisition entails actual purchase or takeover of a small firm by a bigger firm. According to Soludo (2004) mergers and acquisitions is aimed at achieving cost efficiency through economies of scale, and to diversify or expand on the range of business activities for improved performance of the entire system.

In his speech, Soludo (2004) identifies some of the problems of Nigerian banking system that necessitated consolidation and recapitalization to include the following: weak corporate governance, gross insider abuses, insolvency, weak capital base, over-dependency on public sector deposit and neglect of small and medium class savers. He asserts that the Nigeria banking system faces enormous challenges which if not addressed urgently could degenerate into crisis in the nearest future. These challenges, according to him led to the approval of the guidelines and incentives by the Bankers' committee and the Board of the CBN on the 6$^{th}$ July, 2004. This process is expected to facilitate consolidation in the banking industry in order to assist banks in meeting the approved capital base of N25 billion by December 31$^{st}$ 2005. The directive posed both threats and opportunities to stakeholders which eventually reduced banks within the country from eighty-nine to twenty five (25) as at the end of the whole process. Overall many of the emerged banks engaged in consolidation which led to mergers, acquisitions or a combination of both as recommended by the CBN.

From the foregoing, this study examines the effect of the recapitalization exercise on the improved performance of the banking sector in Nigeria with a view to assess the consequences and implications to the stakeholders and the economy in general. It examines the effect before and after the exercise to capture the impact generated by the government directive over ten years and make recommendations that will assist the industry to explore beyond the shores of the country.

## 2. Literature Review

Banking sector reforms is part of government efforts to enact deliberate policy response to correct perceived or impending banking sector crises and subsequent failures. A banking crisis or failure can be triggered by weakness in banking system as a result of persistent illiquidity, insolvency, undercapitalization, high level of non-performing loans and weak corporate governance etc. It is essential that banks must have sufficient capital to provide adequate cushion for absorbing possible loan losses, expansion, fund internal needs and act as backup for depositors' fund (Spong, 1990). A country like Nigeria, with fragile financial system, can be readily vulnerable to banking crises emanating both from within and outside the shores of the country. Such occurrences are capable of disrupting the banking habit of the populace who might lose funds from emanating crisis. In view of this, bank reform is an important exercise for the effective performance of the system.

Bank consolidation is implemented to strengthen the banking system, embrace globalization, improve healthy competition, exploit economies of scale, adopt advanced technologies, raise efficiency and improve profitability. Ultimately, the goal is to strengthen the intermediation role of banks and to ensure that they are able to perform their developmental role of enhancing economic growth, which subsequently leads to improved overall economic performance and societal welfare. The proponents of bank consolidation believe that increased size could potentially increase bank returns, through revenue and cost efficiency gains. It may also reduce industry risks through the elimination of weak banks and create better diversification opportunities (Berger, 2000). However, some researchers argue that consolidation could increase banks' propensity toward risk taking through increases in leverage and off balance sheet operations. In addition, scale economies are not exclusive as larger entities are usually more complex and costly to manage (De Nicoló et al., 2003).

Recapitalization is a major reform objective which literarily means increasing the amount of long term finances used in financing the organization. It is believed to be a major driving force of bank reforms (Omoruyi, 1991) and this entails increasing the debt stock of the company or issuing additional shares through existing shareholders or new shareholders or a combination of the two. It could even take the form of merger and acquisition or foreign direct investment. Whichever form it takes, the end result is that the long term capital stock of the organization is increased substantially to sustain the operational activities of the business which is capable of impacting positively on the economy.

