Intervention Strategy, Banking Reengineering and Capital Formation in Nigeria

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Abstract

Over the years, successive governments in Nigeria have not relented in advancing measures designed to boost capital formation in the economy. Prominent among these efforts is the commitment to upgrade critical socio-industrial amenities in order to bring about meaningful transformation of various parts of the country. Against this backdrop, this study adopts gross fixed capital formation as focal criterion variable. It encapsulates all production and distribution – oriented facilities in such core economic areas as transportation, communication, electricity, education, and industrial equipment manufacturing, among others. The provision of these critical effects in the right quantity and quality determines, to a large extent, separates thriving economies from merely surviving economies. For analytical purposes in this study, secondary data are drawn from the publications of the Central bank of Nigeria (CBN), National Bureau of Statistics (NBS) and Federal Ministry of Finance (FMF). The time series are utilized in testing three formulated hypotheses, through the statistical instrumentality of software package for social sciences (SPSS). The outcome fundamentally indicates that banking reform, the intervention strategy thrust, is significantly related to the dynamics of capital formation in the Nigerian economy. To this end, the ideals which make for structural viability, auspicious liquidity and sustainable functionality are strongly recommended to form the thrust of on-going systemic soundness advocacy. This is good for the repositioning of the financial sector in general and banking reengineering in particular. No economy can afford to showcase banks which are peripherally hale and intrinsically pale.

Keywords: Banking reform, Capital formation, Nigerian economy

1. Introduction

Ideally, banks engage in mobilization of savings, allocation of credit, and facilitating of payments. Analysts equally underscore a strategic the link between banking system dynamics and economic growth. However, many studies in the Nigerian context highly stress the contemporary institution-specific challenges and not necessarily the realities of banking reforms and the functional intervening linkages with financial sector revitalization and repositioning. Fundamentally, banking reform usually goes with monetary policy redirection with a view to influencing critical economic aggregates such as gross domestic product, gross fixed capital formation and aggregate credit to the private sector. Prior to the bank consolidation exercise of 2005, the Nigerian banking industry was under intense stress. The systemic instability/volatility widely eroded public confidence which constitutes the quintessential asset on which thriving banking business anchors. Again, investors' and depositors' funds were not spared as they were not so protected from the ensuing economic vagaries. Many banks came under the severe stroke of capital inadequacy and attendant financial fragility. The challenges greatly undermined the quality of banks' assets with non-performing loans (NPLs) becoming overbearing. The financial intermediation role of the banks became so weakened that various inter-connected macroeconomic activities slowed down and significantly ebbed. It was so economically critical that the Central Bank of Nigeria (CBN) was statutorily compelled to invoke its intervening powers and pedigree in order to speedily recover, reposition and revitalize the banks for overall financial sector repositioning and sustainable advancement of the economy.

The main thrust of the 2005 banking reform program in Nigeria was the recapitalization of banks from N2 billion to N25 billion. Also, there were appreciable variations in cash reserve ratio, liquidity ratio, monetary policy rate, interest rate and exchange rate as deliberate measures to reshape and refocus the financial system. Consequently, the outlook of the economy was redefined by the monetary authorities in terms of key economic aggregates such as bank capital, monetary policy rate, and exchange rate (Gbosi, 2005; Iyoha & Igbatayo, 2004). These macroeconomic variables are adopted in this study as proxies of banking reform, reminiscent of the intervention strategy of the Central bank of Nigeria (CBN). On the other side, gross fixed capital formation

(GFCF) is adopted as the criterion aggregate. Ideally, banking reengineering is expected to facilitate the realization of crucial national goals including economic stability, full employment and enhanced standard of living of the people. In the light of the fore-going, this study focuses and examines the relationship between the afore-identified focal predictor variables and criterion aggregate. Specifically, the study examines:

- The extent to which gross fixed capital formation is related to bank capital;
- The extent to which gross fixed capital formation is related to monetary policy rate; and
- The extent to which gross fixed capital formation is related to exchange rate.

