

Assessment of the Health Status of Banks in Nigeria

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Abstract

Due to the Central role banks play in the development of an economy, banks requires persistent monitoring to ensure and safeguard their existence and efficient operation. However, banks failures were evident in Nigeria at different time in the history of the banking industry. Consequently monetary authority adopts policies such as the re-capitalization policy to ensure that the industry is viable, strong and efficient in performing it laudable task. With the completion of the consolidation exercise that brought to the emergence of bigger and stronger banks and yet others are still weak that desire bailout. So they are granted. Upon this, therefore, the paper intends to examine the operational status of Nigerian banks, after their reformation. Ratio analysis- Multiple Discriminates Analysis was adapted to assess the health status of banks in Nigeria. It is found that Nigerian banks exhibit threat of unhealthy situation. It is recommended that professionalism must prevail in banking operations and favourable atmosphere must be provided for efficient performance.

Keywords: Financial position, Efficiency, Capital adequacy, Ratio analysis and Distress.

Background to the Study

Banking industry plays a prominent role in the development of every nation in the world. They serve as a financial intermediary by attracting deposits from the surplus sector (those who have excess money), and extending money to the deficit sector (those in need of money to finance economic activities). The industry equally serves as machinery for the execution of monetary policies to direct and re-direct the economy towards growth and development. Therefore, this institution stands to be the most nurtured, regulated, monitored and controlled in the course of their operational activities. This becomes necessary because the speed of growth and development of a nation depends on the efficiency of its banking industry.

In Nigeria banking industry had experienced a number of reforms at different point in time. Reforms are predicted upon the need for re-orientation and repositioning of an existing status quo in order to attain an effective and efficient state. Reforms are executed through either government institutions or private enterprises depending on the target objectives and its transmission mechanism. Hence banking sector requires time to time reformation in order to enhance its competitiveness and capacity to play a fundamental role of financing investments, and ultimately preventing bank distress and, or, bank failure.

However bank distress, bank failure are common experiences in the Nigerian banking sector. Therefore, monetary authorities have been taken several measures to curb this menace. These measures are statutory controls, recapitalization policy, introduction of Asset Management Corporation of Nigeria (AMCON), and the bailout options. This becomes necessary to the fact that bank failures generate serious negative externalities for the economy as a whole. It can also create difficulties for monetary policy implementation by distorting the normal relationship between monetary instruments and the intermediate as well as the final targets of monetary policy, and compromises the overall stance of monetary policy (Sundaravajan and Balino, 1991).

Often than not, the failure of banks can be avoided, or the bailout cost minimized, by early detection of banks' troubled status and subsequent intervention by regulatory authorities. Key to this effort is the identification of the banks' potential for failure. To this end, researchers have sought mathematical models that predict institutional failure in an accurate and timely manner (Barr, and Siems 1996).

Objective

Base on the foregoing, the paper aimed at examining whether or not Nigerian banks are financially sound and healthy.

Problem Statement

Although the Nigerian banking system had undergone several reformation activities, their efficiency is doubtful, despite the fact that some of these banks are going regional as well as international by operation. The existence of Amcon simply implies that Nigerian banks are yet to be sound and healthy. The mandate of Amcon therefore, tells that there exist trouble banks in the system which cannot independently absorb both internal and external shocks.

Literature Review/ Conceptual Framework

Techniques for Measuring Banks' Health Status

In the finance literatures a lot of importance has been attached to financial ratios for assessing the financial health of a firm. These ratios are classified into four in the work of Pandey (2011).

1. Liquidity ratio;
2. Leverage ratio;
3. Activity ratio and
4. Profitability ratio

1. **Liquidity Ratio:** This measure the ability of the firm to meet its current liabilities. A firm must ensure that it neither suffers from lack of liquidity nor have excess liquidity. Lack of liquidity will result in a poor credit worthiness, loss of creditors' confidence or even lead to a legal problem that may result to closure of the firm. On the other hand excess liquidity does not speak well to the firm, since idle fund earn nothing, or it may unnecessarily tie up in current assets. Therefore, it becomes necessary for an efficient firm to strike a balance on its liquidity position.

2. **Leverage Ratio:** This is ratio that shows the proportion of debt and equity in financing the firm's assets. A highly debt burden firm finds it difficult to raise more credit thus, reduces its credit worthiness. Normally, creditors use shareholders equity as a margin of safety and, if, the equity is small, and then creditors' risk will be high. This leverage ratios are calculated to measure the financial risk and the firm's ability of using debt to magnify shareholders' earning while they hold little stake in the company.

