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FINANCIAL LINKAGE AND DEVELOPMENT IN SUB-SAHARAN AFRICA:

THE ROLE OF FORMAL FINANCIAL INSTITUTIONS IN NIGERIA

Adedoyin Soyibo

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Preface

As part of Structural Adjustment Programmes, many governments in Sub-Saharan Africa initiated a large scale restructuring of the financial system in the 1980s. Emphasis in these programmes was placed on the need i) to adopt financial liberalisation measures, and ii) to enhance regulatory and supervisory functions to ensure prudence of the financial institutions. Special Financial Sector Adjustment loans have been taken up to uphold reform measures and to restructure and strengthen distressed financial systems in several African countries. An improved regulatory environment with enhanced supervision is underscored in these operations, while the recent literature on the subject points to the need for careful design of the sequence, pace and timing of financial liberalisation and the importance of its coordination with changing macroeconomic conditions.

However, financial reform has at best had limited *developmental* effect in the region so far. It has been increasingly recognised that adoption of financial liberalisation policy alone has not been sufficient to generate a strong response in terms of increased savings mobilisation and intermediation through the financial system, wider access to financial services, and increased investment by the private sector. Fragmentation of financial markets persists, impeding efficient resource mobilisation and financial intermediation.

Given this background, a research project, 'Financial Integration and Development in Sub-Saharan Africa' has been undertaken at ODI, with financial support from the World Bank and SIDA, to examine the performance of financial systems for resource mobilisation and intermediation for economic development in Sub-Saharan Africa. The field work has been conducted in Ghana, Malawi, Nigeria and Tanzania, based on common questionnaires addressed to formal, semi-formal and informal institutions and borrowers. The main objectives of research were to:

i) investigate the nature and degree of fragmentation and segmentation of financial markets in Sub-Saharan Africa;

ii) examine the sources of segmentation against several theoretical paradigms and evaluate the conditions under which linkages between segments utilise the comparative advantages of each, and obstacles to such linkages;

iii) examine operational constraints facing formal financial institutions and informal associations/lenders;

iv) evaluate the effects of financial liberalisation on the whole financial system; in particular, to provide understanding of the impediments to financial deepening in Africa and the extent to which they can be relieved through financial liberalisation and through active policies of positive interventions, technical assistance and infrastructure that support market development by facilitating information flows and lowering transaction costs and risks;

v) help the design of long-term policies towards financial sector development and evaluate which policy and institutional measures can most effectively accelerate the financial system's ability to mobilise resources and intermediate between saving and investment for broad-based development in Africa.

This present paper is one of a series that will provide initial presentation of results of the country case studies. It presents the *Nigerian* case study, reporting the results of the field work on the behavioural characteristics of *formal* financial organisations/agents and the operational constraints in urban and rural areas.

Machiko Nissanke
(Project Coordinator)

May 1995

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1. Introduction

1.1 The Background

The formal financial sector in Nigeria has grown phenomenally in size, structure and complexity since 1960, when the country became politically independent. The passing of the Central Bank of Nigeria (CBN) Act in 1959, on the eve of independence, provided an effective regulatory basis for running a stable and sound banking system following the numerous bank failures recorded prior to that date. Thus, the number of commercial banks increased from 4 in 1959 to 12 in 1960 and 17 in 1962. Merchant banking started in Nigeria in 1960 when two companies, Phillip-Hill (Nigeria) Ltd and Nigeria Acceptances Ltd, began operations. However, these two companies merged in July 1969 to become Nigeria Acceptances Ltd and later NAL Merchant Bank Ltd.

Government involvement in banking operations went beyond provision of the necessary regulatory guidelines for sound banking practice with the acquisition of controlling shares in foreign-owned banks as a result of the enactment of the Nigeria Enterprises Promotion Decree, of 1977 (Soyibo and Adekanye, 1992). The Nigerian Industrial Development Bank, a Development Finance Institution (DFI), was established in 1964 through the reconstitution of the Investment Corporation of Nigeria, which had been in existence since 1959 (Adekanye, 1988). By 1977, the Federal Government had established three other DFIs, the Nigeria Bank for Commerce and Industry, the Nigerian Agricultural and Cooperative Bank and the Federal Mortgage Bank. During this period a host of Non-bank Financial Institutions (NBFIs) like insurance companies, pension and provident funds, hire purchase and leasing companies and the Nigeria Stock Exchange also existed in Nigeria.

