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AN OVERVIEW OF FINANCIAL SECTOR REFORMS AND INTERMEDIATION IN NIGERIA

BY

***George Okorie and Uche J. Uwaleke*[3]**

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INTRODUCTION

Financial systems all over the world play very important roles in the development and growth of the economy. However, the effectiveness and efficiency of the system as well as its scope and capacity varies quite considerably among economies. This is partly because of the varied levels of development. More developed financial systems tend to be associated with the more developed economies. However, a sufficiently rigorous understanding of the emergence, development, and economic implications of different financial structures in the development process is absent (Levine, 1997).

A well-developed financial system fosters robust efficient and vibrant financial markets, which facilitate sustained economic growth. Developing countries have small financial systems. This is largely a reflection of their modest gross domestic product (GDP) and macroeconomic policy. The relative small size of banking, capital and pension markets has hindered the achievement of economies of scale and scope and reduced competition. For these countries, the aim should be to develop, over time, an efficient and sustainable system of financial development and intermediation for economic activities to thrive.

Financial sector reform can be defined as a set of policy measures designed to transform the financial system and its structures with a view to achieving a deregulated market-oriented system within an appropriate regulatory framework. It is also the introduction of market-based procedures for monetary control, the promotion of competition in the financial sector, and the relaxation of restrictions on capital flows (Waqabaca, 2000).

Financial intermediation facilitates the savings and investment process through the mobilization of savings from the surplus units to investment by the deficit units. Van Wijnbergen (1990) notes that interest rate, among others, is a major policy instrument with the most influence on savings. According to him, private portfolio choice/ allocation is also a function of interest rate. Financial services therefore encourage savings if they raise the net returns by raising the interest rate on savings. Higher real interest rates in turn are likely to lead to financial deepening as savers switch some of their savings from real to financial assets and from foreign to domestic assets. Conversely, negative real interest rates discourage holding of financial assets.

The ability of the financial system to mobilize savings and hence contribute to investment and economic growth depends on the quality of financial services, and the effectiveness and efficiency of the financial system. Since one objective of the financial system (apart from the operation of the payments mechanism) is to mobilize finance for investment, the system can be judged to be effective when it is able to contribute to or raise the level of investment needed to achieve growth in the economy (Ndekwu, 1998).

Nigeria's financial system in common with those of many developing economies, particularly African economies, has for the greater part of the country's history been severely repressed. For most of the period since independence in 1960, intermediation was ineffective, as interest rates were held at very low levels, following excessive government interference with the system. In 1987, the authorities commenced extensive reform of the financial system as part of a Structural Adjustment Programme (SAP). Reforms involved liberalizing interest and exchange rates, promoting a market-based system of credit allocation, enhancing competition and efficiency in the financial system and strengthening the regulatory framework. Since the SAP reforms, the financial sector has experienced various phases of reforms. The importance of financial sector reforms in Nigeria derives from the fact that the foundation for economic growth is fragile, particularly vulnerable to a drop in oil prices.

This paper focuses on the impact of

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various financial sector reforms on financial intermediation in Nigeria. In other words, it focuses on the effects of various policies on the sector's ability to effectively perform its financial intermediation role. One way to evaluate the financial sector reform is to make a comparison between pre- and post- reform performances of the financial sector using appropriate financial ratios. An alternative is to make a cross-section comparison with countries in the same (analytical) group as Nigeria. Whichever way is adopted, the following pertinent questions are raised:

- to what extent has financial sector reforms resulted in financial deepening, scope and quality of intermediation?
- to what extent has the measures to improve the capital markets led to increased resource flows to the markets?
- to what extent has measures to improve the banking system led to the promotion of banking habits?

The remainder of the paper is organized into five sections as follows: Section 2 undertakes a broad review of literature on the subject. Section 3 surveys Nigeria's experience with financial repression, liberalization and reforms, while Section 4 reviews the post-liberalization/reform performance of the Nigerian financial sector. Section 5 summarizes, provides policy recommendations and concludes the paper.

2.0 THEORETICAL AND LITERATURE REVIEW

The theoretical link between financial sector reforms and intermediation is found in the financial liberalization theory of McKinnon (1973) and Shaw (1973). The McKinnon-Shaw hypothesis postulates that government control and intervention in the financial system, limits the operation of market mechanisms, leads to financial repression, and slows economic growth and development. Under financial repression investment is repressed by a shortage of savings, which results from administered real interest rates at below market-clearing levels. Liberalizing the financial sector however, causes real interest rates to rise, thus generating more domestic savings and investment.

According to the World Development Report (1989), a financial system provides services that are essential in a modern economy. The use of a stable and widely accepted medium of exchange reduces the cost of transactions, facilitates trade and exchange and, therefore, specialization in production. Financial assets with attractive yield, liquidity, and risk characteristics encourage financial savings. By evaluating alternative investments and monitoring the activities of borrowers, financial intermediaries increase the efficiency of resource use.

Financial systems aid economic growth by augmenting the liquidity needed for long-term investments. Liquidity risk arises due to the uncertainties associated with converting assets into a medium of exchange. Informational asymmetries and transaction costs may inhibit liquidity and intensify liquidity risk. Based on these frictions, the emergence of financial markets and institutions to augment liquidity becomes necessary. The link between liquidity and economic development arises because some high-return projects require a long-run commitment of capital, but savers do not wish to part with their savings for long periods. Thus, the financial system moves in to augment the liquidity needed for long-term investments, thereby helping to avert the reduction in investments that would have occurred in the high return projects (Mckinnon, 1973, Shaw, 1973). Hicks (1969) contend that the financial system, which played the role of mitigating liquidity risk, was behind the industrial revolution in England.

Agenor and Montiel (1996) express the view that financial intermediaries increase the average productivity of capital (thus the growth rate) in two ways: (a) by collecting, processing, and evaluating the relevant information on alternative investment projects; and (b) by inducing entrepreneurs, through their risk sharing function, to invest in riskier but more productive technologies. By accepting demand deposits and choosing an appropriate mixture of liquid and illiquid investments, banks provide high levels of insurance to savers against liquidity risk while simultaneously facilitating long-run investments in high return projects.