Logically arising from the above objectives are the following hypotheses:

Ho$_1$:   There is no significant relationship between gross fixed capital formation and bank capital;

Ho$_2$:   There is no significant relationship between gross fixed capital formation and monetary policy rate; and

Ho$_3$:   There is no significant relationship between gross fixed capital formation and exchange rate.

2.   Literature Review

The financial market is a vital component of a nation's macroeconomic infrastructure. With neo-classical tendencies, the market works competitively towards equilibrating the demand and supply of funds. In this view, when interest rates are kept relatively low, it results in little savings and paucity of funds for lending, which consequently limits investment and growth of the economy. In this circumstance, financial intermediation is highly repressed. The removal of controls in the financially repressed economy, implies that interest rates will increase and lead to higher savings. Thereafter, the higher savings occasion availability and multiplicity of investment capital and, hence, expansion of output. These submissions constitute the very basis of many research works on financial sector intervention strategies, although they did not critically address the fundamental workings of banking systems and the imperatives of financial sector revitalization and repositioning in developing countries. They do not also elaborate on contextual economic liberalization regimes and how they realistically prevent systemic fragmentation and retardation. After long periods of repression and financial underdevelopment, many banks may not have the right disposition to fairly assess the risk profiles of potential borrowers. Two issues often associated with their dilemma are:

- Adverse selection possibilities bordering on high interest rates which increase the pool of high risk borrowers; and
- Moral hazard challenges bordering on soaring interest rates which induce firms to make more risky investments, with the hope of attracting higher expected returns.

In addition to adverse selection and moral hazard concerns, financial liberalization strategies tend to initially increase interest rates but later unfavorably alter the banks' loan portfolios (Simatele, 2003; Khan, 2003). Comparatively, increase in credits is likely to be higher than increase in deposits because deposits may not be directly constrained before the introduction of the intervention strategy. They rather respond to changes in monetary policy mechanisms. Following this adjustment period, credit growth slows down while deposits continue to grow as positive real interest rates are maintained. Credits and deposits eventually converge, allowing for balanced growth with higher levels of market sensitization and resource mobilization for institutional revitalization and systemic repositioning. If positive interest rates are not maintained, credit expansion may result in defective control, higher inflation, unfavorable balance of payments and other macroeconomic maladies. Controlling credit expansion by the use of interest rates or indirect monetary mechanisms, therefore, reasonably causes higher interest rates. Where the capital account liberalization leads to massive capital inflows, subsequent appreciation of the exchange rate may adversely affect the real sector (Ajayi, 2005; Simatele, 2003). This justifies the close link between the design of monetary policy instruments and operations, structure/depth of money markets, and functionally supportive payment systems. In recognition of this, intervention strategies and reinvention of monetary control procedures are usually accompanied by institutional measures that strengthen and galvanize money market and inter-bank sub-systems as well as established payment mechanisms.

Consequently, monetary control mechanisms may grow weak and become very ineffective. It, therefore, heightens the need to reengineer and redirect monetary control processes to regain systemic viability and vitality. With increased capital mobility, the demand for domestically denominated economic aggregates becomes more sensitive to international interest rate differentials. The factors that cause difficulties in the process of achieving stable domestic monetary aggregates may be further isolated, thus, reinforcing the adoption of eclectic monetary

frameworks. This moves towards according more weight to exchange rates in relation to the tracking of monetary and allied economic aggregates, including gross fixed capital formation. The gross fixed capital formation as a critical criterion variable is underscored in this study, in view of the fact that it constitutes a flow variable, widely accepted as the aggregate value of producers' acquisitions. It excludes all fixed assets disposed during the accounting period, but also captures additions to the value of non-produced assets. It facilitates the determination of net investment acquisitions less disposals in fixed capital assets by government institutions, private enterprises, and households within the domestic economy, in the accounting period under review.