Some lapses have been observable in the operations of Formal Financial Institutions (FFIs), particularly banks, in Nigeria. First, they are urban-based, and highly oligopolistic in their operations. For example, the 'Big Three', i.e. First Bank, Union Bank and United Bank for Africa, controlled over 60% of the deposit market by the early 1980s. Second, their methods of granting credit discriminated against certain vulnerable and disadvantaged groups, because banks based their assessment criteria purely on economic principles. Accordingly, farmers, rural dwellers, small and medium enterprises (SMEs) are often not favoured by banks in credit allocation. Bankers emphasised that these groups of customers made them incur high transaction costs, among other difficulties.

Because of these lapses, the Nigerian Government, like those of other countries of sub-Saharan Africa (SSA), intervened directly in the way banks allocate credit by means of a policy of directed credits and prescribing interest-rate ceilings via the annual CBN guidelines on monetary and credit policy. These guidelines stipulate aggregate credit ceilings for commercial and merchant banks, prescribe the sectoral distribution of loans and advances and spell out the structure of commercial and merchant bank assets. They also contain policy information relating to indigenous borrowers particularly in the rural areas, and prescribe the banks' capital funds and reserve requirements (ibid.). In prescribing interest-rate ceilings and directed credits, the CBN distinguished between preferred or priority sectors and less preferred or 'other' sectors. The preferred sectors are charged lower interest rates for loans and enjoy a preferential allocation of credits. Because of high inflation rates, interest rates have been negative in real terms. Thus the maximum real deposit rate was –8.3% in 1974, and –29.6% in 1975, becoming –28.8% in 1976 and –17.3% in 1977.

To encourage commercial banks to extend their services to the rural areas, the Federal Government embarked on a rural banking programme in 1977. Prior to this programme, all the 487 branches of the 19 commercial banks operating in the country were located in urban areas. Under the programme, which was implemented in three phases, the commercial banks were expected to open 766 branches in the rural areas. By 1983, when the third phase was initially expected to end, the number of commercial bank branches had grown from 487 to 1,101. The final phase was extended to 1985, however, when it was found that only 68% of the 266 rural branches expected to be opened during that phase had actually been opened. As the number of commercial banks in the country had increased from 19 in 1977 to 25 at the end of 1983, and the number of merchant banks from 5 to 10, with 25 branches.

Alongside the formal financial institutions there are informal institutions to meet the needs of those who cannot satisfy the stringent conditions of the FFIs and other programmes instituted by the government in order to ensure the access of rural dwellers and farmers to credit. An earlier study (Soyibo, 1995) shows that four of the identified informal financial institutions, namely, moneylenders, savings and credit associations, savings and credit cooperatives and *esusu* collectors, have a significant presence in the rural areas. In urban areas, in addition to these four, two semi-formal financial institutions; savings and loans companies and credit unions, also have a significant presence. The study also shows that the operators have a complex network of direct mechanisms for screening loan applicants and enforcing loan contracts through their deep personal knowledge of their clients and kinship relationships with them. They lend in small amounts for short maturity periods ranging between 3 and 8 months, on average, and were found to lend mostly to traders who use the funds for increasing working capital, and to others for consumption purposes. There is very little lending for investment purposes in SMEs.

The distortions created by direct government intervention in the operations of the economy in general, and of the financial sector in particular, led to the adoption of policies of financial reform. These reforms brought about relaxed entry rules for banks and NBFIs in Nigeria. In particular, they resulted in an increase in the number of commercial banks in the country from 29 in 1986, when financial sector reforms began to 65 (over 124%) in 1992. Correspondingly, the number of commercial bank branches increased by 67% from 1,360 in 1986 to 2,269 in 1990. The growth in the number of merchant banks is even more spectacular: they increased by 350% from 12 in 1986 to 54 in 1992, while the number of branches increased from 27 to 116 (330%). In spite of this phenomenal growth, the rural areas are still inadequately served. The number of rural branches of commercial banks grew on average by only 8.7% per year between 1986 and 1992, even after the reforms. By 1992 there were 774 rural branches out of a total of 2,275 commercial bank branches, representing 34% (see Table 1). Yet over 75% of the population live in the rural areas. In spite of the reforms, the banking needs of the rural people have still to be satisfied.

