

MARKETING OF BANK SERVICES, REGULATION, AND BANK PROFITABILITY IN AN EMERGING BANKING SYSTEM*

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1. Introduction

In January 1994, the military government in Nigeria introduced some measures indicating a new direction towards financial re-regulation. The financial industry was one of the most regulated sectors of the Nigerian economy prior to 1986 when the government started a deregulatory policy. More specifically, the monetary authorities had relied on selective credit control as its major axle of monetary management. During the 1969/70 fiscal year, the Central Bank of Nigeria (CBN) began to consistently use directives to regulate the amount and price of credit that went into different sectors of the economy.

Credit controls constitute attempts by government to direct the flow of funds to socially desirable sectors or to lower interest cost of loans and advances to socially desirable borrowers. According to Akintola-Bello and Ayadi (1980), credit controls lead to less efficient financial markets because they impose adverse distributional effects, and distort relative factor prices between sectors. More importantly, credit controls may further politicize intersectoral economic conflict.

Oyewole (1993) argued that restrictive policies could discourage rather than induce financial institutions to undertake innovation. Several other scholars of financial markets have also condemned the policy of strict financial regulation. According to them, when financial institutions operate under strict regulatory policies, the tendency is for them to develop financial instruments that allow them to circumvent some of the restrictions [Askari, (1991); Mauri (1983), (1985); Sobodu and Chide (1991); and Bhatt, (1989)]. By implication, deregulation is a precursor to financial innovation, and financial innovation is a strong driving force behind financial as well as economic development. Of more relevance is the argument of Bhatt (1989) that financial innovation helps to promote the efficiency of financial intermediation through a reduction in transaction costs and risk.

In a recent analysis of the Nigerian financial system, Oyewole (1993) found that the financial environment was not conducive to financial innovations prior to the reforms of 1986. Moreover, banks were found to have used various means to circumvent regulations. In view of the foregoing, the objective of this study is to identify the various ways that commercial banks in Nigeria circumvented the monetary authorities' regulations. More importantly, many of the banks recorded significant levels of profitability prior to deregulation. It is hoped that this paper will throw some light on the sources of banks' profitability in a regulatory environment. Finally, the results of this study could guide the present policy

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makers in Nigeria and other developing countries that what is needed for financial innovation to take place is less regulation and not more.

2. Nigeria's Banking Sector

Nigeria operates a multiple branch banking system. Thus, most of the banks operate throughout the country through their multiple branching network. For example, there were 25 commercial banks with 1,108 branches in 1983. The number of commercial banks operating in the country rose to 28 while their branch network increased by 55 from 1,242 in 1984 to 1,297 in 1985. As at the end of 1986, there were twenty-nine commercial banks with a total of 1,367 branches all over the country. By the end of 1991, there were 65 commercial banks operating through a network of 2,023 branches.

Prior to financial system deregulation in Nigeria, commercial banks reported large profits annually. Table 1 shows the level of profitability of some publicly registered Nigerian banks between 1984 and 1988. When compared to non-financial corporations in Nigeria, banks are by far more profitable. It was not clear to a student of Nigerian banking and finance how banks in Nigeria are highly profitable in spite of the regulations that guide their operations.¹

Table 1: Profitability of Selected Nigerian Banks; 1984-1988 (in million Naira)

BANK	1984	1985	1986	1987	1988
First Bank	29.14	53.40	86.63	68.01	74.22
Progress Bank	(1.52)	2.40	2.53	3.48	3.67
Savannah Bank	10.10	8.84	12.65	18.52	20.68
UBA Limited	31.48	34.19	42.08	73.65	54.77
Union Bank	57.08	81.15	103.78	83.51	70.36

One thing that is obvious is that bank customers realize that they are paying too much in bank charges. Due to data problem, it is impossible to isolate service charges in banks' income. While commenting on the operations of banks in Nigeria Obasanjo (1991) observed that: "Banks and financial industry in Nigeria seem to have made money-making without regard to production and the health of the economy their objective. Banks have

1. Ibe (1992, p.245-248) contains a more extensive description of the Nigerian banking industry. Ojo (1994) also contains a detailed characterization of the structure of banking in Nigeria.

behaved irresponsibly, verging on criminality and fraudulence". Obanya (1990) also observed that: "Their (bankers) usually well-cut suits, fat pay packets and luxurious offices often let them out as the best the economy can give, even, in a recession. And for many bankers, nothing supports this general feeling than banks' huge profits. And the profit margin seems to have increased more in the last few years of the recession".

