CHAPTER THREE

BANK CONSOLIDATION AND INFORMAL FINANCIAL SECTOR IN NIGERIA: ANALYTICAL PERSPECTIVE OF LINKAGE EFFECTS

By

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Abstract

The financial sector plays significant role in the growth of an economy via the process of directing funds from surplus sector to areas of need – real sector. The operations in which the banking sector can undertake depend, to a large extent, on the soundness of the capital base. Hence, the need for the bank consolidation that is being pursued in Nigeria. However, the Nigerian financial sector is highly dualistic in nature, involving the formal and informal. Using the McKinnon-Shaw analytical framework, the paper examines this policy and explains how it can induce positive influence in the economy, especially by integrating the informal financial sector. Thus, it is expected that bank consolidation will increase the scope of the financial transactions and create public confidence in the system thereby encouraging those in the informal sector to patronize the formal.

1.0 Introduction

The financial system in an economy plays a considerable role in stimulating economic development. It channels funds (like credit, loans) to the various economic agents that need them for productive uses. This function is very imperative for any economy that intends to be viable with respect to economic growth because it creates and makes contractual arrangements that link borrowers and lenders more efficiently than if they had to trade directly (Adam, 1998). Thus, it could be said to be the bridge that connects the lenders and the investors in an economy.

Beside the commercial banks and the merchant banks (which form the bulk of the formal financial sector exerting an influence of about 90.7% in terms of total bank assets), there are other institutions that do similar activities of directing funds from saver to users in the economy (Adam, 1998; Khan and Senhadji, 2003; Duruji and Osabuohien, 2005). They include mortgage houses, saving and loans associations and other non-bank institutions such as credit unions, insurance companies and other financial service providers. However, other important financial institutions generally referred to as the informal financial sector exist and they equally contribute to the entire financial system in the economy especially those of the developing nations like Nigeria. For instance, Soludo (2004) revealed that the currency outside the formal banking sector was over 400 billion naira. To him, the reversal of this unhealthy trend was one of the main aims of 'July 6, 2004 declaration'. This stipulates a minimum capital base of 25 billion naira for commercial banks in Nigeria if they must be in operation by December 31, 2005 and beyond.

The bank consolidation that is currently being pursued in the nation with a view to making banks viable and solid has received tremendous attention in the literature but consideration has not captured on how this essential segment (the informal financial sector) can be integrated for the realization of the overall economic objectives. This is what the study is poised to do. To achieve this, the study is structured into sections. The next is analytical framework and methodology; section 3 expounds a review of recent literature and financial reforms in Nigeria. The informal financial sector in Nigeria and the envisaged linkage between the informal financial sector and the formal, are covered in sections 4 and 5 respectively. The last section concludes the work.

2.0 Analytical Framework and Methodology

The exploratory research approach is adopted in the study. A careful examination of views in order to establish the basics in which the financial reforms (with main emphasis on the bank consolidation) in the formal financial sector can not only embrace the informal financial system but also meaningfully integrate them for the benefit of the entire society. Thus, the McKinnon (1973) and Shaw (1973) analytical framework will be helpful in achieving this.

The framework is rooted in the premise that growth in an economy depends strongly on the strength and depth of the financial sector (Adam 1998; Ezirim and Muoghalu; 2004; Adam, 2005). In this relationship, consumption and investment are both influenced by interest rate, as individuals and other economic agents consider between current and future consumptions. In the same way, investors make decisions of investing at a given moment or hold back investment to later date. This portrays an inverse relationship between interest rate (cost of funds) and the demand for loanable funds (investment). Therefore, allowing the markets to determine the allocation of credits with the real interest rates moving towards equilibrium, funds with high-level rate would be avoided by investors and lenders (financial institutions) would not fancy the trend, so the interest will drop, ceteris paribus. In the long run, the overall efficiency in investment will be achieved at desirable point (see figure 1.0). The equilibrium point is attained at point A* along the secant and the equilibrium interest rate is r*, while the equilibrium level of investment is I*. In sum, removal of interest rate limit and elimination of direct credit control are essential for ideal financial intermediation that will ensure economic growth.