A major impediment to the efficient functioning of the financial system is asymmetric information, a situation in which one party to a financial contract has much less accurate information than the other party. For example, a borrower who takes a loan usually has much better information about the potential returns and risk associated with the investment projects the loan will finance than the lender does. Mishkin (1997) identifies two basic problems associated with asymmetric information. These are (a) adverse selection and (b) moral hazard.

Adverse selection is an asymmetric information problem that occurs before the transaction. This exists when the parties who are most likely to produce the most undesirable (adverse) outcome are the most likely to be selected for a loan. Borrowers who want to engage in big risks are likely to be the most eager to take out a loan because they know that they are unlikely to pay it back. Since adverse selection makes it more likely that loans might be made to bad credit risks, lenders may decide not to make any loans, even though there are good credit risks in the market place.

Moral hazard is an asymmetric information problem that occurs after the transaction. The lender is subjected to the hazard that the borrower has incentives to engage in activities that are undesirable (immoral) from the lender's point of view because they make it less likely that the loan will be paid back. Moral hazard occurs because the borrower has incentives to invest in high-risk and sometimes in unprofitable projects in which the lender bears most of the loss if the project fails. The conflict of interest between the borrower and the lender stemming from moral hazard (the agency problem) implies that many lenders will decide that they would rather not make loans, so that lending and investment activity will be at low levels.

Moral hazard can also occur if high enforcement costs make it too costly for the lender to prevent moral hazard even when the lender is fully informed about the borrower's activities. Information acquisition costs create the incentive for financial intermediaries to emerge (Diamond 1984). The existence of financial intermediaries, economizes on information acquisition costs, hence, facilitating the acquisition of information about investment opportunities and thereby improves resource allocation. Also, financial intermediaries can set-up special arrangements and contracts, such as the collateralization of credit, to generate the correct incentives (Gross, 2001)

As noted earlier, one major role of financial intermediaries which influences growth in a positive direction is the mobilization of savings. According to Levine (1997), mobilization involves the agglomeration of capital from disparate savers for investment. Mobilizing the savings of many disparate savers may be costly as it involves (a) overcoming the transaction costs associated with collecting savings from different individuals and (b) overcoming the informational asymmetries associated with making savers feel comfortable in relinquishing control of their savings. Financial systems that are more effective at pooling the savings of individuals can profoundly affect economic development. Besides the direct effect of better savings mobilization on capital accumulation, better savings mobilization can improve resource allocation and boost technological innovation.

Shortage of savings is likely to be a limiting factor for investment. An increase in national savings has a substantial effect on the level of investment, as investment must be supported by saving and domestic firms compete for the flow of available domestic saving. Asamoah (2008) notes that the extent to which financial sector reform are successful in promoting saving, investment and growth depend on the interest rate elasticity. The real rate of interest exerts a positive influence on the ratio of savings to the Gross National Product (GNP). The positive association between the rate of savings, investment and growth is usually explained in terms of a causal link running from the former to the later. However, higher growth might drive savings up, leading in turn to higher investment.

According to Agenor and Montiel (1996), the term 'financial repression' is due to analysts who take their lead from McKinnon (1973) and Shaw (1973). According to these authors, the financial system in many developing countries is 'repressed' (kept small) by a series of government interventions that have the effect of keeping very low (and often at negative levels) interest rates that domestic banks offer to savers. To a large extent, the motivation for this type of interventions is fiscal; the government wants to actively promote development but lacks the direct fiscal means to do so, because of either a lack of political will or administrative constraints.

By keeping interest rates low through the imposition of ceilings on lending rates, it creates an excess demand for credit. It then requires the banking system to set aside a fixed fraction of the credit available to priority sectors. This system has implications both for economic efficiency and for the distribution of income. The combination of low rates of return on assets and high reserve requirements implies that even a competitive banking system will be forced to offer low interest rates on deposit liabilities: because this is the only way to achieve an adequate spread.

In many developing countries, the combination of low nominal deposit rates and moderate to high inflation rates has resulted in highly negative rates of return on domestic financial assets, with an adverse effect on savings and the financial intermediation process. This in turn has provided the wrong 'target' rate of return against which to judge investment projects.

The portfolio effects of interest rates ceilings encourage financial disintermediation, as savers are induced to switch from the acquisition of claims on the banking system to accumulation of real assets traded in informal markets, and foreign assets. In all, financial repression tends to induce disintermediation, which can take the form of the emergence of a domestic informal credit market or financial intermediation through external financial markets which can lead to capital flight (Agenor and Montiel, 1996).

According to Roe and Sowa (1997), the objectives of financial sector reform which includes the liberalization of interest rates are linked to the view that more and better financial intermediation is a critical factor in the productive system of an economy. In other words, financial sector reform gives rise to better intermediation.

Oloyede (1998), writing about the Nigerian financial system, is of the view that the main objectives of financial sector reform are to: (a) improve mobilization of domestic savings (private and public) by implementing measures to develop money and capital markets; (b) improve the level and structure of interest rates through reduction of interest rate subsidies and bad debt or through liberalization of interest rates and the introduction of prime rate or base lending rate system.

A wave of liberalization of financial markets swept over much of the developing world, beginning in the mid-1980s when these countries embarked on the reform of their financial systems. This liberalization has been characterized by greater scope being granted to market forces in determining interest rates and in allocating credit. Although this has occurred under the pressure of increased globalization of financial markets, and following the example of many industrial countries, there has been an expectation that financial liberalization would aid intermediation and consequently impact economic growth. In particular, the early literature on financial liberalization stressed the potential role of higher interest rates in mobilizing savings that could be put to productive use. Bandiera, Caprio and Honohan (1999) are of the opinion however, that financial liberalization may actually not increase private saving. According to them, the effect of interest rates on saving is ambiguous, as the income effect might offset substitution effects.

Based on the econometric results of their study, they advised that it is at best unwise to rely on an increase in savings as the channel through which financial liberalization can be expected to increase growth.