The fixed assets acquisition value includes related taxes and fees, thus capturing all costs associated with fixed investment. Fixed assets value adjustment excludes consumption of fixed capital and exceptional loss due to natural disasters. Conventionally, the fixed assets relate to facilities that are produced, which in turn are used to continuously engage in production for a period exceeding one year (Kama, 2006; Essien, 2005; Imala, 2005). The gross aggregate value does not compositely measure total investment, because some financial assets are traditionally excluded, such as inventories and related operating costs. With regards to banks' revitalization and repositioning, banking reengineering imperatives require capital adequacy to be critically considered in relation to the magnitude of risk exposures of the institutions. Thus, bank capital ideally serves as the bedrock for institutional re-launch on the path of viability and growth. Nonetheless, contributions on banking reform and allied intervention strategies still anchor on the assumptions that economic units are self-financed and that investors accumulate money balances with which they elect to invest in attractive outlets. Without necessarily underscoring the direction and extent of association, the submissions reasonably y recognize the tango of banking reform as an intervention strategy and capital formation for ultimate financial sector revitalization possibility.

Essentially, as money stock becomes large relative to the level of economic activity, the level of financial intermediation between savers and investors is expected to intensify. This amplifies the role of financial institutions, particularly when the monetary authorities initiate structural/operational reforms. This is expected to bring about higher average efficiency of investment by lowering the cost of borrowing and facilitating risk diversification. It also particularly accommodates liquidity preference, minimizes informational cost, increases operational efficiency and boosts systemic revitalization and repositioning (Ebong, 2006; Toby, 2006; Simalele, 2003). Nonetheless, bank distress, if not quickly nipped in the bud, may severely complicate macroeconomic shock absorption and allied response mechanisms, thus greatly undermine growth intents concerning key sectors of the economy. Consequently, the banks may be faced with very risky lending options, which often result in high levels of non-performing loans (NPLs). However, with comprehensive banking reforms which significantly facilitate the putting in place of more precise regulations, the financial market is accorded sharper systemic signals which promptly inform key players and help ensure the maintenance of operational and associated costs within acceptable limits. When financial liberalization enthusiasm overrides prudential regulation, inherent market weaknesses usually intensify and distort monetary policy frameworks, leading to greater systemic volatility, structural fragility and institutional mortality. Intervention strategies are expected to be conceptualized with assured prevalence of appropriate regulations in the economy. Any leap to the contrary brings about a banking system that is acutely undercapitalized, insolvent and vulnerable. It may further deteriorate into full scale distress as the systemic fragility goes out of control. This was the condition of Nigeria and many other developing countries some years ago but now, this is history for so many positively impacted banks (Agundu, 2012; Jhingan, 2010; Adebiyi, 2002; Anyanwu, 1995).

3.   Research Methodology

Secondary data for this study comprise time series contained in the publications of the Central Bank of Nigeria (CBN), National Bureau of Statistics (NBS) and Federal Ministry of Finance (FMF). They relate to banking reform proxies such as bank capital (BC), monetary policy rate (MPR) and exchange rate (EXR) as well as key macroeconomic target proxies such as gross domestic product (GDP), gross fixed capital formation (GFCF) and aggregate private sector credit (APSC). GFCF is adopted as the criterion aggregate in this study. Aided by software package for social sciences (SPSS), the time series of 23-year period (1986-2008), are analyzed using regression method (Agbahiwe, 2013). The model specifications are as follows:

- *Model 1*:

GFCF = f (BC)

GFCF = $a_0 + a_1 BC$

$GFCF = a_0 + a_1 BC + \mu$

a' priori Economic Expectation: $a_1 > 0$

- *Model 2*:

$GFCF = f(MPR)$

$GFCF = a_0 + a_1 MPR$

$GFCF = a_0 + a_1 MPR + \mu$

a' priori Economic Expectation: $a_1 > 0$

- *Model 3*:

$GFCF = f(EXR)$

$GFCF = a_0 + a_1 EXR$

$GFCF = a_0 + a_1 EXR + \mu$

a' priori Economic Expectation: $a_1 > 0$

Where:

a_0 = Independent constants,

a_1 = Regression coefficients, and

μ = Stochastic sundry variables.

