

THE REGULATORY GEARING RATIO AND THE NIGERIAN BANKING SYSTEM

Christian S. Nwinia
Port Harcourt, Nigeria

1. Introduction

There is a widespread acceptance of the need to regulate banking business, but there is no lack of criticism of certain aspects of the regulatory system. One aspect of the Nigerian banking regulations which has been publicly criticised is the ratio of capital to Loan and Advances required to be maintained by the banks.

Following a comparison of ratios of some major foreign banks, Ogwuma (1) asserts that the 1:10 ratio of capital to Loans and Advances was low, damaging to a developing economy, and had the tendency of retarding the growth of the Nigerian banking industry. This is disputable. It is, therefore, the aim of this paper to show that the criticism is not founded on objective assessment and is part of the general attack on government interference, characteristic of a democratic society, and to stress that fundamentally, regulatory measures need be determined and assessed based on the consideration of environmental circumstances or situational analysis.

2. The required ratio of shareholders funds to loans and advances

Section 6(3) of the Banking Decree, 1969, as amended, states: «The Central Bank may, after consultation with the Commissioner specify the minimum ratio which licensed banks shall maintain between their respective paid-up capital and all retained earnings on the one hand and their loans and advances on the other». In implementing this provision, which may be described as the maintenance of a gearing ratio, the Central Bank of Nigeria (CBN) tends to link the payment of dividends to the maintenance of the capital to Loans and Advances ratio.

Before 1982, the CBN Credit Guidelines specifically associated the maintenance of the gearing ratio with commercial banks. For example, the monetary policy circular No. 13 - Credit Guidelines for 1981 Fiscal year, states:

«Except with the approval of the Central Bank.... a commercial Bank may not apply its funds for payment of dividends to its shareholders unless such a bank maintains a ratio of not less than one to ten (1:10) between its adjusted capital funds and its total loans and advances (that is, the former should not be less than 10 per cent of the latter)....»

Though the Monetary Circulars have, prior to 1982, consistently and specifically referred to a commercial bank, the CBN restated this requirement in its 1976 Annual Report thus: «Before paying dividend to its shareholders, every bank was required to maintain

a ratio of not less than 1:10» (2). However, the Monetary Policy circular No. 14 for 1982 explicitly stated that «a bank may not apply its funds for payment of dividends to shareholders in 1982, unless such a bank maintains a ratio of not less than one to twelve (1:12) between its adjusted capital funds and its total loans and advances (that is, the former should not be less than 8.33% of the latter). Provision for bad and doubtful debts would be netted out of the loans and advances before the calculation of the ratio» (3).

From the tone of the Monetary Policy circulars, this requirement appears conditional and not mandatory. However, the ratio which had been 1:10 (10%) and increased to 1:12 (8.33%) from 1982 applies to all banks irrespective of size, strength and deposit resources, and penalties have also been prescribed for infringement (4). Infact, section 6(4) of the Banking Decree stipulates that except with the approval of CBN, a bank which fails to maintain the gearing ratio may not increase its loans and advances.

3. The criticism

Based on the statistics in Table 1, Ogwuma contends «that in countries where the banks have played and are expected to continue to play, a major role in economic development, the gearing is high» (5) (low percentage). He attributes the low gearing (high percentage) of the United Kingdom (U.K.) banks to the settled and already developed state of that country's economy. He did not explain why there were differences in the gearing of U.K. banks in his sample, particularly the 5.3% of BNP London and 20% of Barclays Bank, or say whether the U.K. was more settled or economically developed than France and even the United States of America with relatively higher gearing. In suggesting a gearing ratio of 1:20 for Nigerian banks, he points that a low gearing was «damaging to a developing economy and would have an adverse effect on the growth of the banking industry» (6).

Comparatively, the current ratio of 1:12 for Nigerian banks is still low. First, although Ogwuma recognizes the main object of the gearing ratio: «to prevent over-trading and placing depositors at greater risk» (7), he did not take into account some strategically critical facts:

- (i) while the depositors' interest was paramount, the developed countries, even the U.K. with a lower ratio, has a deposit protection scheme;
- (ii) the sophisticated legal and regulatory banking framework existing in these countries;
- (iii) the ownership and management of the banks; and

(iv) banking structures of the respective countries.

