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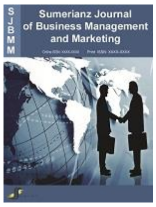

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A Review of Indices of Capital Adequacy and Performance among Nigerian Banks: A Theoretical Consideration

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Abstract

The paper examines concept of capital adequacy and performance from recapitalized banking system perspective to ascertain whether some indices of financial condition and performance like capital-to-total assets ratio, asset quality, liquidity profile, earning and profitability and competence of management are effective in ensuring bank health in a deregulated banking system. In particular, we investigated, from existing literature, the possibility of financial supermarkets or mega banks existing side-by-side small banks in a consolidated Nigerian banking environment. Hence the paper employed descriptive statistical analysis to analyze conceptually, selected indices of bank capital adequacy and performance (profitability) to propose the way forward for a supermarket cum- small bank industry which will finance the real sector of the Nigerian economy in a bid to stimulate needed economic growth and development in the 21st century. Findings from our analysis confirmed a-priori economic thinking, that the capital adequacy is only a part of a bank's overall soundness, but that a bank can still be small in its capital base composition and continue to operate profitably provided it maintains a balanced mix in its asset structure to ensure both high liquidity and profitability ratings. We, therefore, recommended that the Nigerian monetary authorities should not focus attention exclusively on the adequacy of bank capital. Rather, they should be concerned with the overall soundness of the bank instead of fixing N25 billion mark capital base requirement to be met by all banks as it will singly do all the magic.

Keywords: Capital adequacy, Performance, Corporate governance.

1. Introduction

Due to severe banking system crisis that has occurred in the Nigerian banking sector for over a decade now resulting into bank failures, poor performance and inability of banks to realize enough savings and supply adequate credits to the real sectors of the Nigerian economy, suddenly the Nigerian monetary authorities, have woken up to declare "a state of emergency" on banking industry. The day was July 4th, 2004 in one swoop statement, the Central Bank of Nigeria Governor, Prof. Charles Soludo, announced to the Nigerian bankers that government is set to uphold a new bench mark to the tune of N25 billion as the required capital base in Nigeria, come December 31st, 2005. Now that the period is ever nearer to the corner than before, the reality and urgency of the time has dawned on all banks.

Consequently, so many questions are beginning to emerge such as:

i. What are the core indicators of bank capital and corporate government in Nigerian?
ii. How are these indices to be monitored in a re-capitalized banking environment?
iii. capital adequacy a catch-all index for sound bank condition?
iv. Are there financial and or macroeconomic indices that do impinge on bank capital and profitability?
v. What are we to expect in the years ahead beyond bank consolidation era in Nigeria?
vi. What role does management competence play in bank performance and cooperate governance?
vii. Is capital adequacy the only factor that ensures a supermarket banking institution or do small banks also have room, where to operate profitably in a deregulated recapitalized banking system?

These questions and other aligned issues shall be treated in this paper in a conceptual underpinning manner since a reasonable period of time has not yet passed for us to empirically evaluate effects of banks capital adequacy and or performance in an emerging dispensation of recapitalized banking environment in Nigeria. If anything, the current regulation directives (urging banks to consolidate) have put bankers on their toes, and definitely it is expected that in the end it will inject some discipline in the profession. Besides, it has shown that Nigerian banks via the Nigerian capital market have the potentials to mobilize adequate funds to meet the investment needs of the economy (Lemo, 2005).

Against this backdrop, this paper will specifically attempt to establish conceptually, through extensive literature review, that bank capital adequacy is only a part of other aspects of health indicators that affect bank financial

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soundness and corporate governance. We shall recommend that all these other indices of profitability cum capital are considered holistically while formulating policies that should lead to an enduring banking system in Nigeria.

2. Methodology Used for the Study

In this paper, we adopted both descriptive analysis and inferential statistics to carry out conceptual-cum-theoretical discussions on the indices of bank performance and financial soundness in Nigeria with a view to determine if capital adequacy is a catchall indicator or only a part of the indices that impinge on bank health soundness, earning and profitability, the world over, and in Nigeria, in particular. Hence, discussion will center on key indicators of bank capital adequacy, performance and corporate governance such like bank capital, asset quality (i.e. liquidity profile, earnings and profitability), and competence of management.

The study used, in the main, secondary data from financial journals, textbooks, academic magazines and newspaper articles to carry out its studies. We equally consulted the University of Abuja library, CBN Library and research department, to optimize our data gathering efforts. We also had face-to-face discussions with academics, financial researchers/analysts and practicing bankers in a bid to enrich our study.

Conclusions reached through this systematic study are expected to underscore the theoretical cum conceptual framework and or underpinning of the core indices of capital adequacy, financial condition, performance and corporate governance in Nigeria.