William Asuquo, a senior manager at one of the Nigerian banks noted that the banks' huge profits are not a result of sound and strategic planning. According to him, "they are not the result of innovative banking services. Banks now simply make money from under the table" (cf. Ukeve *et. al.*, 1991). While reviewing the role of Nigerian commercial banks in economic development, Ojo (1994) suggested that the financial authorities in Nigeria introduce bolder but positive initiatives. Under this new dispensation, banks should be encouraged to become more of assets than liabilities in the country's efforts to achieve concrete development.

In 1986, the Nigerian financial services industry began, to experience a broad restructuring as a part of the Structural Adjustment Program (SAP). The major objectives of the program are to restructure and diversify the productive base, and achieve fiscal and balance of payments viability. Other objectives are to lay a basis for non-inflationary sustainable growth and improve public sector efficiency.

The main strategy adopted includes a deregulation of interest rates, rationalization and restructuring of public expenditure and custom tariffs, adoption of a realistic exchange rate policy and adoption of appropriate pricing policies in all sectors of the economy. Among other specific policies, the monetary authority introduced the auction-based trading system for federal government treasury bills and certificates. The Nigerian Deposit Insurance Corporation (NDIC) was established and the Second-Tier Foreign Exchange Market (SFEM) was also opened. Since the policies were put in place, the financial sector has recorded a tremendous growth in terms of increase in the number of banks and non-bank financial intermediaries.²

2. For a more comprehensive discussion of the rationale and elements of financial reform in Nigeria, refer to Oyewole (1993). Oyewole also compiled a detailed catalog of the various innovative financial instruments introduced into the financial system after deregulation. Oresotu (1992) also documents the behavior of interest rates under the Nigerian financial reform program. Tella and Okusun (1993) discuss the different ramifications of the phenomenon of banking deregulation in Nigeria. They also analyze the effects of interest rate deregulation on savings, investment and capital flows.

3. Models of Bank Behavior

The financial firm is faced by some technical constraints which affect its production. Thus, the condition that marginal cost be equal to marginal revenue does not hold for a financial firm (Mullineaux, 1978). The appropriate profit maximizing conditions and optimal output and input combinations for the financial firm are possible only by approaching the financial firm from the output side. One of the early theories of the banking firm was by Shull (1963). He viewed a bank from the perspective of a profit maximizing producer. Shull assumed that:

- (1) The banking firm has mobility of resources, principally bank reserves, that can produce a variety of product lines.
- (2) The scale or size of the banking firm's plant is fixed; that is, the firm varies output within the plant capacity.
- (3) Bank output is homogenous with respect to costs and marginal costs increase gradually over ordinary ranges of output, increasing sharply as full capacity is approached.
- (4) Price elasticity of demand differ for the bank's various product lines.
- (5) The demand for various products are not related; that is, the markets for the banking firm's product lines are separate and distinct.
- (6) The banking firm attempts to maximize profits.

If these assumptions hold, Shull argued that the observable forms of banking behavior occur within the context of changing demand in various markets and of bank's willingness to allocate resources into the most profitable lines. His thesis is that profit is maximized for the banking firm that adheres closely to multiple-product, price-discriminatory behavior.

According to Mitchell (1979), the bank is a rate taker on its asset side but faces an imperfectly elastic demand functions of consumers. Thus its profit function is defined as follows:

$$\pi = r(1 - z_s) S(.) + r(1 - z_d) D(.) - r_s S(.) - R_d D(.) \quad (1)$$

where,

$$R_d = r_d + [k-b](n/D)(r_d/b)$$

π = profit

z_s = exogenous reserve ratio for savings deposit

z_d = exogenous reserve ratio for demand deposit

r = return the bank's interest-earning asset

$S(.)$ = savings deposit demand function facing the bank³

3. The savings deposit demand function depends on the return on bank's interest-earning asset, the explicit rates on savings and demand deposits.

$D(.)$ = Demand deposit demand function facing the bank⁴

r_s = explicit rate on savings deposit

r_d = explicit rate on demand deposit

k = average/marginal cost to the bank of clearing a check

b = service charge per check

$(n/D)(.)$ = ratio of checks written to deposit balances

Equation (1) states that profit is made up of the return on investment funds obtained from savings and checking accounts (given a required reserve ratio), less explicit savings account interest and explicit-plus-implicit checking account interest, R_d . Thus, the banking firm maximizes profit with respect to the service charge b and the savings account rate r_s if it is not subject to a binding ceiling.

Mitchell considered several possible responses of a bank to binding ceilings on savings deposits. According to him, an exogenous rise in the explicit rate induces a rise in the check-clearing charge. On the other hand, when the explicit rate rises, the implicit rate does not go down point-for-point because of the divergence between the way consumers and banks value any given amount of implicit interest.