A close look at the French banks with exceptionally high ratios will show that the ratios cannot be compared per se. The three major French banks: *Banque Nationale de Paris* (BNP), *Credit Lyonnais*, and *Société Générale* are all state-owned banks. They are the

Table 1

GEARING RATIOS OF MAJOR FOREIGN BANKS

BANK AND COUNTRY			RATIO (a) Actual	% ¹	RATIO (b) Actual	% ¹
Bank of America	U.S.A.	1977	1:14	7.1		
Chase	U.S.A.	1978	1:15	6.7	1:13	7.7
BNP	France	1977	1:59	1.7	1:13	7.7
Credit Lyonnais	France	1978	1:64	1.6		
Deutsche Bank	Germany	1978	1:11	9.1		
Dresdner Bank	Germany	1979	1:11	9.1		
Commerzbank	Germany	1978	1:17	5.9		
BNP London	UK	1978	1:19	5.3		
Barclays Bank	UK	1978	1:5	20.0		
Midland Bank	UK	1978	1:11	9.1	1:8	12.5
National Westminster	UK	1978	1:11	9.1	1:9	11.1
Barclays Bank Int.	UK and Worldwide	1979	1:23	4.3	1:12	8.3
Midland International	UK and Worldwide	1978	1:17	5.9	1:11	9.1
State Bank of India	India	1978	1:31	3.2		

Nigeria - as prescribed by the authorities 1:10

Notes:

(a) Loan Capital excluded - since term is not known

(b) Including Loan Capital - assuming that it is long-term.

1. The percentages are author's computation

Source: Bankers' Almanac, as cited by P.A. Ogwuma in «The Growth of Banking Industry in Nigeria» Bullion, Vol. 6, No. 1, 1981, CBN Lagos, p. 9.

closest equivalent in France of the London clearing Banks, although they differ to a significant extent in their organizational structure and the type of activities in which they engage. These banks integrate in the parent bank the majority of their international activities. In addition, they carry out through the parent bank most of their mortgage lending and housing finance business — a practice not followed for instance by the big German banks, which have separate mortgage subsidiaries.

Although these banks dominate the French Commercial banking sector, they also have substantial interests in smaller deposit banks — mostly of a regional or local character.

Moreover, all three have separate investment banking and financial holding company subsidiaries and own or participate in medium — and long-term credit banks and finance companies. Indeed, since the reforms of the mid — 1960s, these banks have developed rapidly towards the universal or multipurpose type of bank, and their activities now include almost all the mainstream and peripheral financial activities such as leasing and factoring, property development and real estate management, unit trusts and fund management, consumer and housing finance, investment banking and new issue activities, and data processing and computer services.

Acceptably, the big three French banks are grossly undercapitalised by international standards, but according to the Inter-Bank Research organization (8), they are subject to a number of control ratios that cover prudential investment and credit control objectives. These ratios include:

- (i) liquidity ratio: liquid assets must cover at least 60% of current liabilities (liquid and current being defined as falling within three months);
- (ii) medium- and long-term loan ratio: medium- and long-term loans which are not refinancable must not exceed three times the sum of capital resources of the banks, plus all deposits from the public and non-banking institutions of more than three months' duration;
- (iii) employment of stable resources ratio: own funds plus certain deposits should be at least equal to investment in fixed assets, securities and certain loans of more than three month's duration.

Also, the monetary and credit control ratios include the reserve requirements (2% resident sight deposits plus 0.50% of loans), the supplementary reserve requirements, portfolio ratio, and certain other ratios limiting various activities such as hire purchase credits (10 times capital and reserves), property guarantees (20 times), and leasing operations (10 times).

The ratios applicable are described as cumbersome and complex, and having the potentiality of impairing the operational flexibility of banks. Bank failures are rare in France, and it might be argued that the system of prudential ratios in force contributes to greater solvency, particularly for the smaller banks. The large state-owned banks benefit both domestically and internationally from the implicit guarantee of the French government.

Second, it is equally inappropriate to compare the ratios presented in Table 1 because no precise definition of the components has been given. Even Ogwuma is uncertain of the composition of loans and advances as defined by the CBN.