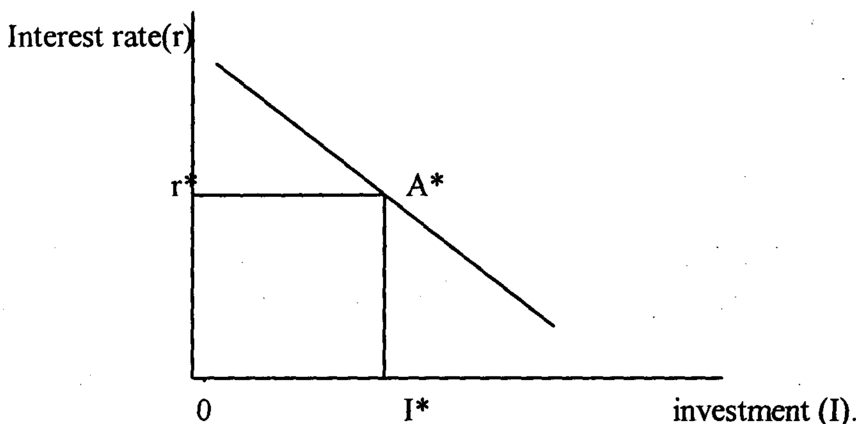

Fig. 1.0: Equilibrium Interest Rate and Investment.

The responsibility of charting the alleyway for conducive investment atmosphere rests on the regulatory authority of in terms of initiation of sound policy measures. This is because the measures will help the various actors in the system in aligning their activities towards desirable directions, thereby making interest rate favourable to spark off both investment and consumption toward the attainment of growth. Therefore, the current bank consolidation measure of 25 billion naira minimum capital base for commercial banks can be said to be a right step in the right direction because it will create room for competition in terms of loan provision as its supply will be increased resulting from higher capital base. Of course, we are not unmindful of the immediate shocks that may precipitate regarding loss of portfolios by some top management staff of banks and a little dose of structural loss of jobs due to the process of mergers and acquisitions (M&A). It will be a good trade off, a kind of short-term shocks for long-term stability, when the system becomes healthy from both national and international standard. This is with the understanding that it will make such institutions resilient, robed

with the mechanism of absorbing shocks against financial dwindling and liquidation. In addition, a viable formal sector will help in integrating the informal sector as public confidence is guaranteed; those in the informal financial sector will be encouraged to channel most of their activities to the formal system, as the fear of losing their hard-earned income during bank failure becomes almost non-existent. Hence, the scope of financial intermediation in the economy will be expanded.

3.1 Review of Recent Literatures.

Bank consolidation is not a new concept in the world of banking; it has been practised in advanced nations especially in Britain and the United States of America usually in form of M&A (Adam, 2005). However, it is relatively in Nigeria, though the path was opened in 1986 during the Structural Adjustment Progrmame (SAP) that gave rise to liberalization in the sector, this development has manifested in many facets of the sector till date (see table 1.0 for the list).
Within this time, series of scholarly debates have oozed out with varying claims and findings.

Reinhart and Tokatlidis (2003) found that financial liberalization produces higher interest rates and higher savings, which will boost investment and economic growth of a nation. Six dimensions of financial liberalization have been identified, viz: elimination of credit controls; deregulation of interest rates; free entry into the banking sector; bank autonomy in terms employment and location; privatization of banks ownership and liberalization of international capital flows. This means that the whim of liberalization is geared towards the process of moving toward market-determined interest rate and prices of all categories of products (Ihide, 1998).

Afolabi and Osota (2002) note that the reason for a rise in capital

base was to ensure adequate capitalization of banks against the background of rapid increase in activities, restrict entry of promoters without sound financial base. Aryeetey (2003) cautioned that high rates of interest might not considerably increase savings in an economy that is characterized by low level of income by households and in an under-banked economy where the bulk of financial intermediation takes place in the informal sector. This connotes that the McKinnon (1973) and Shaw (1973) posture would be more rewarding in advanced and rich countries than developing nations. King and Levine (1992) using a cross-country study indicate a strong positive link between financial development and economic growth. In addition, it has a predictive power for future economic growth and it explains causal relationship that runs from financial development to economic growth. In the words of Onwioduokit and Adamu (2005), consolidation of the banking system currently embarked upon by the Central Bank should be done to a logical conclusion if the financial sector in Nigeria is to be developed adequately.