2.1. Review of Related Literature: An Analysis of the Indices of Bank Capital Adequacy, Performance and Corporate Governance

The banking sector in any economy serves as a catalyst for growth and development. Banks are able to perform this role through their functions of financial intermediation, provision of an efficient payments system and facilitating the implementation of monetary policies. It is not surprising therefore, that governments the world over, attempt to evolve an efficient banking system, not only for the protection of depositors, encouragement of efficient composition, maintenance of confidence and stability of the system, but also for protection against systematic risk and collapse (Alashi, 2003). It is in the light of the above scenario that the monetary authorities in Nigeria, through the central bank, had requested all lending banks to recapitalize to the tune of N25 billion capital bases by the end of 31 December 2005. Since the mandate issued to banks to consolidate their capital requirement is almost expiring, this study deemed it fit to pursue a theoretical treatise of indices of bank capital adequacy, and corporate governance in the Nigerian banks.

Hence, analysis will take the following step-by-step discussions of these indicators of bank health condition in Nigeria,

1. **Capital Adequacy:** Generally, three ratios stand out to measure capital adequacy of commercial banks. These include (1) capital-to-total asset ratio (CTAs), (ii) capital to risk weighted asset ratio (CTRWAR), and (iii) adjusted capital to loan ratio (ACTLR). These will be systematically considered in the discussions of this paper as they affect the financial condition of banks in Nigeria.
2. **Asset Quality:** Usually, a bank asset portfolio comprises two factors; (i) earning and profitability assets and (ii) liquidity assets. Hence here we shall consider (a) non-performing credit to total (NPCTCR) and (b) non-performing credit to shareholders funds ratio (NPCTSFR).
3. **Earnings and Profitability Measures of Performance:** In this context, we shall discuss returns on asset ratio (ROA) and returns on equity ratio (ROE) as indicators of bank earnings and profitability performance evaluation.
4. **Liquidity Profile:** In this case, we shall specifically look at three ratios:- (i) average liquidity ratio (ALR), (ii) net loans to deposit ratio (NLTDR) and inter-bank takings to deposit ratio (IBTDR)
5. **Skill of Bank Management:** This is a test of competence of management. No doubt the quality of bank staff or management team as par the number of chattered bankers compositions or number of B.Sc. (degree) holders in banking and finance, or finance, economics or M.Sc and Ph.D (degree) holders, can be a measure of the professional content of the banks workforce. Had we to carry out an econometric investigation of corporate governance and financial condition of Nigerian banks, the number of staff terminated/retired/dismissed could equally serve as a mirror of the skill of bank management or competence of personnel. In the present study, however, we shall theoretically consider this human capital factor qualitatively under a sub-heading titled poor corporate governance management.

   Below we pursue a general theoretical review of literature of the topic in hand.

2.2. Purpose and Adequacy of Bank Capital

Purpose: Bank regulatory authorities have been concerned with the size of a bank's capital relative to the size of the bank. The reason for this concern is that capital accounts have traditionally been viewed as representing a buffer between the mismanagement of the bank and losses suffered by depositors (Luckett, 1984). In other words, monetary authorities' concern about bank capital is basically of concern about the solvency of banks their potential for paying off their debt (deposits) during hard times. Obviously, “the larger a banks capital accounts are relative to its assets, the safer the bank is for depositors” (Luckett, 1984).

This way of viewing the capital accounts has led to number of regulatory devices having bank capital as their focal point. One of such devices, for example, is the minimum capital requirements of federal (and sate) laws relating to the chartering of new banks in America, (i) These laws typically require progressively higher capital for a bank, the larger the size of the town in which it does business, (if Another such provision is that national banks are prohibited from paying dividends to their shareholders until they have built up a surplus account at least equal to the size of their capital stock (Luckett, 1984). A bank surplus account represents an assignment of .bank profits to a special account and is meant to give extra protection to depositors. Commenting on the above laws, we observe that provision (i) Is in monetary authorities. For example the CBN threw up a blanket capital base of N25 billion and has continued to insist that it must be met by all banks in Nigeria otherwise the particular bank fails. Our regulatory authorities should take a leaf from America and other western countries and learn that a capita base “must be tied to a. condition that necessitates its adoption” as it is usually done in developed economics like USA. Second, it is equally noteworthy for operators in the financial industry that banks are supposed to be prohibited from paying dividends to their stockholders until they have built up their surplus accounts to a certain level at least equal to the size of their capital stock. Recently, we learnt that Zenith bank, PLC, which had earlier gone to the capital market to raise money to beef up its capital base, paid dividends of 17k/share to its shareholders. One wonders what land of banking practice they are exhibiting. It shows that the quality of their bank's management should be called to question. It shows poverty of knowledge of bank management in the area of dividend policy formulation and or as applicable in that banking firm (Uremadu, 2004).