The financial data inputs for the analytical framework are presented in Tables 1 and 2:

Table 1: Nigeria's Banking Reform Proxies (1986-2008)

Year	BC (₦ Million)	MPR (%)	EXR (₦ to $)
1986	235	l0	4.08
1 987	273	12.75	4.59
1988	334	12.75	7.39
1989	334	18.5	8.04
1990	646	18.5	9.91
1991	1,993	14.5	17.45
1992	3,610.5	17.5	22.41
1993	5,929.8	26	22
1994	6,925.3	13.5	81.2
1995	7,360.5	13.5	81
1996	7,509.5	13.5	82
1997	7,995.8	13.5	83.8
1998	10,139.5	14.31	94
1999	11,936.5	18	101.7
2000	21,210.4	13.5	111.94
2001	37,527	14.31	111.94
2002	43,473	15.75	120.97
2003	43,473.4	15	129.35
2004	49,179	15	133.5
2005	49,180.3	13	129
2006	50,533.5	10	127
2007	55,720.4	9.5	124.76
2008	64,847.5	9.5	117.78

Source: CBN, NBS and FMF Publications (various years)

Table 2: Nigeria's Key Macroeconomic Variables (l986-2008)

Year	GDP (₦ Million)	GFCF (₦ Million)	APSC (₦ Million)
1986	143,623.90	7,323.00	17,370.50
1987	203,037.10	10,661.10	25,483.40
1988	275,198.20	12,383.70	29,772.30
1989	403,762.90	18,414.10	30,940.10
1990	497,351.30	30,626.80	36,630.00
1991	574,282.10	35,423.90	45,333.00
1992	909,754.20	58,640.30	76,098.70
1993	1,132,181.20	80,948.10	91,239.30
1994	1,457,129.70	85,021.90	145,103.90
1995	2,991,941.70	114,476.30	204,945.10
1996	4,135,813.60	172,105.70	255,558.80
1997	4,300,209.00	205,553.20	316,577.30
1998	4,101,026.30	192,984.40	370,706.70
1999	4,799,966.00	175,735.80	452,411.10
2000	6,850,228.80	268,894.50	587,486.20
2001	7,055,331.00	371,897.90	827,122.90
2002	7,984,385.30	438, 114.9	938,271.20
2003	10,136,364.00	871,730.40	1,281,125.50
2004	11,673,602.20	1,389,158,40	1,507,885.20
2005	14,894,500.00	1,787,340.10	1,832,180.00
2006	18,222,800.00	2,277,850.00	2,840,100.00
2007	22,848,900.00	3,175,997.10	4,676,340.00
2008	24,313,514.00	5,956,810.90	7,411,430.00

Source: CBN, NBS and FMF Publications (various years)

4.   Findings & Discussion

The outcomes of statistical data analysis are presented in Table 3, 4 and 5:

Table 3: Results of Regression Analysis (RH1)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
BC	49.88023	8.666368	5.755609	0.0000
C	-29582.4	260991.l	-1109549	0.2797

R-squared	0.612024	Mean dependent var.	752192.0
Adjusted R-squared	0,593549	S.D. dependent var.	1414438.
SE of regression	901754.1	Akaike info criterion	30.34501
Sum squared resid.	1 .71E+13	Schwarz criterion	30.44375
Log likelihood -	346.9676	F-statistic	33. 12704
Durbin-Watson stat.	0.474476	Prob. (F-statistic)	0.0000 10

Source: Research Data (SPSS-aided)