Ezirim and Muoghalu (2004) compared regulatory and deregulatory financial eras in Nigeria and discovered that the latter favoured increased financial intermediation operations of banks that in turn improved the contribution to real economic growth. Adam (1998), on the other hand, employed two stages least square to test bank deposit to credit ratio and other variables and established that deregulation led to increased deposit, higher credit availability and enhanced economic growth.

In another study by Alege and Ogunrinola (2005), economic reforms were found to be the engine for financial development that amount to benefits to the economy. However, interest rates failed to contribute to the improvement of financial development, liberalization and deregulation efforts not withstanding. Oyaromade (2005), on the other hand, focused on savings and discovered that

financial reform in Nigeria resulted in higher financial deepening and that savings responded positively to financial variables. In his view, the ongoing consolidation is a welcome development but recommends among others that price stability is essential for efficient savings mobilization.

3.2 Analysis of Financial Reforms and Bank Consolidation in Nigeria.

From table 1.0 it could be noticed that financial liberalization started in 1986 in Nigeria with the advent of the SAP policy. The era was characterized by the removal of official restraints in allocation of bank credits vis-à-vis interest rates, thus allowing the market forces to control same as against the visible hands of government. The creation of specialized banks viz Peoples Bank in 1989 and Community Bank in 1990 was aimed at bringing the banking services closer to the people and inculcates more savings habit. This was to corroborate the rural banking scheme that was earlier established in 1977. The period witnessed increase in the number of commercial and merchant banks. For instance, the number grew from 41 to 120 between 1986 and 1992 as new ones were established while the total number of branches for both increased from 1394 to 2391 (see table 2.0).

Table 1.0 An Overview of the Major Financial Reforms in Nigeria (1986-Date)

S/N	Reforms/Events	Year
1	Deregulation of Lending & Deposit Rates	1987
2	Deregulation of Entry	1987
3	Partial Abrogation of Sectoral Allocation of Credit	1987
4	Determination of Foreign Exchange by the Market Forces	1987

S/N	Reforms/Events	Year
5	Creation of Deposit Insurance Co-Operation/Scheme	1988
6	Changes in Minimum Paid Up Capital for Banks (Still on Till Date)	1988
7	Withdrawals of Public Sector Deposits	1989
8	Creation of Peoples Bank, 1989 & Community Banks, 1990 (Specialized Banks)	1989
9	Licensing of Non-Bank Financial Institutions	1990
10	Prudential Guidelines	1990
11	Partial Privatization of Banks	1991
12	Reform of The Regulatory & Supervisory Framework i.e. CBN Decree & BOFID*	1991
13	Indirect Monetary Control Allowing Discount House Entry	1993
14	Capital Market Reforms	1997
15	Re-Entry of Foreign Owned Banks	1999
16	Institutionalization Of Foreign Currency Deposits	2000
17	Universal Banking Scheme	2001
18	Bank Consolidation	2004

Adapted from Asogwa (2005:5).

*BOFID- Banks and other Financial Institutions Decree No. 25 of 1991 (as amended 1997, 1998, 1999).

Table 2.0 Number of Commercial, Merchant Banks and others in Nigeria (1980-2002)

S/N	Year	CoB	MeB	CoB& MeB	Br CoB	Br MeB	BrCoB & MeB	BrCoB (Rural)	Peoples Banks	Commu Banks
1	1980	20	6	26	740	12	752	168	-	-
2	1982	22	8	30	991	19	1010	308	-	-
3	1984	27	11	38	1249	25	1274	432	-	-
4	1986	29	12	41	1367	27	1394	481	-	-
5	1988	42	24	66	1665	46	1711	602	-	-
6	1990	58	49	107	1939	74	2013	765	169	-
7	1991	65	54	119	2023	84	2107	765	221	66
8	1992	66	54	120	2275	116	2391	774	228	401
9	1993	66	54	120	2258	124	2382	775	271	879
10	1994	65	51	116	2403	144	2547	763	275	970

S/N	Year	CoB	MeB	CoB& MeB	Br CoB	Br MeB	BrCoB & MeB	BrCoB (Rural)	Peoples Banks	Commu Banks
11	1995	64	51	115	2351	149	2500	701	275	1355
12	1996	64	51	115	2402	147	2549	675	278	1368
13	1997	64	51	115	2330	147	2477	675	278	1015
14	1998	51	38	89	2107	113	2220	714	278	1015
15	1999	54	36	90	2185	113	2298	714	278	1014
16	2000	54	36	90	2193	113	2306	722	278	881
17	2001	90	-	90	2193	-	2193	722	-	-
18	2002	90	-	90	2317	-	2317	722	-	-

Source: Central Bank of Nigeria (CBN) Statistical Bulletin (2002).