New deposit-taking institutions also came on stream as a result of the financial sector reforms. Among banks, these included community banks, the People's Bank and mortgage banks, officially called primary mortgage institutions (PMIs). Among NBFIs, there are the finance houses or companies, unit trusts and discount houses.

A community bank is defined as a self-sustaining financial institution owned and managed by a community or group of communities for the purpose of providing credit, deposit, banking and other financial services to its members on the basis of self-recognition and creditworthiness (CBIC, 1990). Its capital base is very low, being just ₦250,000. This is 0.5% of that of a commercial bank or 0.625% of that of a merchant bank.

The People's Bank of Nigeria is a specialised bank established by Decree 22 of 1990 with the aim of serving low-income earners operating low-level business. Its rationale is similar in conception to the Small Business Administration of America and Japan, the Industrial and Commercial Corporation in the UK, the Grameen Bank of Bangladesh, the BKK of Indonesia, and the Village Adoption Scheme, the Agricultural Development Bank and the Rural Regional Development Banks of India (Shah, 1983).

Finance houses are privately-owned investment companies engaged in such services as the provision of loans, hire purchase, equipment leasing, factoring project financing, debt administration, fund management, and local purchase order financing, among others. They offer short-term funds to a clientele often not in a position to meet the conventional requirements of banks in terms of the provision of adequate security and collateral. These are small and medium-scale entrepreneurs with a limited capital base requiring short to medium-term funds for commerce, export promotion, working capital and other productive purposes (Soyibo, 1994a).

Table 1 **Growth of the banking system**

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*	*1991*	*1992*
Total number of banks	26	26	30	35	38	40	41	50	66	81	106	119	120
Total number of branches	752	884	1010	1232	1267	1323	1394	1516	1711	1912	2013	2107	2391
Number of commercial banks	20	20	22	25	27	28	29	34	42	47	58	65	66
Rural Branches	194	237	314	n/a	n/a	n/a	481	529	602	756	765	765	774
Urban Branches	546	632	677	n/a	n/a	n/a	886	954	1063	1100	1169	1253	1495
Total[a]	740	869	991	1208	1242	1297	1367	1483	1665	1856	1939	2023	2275
Number of merchant banks	6	6	8	10	11	12	12	16	24	34	48	54	54
Urban Branches	12	15	19	24	25	26	27	33	46	56	74	84	116

Notes: a. Includes overseas branches.

Source: Central Bank of Nigeria

Community banks increased by leap and bounds from 1 in 1990 to 66 in 1991 and 401 in 1992, finance companies from 558 in 1991 to 666 in 1992, People's Bank branches from 200 in 1991 to 228 in 1992, and unit trusts from 1 in 1990 to 9 in 1991 and 10 in 1992. Stockbrokers operating on the Nigerian Stock Exchange also increased from 19 in 1985 to 43 in 1988, 110 in 1991 and 140 in 1992. The trading activities of the Exchange were also extended, with three trading floors opened in Ibadan, Kaduna and Port Harcourt in addition to that in Lagos. The establishment of the Nigeria Deposit Insurance Corporation (NDIC) also came with the financial sector reforms. It is charged with the responsibility of insuring bank deposits and ensuring good banking practices through effective supervision, and assisting the CBN to formulate banking policies with a view to ensuring the stability of the financial system (NDIC, 1990).

The financial sector reforms began in 1986 with the liberalisation of the foreign-exchange market. In August 1987 the CBN ceased to prescribe interest rates on deposits and loans. Simultaneously, the entry of new banks was liberalised, and the use of the policy of directed credits was substantially relaxed.