The view of researchers on the effectiveness of recapitalization is much settled. Several papers assert that it is a viable tool for efficiency. According to Demirguc-Kunt & Levine (2003), recapitalization serves as a major tool for bank consolidation which assists operational efficiency. Many scholars support this view that increase in capital base strengthens the banks to provide services that ensures economic development (Aruwa, 2004; Imala, 2005). Even Mukherjreem et al. (2004) opines that recapitalization exercise through mergers and acquisition option assists in achieving operational synergy while Sharma (2009) equally postulate that it aids economies of scale because institutions can reduce their operating costs as a result of reduction in branch networks, staff overheads etc. Nonetheless, there are few divergent views, notable amongst which is Asedionlen (2004) who opined that "recapitalization may raise liquidity in short term but will not guaranty a conducive macroeconomic environment required to ensure high asset quality and good profitability" Likewise, Adegbaju and Olokoyo (2008) in his study of twenty Nigerian banks found that only few banks had appreciable improvements in their performances while others were worse or remain the same. Similarly,

Nigerian banks adopted different strategies to achieve the stipulated minimum capital base of N25 billion during the banking sector consolidation of 2004 and 2005, including mergers and acquisitions and internal growth (Jimmy, 2008). The choice of a consolidation strategy is mainly determined by the organisational form of the involved institutions as well as the driving motive behind its corporate strategy. Mergers & acquisitions represent the most widespread corporate/business strategy used by many firms to penetrate into new markets and new geographical regions, gain technical/management expertise and knowledge, or allocate capital. Although a very popular corporate/business strategy, most literatures on the subject reveals that almost 50% of mergers & acquisitions end up being unsuccessful (Gadiesh, Ormiston, & Rovit, 2003; Kaplan, 2002; Schneider, 2003; Weber, Shenkar, & Raveh, 1996). Many literatures indicate that banking sector reforms are propelled by the need to deepen the financial sector and reposition for growth, to become integrated into the global financial architecture; and involve a banking sector that is consulting with integration requirement and international best practices (Somoye, 2010). It is therefore important that processes involved in achieving the objective are monitored by appropriate government agency.

## 3. Model Formulation and Analysis

The study uses secondary data sourced from the sample banks. A multiple regression model was formulated in relation to the research objective as stated below.

$$TC = f(BSIZE, BFC, BMS, UBDEP, MBEP, TBSDEP)$$

The functional relationship of the model can be presented as:

$$TC_t = \beta_o + \beta_1 BSIZE_t + \beta_2 BFC_t + \beta_3 BMS_t + \beta_4 UBDEP_t + \beta_5 MBEP_t + \beta_6 TBSDEP_t + e$$

Where: **BSIZE** = Bank Size which is explained by bank gross total asset;

**BFC** = Bank Financial Characteristics which is explained by bank's total capital divided by bank's gross total asset;

**BMS** = Bank Market Share which is explained by the ratio of the bank deposit to total deposit of the banking sector;

**BDEP** = Bank Deposit;

**TBSDEP** = Total Banking Sector Deposit;

**TC** = Total Capital.

## 4. Data Analysis

Table 2. Pre recapitalization analysis for banks in Nigeria

| Coefficients[a] | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. | 95.0% Confidence Interval for B | |
| | | B | Std. Error | Beta | | | Lower Bound | Upper Bound |
| 1 | (Constant) | 995.603 | 9014.059 | | .110 | .913 | -17323.169 | 19314.375 |
| | BSIZE | .070 | .029 | .688 | 2.430 | .021 | .011 | .128 |
| | BFC | 55227.61 | 11761.11 | .356 | 4.696 | .000 | 31326.161 | 79129.053 |
| | BMS | 7981800.820 | 7030891.866 | .376 | 1.135 | .264 | -6306690.570 | 2.227E7 |
| | BDEP | -.019 | .073 | -.126 | -.260 | .796 | -.168 | .129 |
| | TBSDEP | -3.919E-5 | .000 | -.088 | -.871 | .390 | .000 | .000 |

| Model Summary[b] | | | | | |
|---|---|---|---|---|---|
| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
| 1 | .947a | .897 | .881 | 3943.81663 | 1.748 |

*Note*. a. Dependent Variable: TC.

b. Predictors: (Constant), TBSDEP, BSIZE, BFC, BMS, BDEP

## 5. Interpretation

The result shows that only two of the variables prior to recapitalization (two of the five variables) are able to impact total capital. $R^2$ for the model at about 90% specifies the extent by which the explanatory variables are able to impact on the dependent variable. Total Asset proxy (BSIZE) is significant at less than 5% has a coefficient of 0.070. This suggests that a unit change in total assets will result in seven percent positive change in Total Capital. Similarly, BFC which is represented by the percentage of total capital to total asset exhibits 1% level of significance with a very large coefficient of 55227.607. This suggests that a 1% change in the ratio of total asset (BFC) will result in over 55 units change in total capital. This is a huge and significant impact on total capital by total asset (BFC) along with the proxy for Bank Size prior to recapitalization. The correlation of 0.947 indicates that there is a strong correlation between the variables.