Note: CoB- Number of Commercial Banks; **MeB**-Number of Merchant Banks; **CoB&MeB**-Total Number of the two; **Br CoB**-Branches of commercial Banks; **Br MeB-** Branches of Merchant Banks; **Br CoB & MeB**-Total of the two; **Br CoB (Rural)** –Rural Branches of Commercial Banks; **Commu Banks-** Number of Community Banks.

The establishment of Nigeria Deposit Insurance Corporation (NDIC) in 1988 and the deregulation of interest rates in 1993 engendered more reforms. Moreso, the minimum capital base for commercial banks was pegged at 20 million naira from its previous value of 10 million naira in 1989. It was also raised to 50 million and 500 million in 1991 and 1997 respectively, which was later increased to 2 billion in year 2000 and finally to its current base of 25 billion with the July 6, 2004 declaration (Soludo, 2004; Adam, 2005; Asogwa, 2005).

The policy changes on bank consolidation are the summation of those variations that occur in the direction of a comprehensive banking system. This will lead to the evolution of a banking system that will be part of the global financial change in which depositors can have rest of mind and investors can rely on for the supply of needed credits for the enhancement of economic growth. It is also believed that with the present consolidation being implemented, Nigerian banks could expand their scope of operations and network of branches to cover the various Nigerian localities, which will help to integrate the informal financial sector. For instance as at June, 2005 about 17 groups consisting of 51 commercial banks have undertaken memoranda of understanding (MOU) and have applied and granted pre-merger approval while two groups involving 6 banks have reached approval in principle and well over 16 have raised capital via the stock market (Adam, 2005). This pace is on going as many of them are working round the clock to meet up with the December 2005 deadline (Olesin, 2005).

The relative efficiency of the previous bank consolidations above is a question that has been addressed elsewhere (Adam, 2005; Asogwa, 2005). And whether it is because this current consolidation of 25 billion minimum naira capital base that is being pursued is done in a democratic dispensation, while most of the previous ones were

done in military dispensation is a question sufficient for another research. The main issue being addressed in this study is how the informal financial sector can be integrated in the process of consolidation.

4.0 Informal Financial Sector in Nigeria.

The informal financial sector generally entails the financial activities that occur outside the immediate control government agencies. It involves those financial transactions that operate without official regulations, conventions and polices. Even when they do; they are not compelled by any possible means to render official returns on its operations or processes. Thus, informal sector activities generally consist of enterprises, which render no account to any statutory agents. They are not fully organized, but they play essential roles in the economy (UNDP, 1997). Most people in this sector 'save' their money in their own ancient ways such as putting it under their pillows, holes dug in their homes or carry it about in their 'bullion' tied around their waist.

In Nigeria in particular, there are quite a lot of intermediary functions in the informal financial sector. The "Esu-Esu" scheme is the most developed and widely practised financial intermediation; it is a system that targets the low-income, artisans and petty-traders in the country. It is a thrift business, where an individual or a small-holding goes round to its registered members periodically (it could be daily, weekly or monthly) depending on the agreement and pool together a certain agreed amount of money that the individuals (clients) want to save at a given point in time (Okafor, 2000; Duruji and Osabuohien, 2005). The aim is to inculcate saving culture. As such, individuals who do not have access to the formal banking system can afford to make savings through the thrift collector or esu -esu system. The periodic deposits accumulate in the hand of the thrift-collector until it matures for collection, then the depositor is

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eligible to get back his/her money. One major advantage of this arrangement is that it enables individuals to accumulate fund from the savings that can be used for investment or bulk purchases and he/she can also request for loan from the operator at a given rate of interest and duration (Okafor, 2000; Umoh and Ekpo, 2005).