As a consequence, nominal lending rates rose to a maximum of 9.2% in 1987, reaching an all-time high of 37.22% in the second quarter of 1993. The maximum real lending rate was positive in 1987, rising to 14%, but declined to -25.8% in 1989 because of very high inflation. In 1990, it became positive again reaching 28.3% but relapsed to -13.9% in 1992. Besides the measure of financial deepening, the ratio of M_2 to GDP was on the decline from 1987 when it was 0.27, dropping to 0.26 in 1988 and 0.19 in 1989. Since 1990, an increasing trend is observable rising from 0.22 to 0.27 in 1991 (Soyibo, 1994b).

The increase in the form and varieties of FFIs that came on stream with the financial reforms is expected to promote competition in the formal financial sector. This study attempts to evaluate the extent to which the reform programme has promoted increased and sustainable competition in the financial market. It seeks to analyse the competition between institutions in the formal segment of the market and also between FFIs and units of the informal segment of the market. In this regard, it attempts to address the issue of the non-clearance of the financial market, even after comprehensive financial reforms, which Caskey (1992) has described as a costly undertaking. It posits that a number of structural and institutional bottlenecks prevent the clearance of the market, and argues that they need to be thoroughly understood before successful reforms directed at improving service delivery and the efficiency of the various segments of the financial system can be realistically put in place.

1.2 Methodology

The data used in the study were obtained from secondary and primary sources. Data from secondary sources are of three types: those collected from head office interviews and the published accounts of some banks, those obtained from published aggregate financial sector data, and published works relevant to the main hypotheses of the study.

Data from primary sources were obtained from a survey of formal financial institutions using a comprehensive questionnaire made up of 12 sections. The questionnaire sought information on such things as deposit characteristics; characteristics of usual borrowers; loan processing and decision-making responsibilities; loan characteristics; maturity and other conditions, the loan screening process and characteristics; costs associated with the screening process; the loan monitoring process and associated costs; loan repayment trends; and the costs associated with loan repayment.

The data generated were for a three-year period 1990–92 in order to gain an insight into any possible changes in trend. The data were used to determine the extent of the varying information base among the different banks and to estimate the different transactions and other costs. This was done with a view to accepting or rejecting the hypothesis that the varying information base and different transactions and other costs inhibit the development of effective linkages within and among the financial sectors of SSA countries. The whole process of loan transaction was broken down into screening, monitoring and enforcement for each type of borrower category. For each aspect of the process we established the information required to assess its adequacy as well as how the information is obtained. We then estimated, using data provided for personnel, transportation and stationery, the administrative cost component of the process. Disaggregating the costs according to borrower categories helps to estimate the average administrative cost incurred for each monetary unit of loan given to the client. This can help establish the structures of the different banks and the corresponding lending costs incurred in order to gain an insight into how to ease the burden of the institutional framework on the granting of credit.

The banks surveyed were selected from a purposive cluster of banks. Three clusters of big banks, medium-sized banks and new-generation banks were defined for this purpose. The big banks, which mobilise over 40% of total deposit, constitute a self-representing cluster; we made an effort to ensure that we obtained approval for including all banks in this cluster in our sample. With regard to the other two clusters, the selection was based principally on the willingness of head office staff to take part in the study, subject to ensuring that not less than 50% of the branches actually studied belonged to these clusters. The selection of community banks and People's Bank branches studied was based entirely on the willingness of bank officials to participate in the study.

However, one overriding criterion was the need to ensure the locational and ethno-geographic balance existing within Nigeria in the actual branches studied. Accordingly, we ensured that the bank branches sampled were located in the southwestern, southeastern, middle-belt and northern zones of the country. The southwestern zone was deliberately given greater weight in the selection of samples studied, for two reasons. The first is that it is the zone with the greatest proportion of business and commercial activities in the country. Lagos, the country's commercial nerve-centre, is located in the zone and has a reputation for originating close to 70% of all financial transactions in the country. Moreover, over 80% of all Nigerian banks have their head offices and not less than 60% of all their branches in the zone. Secondly, the zone is the most cosmopolitan of all the geographical regions in Nigeria, with a fair representation of all ethnic and religious groups.

