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BANK CONSOLIDATION AND SOLVENCY: THE NIGERIAN EXPERIENCE

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ABSTRACT

Bank consolidation was introduced in the Nigerian financial sector in order to recapitalize banks and to make them capable of withstanding the intense competition posed by globalization. This process was introduced when the operating solvency of the banks has been completely eroded by their inability to meet their debt obligations as they arise and the banks were engaged with more financial stress through excessive loans. This paper examines the impact of consolidation on the operating solvency of the banks in Nigeria using regression analysis. Eight (8) banks were randomly chosen to represent the population. Accounting data were obtained from the Fact-book and Annual Stock Price Summary maintained by the Nigerian Stock Exchange (NSE) and the published Annual Reports and Accounts of the sampled banks. The result shows that the absolute value of the correlation coefficient between the dependent variable SOLVENCY and the independent variable CONSO of 0.097 indicates that the strength of the linear relationship is less than 10 per cent at a significance level of 0.329. Again, it indicates an R squared of less than 1 per cent which represents the proportion of variations in SOLVENCY that is explained by the regression model. Thus, the study finds a weak and insignificant influence of consolidation on the solvency of Nigerian banks and therefore, concludes that consolidation does not significantly impinge on the solvency of the banks. The paper recommends that schemes of loan guarantee and debt factoring should be encouraged by the apex bank in this way the banks could reduce some of the risk assets that are not performing and in order to improve on their short term liquidity and solvency in the long run.

KEYWORDS

Bank, Consolidation, Nigeria, Solvency.

INTRODUCTION

Bank consolidation was introduced in the Nigerian banking sector to recapitalize banks and make them capable of withstanding the intense competition posed by globalization. Structurally, the sector was highly concentrated, as the ten largest banks accounted for about 50 percent of the industry's total assets/liabilities. Even the largest bank in Nigeria has a capital base of about US\$240 million compared to US\$526 million for the smallest bank in Malaysia. The banks were typified with expensive headquarters, unique investment in software and hardware, heavy fixed costs and operating expenditures, and the horde of branches in the commercial cities resulted in a very high average cost for the industry.

Generally, the major problems of many Nigerian banks, among others, include huge credits and inadequate cash balances to meet their customers' demand. Thus, the operating solvency of the banks has been completely eroded by their inability to meet their debt obligations as they arise. The CBN in 2004 declared the process of recapitalization of the Nigerian banks through consolidation (Poyi, 2006). The board of the CBN approved and published the guidelines and incentives to facilitate the consolidation process in order to assist the banks in meeting the approved capital base of N25 billion by the end of December, 2005 (Soludo, 2006). The objective of the consolidation exercise is to ensure adequate capitalization of the banks in the sector in order to enable them to achieve effective and efficient operations, strengthen their solvency position and contribute to the stabilization of the banking sector. Boosting the solvency of the banks means their ability to meet customers' demands as they arise is also enhanced (Adejobi, 2008) as well as depositors' trust.

However, prior studies on bank consolidation in the developed markets have shown that bank consolidation has been criticized for not producing the cost savings or increased revenues that were anticipated (Peristiani, 1997). Also, the effects of consolidation on the solvency of banks have shown two patterns: the ambiguous effects of consolidation on the banks' solvency or increase in the insolvency of bank coupled with insignificant improvement in the profitability upon consolidation (Souza and Lai, 2002). Another problem of this research is that there are limited studies on this phenomenon in Nigeria to the best of the researcher's knowledge. The only known study is Adejobi (2008) who used Data Envelopment Analysis (DEA). However, this method estimates "relative" efficiency of a Decision Making Units (DMU) but it converges very slowly to "absolute" efficiency. Thus, it tells how well to compare peers but not to ascertain a "theoretical maximum". Since the DEA is a nonparametric technique, statistical hypothesis testing is difficult which is the focus of this research. This study examines the effects of consolidation on the solvency of Nigerian banks to the theoretical maximum which is presented by values of correlation coefficients, " R " and coefficient of determination, " R^2 " in regression analysis. Thus, this study tests the statistical hypothesis that consolidation has no significant impact on the solvency of banks in Nigeria. The remaining part of the paper is organized as follows: the next section presents the literature review followed by the methodology section. Sections four and five of the paper present discussions of results and conclusions of the paper respectively.