Table 4: Results of Regression Analysis (RH2)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
MPR	-191189,6	73827.85	-2.589667	0.0171
C	3515048.	1098770.	3.199076	0.0043
R-squared	0.242052	Mean dependent var.		752192.0
Adjusted R-squared	0.205959	S.D. dependent var.		1414438.
SE of regression	1260391.	Akaike info criterion		31.01468
Sum squared resid.	3.34E+13	Schwarz criterion		31.11342
Log likelihood	-354.6689	F-statistic		6.706377
Durbin-Watson stat.	0.635095	Prob. (F-statistic)		0.017098

Source: Research Data (SPSS-aided)

Table 5: Results of Regression Analysis (RH3)

Variable	Coefficient	Std. Error	t-Statistic	Prob.
EXR	14242.05	5360.811	2.656698	0.0148
C	-316463.7	479591.5	-0.659861	0,5165
R-squared	0251552	Mean dependent var.		75292.0
Adjusted R-squared	0.215911	S.D. dependent var.		1414438
SE. of regression	1252468	Akaike info criterion		31.00207
Sum squared resid.	3.29E+13	Schwarz criterion		31.10081
Log likelihood	-354.5238	F-statistic		7.058043
Durbin-Watson stat.	0.347455	Prob. (F-statistic)		0.014758

Source: Research Data (SPSS-aided)

In Table 3, the results establish strong relationship between gross fixed capital formation and bank capital, as indicated by the R^2 of 0.61 and adjusted R^2 of 0.59. The latter implies that bank capital explains 59% of the variations in gross fixed capital formation in the period. The t-statistic of 5.76 is also very significant, thereby recognizing bank capital as good predictor of gross fixed capital formation. The F-statistic of 33.127 is higher than the critical equivalent at 0.01 and 0.05, which confirms the overall model fit. In Table 4, the negative t-statistic indicates an inverse relationship between gross fixed capital formation and monetary policy rate. In Table 5, the t-statistic is positive as it is the case with bank capital. Taking all these comprehensively and holistically, bank capital manifests and prevails as a leading proxy of banking reform. Monetary policy rate and exchange rate also contribute to explain the variations in gross fixed capital formation in the period under study. Basically, banking reform seeks to drive the settlement balances of banks with the apex bank towards the zero mark. Where it fosters a symmetric treatment of deficits, the cost of overdraft becomes equal to the opportunity cost of holding surpluses. Thus, with gross fixed capital formation as macroeconomic criterion variable, the value of acquisitions made in respect of new or existing fixed assets by business, government and household sectors of the Nigerian economy is critically captured and viewed against the potency and efficacy of banking reengineering (Alade, 2006; Adam & Ogba, 2006; Ojo, 2005). The gross fixed capital formation measure characteristically aggregates the stock of produced fixed assets, especially core tangible assets, including residential and non-residential building, roads, bridges, airports, railway, machinery, transport equipment, office equipment, vineyards/orchards, breeding livestock, dairy livestock, and other reared animals. Mineral explorations, computer software, copyright protected entertainment, literary/artistic creations may also fall within this definition and profile of fixed assets.

Except the values relating to land improvements, sub-soil/mineral resources, other natural resources (including water, primary forests, etc), all other non-produced assets (including the primary value of lands) are excluded from the official measure of gross fixed capital formation. Furthermore, ordinary repair, purchase of durable household equipment (such as private cars and furniture) and keeping/rearing of animals for meat are not part of