It is important to note at this juncture, that ending repression and introducing reform is not a smooth process. There are many aspects of the initial conditions in a reforming economy that are likely to influence the prospects of success of financial reform. Roe and Sowa (1997) identifies two of these conditions as being of pre-eminent importance. These are: the portfolio quality of the domestic banking system; and the size of the fiscal deficit. According to them, it is impossible to expect banks to make the correct responses to policy instruments, including interest rates associated with market-based methods of monetary control, when these banks, are insolvent or nearly so. Also, it may be unrealistic to expect governments with very large fiscal deficits to surrender the easy sources of implicit taxation associated with tightly controlled financial systems, or to make the very large fiscal adjustments that would enable them to balance their books without having to depend on these easy sources of revenue and borrowing.

Liberalization no doubt, is essential to the growth of an economy. However, there exists a mixed feeling as to the actual role of liberalization. While it is believed that liberalization will give interest rates an upward push which will stimulate private savings and investment, the high lending rates which liberalization is likely to also induce, increases cost of production and consequently reduce the utilization of savings (Fajana, 1990).

Ang and McKibbin (2005) note that despite the fact that financial liberalization enlarged the financial system in Malaysia, it does not appear to be effective in promoting long term growth. Financial liberalization is unlikely to result in higher economic growth without an efficient and well-functioning financial system. To accelerate growth, the financial system must be properly shaped before under taking any liberalization program. Policy makers must ensure that while encouraging the expansion of financial systems, no excessive inflation and sub-standard loans are created. It is imperative that proper regulatory structures and a healthy economic climate are already in place before liberalization is carried out.

Ikhide and Alawode (2001) discovers that the implementation of financial sector reforms in Nigeria has been disappointing as bank insolvency, high inflation and excessively high interest rates have become common phenomena in the economy. Their study identified wrong sequencing process as a major factor in the poor performance of financial sector reforms.

To measure the provision of financial services, most studies such as (Levine, Loayza and Beck, 1997 and Okorie, 2000) identifies liquid liabilities as a ratio of GDP (Broad Money divided by GDP) and Private Credit as a ratio of GDP (Credit to the Private Sector divided by GDP) as key indicators of financial intermediary development. Liquid liabilities as a ratio of GDP is a typical measure of financial depth and thus of the overall size of the financial sector. Liquid liabilities, however, does not consider the allocation of capital; it is just an indicator of size. Private Credit which equals the value of credits by financial intermediaries to the private sector divided by GDP is more than a simple measure of financial sector size. While private credit does not directly measure the amelioration of information and transaction costs, higher levels of Private Credit is interpreted as indicating higher levels of financial services and therefore greater financial intermediation. One of the expected gains of financial sector reform is the development of a financial system that would improve banking habits and by extension the development of the payments system. A recent study such as Onwioduokit, 2006, identifies Currency Outside Banks as a ratio of Broad Money as a useful indicator in measuring financial sector efficiency.

3.0 NIGERIA'S EXPERIENCE WITH FINANCIAL REGULATION, LIBERALIZATION AND REFORMS

The Nigerian financial system is at first sight a complex one comprising as at end-December 2008, 24 deposit money banks (DMBs), 5 discount houses (DHs), 5 development finance institutions (DFIs), 73 insurance companies, several insurance brokers, 25 pension fund administrators, 1 stock exchange, 1 commodity exchange, 840 microfinance banks (MFBs), 99 primary mortgage institutions (PMIs), several stock brokers, 113 finance companies (FCs) and 1,264 bureaux-de-change (BDC). The Central Bank of Nigeria (CBN) conducts monetary policy and together with the Nigeria Deposit Insurance Corporation (NDIC), supervises banks and since 1991, certain other financial institutions. Capital market institutions include the Securities and Exchange Commission (SEC) which also directly supervises the Stock Exchanges. National Insurance Commission (NAICOM) has oversight functions over the insurance sub-sector, while the National Pension Commission (PENCOM) is the sole regulatory agency with oversight functions on pension funds management in Nigeria under the contributory pension scheme that came into effect in 2005 as stipulated in the Pension Reform Act of 2004 (CBN Annual Report 2008). The Debt Management Office (DMO) also exists to manage Nigeria's domestic and external debts.

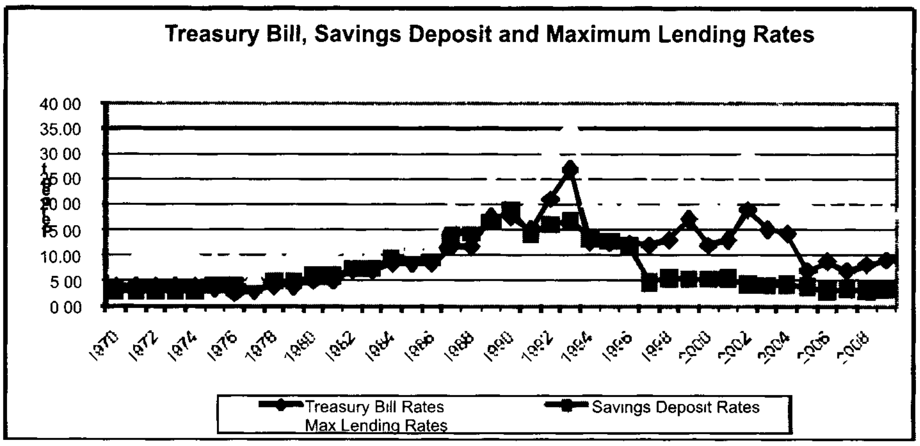
3.1 Pre-Structural Adjustment Programme (period before 1986)

In spite of the seeming complexity of the Nigerian financial system, its role in the mobilization and allocation of resources has been rather limited especially prior to the reform measures in 1986. Before this period, the financial system had come under severe government regulation. This control stems from government pursuit of monetary and macroeconomic policies, aimed at promoting price stability; reducing pressures on the external sector; stabilizing the exchange rate; and stimulating employment and economic growth.

To achieve these objectives, it relied on direct methods of monetary control such as[1]: administrative control on most deposit and lending rates; directed credits to particular sectors such as agriculture; preferential interest rates to same sectors; significant controls on new entry into banking; and significant shareholding by government in some major banks.