LITERATURE REVIEW

One of the major benefits of consolidation is to avoid banks becoming unable to meet liabilities during periods of firm specific or market-wide liquidity stress and increase banks' resilience to liquidity stress given the market failures. Others include: reducing the risk of asset sales at fire-sale prices that might prejudice balance sheet solvency and, if sufficiently widespread, disrupt the asset markets more widely; and reducing the need for intervention by the authorities, with potential costs to the public purse. Consolidation is viewed as the reduction in the number of banks and other deposit taking institution with a simultaneous increase in the size and concentration of the consolidation entities in the sector (BIS, 2001; Adedipe, 2005 and Ajayi, 2005). It is mostly motivated by technology innovation, deregulation of financial services, enhancing intermediation and increased emphasis on shareholder value, privatization and international competition (Berger et al., 2000; IMF, 2001 and De Nicole et al., 2003). Consolidation has been seen as a deliberate policy designed by the governments of various countries to check their impending banking sector crisis subsequent to probable failures and the need to sustain public confidence in the sector (Uchendu, 2005). The process of consolidation creates bigger banks with huge capital that could not be eroded by statutory provisions and as well, creates opportunities for greater diversification and financial intermediation.

Empirically, Hughes et al. (1999) examine the effects of consolidation on profit, solvency and the degree of profit inefficiency in the U.S. Using regression analysis; they found that consolidation improves bank safety measured by reducing the banks' risk of insolvency. De Nicole et al (2003) find that complex banks have high level of risk of insolvency than smaller, less complex or specialized banks. Deregulation need to be complemented with more detailed analyses of banks' managerial incentive to take risk and to exploit the indirect subsidies provided by modern safety nets. Basu et al. (2004) study the impact of consolidation on bank performance in Argentina, using regression analysis. They found that a bank's insolvency risk is reduced significantly through consolidation. Adejobi (2008) used DEA to study the solvency of Nigerian consolidated banks and his findings suggest significant improvement in the solvency of the banks. However, Adejobi's results may not be robust due to the methodology he employed. Therefore, this study contributes to the consolidation literature using similar methodology as in Basu et al. (2004) as evidence from Nigeria on the impact of consolidation on the solvency of Nigerian banks.

METHODOLOGY

The study covers three financial periods in the post consolidation era (2006-2008). Eight (8) banks were randomly chosen from the twenty-two (22) banks listed banks. Accounting data were obtained from the NSE Fact-Book, NSE Annual Stock Price Index and the published Annual Reports and Accounts of the sampled banks. The data collected are used for computing solvency ratios such as Loan to Deposit Ratio (LDR), Deposit to Cash Ratio (DCR) and consolidation, CONSO. The dependent variable, SOLVENCY, represents the average of the LDR and DCR. The LDR measures liquidity as well as the credit risk of a bank. A high value indicates a potential source of illiquidity and insolvency, lower DCR stimulates depositors' trust (Kakani, Saha and Reddy, 2001) and CONSO, the independent variable, represents bank's share of the total assets of the banking industry (Basu, Druck, Marston and Susmel, 2004).

This paper adopts a model used by Basu, Druck, Marston and Susmel (2004) in explaining the relationships between the consolidation and returns of bank in Argentina to test the null hypothesis that consolidation has no significant impact on the solvency on Nigerian banks. The model is similar to the model used in Demsetz and Strahan (1995) with some differences in estimation technique. In order to indirectly test the effect of bank consolidation on bank returns, they check its effect on the Sharpe ratio, that is, the risk-adjusted returns. They estimated the relationship in the model: $(rit/a2it = \alpha + x'it P + uit...1)$. Where i denotes cross-sections and t denotes time-periods with $i=1,2,...,N$, and $t=1,2,...,T$. They used the variance of bank returns divided by bank returns, as the dependent variable in model, α is a scalar, P is $K \times 1$ vector of coefficients and xit is the it -th observation on K explanatory variables or risk factors and random error term as $uit = \sum \mu_i D_i + \epsilon$. From this, model (2) is estimated for this study: $(SOLVENCY = \alpha + CONSO'it P + uit...2)$. Therefore, a solvent bank's total assets value is greater than its liability otherwise its risk of insolvency becomes high. For consolidation to have a positive impact on the solvency of the listed banks in Nigeria, it is expected that the CONSO would be positively related to SOLVENCY in the model.

RESULTS AND DISCUSSION

The results (Appendix 1) show a value of 0.097 for the correlation coefficient between the SOLVENCY and the CONSO. The significance (or p-value) of the coefficient of 0.329 shows the probability of obtaining a linear relationship, as observed between the two variables. However, the value of the p-value indicates an insignificant correlation between the variables. The proportion of variations in SOLVENCY that is explained by the regression model is 0.009, precisely less than 1%. This implies that CONSO explains less than 1% of the variability in SOLVENCY of the listed banks. The regression sum of squares is 8.017 (Appendix 2) is considered small in comparison to the residual sum of squares of 836.339. This implies that the model accounts for less of the variations in the dependent variable SOLVENCY. The model fails to explain much of the variations in the SOLVENCY of the listed banks in Nigeria.