Consequently, an important measure put in place to enhance banks’ viability is the high capital requirement for banks. The capital requirements are now ties to the risk profile of the assets that banks are carrying. In justifying the need Benston and Kaufman (1988), argued that because the larger the amount of capital required the greater the incentives of bank managers and shareholders not to take excessive risks, the capital requirements should be relatively high. Abnkigm supervisors all over the globe have continued to put measures in place aimed at making banks to have adequate capital and minimize their risk taking for the sake of stability in their banking system. In recognition of this, the Base Committee in 1988 presented the minimum capital adequacy ratio (CAR) at 8 percent and has issued at new accord expected to make banks capital to be more risk sensitive, to be effective in early 2007. In trying to comply with this new prescription, “Banking supervisors in Nigeria have since implemented the United St requirement of minimum capital adequacy ratio (CAR) of 8 percent will raise the minimum for Nigeria banks to 10 percent by early 2004” (NDIC Research Department, 2004) .

Meanwhile, the machinery is being put in place for Nigerian banks to fully comply with the New Capital Accord. Any wonder, we have frog-jumped form N2 billion minimum paid-up share capital for a new bank and N1 billion minimum paid share capital for an existing one, on 31st December, 2005. What an upsurge of re-capitalization procedure.

2.3. Tends in Bank Capital: A Conceptual Outlook

Since the regulatory authorities are often motivated by a desire to protect the interest of the depositing public, they have traditionally favoured high capital/asset ratios for commercial banks. The difficulty with this attitude is that it tends to run directly counter to the interest of the banks. Banks shareholders, like other business people, are concerned with managing their affairs so as to maximize their profit rate. Generally speaking, the profit rate is simply the ratio of bank earnings to invested capital. The usual way of increasing this ratio is to increase earnings. But it is also true in banking to increase the ratio by decreasing its denominator that is, by decreasing the amount of capital invested in business. As a consequence, there has been a strong long run tendency in banking for the capital/asset ratio of banks to decline. For example, in 1988 the average was about 20 percent, by 1982 the ratio had fallen to about 7 percent (Luckett, 1984). The question is, who is right, the banking authorities or the banks? How much capital is enough capital?

2.4. Adequacy of Bank Capital

When you think about it for a moment, it becomes apparent that the question of enough capital cannot be answered with a single number like 10 percent of assets. The answer has to be more complicated if for no other reason than that banks differ from one another in many respects besides size. Thus if the purpose of bank capital is to offer some measure of protection to depositors, one should immediately think that the safer a bank is in other respects, the lower its capital/asset ratio might be permitted to be (Luckett, 1984). This line of reasoning has led to a variety of measures that attempt a more sophisticated analysis of the adequacy of the bank capital than the somewhat simplistic capital/asset ratio. We will describe briefly below three such measures:

a. The Capital/Risk Asset Ratio: The first attempt at a more sophisticated answer to the question of "enough" capital came about largely as a response to the very sophisticated rise in bank-held government securities during World War II. In general, bankers argued that the increased percentage of their asset held in the form of government securities made them mush safer repositories of depositors’ funds. Consequently, the bankers said, they should be permitted lower capital/asset ratios (provided they maintain a proportionate volume of liquid assets in their accounts). Out of this line of reasoning grew a new measure of capital adequacy, the capital/risk-assets ratio. By risk assets is meant all assets that are meant neither United State government securities nor cash. Using this measure, those with fewer loan and more cash and government securities than other banks accounts relative to their size. Many banking authorities in particular, the controller of the currency and some other state authorities, accepted this argument as valid and subsequently used it in their examination procedures (Luckett, 1984).

b. The Secondary Risk Assets Ratio

Although the capital/risk asset ratio is an improvement over the capital/asset ratio, it is nevertheless an arbitrary measure. What is arbitrary about it is the definition of risk asset as all assets except cash and United States government securities are considered "riskless" and loans guaranteed by the united State government not be considered riskless. There is obviously a problem of consistency of definition here. The argument then is that many assets held by banks may be considered virtually as riskless as government securities. Federal funds, loans collateralized by government securities, passbook savings loans, and so on, involve virtually no risk of default "sofa as the bank is concerned. Therefore, why not also exclude them from risk assets? Following this line of reasoning (and under pressure form the banks), many supervisory authorities began calculating a secondary risk-asset ratio, which also define these type of Asses as riskless (Uremadu, 2000a).

Moreover, the secondary risk-asset ratio is generally used as a supplement to, rather than a substitute for, the more conventional risk-asset ratio. That is, in examining a bank, the examiner first calculates the capital/risk-asset ratio. If this ratio is in line with the average ratio of other banks, then no further calculations are made. But if it is below the average, this ratio is not taken as absolute proof that the bank has inadequate capital amounts. Instead, the secondary risk-asset ratio is calculated, and if this ratio is high, it can be used to compensate for the low capital/risk-asset ratio. In other words, government guaranteed loans could be used as a partial offset to a lack of government securities. Hence, it i: noteworthy that there is need for Nigerian monetary authorities to go the extra mile in employing several measures to assess the adequacy of bank capital rather than dwelling just only on one, the capital/ass ratio. It was late Prof. William Okefie Uzoaga, of blessed memory, who once stressed in Uremadu (2004) that:

Because of the importance of bank capital, many interested parties have wished to establish set of standards that could be employed to test the adequacy of capital funds of a particular bank or for a banking system. This has been done and although ratios may be helpful as a starting point in analysing the capital adequacy of individual banks, they should not be considered as an end in themselves.