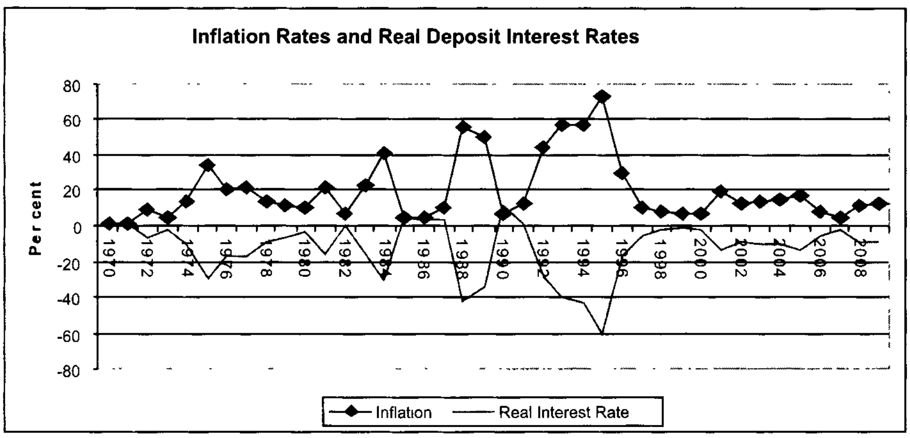
The control of interest rates was aimed at maintaining a stable long term nominal interest rates, while directed credit was aimed at promoting growth of key sectors that were believed to be of prime importance in overall economic growth. Although these objectives were achieved to some reasonable extent, the resultant effects of these policies were evidenced in less incentive to mobilize savings; due to low nominal interest rates on savings deposits prior to 1986. Likewise, lending rates stayed at low levels prior to 1986. As seen in Figure 1, for a substantial part of the period under review, interest rates have thrived outside the market system.

Figure 1



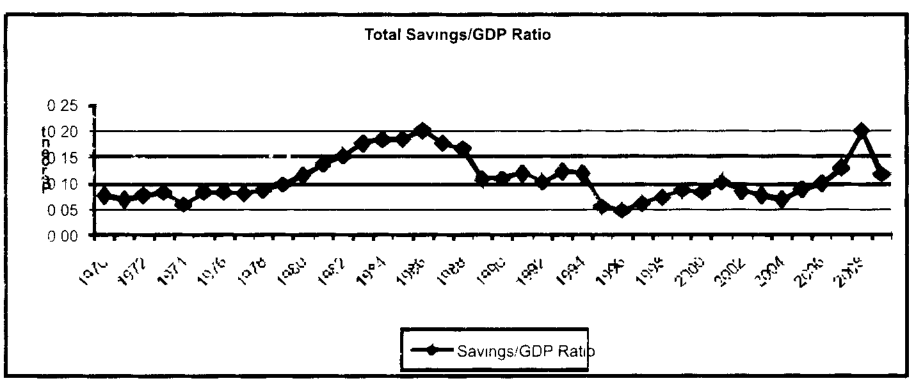
Central Bank of Nigeria (CBN) Statistical Bulletin, 50th Anniversary Edition, 2008

Figure 2



Central Bank of Nigeria (CBN) Statistical Bulletin, 50th Anniversary Edition, 2008

Figure 3



Central Bank of Nigeria (CBN) Statistical Bulletin, 50th Anniversary Edition, 2008

Reflecting the effects of past restrictive measures, real deposit rates have been highly unstable as nominal rates were slowly raised, while inflation fluctuated widely upwards (see Figure 2).

Following the dominance of government in the economy, financial allocation decisions were made by government. Consequently, the role of the Nigerian financial system became relatively insignificant for effective mobilization and efficient allocation of financial resources, prior to 1986 (Oloyede 1998).

These policy changes on interest rates adversely affected financial savings as a proportion of GDP (see Figure 3). The control of interest rates in 1991 and 1994 through 1996 saw financial savings as a proportion of GDP, falling back (closely) to their early 1980s pre-liberalization levels, before gradually rising after the banking consolidation exercise that ended in December 2005. Again, the different policy changes on interest rates are evident of the gross instability that has characterized Nigeria's reform exercise.

3.1.1 Post-Structural Adjustment Programme (1987 - 2003)

The Nigerian financial system prior to the introduction of the World Bank/IMF-supported Structural Adjustment Programme (SAP) in 1986 had been impeded in its pivotal role of savings mobilization and allocation by an environment where market forces had not been permitted to fully determine prices. Liberalization which commenced in 1987 was therefore, prompted by the growing realization that controls had become less effective over time. Government recognized that the prolonged use of interest rate ceilings and directed

[1]*Roe (1998), made similar observations in respect of the Egyptian Banking system*

credit programs would lead to low savings with the financial system and inefficient use of resources which overall would hinder the development of a better financial system. The reform measures adopted in 1986/87 were therefore, expected to improve the conduct of monetary policy and the mobilization of financial resources by broadening and deepening the financial system. In other words, the reforms were directed at attaining allocative efficiency in the economy.

Accordingly, various reform measures implemented in 1987 were designed to liberalize the financial system so that market forces would provide appropriate signals for savings and investments while encouraging financial innovation and technological development. The measures introduced entailed the dismantling of controls aimed at creating an enabling environment for the growth and development of financial institutions, markets and instruments, through competition and appropriate pricing of financial instruments thus ensuring an optimal allocation of resources for economic growth and development. Some component parts of the financial sector reform introduced in 1987, included: constraints on the public sector's access to credit in order to ensure that the private sector receives an adequate share of credit; freeing interest rates from rigid controls which had resulted in negative real rates of interest, and allowing them to be market determined; granting the central bank some autonomy in the conduct of monetary policy by freeing it from the control of the Federal Ministry of Finance and allowing it to report directly to the President; the licensing of new (commercial and merchant) banks, both local and foreign owned; and relinquishing stakes in banks previously dominated by government.