The sample slope of the relationship between CONSO and SOLVENCY is -0.065 and a standard error of 0.145 and a value of t statistics as 0.449 in absolute terms of standard error units away from the hypothesized value at the level of significance, 0.658, (Appendix 3). Thus, the null hypothesis that consolidation has no significant impact on the solvency of the listed banks in Nigeria is not rejected. From this result, *Model 1* is developed to explain the relationship between SOLVENCY and CONSO variables. The model shows that whenever CONSO increases by 1 unit SOLVENCY will decrease by 0.065 units. CONSO improves solvency if the ratios of the SOLVENCY falls as it increases. The fall in SOLVENCY is a source of better liquidity for the banks. This linear relationship shows that consolidation is improving the solvency of the listed banks in Nigeria. However, the proportion of the change in SOLVENCY is not significant in relation to the change in CONSO. This is showed in model 3:

$$(SOLVENCY = 5.877 - 0.065CONSO + 0.145, 3)$$

The summary of the results show, to the theoretical maximum, consolidation does not have significant on the solvency of the sampled banks and not in relative terms as in the case of Adejobi (2008). Instead, it is observed that consolidation deteriorated the solvency and credit risk of the sampled banks given the values of the coefficients in the regression model. This result is consistent to the findings of Amel, Barnes, Paneta and Salleo (2002), De-Nicolo, Bartholomew, Zaman and Zephirin (2003), who discovered that consolidated banks' risk of insolvency tended to increase with significant loan portfolios. These findings are contrary to the results of Hughes, Lang, Mester, and Moon (1999), Altunbas and Ibanez (2004), Basu, Druck, Marston and Susmel (2004), who found that consolidation improves bank safety measured by solvency. Particularly, De Nicola and Kwast (2002) found a dramatic reduction in bank capital ratios associated with increased safety-net support; they also found that the structure and strength of safety-net guarantees might affect risk taking. The Group of Ten (2001) concluded that there were reasons to believe that financial consolidation had increased the risk and that the failure of a large complex banking organization would be disorderly.

CONCLUSIONS

There is improvement in the liquidity as well as the credit risk of the consolidated banks. There is also an increase in the ability of the banks to give more loans to customers without much financial stress or over stretching their liquidity. Moreso, the consolidated banks have maintained higher amounts of cash to cover up their customers' deposits. However, these improvements in the solvency of the banks are not statistically significant as shown by the weakness in the coefficients of correlation and determination.

It is recommended that the process of setting up National Loan Guarantee Scheme should be set in motion. This will guarantee billions of naira of loans to Nigerian businesses at commercial insurance fees. The guarantee, which will be provided by the government through its agencies that are to be established, would not cover 100 per cent of the loan - it is important that banks take a share of the risk to prevent reckless lending. And it is the banks, not the Government, that would make decisions about which companies to lend to. Bank's solvency policy should have a contingency plan that addresses alternative funding if initial projections of funding sources and uses are incorrect or if a solvency crisis arises. This would help to ensure that a bank can prudently and efficiently manage routine and extraordinary fluctuations in solvency.

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APPENDICES

APPENDIX 1: REGRESSION MODEL SUMMARY

Model	R	Significance of R	R Square	Adjusted R Square	Std. Error of the Estimate
1	.097	.329	.009	-.038	6.31098

Source: NSE Fact-Book and Annual Accounts of Sampled Banks (SPSS 15)

a Predictors: (Constant), CONSO

b Dependent Variable: SOLVENCY

APPENDIX 2: ANALYSIS OF VARIANCE OF THE REGRESSION MODEL

	Sum of Squares	df	Mean Square	F	Sig.
Regression	8.017	1	8.017	.201	.658(a)
Residual	836.339	21	39.829		
Total	844.416	22			

Source: NSE Fact-Book and Annual Accounts of Sampled Banks (SPSS 15)

a Predictors: (Constant), CONSO

b Dependent Variable: SOLVENCY

APPENDIX 3: THE COEFFICIENTS OF CONSO ON SOLVENCY

	Unstandardized Coefficients		t	Sig.	95% Confidence Interval for B	
	B	Std. Error			Lower Bound	Upper Bound
(Constant)	5.877	1.384	4.247	.000	2.999	8.755
CONSO	-.065	.145	-.449	.658	-.367	0.237

Source: NSE Fact-Book and Annual Accounts of Sampled Banks (SPSS 15)

b Dependent Variable: SOLVENCY

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