The loophole in Mitchell's discussion rests on the possibility of a banking firm maximizing profit by circumventing regulation as is suspected in the case of Nigeria. The monetary authorities in Nigeria regulate r_s , r_d , b , z_s and z_d . Implicitly banks' profitability is strictly under the control of the monetary authorities. This view is well documented in Akintola-Bello and Ayadi (1980) when they argued that regulation of interest rates affects the efficient functioning of the financial markets. In an attempt to avoid and evade controls, banks resorted to "price shading" and the actual costs of loans to borrowers would be more than what they should be if rates were not regulated.

Passmore and Sparks (1993) analyze a model of asymmetric information about banking services provided to depositors. They assume that depositors imperfectly monitor the level of banking services. If a depositor finds a bank's service to be inadequate, he pulls out his deposit. This threat of withdrawal in a competitive environment motivates the bank to provide adequate service. They defined the bank's per period profit per deposit (V) as:

$$V = [r_b - r_d] D - cD \quad (2)$$

4. The demand deposit demand function depends on the return on the bank's interest-earning asset, the explicit rates on savings and demand deposits, and the service charge per check.

where,

- D = deposit in dollars per customer
- c = cost of providing a service by the bank
- r_d = deposit rate of interest
- r_b = rate of return on bank's investments

Banks in general have two choices if $c > 0$. They may choose to provide service or shirk. If a bank shirks and the depositor finds out, he withdraws the deposit at the end of the period and finds another bank. The probability of detecting a shirking bank is q . If the bank does not shirk, its non-shirking profit level is defined as:

$$V^{DN} = \frac{1}{(r+h)} [(r_b - r_d) D - cD + hV^M] \quad (3)$$

where,

- V^{DN} = Profit level for the bank if it does not shirk
- V^M = The bank's expected discounted lifetime profits
- h = Probability that a bank loses the deposit for exogenous reasons such as depositor bankruptcy or relocation.

A shirking bank on the other hand has the following profit function.

$$V^{DS} = \frac{1}{(r+h+q-qh)} [(r_b - r_d) D + (q(1-h) + h) V^M] \quad (4)$$

where,

- V^{DS} = Profit level if the bank shirks
- q = Probability that a shirking bank is caught.

Passmore and Sparks argued that a bank will not shirk if its non-shirking profit level, V^{DN} is greater or equal to its profit level if it shirks, V^{DS} . The focus of the bank is to reduce the number of disgruntled depositors and lost deposits by increasing its service level. The depositors, on their part will view the deposit rate as an important decision variable even though it may not have any significant effect on depositor utility.

One device that was widely used in Nigeria prior to 1987 was fixing minimum and maximum rates of interest on lending, borrowing and other banking service charges. The monetary authorities control bank transaction fees by issuing maximum and/or minimum tariff rates to be charged by banks. The maximum ceiling device was aimed at lowering the

cost of borrowing and doing business with a banking institution. The expectation is to increase the supply of capital at rates of interest lower than what would otherwise be the market clearing rates.

Oyewole (1994) applied Spellman (1980) framework for financial intermediation cost to Nigerian banks. He concluded that the financial repression policy of the Nigerian government prior to deregulation, artificially restrained financial institutions from charging market price for their services. Consequently, this policy, would raise the cost of financial intermediation and contributed to inefficient delivery of financial services.⁵

The claim of the political leaders was that bank customers are not aware of these tariff rates and that commercial banks cash-in on the ignorance of these customers by charging rates that do not reflect the regulated rates. This study represents an investigation of the claim that commercial banks in Nigeria flout regulation and thus, defraud customers. In other words, the author hopes to report the wide variation found in the basic component of bank service charges in Nigeria. Moreover, the diversity of average total service charges for typical banking transactions are surveyed.

4. Methodology

A questionnaire was administered to seventeen of the twenty-nine commercial banks in Nigeria in January 1987. The selection criterion was the number of years in operation. A bank is selected if it had been in business for more than five years. The response rate was quite good because research assistants were used to continually contact the head office of the respective banks.

The questionnaire design was based on selective variables from the 1986 Bankers' Tariff. The Bankers' Tariff is issued annually by the Central Bank of Nigeria (CBN) to commercial and merchant banks. It contains guidelines on maximum and minimum fees and operational procedures that banks are required to maintain during the year. The analysis of the results is based on simple descriptive content analysis.

5. Analysis of Results

The results of the study are presented below.

5. The Spellman framework used by Oyewole (1994) is in fact a variant of Mitchell (1979) analysis of commercial bank behavior.