As part of the reform programme, the process of establishing banks was liberalised, which led to the setting up of private indigenous banks in large numbers. Prior to 1986, Nigeria had only 40 banks made up of 28 commercial and 12 merchant banks with the former accounting for 60 per cent of total banking assets and the latter accounting for the rest. Following the liberalisation of the financial sector however, the number of banks in operation increased significantly to 120 by 1992, comprising of 66 commercial banks and 54 merchant banks.

Not only did the number of banks and products offered increase during the period, 1986-1992, there was also a change in the ownership structure, with foreign ownership limited to only a few banks. The rest were wholly owned by Nigerians. The rapid growth in the number of local banks could be attributed to several factors. First, the inefficiencies of the government owned banks provided opportunities for new entrants to target corporate and high income urban customers. Another reason for the proliferation of banks could be traced to the opportunities provided to banks by the liberalisation of the foreign exchange market in 1986, with the introduction of the second-tier foreign exchange market (SFEM). A third reason was that, between 1986 and 1991, the licensing requirements including minimum paid-up capital, were rather liberal, resulting in a significant reduction in the barriers to entry.

3.1.2 Capital Market Reforms

Equities

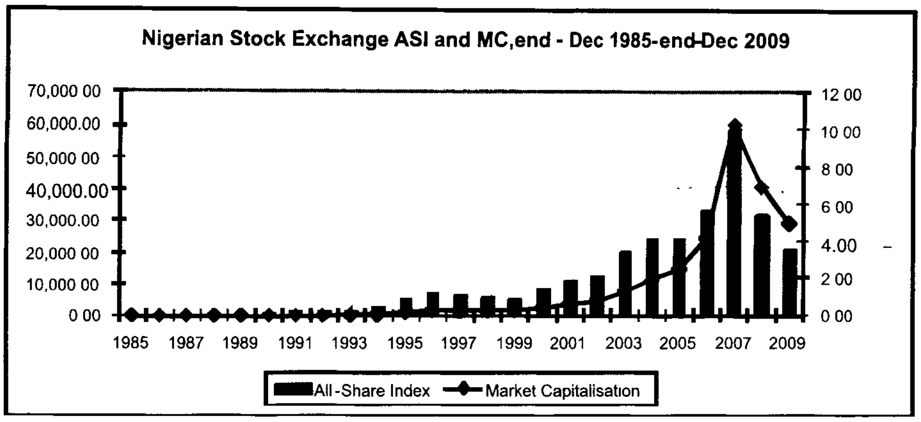
Following the deregulation of the Nigerian capital market in 1993, the Federal Government in 1995 liberalized the market, with the abrogation of laws that constrained foreign participation in the market. Consequent upon the abrogation of the Exchange Control Act of 1962 and the Nigerian Enterprises Promotion Decree of 1989, foreigners began to participate in the market both as operators and investors. Also, limits to the percentage of foreign holding in any company registered in the country were removed. In anticipation of this development, the Nigerian Stock Exchange (NSE) had since June 2, 1987, linked up with the Reuters Electronic Contributor System for online global dissemination of stock market information with a view to engender foreign interest in the day to day activities of the stock exchange. In November, 1996, the Exchange launched its internet system (CAPNET) as one of the infrastructural support for meeting the challenges of internationalization and achieving an enhanced service delivery. The NSE recently concluded arrangements with Thomson Reuters and Bloomberg for dissemination of real-time market data to the global investment community. This service is designed to compliment that provided by its official Website and local Data Centre. The Nigerian Stock Exchange is working with Bloomberg to co-brand all its newly-created indices, i.e., NSE-30 and the 4 sector indices. This will further enhance the profile of these indices and thereby give institutions the confidence to create products based on them, knowing that they will be displayed to a global investor base. Ongoing reforms of the Capital Market by the SEC have provided a new code of Corporate Governance for quoted companies.

Despite these reforms, the stock market witnessed its major boom during the banking sector consolidation exercise in 2004/2005 which saw banking sector stocks constituting about 72 per cent of the daily traded stocks, and 22 of the 25 capitalized banks listed on the stock exchange. For example, Market Capitalization (MC) rose by 308.20 per cent, from N2.52 trillion at end-December 2005 to N10.30 trillion at end-December 2007, while the All-Share Index (ASI) rose by 140.77 per cent from 24,085.80 at end-December 2005 to 57,990.20 at end-December 2007. The boom was, however, truncated in April 2008, when major market indices began to record substantial declines, following the global financial and economic crises (see Figure 4).

Bonds

One of the major changes that have taken place in the Nigerian financial system was on the domestic debt front which includes the resuscitation of the government bond market after several years of inactivity. In a bid to restructure the Federal Government of Nigeria's deficit funding from shorter to longer tenured borrowing instruments, improve and lengthen the yield curve in domestic money markets and encourage long-term savings, the Federal Government resumed bond issuance in 2003, with a N150 billion issue. The creation of

Figure 4



the Debt Management Office (DMO) in 2000 actually prepared the way for government to return to the bond market.

Major reforms witnessed in the bond market included the development, since 2005, of a framework/calendar for a regular and continuous issuance of bonds and implementation of a regular (monthly/quarterly) issuance programme. The DMO has also established a Monetary-Fiscal Policy Coordinating Committee to articulate and resolve possible conflicts in the implementation of domestic debt management policies and strategies on the one hand, and monetary policy and strategies on the other. In addition to the establishment of a Primary Dealers' Market Makers System (PDMMS) to ensure a strong and vibrant bond market, there is a platform the Bond Steering Committee - for regular interaction with key stakeholders, including market players. Currently, there are 21 Primary Dealer Market Makers comprising of 16 DMBs and 5 Discount Houses. The debt management focus is on deepening the domestic debt market through the use of derivative instruments as well as the introduction of foreign currency denominated FGN bonds in the domestic market to support the pricing of long-term instruments and to access the cheapest available funds in the market; and widening and deepening the scope of the financial and capital markets in line with Financial System Strategy 2020, as well as for purposes of sovereign rating.

A summary of FGN bonds issued from 2005 2009, shows that out of the aggregate amount of N2.36 trillion issued, N4.47 trillion was subscribed, while N2.45 trillion was allotted (DMO). While the bond market has recorded reasonable growth in recent times, the growth has however, been inhibited by such factors including poor macroeconomic environment characterized by high inflation and unstable interest rates. Under a volatile macroeconomic environment, both individual and institutional investors develop a preference for assets with shorter maturities such as bank deposits and government treasury bills thus starving the bond market of funds (Chioke 2010).

