PDF - THE EFFECT OF CAPITALIZATION ON THE FINANCIAL INSTITUTION IN NIGERIA - researchcub.info**ABSTRACT**

This research investigate the effect of capitalization on the Nigeria financial system. Using ten selected banks which include the banks that merged, acquired and neither merged nor acquired. The research employed the secondary data obtained from the annual reports and accounts.

Ordinary least squares method (OLS) regression method was used, with the equity capital a the independent variable, while the three indices (profitability, liquidity and capital adequacy ratios) were used as the independent variables: These paprameters were modeled into the linear Regression models I,I and III. The Pearson's product moment correlation coefficients ® of each model were obtained and interpreted for each model.

The statistical tools used for interpretation and F-test, t-test and Durbin- Watson test statistic. The result shows that majority of the banks that have enough equity are also profitable e.g. banks like First Bank Plc and Intercontinental Bank. However the result shows that a bank can be profited and yet not liquid e.g. UBA. Majority of the banks are adequately stable meeting up standard reslt 5:1. The research concluded that the reform was a success because it brought improvement and stability in the sector

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# CHAPTER ONE

## 1.0 INTRODUCTION

The Oxford mini-dictionary explains that capital is “accumulated wealth” or “money with which a business is started’ in banking, capital has these two meanings. At the out-set, capital in the form of issued and paid up shares is money with which the business is started. Overtime, the capital funds of the bank reflect the accumulated (addition of depletion of capital in goods producing business, the needed for capital is obvious as this is required to provide for substantial fixed capital resources in the form of building, plant and machinery and even working capital in form of raw material. The need for capital is not the same for business organizations. In the financial services industry, market forest and contemporary history have accentuated the need for higher capitalization of banks. The professional know how of the operators is another key factor in the inter mediation between the savers and the borrowers. Thus the first banker the

Gold smith did not require additional capital beyond what he had. However, today the ingenuity of the banker has been developed so much that we can talk of the banker being engaged in financial engineering.

The federal government of Nigeria, in its annual 1997 budgets, announced the decisions to raise minimum paid-up capital for new banks to N2 billion leaving the existing one to its N500 million. The reason for the N2 billion minimum capital requirements could be broadly classified into the following:

- To curb the current distress in the banking industry by injecting fresh funds into the system with a view to enhancing the financial viability of the banking industry. It was banks which have had their capital bases eroded by inflation believe that the injection of new funds in the form of capitalization would give a new lease to live to most banks operational losses and bad credits.
- To ensure capital adequacy in providing initial an subsequent basic infrastructure for banks operation and expansion without undue reliance on external funding.
- To ensure conformity with international standard in view of the depreciation of the country's currency vis-à-vis other major international currencies.

In the recent times, when the Apex Bank realized that the paid up capital did not yield tangible success in terms of management of financial institutions from being distress, the central Bank of Nigeria (CBN) in July 2004 came up with a major policy reform that required bank licensed in Nigeria to increase their paid-up capital to a minimum of N25 billion on or before December 31$^{st}$ 2005.

The new requirement initially raised a lot of dust and became a subject of desirability and feasibility of such high quantum of capital base. However, the emphasis of players in the industry has since shifted o the modus operandi for attaining the target amount by the stipulated date. In the months following the pronouncement, many of the banks resorted to private placements with high net worth individuals and institutional investors to raise the short fall (between the current balance sheet figures and the new required amount). The inadequacy of that option only became apparent when many of the banks (led by all states Trust Bank and four others) began to initiate and sign memorandum of understanding (MOUS) for merger and acquisition with one another.

The recent announcement from the CBN Governor for a new minimum capital requirement of N25 billion for banks, is necessary, since larger capital adequacy was required to create a strong and viable banking system with minimal distress and meaningful contribution to the growth of the Nigerian economy. Anticipating inability of some banks to singularly satisfy this capital requirement, the Governor has emphasis zed merger and acquisition as a viable strategy.

**1.8 STATEMENT OF THE PROBLEM**

This research study to highlight major weakness in the banking system. A combination of many weak elements of financial institutions could jeopardize the health of the system. These results primarily from the extraction of which are made possible through weak regulatory system frame work, poor corporate governance and structure of the banking system. In view of these, the facets of banking reforms aimed at ensuring a healthy ambience. The vortex of the reforms is around firming up capitalization. Therefore, capitalization is an important component of reforms in the banking industry, owing to the fact that a bank with a strong capital base has the ability to absolve losses arising from non-performing liabilities. This is attained through consolidation, convergences as well as the capital markets. Thus stabilities are primarily driven by the need to achieve the objectives of consolidation and convergence and competitions ( Deccan, Herald 2004).

Majority of the back drop of banking crisis was due highly under capitalization of state owned banks. This research study tends to look into diversities of the major crisis that arises with undercapitalization.

## 1.9 OBJECTIVES OF THE STUDY

Realizing that various ad-hoc distress resolution strategies had not significantly achieved the desired objectives in terms of the safety, soundness and stability of the financial system. The present study was initiated. Its aim is to objectively determine the real causes of the current distress in the financial services industry as a basis for re-assessing various distress resolution strategies already embarked upon.

The specific objectives of the study are:

- To investigate the desirability or other wise the increased minimums capitalization requirement for banks as the basis of improvement in banking viability.