5.1 Interest Allowed on Accounts

In 1986, the CBN directed banks to pay 9.5% minimum interest rate on savings accounts. When the sampled banks were asked to report the interest rate they paid on savings accounts, the results indicate a significant deviation from 9.5%. Table 2 shows that about 7 out of every 10 banks in Nigeria paid 11% rate on savings accounts. Only 12% of the sampled banks paid exactly 9.5%. A cursory observation of table 2 shows that banks have done very well by paying rates that are higher than mandated. Oyewole (1994), estimated the actual interest rate paid on deposit as total interest paid by banks on deposits as a percentage of total deposits in a given year. He found that actual interest rate paid on deposit was substantially lower than the rate stipulated by the monetary authorities.

Table 2: Interest Payment on Savings Account

Rate (%)	Number of Banks	% of Total
9.5	2	12
11.0	11	65
11.5	2	12
12.0	2	12

Note: Banks are expected to pay a minimum 9.5% interest rate on deposits.

Commercial banks in Nigeria are required to calculate interest payments on savings account based on the balance in the customer's account on the 15th day of each month. The interest so calculated should be reflected in depositors' accounts at the time of calculation. This survey shows that 30 percent of Nigerian banks do not comply with this guideline. They post interest to customers' account once per quarter. For example, one bank based its interest calculation on the customer's balance on the 16th day of the month while two banks used the last business day of the month. Table 3 shows that seventy percent of the banks credit interest to customers' accounts on a monthly basis. The remaining thirty percent, credit customers' accounts quarterly. Oyewole (1994, p.59) confirmed that commercial banks pay interest on the minimum quarterly balance on savings deposits. By posting interest quarterly rather than monthly, these banks deprive their customers some of their interest revenue.

Table 3: Balance on Which Interest is Based

Date	# of Banks	% of Total
On or Before 13th of the month	1	6
15th day of the month	11	64
16th day of the month	1	6
25th-26th day of each month	1	6
Last Business day of the month	2	12
No Response	1	6

Note: The regulation states that "interest payments on savings account should be on the balance in the customer's account on the 15th of each month."

The Central Bank of Nigeria mandates commercial banks not to pay interest on a savings account in any month in which there are more than three withdrawals. However, table 4 shows that most commercial banks do not violate the regulation. Thirty-five percent of the sampled banks do not place any withdrawal restriction on their customers. Nine of the banks allow their customers a maximum of three withdrawals. Only two banks violate the regulation by placing a maximum of two withdrawals per month.

Table 4: Restrictions on Withdrawal from Savings Account

Restriction	#of Banks	% of Total
None	6	35
Maximum of 2 withdrawals per month	2	12
Maximum of 3 withdrawals per month	9	53

Note: The regulation states that no interest will be paid on Savings Accounts for any month in which there are more than three withdrawals.

5.2 Interest Charged/Lending Rate

The CBN sets minimum and maximum lending rates to the different sectors of the economy. Table 5 shows that most of the banks charge rates that are higher than the maximum rates to each sector. The maximum lending rate to the agriculture sector is set at 9% but this survey shows that only two banks charge rates between 7% and 9%. Thirteen banks charge rates that far exceed 9%. The maximum lending rate to the commercial sector is set at 13% but thirteen of the fourteen banks that responded to this question charge rates that are higher than 13%.

Table 5: Lending Rates to Different Sectors

Sector	Lending Rates to Sector (%)				NO Response
	7-9	9-11	11-13	Over 13	
Agriculture	2	6	3	4	2
Residential	1	5	4	5	2
Commercial	0	0	1	13	3
Specialized	0	0	1	12	4
Gen. Commerce	0	0	0	15	2

Note: The maximum lending rates to the sectors are Agriculture, 9%; Residential Housing, 9.5%; Commercial Property, 13%; Specialized Financial Institutions 13% and General Commerce 13%.

Aside from the explicit interest rates stated in table 5 above, commercial banks also impose other charges on borrowers. These charges include legal fees, commission on turnover, commission on transactions and commission on guarantees.

5.3 Service and Administration Fees

The results of this study also revealed that banks overcharge customers to various services. In some cases they resist performance of services that they were required to provide free to customers. This is the shirking behavior that was analyzed by Passmore and Sparks (1993). For example, banks are required to provide exchange purchase facilities through local transfer of funds free of charge to customers. The results of this survey show that over 55 percent of all banks charge customers for local transfer of funds. Moreover, about 50 percent of all banks charge above the regulated commission rates on foreign transfer purchases.