3.1.2 Post-Liberalisation Challenges

The explosion in the number of banks resulted in the dearth of experienced staff as well as managerial capacity. This was not helped by the equally enormous pressure on the CBN and NDIC which overstretched their supervisory capacity. The weak supervisory capacity, the inadequacy of prudential. regulation and the contravention of banking laws without serious sanctions, consequently allowed undercapitalised and poorly managed banks to operate unchecked, which contributed significantly to the financial fragility, that later afflicted the banking industry.

The fragility of the banking system clearly worsened during the 1990s following the imprudent lending practices, which constituted a major cause of the distress. Although, the contribution of the financial sector to GDP increased after the financial sector liberalisation of the mid-1980s, nevertheless, many of the new banks appeared not interested in intermediating funds from depositors to borrowers but rather made quick profits from exploiting arbitrage opportunities in the foreign exchange market.

Although the macroeconomic environment improved with the restoration of civil democratic government in 1999, the Nigerian financial system was still characterised by high level of fragmentation and low level of financial intermediation. There was also a high volume of non-performing loans. These problems militating against the maintenance of banking soundness and financial sector stability called for immediate attention of the regulatory/supervisory authorities (CBN, 2009).

In a bid to sanitise the banking industry and minimise bank failures, the following measures among others, were taken: introduction of the prudential guidelines; enactment of the Banks and Other Financial Institutions Act (BOFIA) and the CBN Act, 1991; introduction of new capital adequacy requirements based on risk-weighted assets, periodic review of minimum capital requirements; financial assistance, facilities and regulatory forbearance to banks; and contingency planning framework against banking systemic distress.

3.1.3 Bank Recapitalisation and Consolidation, 2004 2009

The CBN, on July 4, 2004, announced a comprehensive reform programme, which aimed at creating strong financial institutions that would take advantage of the benefits of size to champion economic development of the country. Prior to 2004, the Nigerian banking sector comprised 89 banks, many of which were characterised by: low or eroded capital base; large number of small banks with relatively few branches; poor rating of a number of banks; weak corporate governance; insolvency as evidenced by negative capital adequacy ratios and capital that had been significantly eroded by losses; overdependence on public sector funds and income from foreign exchange trading; neglect of small and medium scale savers; lack of capacity to support the real sector of the economy; gross insider abuses that resulted in huge non-performing credits; and oligopolistic structure of the banking system as the first 10 banks accounted for more than 70 per cent of total deposits and assets (CBN, 2009).

Key elements of the reform among others, included: increase in the minimum capitalisation for banks from N2.0 billion to N25 billion, with end-December 2005 as deadline for full compliance; phased withdrawal of public sector funds from banks, starting from July 2004; consolidation of banking institutions through mergers and acquisitions; adoption of a risk focused and rule-based regulatory framework; adoption of zero tolerance for non-compliance in the regulatory framework; the automation of the process for rendition of returns by banks and other financial institutions through the electronic Financial Analysis and Surveillance System (e-FASS); strict enforcement of the contingency planning framework for systemic banking distress; revision and updating of relevant laws, and the drafting of new ones relating to the effective operations of the banking system and closer collaboration with the Economic and Financial Crimes Commission (EFCC) in the establishment of the Financial Intelligence Unit (FIU), and the enforcement of the anti-money laundering and other economic crimes.

The major outcomes of the consolidation exercise were: emergence of 25 well capitalized banks; the liquidity engendered by the inflow of funds into the banks brought about a significant fall in interest rates, sustained increase in bank lending to the real sector from 2005, through 2008; the consequent high single obligor limit, enhanced banks' capacity to finance large value transactions, more Nigerian banks had better access to credit from foreign banks, the capital market deepened and there was increased awareness among the population; the ownership structure of Nigerian banks changed for the better and depositor confidence improved owing to the "safety in bigness" perception by depositors (CBN, 2009).

3.1.5 Special Audit of Nigerian Banks and Next Steps (2009 Date)

As a result of the recent global financial and economic crises which adversely affected the Nigerian economy, in particular the capital market and oil and gas sectors, it was observed by the CBN that some Nigerian banks had huge concentration of exposure to these two sectors, in addition to general weakness in risk management practices, poor corporate governance practices and signs of illiquidity. It therefore became compelling to ascertain the true financial health of banks in the public interest.

In furtherance of the CBN's statutory duty to ensure a sound financial system in the country, the Governor of the CBN in 2009 ordered the Special Examination of all the 24 banks operating in Nigeria. Following this exercise, the CBN discovered that some banks were exhibiting imminent signs of collapse, which could put the entire banking sector and the Nigerian economy in grave danger. Eight main interdependent factors led to the creation of an extremely fragile financial system that was tipped into crisis by the global financial crisis and recession (Sanusi 2010). These included: macro economic instability caused by large and sudden capital outflows; major failures in corporate governance at banks; lack of investor and consumer protection; inadequate disclosure and transparency about the financial position of banks; critical gaps in regulatory frameworks and regulations; uneven supervision and enforcement: unstructured governance and management process at the CBN and weaknesses in the business environment in the country.

The result of the Special Examination of the first set of 10 banks announced on 14th August 2009 revealed that 5 banks were in grave danger. To save the 5 banks from imminent collapse, the CBN had to inject N420 billion into them as tier-2 capital, while simultaneously replacing their management with interim ones.

After a review of the findings of the Special Examination report in respect of the remaining 14 banks, 8 banks were found to have adequate capital and liquidity to support the level of their current operations and future growth, while 2 banks were adjudged to have insufficient capital but not in grave situation and did not have corporate governance issues. The remaining 4 banks were found to be in a critical situation. Consequently, the CBN injected another N200 billion to support these banks, making a total of N620 billion rescue package for the ailing banks in the banking system. The Bank also guaranteed foreign loans to Nigerian banks as well as provided guarantee for inter-bank placement from July 2009 to March, 2010 in the first instance with an extension to December, 2010.