The values of the standard error for the entire variables in the model show that the parameters estimate were statistically significant. The Durbin Watson statistics at 1.748 is found to be within the normal region and falls within the determinate region of the study that is ($1.5 < DW < 2.5$). This implies that there is first order serial autocorrelation among the explanatory variables.

Table 3. Post recapitalization analysis for banks in Nigeria

| **Model Summary[b]** | | | | | |
|---|---|---|---|---|---|
| Model | R | R Square | Adjusted R Square | Std. Error of the Estimate | Durbin-Watson |
| 1 | .902[a] | .814 | .787 | 46429.59392 | 1.606 |

*Note*. a. Predictors: (Constant), TBSDEP, BMS, BFC, BSIZE, BDEP.

b. Dependent Variable: TC.

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| Coefficients[a] | | | | | | | | |
|---|---|---|---|---|---|---|---|---|
| Model | | Unstandardized Coefficients | | Standardized Coefficients | T | Sig. | 95.0% Confidence Interval for B | |
| | | B | Std. Error | Beta | | | Lower Bound | Upper Bound |
| 1 | (Constant) | -18896.237 | 38917.045 | | -.486 | .630 | -97985.188 | 60192.714 |
| | BSIZE | .278 | .117 | .312 | 2.380 | .023 | .041 | .515 |
| | BFC | 8383.635 | 6133.219 | .145 | 1.367 | .181 | -4080.565 | 20847.835 |
| | BMS | -3.338E7 | 2.120E7 | -.348 | -1.575 | .125 | -7.645E7 | 9699339.740 |
| | BDEP | .213 | .067 | .855 | 3.170 | .003 | .076 | .349 |
| | TBSDEP | .000 | .000 | .165 | 1.190 | .242 | .000 | .000 |

*Note*. a. Dependent Variable: TC.

## 6. Interpretation and Discussion

The result shows that only two of the five explanatory variables have significant influence on Total Capital after recapitalization. $R^2$ for the model at about 81% specifies the extent by which the explanatory variables are able to impact the dependent variable. Total Asset proxy (BSIZE) is significant at less than 5% and suggests that a unit change in total asset will result in about twenty-eight percent positive change in total capital. This is about twenty-one percent more than the influence generated with the pre-recapitalization data. Similarly, BDEP which is represented by bank deposit exhibits 1% level of significance and suggests that a unit change in bank deposit will result in about twenty-one percent change in Total Capital. What is interesting with this result is that BDEP was not significant with the pre-recapitalization analysis, but now is not only significant, but capable of explaining variations in Total Capital by twenty-one percent. This suggests that deposit of banks were increased when customers were impressed with the increase in banks Total Asset. It also implies that Total Asset (BSIZE) and Deposit of banks were positively impacted during the post recapitalization period.

This is a huge impact and supports the policy of the government that recapitalization assisted the banks to improve on their deposit base and enhance banking habit of the populace. It also lends credence to the views of Demirguc-Kunt (2003); Imala (2005) and Aruwa (2004). The result is at variance with the findings of Adegbaju (2008). This may be as a result of the short time to the take-off of the policy within which the study was carried out. Adequate time may be required to effectively assess the impact of the exercise.

The correlation of 0.902 indicates that there is a strong correlation between the variables. The standard error values for the entire variables in the model show that the parameters estimate were statistically significant. The Durbin Watson statistics at 1.606 is found to be within the normal region and falls within the determinate region of the study that is $(1.5<DW<2.5)$. This suggests that there is first order serial autocorrelation among the explanatory variables.