the gross aggregate. The analysis of productive capital stock development involves measurement of the value of acquisitions, excluding disposal of fixed assets beyond replacements for obsolete assets and loss of value due to normal wear and tear. This constrained measure is *net* aggregate because it excludes depreciation of existing assets from investment composition and is synonymous with net fixed capital formation. The *gross* aggregate is adopted because the measure does not make any adjustments that exclude the consumption of fixed capital (depreciation of fixed assets) from the investment composition. Prudential strategy and regulatory process redirection are also of the essence of banking reform implementation and overall intervention strategy realization. Prudential regulations are expected to prevent, mitigate risks and lower costs associated with institutional volatility and fragility. Fundamentally, they help achieve higher efficiency and effectiveness in the overall workings of the financial system (Babatunde, 2007; Adeyemi, 2005). Where government apparently leaves the economy to the dynamics of the market, it has to frantically grapple with the challenge of ensuring credibility and efficiency. In the circumstance, prudential regulations are introduced to the extent that they do not distort established control patterns. With the significant regression statistical results recorded in this study, it is convincing that the relationship between that analytical variables is real, underscoring the potency of banking reengineering in bringing about sustainable financial sector revitalization in the Nigerian economy.

5.   Conclusion

Banking reform as financial system intervention strategy is critically directed at galvanizing the economy. It is vitally instrumental to launching commercial and industrial activities firmly on the path of competitiveness and growth. This process reengineering and institutional revitalization drive of the recent past is not peculiar to the Nigerian economy but relates to many other African countries. Considering their common experiences, intervention strategies are enunciated to forge and sustain healthy banks for overall financial sector virility in the face of excruciating systemic vulnerability, volatility and fragility. In this vein, regulatory and reengineering mechanisms are strengthened to justify and intensify financial intermediation at minimal cost. With the shoring up of capital base of affected banks through merger and acquisition (M&A) and allied mechanisms, foreign investors get attracted to complementarily participate in constructive and competitive investment - rewarding economic activities, including banking business and provision of critical industrial infrastructure which will enhances the creation and promotion of innovative product lines with highly efficient and effective operating technologies (Ndebbio, 2004; Beck & Levine, 2002; Durevall & Ndungu, 2001). In some cases, reform programs are preceded by policy measures strategically directed at warding off systemic contagion, and this particularly relates to the real estate sector and allied capital market constituencies. The key elements of the intervention strategies include prudential regulations sensitization, financial institutions rationalization, and least cost solutions application.

Against this backdrop, many banks get consolidated and congregated into few mega banking groups. Some governments conscientiously resort to promote and retain one large deposit money bank (DMB) unlike the previous regime when the financial sector is visibly proliferated and littered by several banks and other financial institutions. Considering the institutional synergies expected from financial sector intervention strategies in the context of the peculiarities of the Nigerian economy, it is recommended that regulatory authorities, key players and sundry stakeholders should, through the instrumentality of banking reform, foster:

- Better financial sector viability by re-determining bank capital adequacy and financing capacity for banks to increasingly cater for the credit needs of various sectors of the economy;

- Better financial sector vitality by redefining bank liquidity and facility accessibility for banks to increasingly avail the private sector the transacting capacity for acquisition of production assets which when properly utilized would enhance wealth creation and employment generation in the economy; and

- Better financial sector functionality by retraining human resources of banks to keep pace with global modern trends for the repositioning of the sector and sustainable advancement of the economy.

With respect to the regulatory imperatives of financial sector, the monetary policy rate is quite critical. Being *the king* of all rates in the economy, prices move in sympathy with it, thereby illuminating the trend of deposit and lending rates in the financial system. The cost of credit in the money and capital markets depends on it and this consideration eventually extends to cost of production of goods and services in the economy. The exchange rate equally provides a vital link between the domestic economy and the international economy. Under a free market

setting, the rate is determined by the forces of demand and supply; but when the contrary prevails, the non-competitive mechanism undermines the expectations of foreign investors and consequently hinders the flow of foreign direct investment (FDI) into the economy. More so, foreign investors prefer contacting, connecting, and committing investment resources into countries with relatively stable exchange rate. By the outcome of this study, bank capital, monetary policy rate and exchange rate prevail as critical variables of interest in the realization of the targets of banking reform and allied financial system intervention strategies in the Nigerian economy.

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