While replacing the CEOs of troubled banks, the CBN in a bid to strengthen corporate governance in banks, limited the tenure of managing directors to a maximum of ten years. CBN's pro-active intervention was designed to strengthen the affected banks, restore public confidence in the banking sector, protect depositors' money and save the country from an avoidable financial crisis. With the strengthening of the affected institutions and other reforms being undertaken by the CBN, the Nigerian banking sector became more stable, safer and stronger.

The formation of the Asset Management Corporation of Nigeria (AMCON) is expected to facilitate an improvement in banking sector liquidity, protection of the earnings of banks from further erosion and reduction of the debt overhang on the capital market and its participants. This should provide a much-needed impetus for the revival of the Nigerian Capital Market.

The conclusion of the bank audit exercise, brought to an end the first phase of the process of restoring financial sector stability since 2009. Ongoing action focuses on building capacity within the regulatory regime, fast-tracking the implementation of risk-based, consolidated and cross border supervisory frameworks, easing the flow of credit, particularly to the real sector of the economy; improving governance structures and practices in the financial services sector; and improving confidence in the economy in general. The second phase of the banking reforms included: enhancing the quality of banks; establishing financial stability; enabling healthy financial sector evolution; and ensuring that the financial sector contributes to the real economy (Sanusi, 2010). Also, the CBN has intensified efforts through the Financial Services Regulation Coordinating Committee (FSRCC) to foster closer collaboration and harmonization of its policies with those of other regulatory agencies, such as SEC, NAICOM, and PENCOM, for better supervisory impact.

4.0 ANALYSIS OF FINANCIAL SECTOR PERFORMANCE, PRE-AND POST-REFORMS

A comparative analysis of financial sector performance pre and post SAP and post banking consolidation requires an appraisal of various indicators of financial market development. There is no perfect set of indicators that measures the development of the financial sector for effective intermediation. However, indicators such as M2 as a ratio of GDP, Credit to the Private Sector as a ratio of GDP, Currency Outside Banks as a ratio of M2, DMBs Assets as a ratio of GDP and Quasi Money as a ratio of GDP have been adopted in measuring the depth, size, efficiency and intermediation role of the financial system (CBN Annual Report, 2007; 2008).

As revealed in the following analysis (see table-1) the Nigerian financial sector performed better in the post banking consolidation period than in the post SAP liberalization period. For instance, the depth of the financial sector, as measured by the ratio of broad money supply (M2) to GDP which on average stood at 26.69 per cent in the pre SAP period declined to 23.93 per cent in the post SAP period. It however, rose to 28.47 per cent in the post banking consolidation period. Bank financing of the economy measured by the ratio of credit to the private sector to GDP improved slightly from 14.28 per cent in the pre SAP period to 15.97 per cent in the post SAP period, before rising to 23.15 per cent in the post banking consolidation period. The outcome of these major indicators measuring the size and capacity of the financial system to finance the economy indicated that financial liberalization introduced during the SAP period did not impact significantly on the economy. However, banking consolidation improved the banking system's capacity to finance the economy. Financial efficiency measured by currency outside banks as a ratio of broad money supply (M2), increased from 25.02 per cent in the pre SAP period to 26.40 per cent in the post SAP period and thereafter, improved to 13.93 per cent in the post banking consolidation period. The development reflected partly the impact of the increased use of electronic and other forms of payments, particularly ATM and other card products (CBN Annual Report, 2007).

Banking sector size in relation to the economy decreased significantly in the post SAP period compared with the pre SAP period. The ratio of DMBs assets to GDP declined from 46.46 per cent in the pre SAP period to 32.83 per cent in the post SAP period. However, following banking consolidation that commenced in 2004, it rose to 47.00 per cent. Quasi money as a ratio of M2 declined slightly from 43.84 per cent in the pre SAP period to 41.49 per cent in the post SAP period before rising to 43.86 per cent after the banking consolidation exercise. This reflected the outcome of the aggressive competition for deposits by DMBs post banking consolidation.

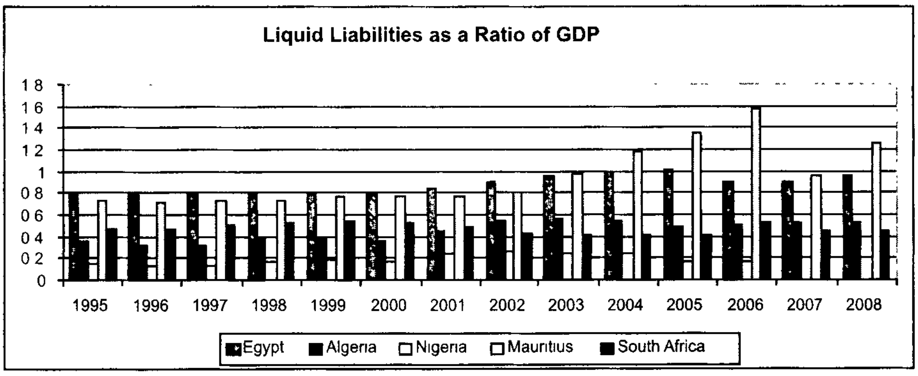
When compared with other emerging African markets in the same group as Nigeria, the Nigerian financial system cannot be regarded as substantially deepened. While some progress seemed to have been made in financial market development in Nigeria, the overall performance of the Nigerian financial system still falls short of expectations. As Figure 5, illustrates, liquid liabilities (a measure of depth and size of the financial sector) as a percentage of GDP, was higher in South Africa, Algeria, Egypt and Mauritius than in Nigeria, from 1995 to 2008.