That says it all on cautious note not to over depend on any particular ratio as a catchall performance indicator for the financial adequacy of a bank.

c. Uniform Interagency Bank Rating System: In 1978, the federal bank regulatory agencies began using a new system for evaluating banks, the Uniform Interagency Rating System (UIRS) in the US (Luckett, 1984). Since one of the federal regulatory agencies using the UIRS was the FDIC, it is applicable to virtually every bank in the country.

The UIRS does not focus exclusively, on the adequacy of bank capital: Instead, it is concerned with the overall soundness of the bank, overall capital adequacy is only a part. The other aspect of the bank that are considered in rating soundness are: the quality of the bank's assets, the ability of the bank's management, bank earnings and the liquidity of the bank. These five areas of the banks are given a numerical score and then a "composite rating" from 1 through 5 is computed with 1 being the best and 5 being the weakest. Definitely the Nigerian banking system is beckoning for the establishment of such an agency to rate our banks.

With respect to capital adequacy specifically, examiners are required to assess the banks' current position with respect to such things as the volume of risk assets, the loan-loss experience and prospect for the future. Additionally, the access of the bank to capital markets may be taken into account to assure liquidity at all times.

One final point should be made about the measures of capital adequacy just discussed; in general, what is deemed adequate depends on the average of all banks, not on some absolute standard. The fundamental rule of thumb for a bank that is stays in line with other banks. In banking, as elsewhere it seems here is safety in numbers.

2.5. Commercial Bank Profiles

The concept of profits, though seemingly simple, is in practice rather vague. Profits can be measured in a number of different ways and each way has some logical support. Probably the most common used measure is the rate of return employed, (ROE), which is the ratio of the net income (after taxes) to capital. Thus:

$$\text{Profits} = \text{rate of return on capital} = \frac{\text{net income}}{\text{Capital}} \qquad (1)$$

Note that, since both net income and capital are in naira amounts their ratio is a rate or percent. By reworking equation (1) to get equation (2) thus:

$$\text{Profits} = \frac{\text{net income (assets)}}{\text{(capital) (assets)}} \quad \frac{\text{net income (assets)}}{\text{(assets) (assets)}} \quad \frac{\text{net income/assets}}{\text{capital/assets}} \qquad (2)$$

This new form of the equation gives us profits expressed as the consequence of to other ratios. The ratio in the denominator is our old friends the capital/asset ratio, discussed in the previous section. The ratio in the numerator indicates the average rate of return that banks make on their total assets. Clearly, anything that increases the numerator will increase the profit.

Bank profits depends largely on the capital/asset ratio. During the late 1960s and 1970s in the US and other western -economies, two factors were at work in increasing bank profits; a declining capital/asset ratio and a rising ratio of net bank income to bank assets. This latter ratio was raising because of generally higher interest rates and because of a shift in the composition of the bank assets from low-yielding United States government securities to high-yielding loans (Luckett, 1984; Rose, 1999).

2.6. Profitability Ratios: A Surrogate for Stocks Values

While the behaviour of a stock price is, in theory, the best indicator of a business firm's performance because it reflects the markets' evaluation of the firms performance, this indicator is often not reliable in banking (Rose, 1999). The reason is that most bank stocks, especially stock issued by smaller banks is not actively traded in international or national markets. This fact forces the financial analyst to fall back on surrogates-for market value indicators in the form of various profitability ratios, we single out two of such ratios to discuss here, in the context of our analysis.

Hence, two among the most important ratio measures of bank profitability used today are the following.

1. Return equity capital = net income after taxes
   (ROE) total equity capital
2. Return on assets = net income after taxes
   (ROA) total assets

Like all financial ratios, each of this profitability measures varies substantially over time and from banking market to banking market.

2.7. Interpreting Profitability Ratios

Each of the foregoing ratios looks 'at a single different aspect of bank profitability. Thus, ROA is primarily an indicator of managerial efficiency; it indicates how the management of the bank has been converting, the institution's assets into net earnings. ROE, on the other hand, is a measure of the rate of return flowing to the bank's shareholders. It approximates the net benefit that the shareholders have received from investing their capital in the bank (i.e. placing their funds at risk in the hope of earning an • suitable profit)). Of the two ratios, comparably, emphasis should be placed on the ROA, to build it up to a optimal level via utilization of computer personnel. It is the bank's managerial efficiency that grows greater net earnings or ROA, which will eventually lead to long-term survival of the particular individual banks, in particular, and survival of the banking system, in general. However, in Nigeria as at now, there is a misplaced priority as much emphasis is always being laid on ROE, to such a deplorable degree that a bank, Zenith Bank Plc, that has just concluded raising funds from the capital market to meet the prescribed N25 billion Naira capital base for banks, turned around afterwards to pay a dividend of 17k/share to its shareholders. What a travesty of faith, we have in Nigeria.