3. **Activity Ratio:** These ratios are employed to evaluate the efficiency with which the firm hire manages and utilizes its assets. They are also called turn-over ratios becomes they indicate the speed with which assets are being converted or turned over into sales. Therefore this analysis involves a relationship between sales and assets. Hence a proper balance between sales and assets generally reflects that assets are managed well. (Pandey, 2011).

4. **Profitability Ratio:** These are ratios computed to evaluate the operating efficiency of a firm. Creditors, shareholders equally pay attention to these ratios, because creditors want to ascertain that their interest as well as principal can be paid and owners want to get a required rate of return. This is possible only when the company earns enough profits.

Overview of banking soundness indicators in Nigeria:

1. **Assets based indicators:** At end of Dec 2011, the ratio of non-performing loans to total loans is 4.99% which showed a decline of 6.7% points from end of June 2011. The system witness improved liquidity since 2010; liquid assets to total assets increased by 3.1% points to 25.7% at end Dec. 2011, from 22.6% at end of June 2011. In the same vein, the ratio of liquid assets to short-term liabilities increased by 5.5% points to 31.2% at end Dec 2011. This condition is as a result of additional bond issued by Amcon and inflow of core investors to recapitalize some banks at the end half of 2011 which contribute significantly to the improved liquidity of the system.

2. **Capital-based indicators:** The ratio of regulatory capital to risk weighted assets stared at 17.8% at end Dec. 2011, showing a 13.6% points increase over 4.2% recorded at end-June 2011. Similarly, the ratio of tier 1 capital to risk weighted assets of 18.1% at end Dec. 2011 was 13.6% puts higher than the level of 4.5% achieved at end June 2011. The substantial improvement in the level of capital adequacy impacted positively on the confidence in, and stability of, the banking system. The industry ratio of non-performing loans (net of provision) to capital, which had been on a steady decline since early 2010, further fell to 8.9% at end Dec. 2011, from 34.7% at end-June 2011. The improvement was attributed to the purchase of Eligible Bank Assets (EBAs) by Amcon improved risks management practices by banks and the directive by the CBN to banks to write off fully provisioned facilities.

3. **Income and expense-based indicators:** The ratio of interest margin to gross income decreased to 45.2% in Dec. 2011, from 50.3% in June 2011. The decrease reflected the efforts of the regulatory authorities to reduce the high lending rates in the banking sector. In the same vein, personnel cost as a ratio of non-interest expense fell by 10.4% to 36.0% at end Dec. 2011.

However, the ratio of non-interest expense to gross income increased by 3.8% point to 75.4% at end Dec. 2011, from 71.6% stand end June 2011. (CBN financial stability Report, Dec. 2011).

The computed capital adequacy ratio (car) for the banks indicted that the industry average stood at 18.3 percent, compared with the computed average of 17.7 percent at end December 2011. Available data further revealed that all Deposit Money Banks (DMBs), except one, met the stipulated minimum ratio of 10.00 percent. The asset quality of the banks, as measured by the ratio of non-performing loans to industry total, improved substantially as it declined from 4.95 percent at end-Dec. 2011, to 3.47 percent at end Dec. 2012. The average industry liquidity ratio (LR) stood at 63.9 percent, and exceeded the prescribed LR of 30.0 percent compared with 69.1 percent at end December 2011.

Empirical Review

A number of researches were conducted to predict and or classify firms' based on their financial analysis (ratios) whether they possess features of failure or not. All researches in this regard uses ratio analysis but in different statistical techniques however, from available literature it is found that corporate bodies health status are best predicted and or classified with modified and advanced ratios analytical technique. Most studies identify five ratios as being critical in prediction or classification of firms.

In the work of Beaver (1966), assessed five ratios-cash flow to total debt, net income to total assets, total debt to total assets, working capital to total assets and current ratios, to discovered that failed firms are those that exhibit low return on assets with high debt, had less cash but more receivable and low current ratios and inventory. In another study by Altman (1968), that uses five ratios in a multiple discriminates analysis (MDA) confirms to the efficiency of these ratios in predicting bankruptcy. He therefore, concludes that the model is accurate (about 70 percent) and can predict bankruptcy five year prior to ultimate failure.

While Barra and Siems (1996) hold that Data envelopment analysis (DEA) is more efficient in prediction. Poor quality management is an essential factor to corporate failure. Similarly, a simple non-parametric test was conducted, by Gupta (1999), employing five ratios as well, with a predicting power of two to three years before bankruptcy. He discovered that incidence of sickness and capital inadequacy (equity base) is associated.