The bank branches were studied in consultation with head office staff, taking into account the need to get a fair ethno-geographical distribution as indicated earlier. Head office staff were visited and an interview was sought with a sufficiently senior official, such as the Managing Director/Chief Executive, Executive Director, General Manager, Deputy General Manager or Assistant General Manager. These officials were normally those directly in charge of, or with substantial responsibility for, banking operations or credit. The objectives of the research were discussed with the officials, and permission to use the bank was then sought. If permission was granted, the bank was chosen, otherwise it was dropped. The visits continued until we had permission from as many banks as possible so that the proportional cluster representation of medium-sized and new-generation bank branches identified was satisfied. Table 2 shows the distribution of the sampled bank branches and questionnaires actually used in the analysis.

A total of 62 questionnaires was distributed, 51 of which were retrieved and 40 actually used in the analysis, representing a response rate of 66.7%. Of these, 26 were commercial banks (65%), 8 merchant banks (20%), 4 community banks (10%), while 2 were People's Banks (5%).

The analysis was mostly descriptive, employing percentages and means to analyse the variables of interest. We used t-statistics to test for differences of significance in some variables.

We also formally investigated whether there was any significant difference in the cost structure of loan administration and its different components across banks and their borrowing clientele, using the F-test statistic:

$$F = MSTR/MSE$$

where

MSTR = mean square treatment,

MSE = mean square error.

$$\frac{\left[\sum\sum nj(Y_{ij}-\bar{Y}_{...})^2\right]/k-1}{\left[\sum\sum\sum(\bar{Y}_{ijk}-Y_{ij.})^2\right]/N-k}$$

where Y_{ijk} = the observation k of level i of the first factor (bank type) and level j of the second factor (type of enterprise);

$$\bar{Y}_{ijk} = \sum Y_{ijk}/n_j$$

is the mean for the treatment corresponding to level i of the first sector (bank type) and level j of the second factor (type of enterprise); and

$$\bar{Y}_{...} = \sum\sum\sum Y_{ijk}/N$$

is the Grand Mean.

1.3 Organisation of the paper

In Chapter 2 of this paper we discuss the structure of the deposits of the financial system, first in the aggregate and then using micro-level data. It shows the highly liquid nature of the financial system deposits which has implications for the type of credit the system allocates, the structure of which is analysed in Chapter 3. The procedure of loan administration, loan costs and their components are described in Chapter 4, while the savings-investment link is presented in Chapter 5. This chapter attempts to provide some explanation for the lending behaviour and the characteristics of loan administration procedures observed in the two earlier chapters. We discuss innovations in the formal financial sector and emerging links between the different segments of the system in Chapter 6, with concluding remarks in Chapter 7.

Table 2 **Distribution of sampled banks and questionnaires actually used in the analysis**

	Sampled					*Used*				
	Commercial Banks	*Merchant Banks*	*Community Banks*	*People's Banks*	*Total*	*Commercial Banks*	*Merchant Banks*	*Community Banks*	*People's Banks*	*Total*
South-West										
Lagos	10	6	2	2	20	6	5	2	-	13
Ibadan	10	2	2	1	15	9	1	1	-	11
Abeokuta	2	-	-	-	2	2	-	-	-	2
Benin	4	-	-	-	4	2	-	-	-	2
South-East										
Port-Harcourt	2	-	-	-	2	1	-	-	-	1
Aba	1	1	-	-	2	1	-	-	-	1
Middle Belt										
Lokoja	2	-	-	-	2	1	-	-	-	1
Ajaokuta	2	-	-	-	2	1	-	-	1	2
Far North										
Kano	4	2	-	-	6	2	1	-	-	3
Kaduna	4	1	1	1	7	1	1	1	1	4
TOTAL	41	12	5	4	62	26	8	4	2	40

Source: Survey.

2. Structure of the deposit system

In this chapter the structure of aggregate bank deposits is analysed as well as the micro-level structure of bank deposits, using data obtained from our survey of the formal financial institutions. The objective of this analysis is to demonstrate that the preponderance of highly liquid deposits in the total deposit liabilities of banks poses structural constraints on their ability to lend for long-term investment purposes. The short-term nature of the maturity of bank deposits leads to a mismatch in asset-liability maturity.