2.8. Commercial Bank Liability

It may sound a bit odd, but it is nevertheless the case that profitability banking depends on the ability of banks to go into debt; the bigger their debt, the more their profits. The reason for this, of course, is that banks earn interests on their assets, and in general, the amount of their liabilities. All of this is simply that liabilities of banks are their major sources of funds (Luckett, 1984). These liabilities can be classified into two categories: banks deposits and bank borrowings.

2.9. Bank Deposits

As the department stores, finance banks offer a wide product line of deposits for sale to consumers, businesses and governments. These deposits may be classified in a number of meaningful ways. Probably the most familiar of these is to distinguish among deposits by term to maturity basically, to distinguish among demand deposits and the various time deposits.

i. Demand Deposit i.e. all deposits of a commercial bank that are legally payable on demand that is, whenever the depositors wants.
ii. Saving and Time Deposits: There is a great hodgepodge of different kinds of earnings and time deposits. Their single identifying characteristic is that unlike transactions deposits, savings and time deposits may be subject to a waiting period, if the bank requires one, before they can be withdrawn (Luckett, 1984). Within this common characteristic, however, there is room for considerable variation, depending primarily on maturity, size, tax, status and government regulation with respect to the maximum interest rate which the bank is permitted to pay (Luckett, 1984)

2.10. Bank Borrowings

Although the vast bulk of the liabilities lie in deposits, banks also have other liabilities, most of which have already been described, notably repurchase agreements and the borrowings of federal funds and Eurodollars (Luckett, 1984). However, one bank liability has not been mentioned as yet because it is not a money market instrument and because it is small compared with things such as time and demand deposits. This is the ability of banks to borrowing form the Federal Reserve System or Central Bank, known as discounting. This liability is quite important.

2.11. Discounting

The Federal Reserve System, equivalent of our own CBN, is sometimes called a banker's bank because it lends money to banks and other depository institutions in much the same way that banks lend money to individuals and corporations (Koch, 1992), This process of Federal Reserve Lending is called discounting, and the rate of interest charged by the Federal Reserve is known as the discount rate. The importance of this does not so much in the dollar (or naira) volume of Federal Reserve (or CBN) loans respectively to depository institution as it does in the fact that discounting and the setting of the discount rate are one of the three main channels through which monetary policy is conducted. At this point an attempt to explain how this process works, may not be necessary, but we will keep at least the following two points in mind:

1. Depository Institution: Have an emergency source of funds available to them borrowing from the Federal Reserve (or the Central Bank)
2. When the Federal Reserve or Central Bank changes its discount rate, this fact is likely to be publicized on the front pages of newspapers throughout the country and influence setting of lion rates. In sum, discounting facility ensures a source of liquidity to commercial banks and minimum rediscount rate (MRR) acts as a guide for proper setting of loans rates to banks. The two factors or openings can be manipulated by the (i.e. equipment of our own CBN) for effective monetary policy management in the country.

2.12. Commercial Bank Assets

As previously discussed, in the long-run banks and other depository institutions grow and earn profits by expanding their liabilities (a source of funds) and acquiring assets (a use of funds), according to Uremadu (2000b). The assets of banks may be meaningfully classified into three categories: Primary reserve, Loans and Investments.

2.13. Primary Reserve

The distinguishing characteristics of the primary reserves of banks are that they are cash assets that is, they do not earn the banks rate of interest. Primary reserves may be further subdivided into required reserves and working reserves.

2.14. Required Reserves

As the name implies required reserves are the cash assets that banks and other depository institutions are required by law to hold. The law stipulates that required reserve be some definite percentage of the bank's transactions and time deposits (Uremadu, 2000a;2004). These reserves have two main functions. First they give the bank short-run liquidity. The bank is riot expected to hold the exact amount of its required reserve every minute of every day, but average reserves a percent deposits, where these items are averaged over a week or more. Thus, on any given day a bank may pay off deposits completely out of its required reserves as long as it makes up such a deficiency within the next few days, it can "buy time" with its required reserves until it can make more fundamental adjustments either in its assets or by borrowing (Luckett, 1984; Uremadu, 2004). The second function of required reserves has to do with the cdnduct of monetary policy. Since this has earlier been mentioned we shall not discussed this in detailed here, in this respect.