Table 1: Period Average Performance of Financial Development Indicators

	Pre- SAP Reforms (1970 - 1986)	Post- SAP Reforms (1987 - 2003)	Post- Banking Consolidation Reforms (2004 - 2009)
M2 as a Ratio of GDP	26 69	23.93	28.47
Credit to the Private Sector as a Ratio of GDP	14.28	15 97	23.15
Currency Outside Banks as a Ratio of M2	25 02	26.40	13.93
DMBs Assets as a Ratio of GDP	46.46	32 83	47.00
Quasi Money as a Ratio of M2	43 84	41.49	43.86

Computed from Central Bank of Nigeria Statistical Bulletin, 50 Years Special Anniversary Edition, 2008

Figure 5



Financial Structure Dataset, 2008, the World Bank/DECRG-FI

Interestingly, the situation is similar with respect to credit to the private sector (measure of financial development) as a percentage of GDP, in which Nigeria exceeded only Algeria in the period under review (see Figure 6).

The foregoing results, though unsatisfactory is however, not surprising, as the Nigerian financial system, has for many years, been repressed by government actions in its pursuit of other economic objectives. By no doubt, the distress in the banking sector which started in 1990 and still lingering till date, may have eroded depositor confidence in the sector, with adverse consequences for financial depth and credit. Interestingly, as we mentioned earlier, some of the government controlled banks, actually set the stage for the banking crisis, which is indicative of the adverse effects of financial sector regulation.

4.1 Key Issues and Challenges

Major challenges currently facing the financial system include: market imperfection with the money market characterized by few players, leading to an absence of competition; over-reliance of the banking industry on public sector deposits; inadequate skilled manpower; lack of breadth, depth and sophistication of instruments; and inadequate infrastructure and Information Communication Technology (ICT). Other issues and challenges include: regulatory oversight, inadequate technology and market infrastructure, inability to mobilize funds in the informal banking sector and inadequate settlement system.

5.0 CONCLUSION AND RECOMMENDATIONS

The purpose of this paper was to analyze the impact of various financial reform measures on financial intermediation in Nigeria. The analyses of various measures of financial system development showed that though some improvements were made, Nigeria still lagged behind some of its emerging market counterparts. One possible explanation of this was that the repression of the financial system for about two and half decades, starting from political independence in 1960, till 1986 when the liberalization policies of the Structural Adjustment Programme (SAP), freed the sector from excessive government regulation, contributed to the shallowness of the system. Even with reform, the financial system and the entire economy operated under guided deregulation with interest rates returning to being controlled at various times in the 1990s.

A strong financial system is critical for financial intermediation and economic growth and development. Recent national and global developments have led to various financial sector reforms in Nigeria, with each of these reforms having a substantial impact on the financial sector and the overall economy. The global financial and economic crises have raised issues concerning regulation and supervision. The quality of financial regulation and supervision, as well as of information and the legal system, is an important factor in financial sector development. Strong regulation and supervision could encourage domestic depositors and investors and attract foreign investors. The inherently risky nature of banks' activities has brought to the fore issues of effective risk management and makes an adequate risk management framework imperative.

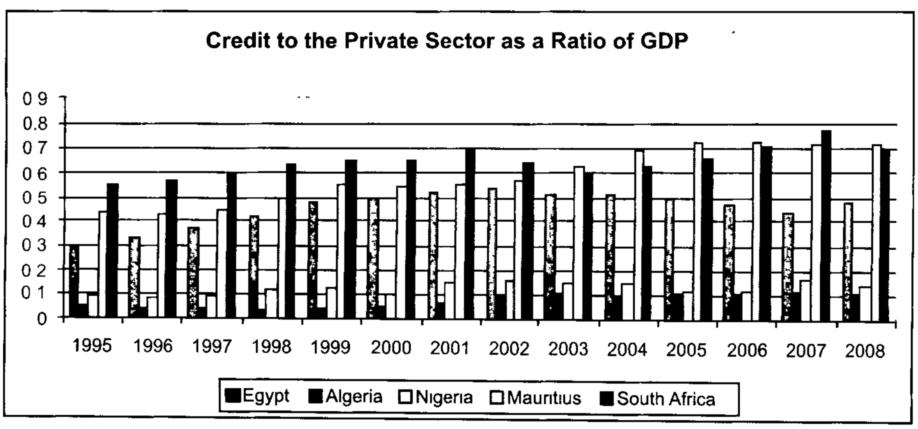
Finally, it is necessary to stress that financial reforms are dynamic and depend on the level of development of the financial system. The challenge is to ensure that financial sector reforms impact on the real economy through efficient policy implementation. For financial system reform to be effective and efficient, some of the identified challenges need to be addressed, and financial sector reforms and supervision require inputs and support from all stakeholders.

5.1 Policy Recommendations

In the light of the foregoing, the paper recommends that policies directed at removing structural distortions and which hold out the promise of a sound macro economy be pursued before the implementation of financial sector liberalization and reform programmes. The financial system needs to be fully liberalized and the range of services offered needs to be broadened. This may imply encouraging greater foreign participation in the sector.

It is generally recognized that the continued underdevelopment of the banking system reflects lack of trust of the population in banks, of banks in borrowers, of foreign counterparties in banks and of banks in one another. As to the lack of trust in banks, the underlying reasons are: poor transparency and corporate governance in the banking sector, lax regulation of the banking system and repeated banking crises. There is therefore, need to improve the legal framework for transparency and management of banks as well as enforcement of compliance with formal requirements to quality and procedures for risk management and control, in line with international best practices.

Figure 6



Financial Structure Dataset, 2008, the World Bank/DECRG-FI

The current strengthening of banking supervision by the CBN in combination with other planned measures to stabilize and strengthen the financial system are steps in the right direction and should go a long way in overcoming the fundamental lack of trust in the system. A failure to strengthen banking supervision and regulation would not only hinder the restoration of trust but could further distort resource allocation, with potentially serious future costs to the economy. Extensive training of auditors and regulators in the near term is an important step in this direction.

This paper advocates the speedy adoption of international financial reporting standard for all Nigerian banks (currently in the pipeline). This reform, while by no means a cure-all for problems of bank transparency, would nonetheless be a significant step forward, if properly implemented. Apart from benefits of higher quality financial information for potential customers, creditors, and portfolio investors, it would also facilitate more effective banking supervision, and make Nigerian banks more attractive for acquisition by larger domestic and foreign banks. There is also the need to establish more credit bureaus, to allow for the provision of information on borrowers' credit history, to address the problem of adverse selection and moral hazards, discussed in the literature.

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