## 7. Recommendation

The outcome of the test shows that bank recapitalization has a positive relationship with financial institution efficiency and enlargement in Nigeria. The study suggests that bank size is enhanced and capable of exerting better impact with recapitalization. Similarly, bank deposit is found to exert significant and huge impact on total capital only after recapitalization. Of the five variables included in the study, only the above specified variables are capable of explaining the relationship after recapitalization.

The above result supports government directive on recapitalization and seems to suggest that continuous improvement in the capital base of the banks will strengthen the banks significantly. Despite recapitalization that assisted banks to improve on their capital base, there is need for prudence that will ensure maximum benefits of the exercise to the populace. The study suggests improvement in banking habit of the populace; every effort should be adopted to enhance this over time. This means that more than before, the regulatory arm of the financial institutions should rise to the challenges of mis-management and insider abuse. The era of ill informed examiners should be done with. The Central bank should get well informed and dogged examiners for the sector.

The current situation is still not the best as banks in Nigeria are yet to fully participate in cheaper global funds. Despite the increase in capital base, many of them are yet to meet requirements for some of these funds. Therefore, the exercise should be on-going until we can position Nigerian banks amongst the best in the world. So far, size is a significant variable hence we must avoid one-man entity banks that can be readily abused. The Central bank should also come up with viable stress test methodology that is able to identify early weaknesses symptoms and equally address them before deterioration. Several countries with viable policies have failed simply due to this issue.

The availability of deposits posits good prospect for the industry as businesses can avail funds for developmental purposes. However, the government should address the high cost of funds to prevent diversion of funds to non- growth promoting areas. If the funds are costly, genuine businesses will not be able to get the funds for profitable ventures. This may result in rent seeking activities and other vices by banks in a bit to make use of the funds. Likewise, efforts should be put in place to ensure that priority sectors can easily get funds for their developmental activities. There is no doubt that such sectors may not be as competitive as others, banks should be prepared to invest in them for the overall corporate growth. In essence, the sectoral allocation of credit should be continued and supported by government. Motivational policies could also be put in place to encourage banks to look in that directive.

## 8. Conclusion

This study has no doubt examined the salvaging role that recapitalization can play in ensuring financial soundness. The paper examines the effect of recapitalization on the operational performance of banks in Nigeria. Sample was drawn from eight banks over ten years and analysis conducted separately on pre-recapitalization and post- recapitalization periods. For both analyses, only two variables were significant in explaining the relationship. The research observes that size is relevant in explaining the relationship over both periods, but more robust during the post- recapitalization period. The pre- recapitalization period analysis show that banks total capital divided by total asset is the second significant variable while bank deposit is the second significant variable for the post- recapitalization period. This result suggests enhanced trust in the banking system with the exercise that resulted in increase in the deposit level of the banks.

The implementation of the recapitalization policy has caused an unprecedented process of revival and resuscitation of the Nigerian banking sector shrinking the number of commercial banks from eighty-nine to twenty-five. No other event is more challenging as this latest recapitalization policy in the history of Nigeria banking. The study opines that recapitalization is good for the Nigerian banking sector. What remains however, is how the country should maintain and review the capitalization upward from time to time in order to sustain the tempo of the revival and stability in the banking sector. In other words, the banking sector together with its complementary institutions should be strengthened and robust stress tests put in place and implemented continuously to prevent bank failures.

The monetary authority has a lot of roles to play in order to maximize the benefits of recapitalization. Primarily, the Central Bank should demonstrate sincerity and transparency in the enforcement of the recapitalization code of conduct. Furthermore, efforts should be made at ensuring consistency in policy objectives and instruments through a good implementation strategy as well as good sense of discipline, understanding and cooperation between the Central Bank and the Federal Government.

Furthermore, thorough supervision and control along with firm disciplines by the Central Bank over the commercial banks is required for the effectiveness of the policy initiatives. In addition to this, policy framework should be put in place to improve the quality of bank management, bank security along with reduction in fraudulent and sharp practices in the banking sector.

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**List of Banks included in the Observation for the analysis are:**

United Bank of Africa; First Bank of Nigeria; Guaranty Trust Bank; Zenith Bank; Ecobank; First City Monument Bank; Stanbic IBTC Bank and Access Bank.