2.15. Working Reserves

Working reserves are cash that banks hold even though they are not legally required to do so (Uremadu, 2004). These reserves arise out of the nature of banking business, they "go with the territory". Foremost among the working reserves of a bank are its cash items in the process of collection, which are simply cheques on the other banks that a bank has had deposited with and that have been sent on for collection. Since it sometimes takes two or three days to collect these cheques, a bank will in the meantime carry them on its books as cash assets (Luckett, 1984).

Finally, some basic will hold excess reserves. By excess reserve is meant cash reserve over and above those legally required, for example, a member bank may hold larger balances in die Federal Reserve than required by law (Uremadu, 2000a; Uzoaga, 1981). In general, big banks bold almost no excess reserves; they figure their non-earning assets with a very sharp pencil indeed. Most excess reserves are held by small banks, where the bankers are harassed by so many different tasks that it is uneconomic for them to engage in the time and expense necessary to adjust their reserves position exactly every week. Even so, with the rise in interest rates in the past few years, the excess reserves of even small banks have fallen substantially. This does not augur well for the banking system in particular, and the economy in general.

2.16. Commercial Bank Loans

It is clear the bankers themselves regard their lending activities as lying at the heart of commercial banking (Compton, 1983). Not only are loans a very profitable type of asset for the bank to hold in terms of sheer earning power, but they also have the additional advantages of attracting deposits and providing a necessary service to the community. But bank loans also have their disadvantages. On the whole, they are the most risky of bank's assets that is the most subject to default. Additionally, they are illiquid; they can seldom be converted into cash before maturity. Bankers are therefore, understandably cautious in making loans insisting on very high standards of credit worthiness (Jessup, 1980; Koch, 1992; Luckett, 1984; Rose, 1999; Uremadu, 2000a;2004; Uzoaga, 1981).

2.17. Commercial Bank Investment

By investment is meant open market securities held by banks. Banks investments arc generally regarded as a residual claimant on bank funds; that is they are considered to be die lowest priority of bank assets. Only after a bank has taken care of its primary reserve needs and has met all the legitimate loan demands of its customers to long-term investments. Indeed, in some of the tight money episode of records years, many large banks had no investments at all; primary reserves and loans had exhausted their funds (Rose, 1999).

While banks may hold investments in corporate bonds, only a. few banks do so. For all practical purposes, bank investments are held in three types of securities in America: United State government bonds, municipal securities, and so-called agency bonds (Luckett, 1984) for details. The Nigeria monetary authorities should emulate them in this regard.

2.18. Skill of Bank Management/Competence of Personnel

It cannot be true that if a depositor puts his/her money in a well capitalized banking firm, he will undoubtedly be rest assured for its safety even in the absence of a competent bank personnel (Soludo, 2004). The above insinuation or remark can be regarded as an over statement because even if a particular bank becomes well capitalized arising from the ongoing consolidation exercise and at the same time lacks competent management team, chances of its survival in the long-run is in doubt.

This fact should be well understood by the monetary authorities, owners of banks and the bankers themselves as they enter into mergers and acquisitions bids targeted to meet the N25 billion bench mark stipulated for a capital base of a Nigerian lending bank, Against this backdrop, we shall discuss, under two subheadings, the expectations form the management team of an emerging consolidated banking environment.

2.19. Poor Corporate Government/Management

It has become a worldwide assumption that the quality of corporate governance or management makes an important difference to the soundness or unsoundness of banks. The US ascribed over 90 percent of bank- failures, since deregulation to poor management (Alashi, 2003; Rose, 1999). Just as it in other parts of the world so it has been established in Nigeria, that mismanagement is the main cause of banking crisis (Alashi, 2003). His study confirms that a significant characteristic of bank management in Nigeria is the negative attitude and behaviour of bank managers, which is often difficult to reverse by the application of external policies and measures.

2.20. Effective Market Discipline

This too is associated with the nature of corporate governance in existence in a banking firm. Effective market discipline as a pre-condition requires that there exists a culture of transparency and the presence of good corporate governance. It is thus expected that bank-lending decisions are carried out in strict commercial sense and without political pressure from the government. In a study carried out by Uremadu (1990) it was found that most indigenous banks have been bedeviled or ruined as a result of political, interference interest, by regional r state politicians and their operatives. For example, the study establishes that ACB Ltd, NBN Ltd, and BON Ltd., are among such banks that were brought to a sorry state due to political interference in their management set-up. Banks are expected to operate credit risk thresholds that are driven strictly by the long-term growth outlook and the safety and soundness of their institutions as the focus (Benston and Kaufman, 1988). However, this has never been the case with the banks in Nigeria, hence, bank failures became rampant.