The agreement on how the business is undertaken is usually between the collector and the depositor based on shared considerations and trust with the hope that none of them will default. The involvement of third parties is usually reduced to the barest minimum in the transaction. Although the formal institutions of state do not regularize this type of financial transaction; disputes are settled through traditional methods. When the case of inability of the thrift collĕctor to discharge his/her obligations to the depositors cannot be resolved via traditional device, it is taken into the judicial system of the state for resolution, but these are often rare.

Apart from the esu-esu system, there are other informal financial mechanisms that exist in Nigeria. One of them is the money lending business (UNDP, 1997). It is an age-old system of financial intermediation channelling funds from areas of surplus to areas of need. This informal transaction ranges from an interest-free close family transfer to interest loan guarantee of the notable moneylender. The moneylender is engaged in a transaction of lending money to artisans and petty-traders that use the borrowed money for regeneration purposes with the agreement to pay back with certain percentage of interest after a given period. Again, this type of business is outside the formal regulation of state institutions, yet they play very important role in the economy. The legal implication of the transaction is entirely between the lender and the borrower, though at times, this may involve third party witnesses or the signing of agreement papers between the lender and the

borrower. The transaction is purely based on confidence and trust between the parties to the transaction (Duruji and Osabuohien, 2005).

Many non-governmental organizations (NGOs) exist, which engage in financial intermediation, acting as intermediaries between the formal finance institutions and the borrowers. Most of them undertake their savings and lending on the principles of self-help. Examples of such groups include the Community Development Trust Fund (CDTF) in Lagos, the Community Women Association of Nigeria (CWAN) in Ondo State, the Live Above Poverty (LAPO) in Edo State, the Farmers Development Union (FADU) in Oyo State, and the Women Farmers Association (WAFAN) in Kano State among others. They all exist with the purpose of channeling surplus funds into investible areas in the economy and make access to credit less difficult (UNDP, 1997; Okafor, 2000; Umoh and Ekpo, 2005).

The Nigerian government has recognized the significance of the informal financial system by devising measures that could help in integrating the transactions at this level into the formal system, to bring about rapid and sustainable development of the economy. The establishments of Peoples bank and Community banks in the rural areas of the country were some of the measures that were put in place to integrate these informal financial schemes by the government. Others include such programmes as the Better Life for Rural Women (BLP) and the Family Economic Advancement Programme (FEAP). Though it is often difficult to regulate activities of the informal sector, we believe that a strengthened supervision of the formal financial system could have linkage effects on the informal sector especially on the part of the clientele, which makes the transactions at this level enormous.

5.0 Highlights of the Linkage Effects of Banking System and Informal Financial Sector.

The Nigerian financial sector, as we have pointed earlier, like any other in the world, is the circulatory system of the economy. However, the financial system is highly dichotomized between the formal and informal. The existence of forward and backward linkage between formal and informal manufacturing sector of the economy has been established (CBN/FOS/NISER, 2001). Moreso, Aryeetey (2003) indicate the linkage between the formal financial and informal financial African markets but requested for further research. It is against this backdrop that we are highlighting the impact of the policies initiated in the formal financial by the regulatory body (i.e. CBN)* will have on the informal financial sector with the understanding that both of them make up the general financial activities in the country.

Both sectors (formal and informal financial) should be envisioned as complements not substitutes, in which case the policies and regulations made in the formal should filter favourably to the informal. In as much as the informal finance is very essential to small-scale investment, policies need to be designed in order to integrate this silent but salient growth element. This was one of the basic reasons for the establishment of the rural banking scheme (RBS) in 1977, Community banks in 1990 and the Peoples Bank in 1989 (Tella 1998; Okafor 2000). These were general mopping of cash from the informal to the formal system where it would be controlled. Therefore, when the policies in the formal sector become favourably disposed to all and sundry, the general public confidence will be instilled in the system which will boost savings culture and more funds will be made available. In addition, the ongoing reform i.e. bank consolidation should be followed with utmost dexterity, which will create a better and smoother playing

ground that will result in better financial deepening in the economy Moreso, the bank re-capitalization of July 2004 is believed to foster the integration of the informal financial sector when it is adequately implemented, because capitalized and vibrant banks that will evolve will lead to higher confidence thereby attracting more saving into the formal sector. Hence, more investible fund will be mobilized resulting in employment creation, productivity, and economic growth, ceteris paribus. A similar effect is that the initial public offer (IPO) that is aggressively flooding everywhere in terms of awareness will make people even in the informal sector to invest in the offers, thus better and greater integration between the two sectors will ensue. This can be likened to the mobile banking system and Hawala international fund transfer in Arab economies (Tella, 1998; El-qorchi, 2002), which make informal financial sector more participatory.