It would appear that the CBN has not clearly defined the term, «Loans and Advances»

for the purpose of computing the gearing ratio. The commercial banking system's loans and advances as statistically classified by CBN (9) are composed of Loans and Advances to (1) banks in Nigeria, (2) subsidiaries of banks in Nigeria, and (3) other customers, plus Money at call outside CBN, and Bills Discounted. As at 31 March 1980, these stood at N4, 786.9 million. Similarly, the merchant banking system's Loans and Advances are defined as for the commercial banking system plus «Factored Debts», and at 31 March, 1980 totalled N277.9 million. Ogwuma implied that the Central Bank monthly report indicated that loans and advances granted by all banks (commercial and merchant) as at 31 March 1980 stood at N4.7 billion. Given Ogwuma's figure of N450 million for shareholders' funds of all banks in Nigeria — commercial and merchant at 31 March 1980, and the gearing ratio then 1:10, the banks were certainly overlent.

For the merchant banking system, «Equipment of Lease», which the CBN classified as «Investment», is, by nature medium-term loan transactions. If the gearing ratio is to serve meaningfully as a measure of capital adequacy, prudence or control of bank over-trading, the term «Loans and Advances» must be precisely defined. Equally important is the need to redesign the First Schedule to the Banking Decree, 1969 section 16(1) — Monthly Statement of Assets and Liabilities to reflect the new developments and to facilitate banks' statistical records, such as those presented in CBN's Economic and Financial Review. It may not be necessary to design separate First and Second schedules for the merchant banking system as called for by Okigbo (10). A new First Schedule that could be used by commercial and merchant banks would only require restructuring the present one by redefining Loans and Advances to include Bills Discounted, call money outside CBN, Equipment on Lease, and Capital Funds to incorporate Issued and Paid-up Share capital, statutory Reserves and other capital and Revenue Reserves. Thus, Bills Discounted and money at call would be sectoralised and added with Loans and Advances in SECTION A of the second schedule.

Finally, a higher gearing ratio would not protect depositors' funds. Prior to the Banking (Amendment) Decree No. 3 of 16 January 1970, the Banking Decree, 1969 Section 6(2) stipulated that «No licensed bank shall permit its paid-up capital and statutory reserves to fall below 10% of its total deposits at any given time». Indeed, this provision gave depositors greater protection than the current gearing ratio of 1:12, since conventionally, Loan-to-Deposit ratio is approximately 2:3 and the paid-up capital and statutory reserves (statutory capital) smaller than paid-up capital and all retained earnings (Networth or capital). The 1970 amendment shifted the relationship from between statutory capital and deposits to that between statutory capital and loans and advances. Similarly, the

1:10 or 1:12 ratio between statutory capital and loans and advances restricts lending more, and also gives better protection to depositors than 1:10 or 1:12 ratio between networth and loans and advances.

With particular reference to merchant banking, Table 2 gives some indication of the actual gearing ratio of banks in Nigeria and the U.K. Accepting Houses. Despite the narrowly defined Loans and Advances base (in A), the U.K. Accepting Houses' ratios are lower than those of the Nigerian merchant and commercial banks. Between 1975 and 1981, the merchant banks recorded 17.2% (median 14.1%) ratio against the elite commercial banks' 14.1% (median 9.9%), indicating that the merchant banks performed better. But the merchant banks' ratios in Table 2B with the definition of Loans and Advances excluding «Call money outside CBN», averaged 12.8% (median 11.3%) against the U.K. Accepting Houses' figure of 14.8% (median 14.4%), which suggests that the Accepting Houses maintained a gearing ratio of 1:7 against the Nigerian merchant banks of 1:9.

Also regulatorily, the Bank Negara Malaysia requires the Malaysian merchant banks to maintain two gearing ratios: domestic borrowings including deposits not to exceed 15 times (6.7%) their shareholders' funds, and domestic borrowings (including deposits)

Table 2
CAPITAL/LOANS AND ADVANCES (GEARING) RATIO (%)

Year End	A Nigerian Merchant Banking System		Nigerian Commercial Banks (9) of Mixed Ownership		B Nigerian Merchant Banking System		Members of UK Accepting Houses Committee	
	Average	Median	Average	Median	Average	Median	Average	Median
1975	38.2	25.5	16.5	8.1	—	—	—	—
1976	14.4	16.9	14.2	9.4	13.2	14.7	—	—
1977	12.3	13.1	15.3	10.9	11.2	12.0	15.9	15.2
1978	11.7	11.7	14.1	11.0	10.7	11.0	15.3	15.2
1979	23.5	11.7	14.9	11.1	22.8	11.4	13.3	12.8
1980	10.9	10.9	12.6	9.5	10.3	10.2	—	—
1981	9.4	9.1	11.3	9.4	8.6	8.4	—	—

Notes:

A. Loans and Advances figures used are as indicated in the Published Accounts of the banks. Capital = Paid-up share capital + Statutory reserves + Retained earnings (Shareholders' Funds).