Forty percent of banks in the sample overcharge customers for sighting bills for negotiation and for foreign currency notes. About 60 percent of all banks sampled also charge excessive commission rates on foreign exchange sales through transfers, foreign currency notes and travellers' checks.

6. Conclusion

In a recent survey of the Nigerian banks, the Nigeria Deposit Insurance Corporation (NDIC) found that over 50 percent of all banks did not meet the statutory paid-up capital. Alawode (1992) also reported results suggesting many banking institutions experiencing management problems due to large-scale frauds, insider abuse and weak internal control

systems. These results raise serious doubts about the effectiveness of regulation within the Nigerian banking system.

According to Ibe (1992, p.243), the banking industry in Nigeria was the fastest growing sector of the economy. In 1980, there were 24 commercial banks with 752 branches, but in 1991, there were 57 commercial banks with 2140 branches. While writing on the determinants of banks' profitability in Nigeria, Agu (1992) noted that market structure as measured by the number of bank branches was highly correlated with profitability performance. Therefore, it is logical to conclude that profitability is the driving force behind banks' branching network.

While nonbank institutions in Nigeria were witnessing operating and profitability problems, most banking institutions prior to banking deregulation were reporting huge profits. According to Ojo (1994), the role of the banking system in Nigeria left much to be desired. To Ojo, banking institutions were more of liabilities than asset in an attempt to achieve real economic development in Nigeria. This conclusion was corroborated by Oyewole (1994) who found that the repressive policies towards Nigerian banks contribute to high financial intermediation costs and thus, harmful to the economy.

The results in this study confirm that banks are not effectively monitored by the regulatory authorities. As a result, banks adopt several deceptive strategies in order to widen the spread between the gross costs of borrowing and the net returns on lending. More specifically, banks mislead customers to believe that they pay higher rates than mandated on deposits. Bank customers also are made to pay for bank services which they are required to obtain free of charge.

These results are in concordance with those of Agu (1992), who found that the number of bank branches is highly correlated with profitability performance. Given that Nigeria is relatively underbanked, the larger the number of branches a bank has, the larger the size of profit it can realize through regulatory avoidance.⁶ On the other hand, the results reported in this study are indicative of the level of banking education in Nigeria. One possible explanation is that bank customers use only the rate of interest on deposits as decision criterion without regard to other bank charges. This is the behavior portrayed in Passmore and Sparks (1993). Closely akin to the explanation above, is the possibility that most bank customers are naive or are not aware that bank service charges are regulated. This situation can be explained by the poor information network in Nigeria. However, this author agrees with Oyewole (1994) that the solution to the current problem associated with financial intermediation in Nigeria is not reregulation but deregulation.

6. According to Ibe (1992), as at December 31, 1989, there was just one branch bank to 59,601 people in Nigeria. This ratio does not measure up to Japan's one branch bank to 10,000 people.

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Abstract

In a recent analysis of the Nigerian financial system, Oyewole (1993) found that the financial environment was not conducive to financial innovations prior to the reforms of 1986. However, many of the banks recorded significant levels of profitability prior to deregulation. This study represents a survey of service charges by banks in Nigeria in an attempt to determine the source(s) of the huge profits reported prior to deregulation. Banks were found to have used various means to circumvent regulations by overcharging customers for services as well as shirking services that they were obligated to provide without charge. The results reported here show the ineffectiveness of regulation in Nigeria. Finally, the author recommends a deregulated banking environment rather than reregulation which the current military government is contemplating.

LE MARKETING DES SERVICES BANCAIRES, LA REGLÉMENTATION, ET LA RENTABILITÉ BANCAIRE DANS UN SYSTÈME BANCAIRE EN DÉVELOPPEMENT**Résumé**

Dans une étude récente du système bancaire Nigerian, Oyewole (1993) a trouvé que l'environnement financier n'était pas favorable aux innovations financières avant les réformes de 1986. Cependant, plusieurs banques ont enregistré un niveau significatif de rentabilité avant la déréglémentation. Cette étude représente une enquête sur la rémunération des services dans les banques au Nigeria, dans une tentative de déterminer les sources des vastes bénéfices relevés avant la déréglémentation.

Les banques ont utilisé des moyens variés pour circonvenir les règlements en surchargeant les clients pour les services aussi bien qu'en se refusant de rendre des services qu'elles étaient obligées de fournir gratuitement. Les résultats reportés ici montrent l'inefficacité de la réglementation au Nigeria. Enfin, l'auteur recommande de déréglementer l'environnement bancaire au lieu de le re-réglementer comme le gouvernement militaire actuel s'apprête à faire.

Cette étude a été en partie supportée par une bourse de recherche de "la banque unie du Nigeria pour l'Afrique".