As a consequence of the high proportion of short-term liabilities in banks' deposits they tend to lend short, according to the commercial bank loan theory or the real bills doctrine. This theory stipulates that bank loans should be short-term, self-liquidating and productive 'commercial paper', because commercial banks usually have short-term deposits. According to the theory, banks should not grant long-term loans such as estate loans and loans for financing the purchase of plant and equipment because they are considered too illiquid (Elliot, 1984; Ritter and Silber, 1986). Nigerian bankers tend to place a lot of emphasis in their lending decisions on the ability of the borrower to repay, the profitability of the sector and the borrower's experience in a similar project, in that order (Soyibo, 1994c). The emphasis on the ability of the borrower to repay, bankers argue, stems from the desire to meet liability obligations to their depositors.

Accordingly, Nigerian banks would rather carry excess liquidity than lend, particularly in view of the experience of non-performing loans in their portfolios because of the less stringent prudential climate that existed prior to financial liberalisation. The problem of the preponderance of short-term liabilities in the banking system poses a challenge to achieving the transformation of liabilities by adopting innovative approaches.

2.1 Aggregate lending in the banking system

Before the reforms, demand deposits constituted nearly 50% of the total deposit liabilities of the banking system. In practice, savings deposits in Nigeria are operated like demand deposits, the only difference being the inability to write cheques on them. With the addition of saving deposits, the proportion of the highly liquid part of the deposit liabilities of the banking system will be seen to have been well above 60% before the financial reforms (Table 3). Thus, in 1980, the corresponding proportion was 63.8%, dropping to 60.6% in 1985 on the eve of the financial reforms. By 1988, a year after the deregulation of interest rates, the corresponding proportion declined to 55%, but it rose to 66.9% in 1989 and 73.2%

Table 3 **Deposit liabilities of the banking system (₦ m., end of period)**

	Commercial				Merchant				
	Demand	*Time*	*Savings*	*Total*	*Demand*	*Time*	*Savings*	*Total*	*Grand Total*
1980	4845.9	3573.7	1589.5	10009.1	66.5	219.6	-	286.1	10295.2
1981	4880.9	3816.8	1979.2	10676.9	122.4	328.0	-	450.4	11004.9
1982	5180.7	4517.0	2321.2	12018.9	272.3	691.3	-	963.6	12982.5
1983	5855.4	5203.6	2879.3	13251.9	484.7	793.7	-	1278.4	14530.3
1984	6343.5	6030.0	3361.3	14908.4	511.0	970.6	-	1481.6	16390.0
1985	7046.2	6851.0	3699.9	16776.1	530.5	1318.2	-	1848.7	18624.8
1986	6649.8	7217.6	4270.2	17771.0	601.9	1739.7	-	2341.6	20112.6
1987	7998.0	9882.0	5206.7	29422.3	560.2	2822.8	-	3383.0	23805.3
1988	10667.9	11274.5	7122.7	29065.1	834.8	3982.8	-	4817.6	33882.7
1989	10188.0	7739.1	9237.8	27164.9	1294.4	2505.2	9.7	3809.3	30974.2
1990	15588.8	10175.0	13013.5	38777.3	2363.4	3946.5	7.9	6317.8	42723.8
1991	22049.0	10964.4	19395.3	52408.7	2022.2	5007.0	39.2	7068.4	59477.1
1992	33639.7	16202.0	26231.8	76973.5	3302.9	8342.5	19.3	11664.7	87738.2

Source: Central Bank of Nigeria, *Statistical Bulletin*, 4, (1), June 1993.

in 1991. The situation with regard to the maturities of deposit liabilities does not therefore appear to have improved, even after the financial reforms. If anything, it seems to have worsened.

Analysing further the maturities of the limited proportion of time deposits mobilised by the banking system in Nigeria reveals the handicap the banks face in getting resources to move into long-term funds. In general, 2% of commercial bank deposits had maturities of more than 12 months between 1989 and 1992. As regards merchant banks, some appreciable improvement, though limited in volume, appears to have been made after the reforms. With about 1% of total deposits having maturities of over 12 months in 1989, the proportion increased to between 5.5% and 10.1% during 1990–92 (Table 4).