2.21. Sizes and Profitability Banking

Part of the purpose of this paper is to provide information using conceptual and theoretical literature on whether small banks can operate profitably in the midst of mega banks under the current, consolidation of Nigerian banks. Such information should provide indirect evidence on the ability of small banks to adjust to changing competition and economic conditions. Since deposits rate deregulation has been almost totally completed, and perhaps products and geographical deregulation are still in progress, the evidence provided from our earlier discussions may be more relevant to assessing the effects of this-one aspect of deregulation. Nevertheless, as shown above in this descriptive analyses of conceptual and theoretical literature on size and profitability in banking under a re-capitalized banking system, there appears to be little evidence thus far to suggest that small banks will be unable to survive arid perhaps prosper in a deregulated Cum-consolidated banking environment. As a matter of fact, all evidence from our analyses of indices of bank capital adequacy, performance and corporate governance, point to the fact that both the small and bigger banks cannot only co-exists but they can also operate profitably provided they have a crop of competent management team who can manage their assets and liabilities within a balanced mix so as to make adequate profit that will enable them to trudge ahead in the industry (Kolari and Fraser, 1984).

The ability to earn reasonable levels of profit is crucial to any private business organization. Profits provide a source of internal capital growth and a potential base upon which borrowing funds may be added. Profits also provide a source of dividend payments to shareholders and an inducement to shareholders in raising new equity. While profits are important to all private organizations; they are particularly, important to commercial banks (Kolari and Fraser, 1984). To all intents and purpose, profits at commercial banks are frequently the only realistic source of equity capital, especially for small banks. Given the equity capital standards currently applied by the regulatory authorities in Nigeria, adequate profits are necessary to allow banking organizations to grow.

3. Summary of Findings, Recommendation

3.1. Findings and Recommendations

We shall now summarise the findings from this paper and subsequently recommend what we think to be an appropriate policy action to be taken in order to remedy the problems.

1. The study established that the banking sector serves as a catalyst for growth and development in any economy and as such banks are able to perform their role through their functions of financial intermediation, provision of an efficient payments system and facilitating the implementation of 'monetary policies.

In a bid to promote efficient intermediation and ensure protection of depositors, encourage healthy competition, maintenance of confidence and stability of the system besides protection against systematic risk and collapse. Nigerian monetary authorities should at all times take special interest in evolving, an efficient banking environment that assures safety, soundness and stability of the banking system in Nigeria.

2. Another finding of the paper is that bank regulators world over have always been concerned with the size of a bank's capital relative to the size of the bank. Their reason for being so concerned is that capital accounts represent a buffer between mismanagement of the bank and losses suffered by depositors.
3. We also discovered that two provisions stand out in America.

i. Laws that typically require progressively higher capital for a bank, the larger the size of the town in which it does business.

ii. That national banks are prohibited from paying dividends to their stockholders until they have built up a surplus account at least equal to the size of their stocks.

Here, we recommend that consolidations be made to fix different required capital bases for banks according to their sizes. That a blank sum of N25 billion capital should not hold water. Rather, banks should be categorized on the basis of their size while fixing their capital bases. Secondly, there is serious need to prohibit Nigerian banks from paying, dividends to their shareholders until they have built up a surplus account at least equal to the size of the capital stock. A case where Zenith Bank, PLC which has just returned from the capital market to raise funds to make up for the required capital base of N25 billion, and paid a dividend of 17k per share afterwards should be seriously discouraged.

4. It was also discovered that the capital requirement is presently tied to the risk profile of the assets that banks are carrying in western economies. This practice should be copied in Nigeria.
5. Study besides found out that, bank regulatory authorities in a bid to protect the interest of the depositing public, have traditionally favoured high capital/asset ratios for commercial banks. On the other hand, bank stockholders have the objectives of seeing that profit rare is maximized. Hence, a dilemma is faced by bank management as to striking a balance between profitability and liquidity.

We thus strongly recommend that bank regulators should be flexible in formulating policies that allow bankers to balance liquidity with profitability so that their banks do not go under.

6. A major discovery of this paper is that argument bankers put forward in America after World War II, that the increased percentage of their assets held in the form of government securities made such safer repositories of depositor’s funds. They sought for a lower capital/asset ratio (provided they maintain a proportionate volume of liquid asset in their account). This has resulted in a new measure of capital adequacy, the capital/risk-asset ratio. Using these measures, those banks with fewer loans and more cash and government securities than other banks would be permitted smaller capital accounts relative to their size.

We strongly recommend application of this new measure of capital adequacy in Nigeria as it has been in existence in the US ever since the end of World War II instead of resorting to twisting a blanket fixed capital base for all banks in Nigeria. We reiterate that there is serious need to go the extra mile in employing several measures (i.e profitability/liquidity ratio) to evaluate the adequacy of banks capital and profit rather than just dwelling only on one, the capital/asset ratio.

7. Study, in addition, observed that the overall soundness of the bank does not depend only on capital adequacy. But that the other aspects of the bank that are considered in rating soundness include the quality of the bank's assets, the ability of the bank's management, bank earnings and the liquidity of the banks.