As banking viability is the major factor being adduced or the large increase in the minimum capital requirement, it therefore becomes necessary.

- To examine the relationship between the two variables (capitalization amongst Nigerian banks ) with a view of studying the performance
- To highlight the implication of the role of capitalization in the financial performance of banks in Nigeria.
- To see how capital formation facilities and promotes economic growth by operating a safe and sound manner.
- To see how capitalization promotes soundness stability and enhance efficiency of the system, to achieve the goals of protecting depositors ensuring monetary stability and efficient and competitive financial system.

## 1.10 RESEARCH QUESTIONS AND HYPOTHESIS

For the purpose of this investigation, there will be a need to ask the following research questions in other to guide our understanding of the topic, these include:

- Why is huge capitalization requirement capable the viability and health of Nigerian banks?
- Why is capitalization a necessary factor for banking viability in Nigeria?
- Would the large capitalization requirement not lead to liquidation, mergers and acquisitions and other impediments to vibrant competition in the banking industry?
- What are the effects of capitalization on the stability of banks in Nigeria?

**HYPOTHESIS 1**

**HO**: There is no significant bank relationship between capitalization and economic growth in Nigeria

**HYPOTHESIS 11**

**HO:** There is no significant relationship between capitalization and bank stability.

## 1.11 JUSTIFICATION OF THE STUDY

The banking sector in the financial landscape needs to be reformed in other to enhance its competiveness and capacity to play a fundamental role of financial investment. Recently, the financial sectors have not met this spectaculars objective. The essence of banking to any nation's financial management is like what lungs are to heart of human being. Nigeria have had bank failure, however, funding revealed that its calamity was as a result of inadequacy of the capital base to trade with.

The major objectives of the banking system are to ensure price stability and facilities rapid economic growth and development. Regrettably, these objectives have remained largely unattained in Nigeria as a result of some deficiencies of which low capital base has contributed immensely to majority of banks failure. The failure of big banks in Nigeria (e.g the old National Bank) has the propensity to cause significant social and financial disease for the economy.

This research study in lieu of the above will like to see if the share holder capital is huge and adequate than it will both be able to absorb to large extent, harsh deposit withdrawals and create a good level of confidence necessary to curtail financial panic. It is also imagined that a reasonable capital adequacy requirement is a pressure on the stakeholders to insist on prudent and skilled management of their bank: hence there is the urgent need for permanent solution in ensuring that banks do not fail any more in Nigeria, thereby sustaining, strengthening and improving the health of the country's financial system. Hence, there is urgent need for permanent solution to this vital area of the economy

**1.12 SOURCES OF DATA AND METHODOLOGY**

The main of data for this research is going to be secondary data, to be retrieved from CBVN quarterly Reports, NDIC reports annual reports of ten banks (randomly selected). The Nigeria banking finance and commerce publication of reputable publisher's e.t.c.

Data analyses would be by statistical inference in nature from the collected data, indices would be completed for profitability, liquidity and capital adequacy, representing the dependent variables.

The nominal level of equity capital represented the independent variables. The bank would be arranged in a table in descending order of equity ranking with their ranks.

Using the Pearson product moment correlation co-efficient® (PMCC) method a coefficient would be obtained for each dependent/independent variable relationship. This coefficient will determine the pattern and extent of relationship between equity capital and each of the three dependent variables .The correlation coefficient would be tested for validity using the student's t-distribution at 95% confidence level. Thereafter, a repression analysis would run for those relation ships which would show significant correlation.

The population size for this research is based on random selection and ten banks have been randomly selected for the test of hypothesis. These are:

First Bank Plc.
Intercontinental Bank Plc
UBA Plc
Union Bank Plc
FCMB
IBTC Chartered Bank Plc
Zenith International Bank Plc
Fidelity Bank Plc
Guaranty Trust Bank
10. First in Land Bank

**1.13 SCOPE AND PLAN OF THE SUDY**

This research is limited to a sample drawn from among Nigeria commercial new generation banks only. The data to be analyzed is limited to the statement of account from 1980 to 2005 for respective samples.

This research study would be di8vide into five (5) inter-related chapters.

A brief over-view of each chapter is given below

**CHAPTER ONE**

This chapter one provides an introduction to the research work. Discussions here are: statement around the objectives of the study, statement of research problems. Justification of the study and the scope of work, others include discussion on sources of work data and research methodology.

**CHAPTER TWO**

This review the related literatures and theoretical and conceptual frame work of banks capitalization.

**CHAPTER THREE**

This is the research methodology which is going to state the hypothesis to be tested and the measure to test these hypotheses

**C H A P T E R F O U R**

If summarize the study, draw up recommendations and conclusion

**1.14 DEFINITION OF DIFFICULT ITEMS**

In other to facilitate reading, there is need to define some terminologies to reflect their deep meanings according to the reach. These technical terms include:

- Capitalization: Referring to the process of strengthening the capital base of a financial institution.
- Stability: Referring to the financial position of a bank.
- Viability: Defining low healthy a bank is in terms of its financial obligation.
- Distress: The state of a bank in un-performance stage.
- Merger/consolidation: The fusion of two or more enterprises through direct acquisition by one of the net asset of the other or others.
- Acquisition: To acquire
- Market Capitalization: The most commonly used method s for companies quoted on NSE.
- NSE: Nigerian Stock Exchange
- SEC: Securities and Exchange Commission