Bankers have always complained that the rural branches of the commercial banks are loss centres, and this was confirmed by our head office interviews. However, there has been some improvement in the deposits mobilised by rural bank branches since the financial reforms began. Thus, the proportion of rural branch deposits in total commercial bank deposits increased from less than 1% in 1982 and 1983 to nearly 5% in 1986 and peaked at over 20% between 1989 and 1991 (Table 5). Despite data on the maturity structure of the deposits not being available, they are, of course, likely to reflect the structure of aggregate deposits in the banking system and to show a preponderance of highly liquid liabilities. The fact that rural people engage mostly in farming, with all the uncertainties of yields due to the vagaries of the weather and other conditions, complicates the inability of banks to lend to them. It will be shown later that the rural branches of commercial banks have smaller loan-to-deposit ratios than urban branches and that, in general, the banks would rather carry excess liquidity than lend. The financial reforms had little appreciable impact in this regard.

2.2 Micro-level analysis of bank deposits

Our survey data also confirm that commercial banks dominate the deposit market. Thus, they have more deposit accounts per branch than merchant banks; however, in numerical terms, the People's Bank and the community banks certainly have more accounts than either the commercial or the merchant banks (Table 6). It can be inferred from the table that merchant banks, in particular, do not usually keep their records of corporate customers according to their size of operations (because a greater proportion of the customers belong to the 'others' category). They often record them by sector of operations, as is required by the regulatory authorities in monitoring how credit is disbursed to the different sectors of the economy.

That the People's Bank has more deposit accounts numerically is in accordance with its mandate to encourage the lower-income group to develop the banking habit. However, the decline in the number of deposits between 1991 and 1992 in

Table 4 **Maturity structure of the deposits of the banking system 1989–92 (%)**

	Commercial Banks				*Merchant banks*			
	1989	*1990*	*1991*	*1992*	*1989*	*1990*	*1991*	*1992*
Demand Deposits	37.5	40.2	42.1	44.2	30.9	19.5	28.7	26.1
Savings Deposits	34.0	33.5	37.0	34.2	0.3	0.1	6.7	0.2
Time Deposits: maturity < 3 months	13.8	13.2	11.2	12.2	48.1	51.7	37.2	42.0
Time Deposits: 3 to 6 months	5.9	5.5	4.5	4.7	13.0	11.7	12.6	9.8
Time Deposits: above 6 to 12 months	6.5	5.5	3.9	3.5	6.7	10.8	9.3	11.8
Time Deposits, above 12 months	2.3	2.1	1.3	1.2	1.0	6.2	5.5	10.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: NDIC, *Annual Report and Statement of Accounts* (Various Issues)

Table 5 **Deposit mobilisation by rural branches of commercial banks**

	Rural Branch Deposits (₦ m.)	*Total Commercial Bank Deposits (₦m.)*	*Rural Deposits as Percentage of Total Deposits*
1982	111.7	12018.9	0.9
1983	131.2	13251.9	0.9
1984	276.6	14908.4	1.9
1985	311.4	16776.1	1.9
1986	873.5	17771.0	4.9
1987	1229.2	20422.3	6.0
1988	1378.4	29065.1	4.5
1989	5722.0	27164.9	21.06
1990	8360.1	38777.3	21.6
1991	10580.7	54408.7	20.2

Source: CBN, *Statistical Bulletin*, 3, (2) December 1992.

Table 6 Average amount mobilised by branch/bank (₦m.)

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	6.9	14.3	15.6	1.9	4.4	8.9	0.2	0.3	5.0	0.2	0.2	0.2
Large-scale enterprises	14.0	16.2	32.0	5.7	14.7	36.7	0.1	0.1	14.1	0.1	0.1	1.4
Small-scale agriculture	2.3	3.5	8.9	4.0	14.0	51.7	0.4	0.4	10.2	0.2	0.4	0.9
Others	20.6	22.1	38.9	22.2	15.2	30.3	0.2	0.5	1.2	0.1	0.2	0.3

Source: Survey

the community banks and the People's Bank suggests that the initial enthusiasm of individual account holders for these innovations needs to be strengthened so that the envisaged impact can be felt.