B. For NMBS: Capital is as defined above (Shareholders' Funds). Loans and Advances cover figures in A + Bills Discounted + Leasing Equipment.

For AHC: Capital = Paid-up share capital + Equity reserves and Minorities. Loans and Advances = Loans to Banks and Local authorities + Loans to customers + Hire purchase loans (Installment Credit) + Leased assets + Advances to associate and Subsidiary companies if interest-bearing.

Source: Nwina C.S. «The Nigerian Merchant Banking System: An Empirical Study of its Role in the National Financial and Economic Development». Unpublished Ph.D. Thesis, University of Birmingham, 1983, p. 202.

and contingent liabilities including guarantees and acceptances not to exceed 20 times (5%) shareholders' funds. Both these ratios were maintained at 9.9 times (10.1%) and 11.5 times (8.7%) on 30 June 1979, 10 times (10%) and 11.5 times on 31 December 1979, and 9 times (11.1%) and 11.4 times (8.8%) on 30 June 1980 respectively; and despite the rapid growth in their operations both ratios continued to be maintained by all merchant banks at a comfortable margin of excess capacity for further expansion (11). Precisely, the first ratio of 1:15 is a capital to working deposits ratio and this is relatively lower than the 1:12 capital to loans and advances currently operating in Nigeria. Significantly, Malaysia is a developing country, and according to Ogwuma's hypothesis and computation the country's merchant banking system must maintain a higher capital to working deposits (being source of loanable funds) ratio, say about 1:30, to enhance economic development and foster the growth of the banking industry.

4. Conclusion

In sum, the gearing ratio, which is a measure of capital adequacy, sets limit to lending operations. It must be recognised that for the promotion of financial and economic development it is not necessarily the volume, but the quality or the allocational efficiency of credits that is important. Clearly, Ogwuma did not take into consideration the structure and the legislative and regulatory environment of banks in the countries in his sample. The components of the ratio are not precisely defined thereby rendering comparison impossible. There is need for the CBN to redefine «Loans and Advances», and restructure the First Schedule to the Banking Decree accordingly. A higher gearing ratio would not offer better protection to depositors, whose position the regulation attempts to safeguard and whose confidence is indispensable for effective mobilisation of savings. Also, high ratio was not characteristic of a developing economy.

Given the very poor management of most Nigerian banks, especially the indigenous commercial banks, the responsibility of the regulatory authorities to protect the interest of depositors, particularly in the absence of any formal deposit insurance scheme, the importance of the health and stability of the banking industry for the task of economic development, the gearing ratio requirement would appear reasonably set. The criticism by P.A. Ogwuma is not constructive. Indeed his argument is primarily defective because he failed to take into consideration the characteristics of the local economic environment and its human ecology.

References

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LE RAPPORT CAPITAL/PRÊTS ET LE SYSTÈME BANCAIRE DU NIGÉRIA.

RESUME

Si on compare le rapport capital/prêts du système bancaire du Nigéria avec celui des banques plus importantes de la majorité des pays développés on arrive à la conclusion que ce rapport est faible et dangereux dans le contexte d'un pays en voie de développement.

Dans cet article on cherche à démontrer que les critiques n'ont pas de sens sur la base de ces trois arguments:

- 1) le développement économique est favorisé par la qualité (efficacité du point de vue de l'allocation des ressources) et non nécessairement par la valeur des crédits accordés.*
- 2) les comparaisons ne sont pas appropriées sans une évaluation précise de la propriété, de la direction/gestion, de la structure, de l'environnement législatif et administratif des banques dans les pays considérés. Il faut encore préciser les composants du rapport capital/prêts.*
- 3) un rapport plus élevé ne garantit pas une meilleure protection des dépôts des épargnants dont la confiance est fondamental dans la mobilisation de l'épargne. Malheureusement cette caractéristique n'est pas répandue dans les pays en voie de développement.*

Toutefois on recommande aux autorités compétentes de mieux préciser les composants du rapport en question: seulement alors ce rapport qui mesure le degré d'adaptation du capital et des investissements prudents pourra être utilisé convenablement. Les autorités doivent aussi modifier le premier du règlement bancaire (Banking Decree, 1969) pour mieux s'adapter au nouvel environnement et pour faciliter le recueil des données statistiques.