The regulatory authorities should therefore not focus attention exclusively on the adequacy of bank capital. They should put their other factors into consideration while formulating policies that influence bank and profitability.

8. We equally discovered that financial ratios stand out for measuring bank profitability. Return On Equity capital (ROE) and Return On Assets (ROA). That of the two, ROA is primarily an indicator of managerial

efficiency and it judges how capable the management of the bank has been on converting the banks' assets into net earnings while ROE, on the other hand, is a measure of the bank rate of return flowing to the bank's shareholders.

We hereby recommend that of these two ratios much emphasis be placed on the ROA, to build it up to an optimal level, since it is me bank's managerial efficiency, which grows greater net earnings that eventually translates into long-term survival of the bank.

9. Study additionally established that the profitability of banking depends on the ability of banks to go into debt, hence the bigger their debts, the more their profit. Reason being that banks earn interest on their assets, which derived from the quantum of their liabilities or deposits.

Hence, we recommend, here and now, those banks manage both their assets and liabilities well, or combine them in a right mix, so that neither liquidity nor profitability suffers in the final analysis. Specifically, there is room for considerable variation in their asset/liability mix depending primarily on maturity, size, tax, status and government regulation with respect to the maximum interest rate that the bank is permitted to pay.

10. We discovered from the study that there exists another source of liquidity open to banks at the central bank, discounting.
11. Moreover, it was ascertained that discounting and the setting of the discount rate (MRR) are one of the three channels through which monetary policy is conducted
12. Study profoundly established that banks keep all kinds of reserves; primary reserves required reserves, working reserves and excess reserves. That these reserves are cash assets and they do not earn a return but they assure liquidity.

Since they are kept to beef up the liquidity profile of the bank and they earn no profits, bank management should strive to maintain the right size of bank reserves in order to strike a balance between liquidity and profitability in banking business (Uremadu, 2000a; Uzoaga, 1981).

13. Study further ascertained that commercial bank loans are very profitable in two respects:

i. In terms of sheer earnings power, and
ii. They attract deposits

However, they are the most risky of all bank assets because they are the most subject to defaults.

We thus recommend that banks should blend their loan accommodations in such a manner as to balance expectations of profitability with that of risks of defaults. Nigeria bankers henceforth should be very cautious in making loans, insisting on very high standards of credit worthiness and be responsible to the economy in their lending (Uremadu, 2000a)

14. We also found out that many large banks in the United State had no investment at all, in open market securities because it is very risky to do so.

Nigerian commercial banks should learn to minimize their investments in corporate bonds, venture capitals and or engage in round tripping of forex.

15. Study profoundly established not to be true that if a depositor puts his or her money in a well capitalized bank that may be lacking in management competence that his/her money can still be safe. It was clearly underscored from the study that once a banking firm has management competence that they can turn around the bank's assets into profitability via efficient financial intermediation (Compton, 1983; Kolari and Fraser, 1984), notwithstanding volume of their capital base.

The Hallmark of bank performance therefore lies in the recruitment of the right personnel to man the affairs of the bank. Success does not lie in the size. Small can still be beautiful! A lot of lessons to the implementers of the policy on bank re-capitlaization in Nigeria (Uzoaga, 1981).

16. Paper finally discovered size and profitability cannot always go together (Benston and Kaufman, 1988; Uremadu, 2000a;2004; Uzoaga, 1981).

Hence, a small bank can still operate side by side with a supermarket or mage bank and still be profitable provided it can manage its assets and liabilities well to ensure a balanced structure that will eventually lead to long-term survival of the bank in question.

4. Conclusion

In this paper, so much has been said on the indices of bank capital adequacy, performance and corporate governance. The study has made several discoveries as well as proffered solutions. Among the findings of the study include: efficient financial intermediation leads to growth and development of the economy, that re-capitalization should be tied to the size of the bank and the environment where it operates; that bank capital requirement should be tied to its risk profile, that balancing liquidity and profitability via ensuring a balance in bank's capital/assets ratio should be a hallmark for efficient bank regulation; that overall soundness of a bank does not only depend on capital adequacy but also on the quality of the bank's assets, ability of the bank's management, bank earnings and liquidity of the bank, that MRR is an additional source of liquidity to the bank; it also influences setting of loan rates by banks; that commercial bank loans are very risky due to high defaults; .that banks should minimize their investment in corporate bonds; that small can exist side by; side with supermarket banks in so far they have competent personnel who effectively manage their assets and liabilities to make reasonable profits; and that it is never true that only adequate capital base ensures' bank survival in the absence of other health indicators of bank's financial soundness. Hence, we strongly urge that Nigerian monetary authorities and commercial banks should have a serious look at our findings and implement our recommendations if the Nigerian banking system should come out of the re-capitalization exercise strong and be better consolidated in the 21st century. A stitch in time saves nine they say.

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