Informal financial sector thrives where access to banking services is limited. They come in to bridge the gap created by formal financial institution. Moreover, informal financial market serves a broad segment of the population and it is not often the desire of any government to have a large segment of the economy fall outside regulatory ambience. It does not make for efficient and effective economic planning that is needed for the growth of the economy.

The dominance of the Nigerian informal system with reference to the informal financial sector is because of the presence of underpinning factors that propel patronage. For instance, cost and risk are two important factors that vary in serving different categories of clients in an economy (Aryeetey *et al*, 1996; Yunus, 2005). Here, interest rate differences across segments of the financial system are largely determined by differences in the cost and risk profiles. The fragmentation of the Nigerian financial system stems from the weak linkages and wider difference in risk-

adjustment returns. This leaves out a large clientele for informal financial sector (Aryeetey *et al*, 1996; Yunus, 2005), which is clearly manifested by structural problems inherent in the formal banking sector. The consequences is that imperfect information and costly contract enforcement and institutional weaknesses in banking systems as well as the legal mechanism that cause wide differences across lenders results in high cost of screening, scrutinizing and foreclosing loan. The informal sector stands to reap the dividends of these shortcomings.

What then will be the relevance of this recent bank consolidation measures in the informal financial sector in sum? The answer lies within reach. The aim of the bank consolidation cum capitalization is the elimination the problems that were hitherto inherent in the banking system especially, as well as strengthen it to the extent of exerting confidence in its various operations. When the objectives are successfully achieved, it will boost the formal sector and attract more clientele restrained by the aforementioned weaknesses.

Another important belief is that strengthening the banking system via viable policy is capable of integrating the informal sector smoothly into the operation of the formal. It has been affirmed that informal financial system in Nigeria is not only vibrant, but also employs a large segment of the workforce. A smooth integration will ensure that there is no hiccup in the economy (CBN/FOS/NISER 2001). For instance, a solid and revitalized banking system is capable of attracting the funds accumulating in the hands of informal operators, like the *esu-esu* thrift collector, the traditional moneylender, and others. A system that is predictable and reliable can stimulate both short-term and investment by these operators. The effect will be that the government via its regulatory institutions will be able to gather satisfactory data on the financial system to make for better and more reliable economic planning.

This finding is in harmony with Ezirim and Muoghalu (2004) and Oyaromade (2005) that bank consolidation will increase the scope of banking system in Nigeria. However, Onwioduokit and Adamu (2005) and Aryeetey (2003) had related views but with mixed feelings.

6.0 Conclusion

The financial system remains the engine of growth in any economy as result of its intermediary roles. In Nigeria, it is dichotomized into the formal and informal with minimal connection between the agents. of these two financial systems in terms of clientele. The study explained that the policy changes on bank consolidation involve the summation of the variations that occur in the direction of a comprehensive banking system. Hence, the bank consolidation that is currently being pursued in the country with a view to making banks viable is hoped to yield desirable results especially in incorporating the informal financial sector. This was built on McKinnon-Shaw framework.

The measure is one of the financial reforms that are pursued especially in recent times, which arose with a view to creating potential ripple effects that will yield pleasant results. Thus, one of the likely effects of the reform on the financial sector, if well implemented and sincerely administered will bring about the desired linkage between the informal financial sector and that of the formal. This is because a stable banking system will instill more confidence in the stakeholders and those that were not positively disposed to banking in the informal sector will be encouraged to patronize the formal system and as a result the scopes of banking operations will be broaden with better coverage for the good of the economy.

In précis, it can be said that the bank consolidation effort is a right

step in right direction. This is because it will enhance synergy of operations, improve efficiency, and induce investors, which will trigger welfare gains. Thus, it is expected that it will increase the capacity of the financial transactions, induce public confidence in the system and encourage those in the informal sector thereby resulting to a better linkage between the formal and the informal.

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