Another study adopted a Black-scholesmerton probability (BSM- Prob.), believes that this model provides more information than Z-Score sand O-Score for bankruptcy prediction. Furthermore, Chukwu (2010), in a documentary analysis see the need for an effective regulation and supervision of the banking sector to forestall healthy condition in their operations.

Methodology

The method of study adopted for this work is a survey of the financial statements of Nigerian banks for a period of five years. Ratios values computed by the CBN are modeled into a multiple Discriminant technique to determine whether or not the banks are safe and healthy or not. The model for this study is therefore adopted from the work of Altman (1968).

Model Specification

$$Z = 0.012X_1 + 0.014X_2 + 0.033X_3 + 0.006X_4 + 0.010X_5$$

Where:

- Z = discriminant function score.
- X₁ = Liquid assets to total assets
- X₂ = Return on assets (ROA)
- X₃ = Regulatory capital to risk-weighted assets
- X₄ = Non performing loans net of provision to capital
- X₅ = Return on equity (ROC).

The Z value is compared with as pre-determined (mark-up) value to be used to classify firms as either financially sound or otherwise. The comparable value is 2.675. Hence if the Z value calculated is higher than 2.675 such a firm is said to be financially healthy. However a Z value low than 2.675 signifies threat to bankruptcy. Therefore, the lower the Z score, the greater is the chances of the firm to fail and vice versa.

Data Analysis/ Results

The Z scores for the model is computed and presented in the table below:

Years

Rations/Z	2007	2008	2009	2010	2011	Average of X values
X ₁	23.0	17.6	16.5	17.2	25.7	20.0
X ₂	6.1	3.7	-8.9	3.9	0.0	0.98
X ₃	20.9	21.9	4.1	1.8	17.8	12.28
X ₄	11.1	9.1	106.8	192.7	12.1	66.38
X ₅	39.3	20.7	-222.8	265.0	0.5	20.54
Z	1.511	1.247	-1.379	4.127	0.973	1.329

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Note: X values are ratios extracted from CBN report; Z values are computed by the Authors.

The table above present selected ratios (x₁-x₅) for the banking industry for five years, while the last row present the Z score for these years. While the last column shows the average ratio selected of the five years and its corresponding Z value. From the analysis, the year by year Z value indicates that our banks experiences unhealthy condition in comparism with the bench mark Z score of 2.675. The trend is a persistent fall in the Z scores each year except for year 2010. The Z score fall from 1.511 in 2007 to 1.247 in 2007 and 2008 respectively, showing a 17.5 per cent decrease. In the subsequent year, the value drops to its lowest at -1.379, declining by -10.6 per cent. On the contrary, a remarkable achievement was made in year 2010, with a Z value of 4.127, increases by 399.3 per cent. While it was drain down by 76.4 per cent to a Z value of 0.973. The increment in year 2010 could possibly explained by the establishment of Amcon that absorbed non-performing loans (NPC) of banks to shake off the burden and prevent the highly affected institutions from collapse.

Furthermore, an overall Z score was computed by taking the industry's averages for each of the ratios under consideration. The result is not different from what was obtained in the year by year analysis, with a Z score of 1.329 as against the 2.675 mark up. Hence from the theory it has been established that the higher the Z score calculated ahead of the mark up, the better is the status of a firm. On the other hand, the lower the Z score the worse will be the financial condition of a business.

Conclusion

From the analysis, one can conveniently concludes that the Nigerian banking industry exhibit features of unhealthy condition that stand as a threat to the industry in particular and the economy in general. This scenario makes it imperative to strategies action that will turn around the industry to operate efficiently to enhance economic growth and development.

Recommendations

1. The central bank of Nigeria should intensity its supervisory role on the activities of the banks this will help in reducing mishaps in the banking operations.
2. Effective supervision will help in ensuring professionalism and standard applied in all facets of the banking activities.
3. Credit risk analysis must be adhered to before making any loan facilities. This will reduce the amount of non-performing loans suffered by the banks.
4. Banks must work out strategies that will enable them attract and capture the potentially unbanked customer so that liquidity position can improve.
5. The monetary policy rate should be fixed at a rate that will allow banks to operate in order to improve upon returns on assets (ROA) and returns on equity (ROE).
6. Supervisory authorities must be proactive sand honest in the discharge of their duty so as to reduce cases of fraud and forgeries.
7. Bank fraud stars should be sanctioned appropriately sanction so that it will serve as a lesson to any person that have this intension.
8. The federal government of Nigeria should ensure regular supply of electricity, this will reduce extra operational expenses incurred by banks in their efforts to run their electronic gadgets that facilitate electronic payment system. This will improve the profit margin of banks.

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