What is cheering, however, is that the average deposit amount mobilised per branch in these banks has not decreased. In fact, they grew phenomenally in nominal terms between 1991 and 1992 for both types of banks. Thus, an average deposit generated by small-scale enterprises (SSEs) increased from ₦0.3 million to ₦5m. for community banks (Table 7).

The fact that the People's Bank take deposit from and lend to large-scale enterprises (LSEs) should not be surprising, given that LSEs are defined in our survey as enterprises employing more than 10 persons. As the People's Bank lends to individuals and groups of low-income earners, and individual and group beneficiaries are expected to belong to groups having not less than 15 members, it is easy to see that loans granted to *groups* rather than individuals are interpreted as being given to LSEs.

The average deposit mobilised per branch between 1990 and 1992 by commercial banks in the sample for SSEs is substantially higher than that mobilised by merchant banks. For large-scale enterprises, it will be seen that commercial banks are offering stiff competition to merchant banks. This is not surprising since, with financial liberalisation, the dividing line between commercial and merchant banking appears to be thinning out. The concept of universal banking has been gaining ground in Nigeria as a result of the financial system reforms (Soyibo and Adekanye, 1992). According to another study (Soyibo, 1994c) top bankers interviewed regard this development as healthy for the industry.

Table 7 Average number of depositors per branch/bank

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	307	390	1453	3	11	16	479	693	234	1451	912	624
Large-scale enterprises	440	558	2057	4	9	14	216	677	553	784	831	580
Small-scale agriculture	316	454	558	3	18	23	185	817	550	2418	1647	573
Others	2202	2206	2564	205	111	140	107	146	665	606	508	630

Source: Survey.

In spite of this development, the foregoing analysis indicates that different units of the banking system have different clienteles when it comes to deposit mobilisation. Merchant banks target LSEs and High Networth Individuals (HNWIs) in particular, community banks and the People's Bank focus on the low-income groups, while commercial banks operate in between the two extremes of the deposit mobilisation continuum.

As expected, the deposit amount per branch mobilised by community banks and the People's Bank is generally much lower than that of commercial and merchant bank branches (Table 7). This means that they will have less funds available for granting credit to their numerous customers.

Rural bank branches tend to have a lower average number of depositors for all sectors under study, except that of the 'others' category (Table 8). In general, this table also shows that bank branches tend to be careless about the classification of clients by size of operation. Rather, they tend to use the sector of operations as required by the monetary authorities to facilitate their supervisory functions. Rural bank branches tend to mobilise a smaller deposit amount than urban branches. In general, the 'others' category is the major source of deposit mobilisation by both urban and rural bank branches (Table 9). This is a reflection of what is observed in the aggregate (Table 5).

The flow of deposits tends to fluctuate during the year between periods of high low volume. However, there is no consensus across different units of the formal financial sector studied as to which is the 'peak' month, though there appears to be a consensus that January is the month when deposits are smallest. Among commercial and merchant banks, 40% of managers indicated that January was the

Table 8 Location of average number of depositors by size of manufacturing/services

	1990				*1991*				*1992*			
Location	*SSE*	*LSE*	*SSA*	*Others*	*SSE*	*LSE*	*SSA*	*Others*	*SSE*	*LSE*	*SSA*	*Others*
Urban	401	442	524	1337	379	490	524	1239	1046	1488	451	1361
Rural	187	145	318	2484	276	274	584	2751	335	353	734	3287

Source: Survey.

Table 9 Average amount mobilised by location (₦m.)

Location	*1990*				*1991*				*1992*			
	SSE	*LSE*	*SSA*	*Others*	*SSE*	*LSE*	*SSA*	*Others*	*SSE*	*LSE*	*SSA*	*Others*
Urban	5.90	12.6	2.36	20.65	12.02	15.77	5.19	20.35	22.30	65.49	16.61	33.80
Rural	0.26	0.38	0.23	1.20	0.23	0.34	0.26	1.41	0.32	0.32	0.28	1.05

Source: Survey.

month of lowest deposit, while 50% of community banks also chose January as the month of least deposit. This is similar to the result obtained for the informal sector, where it was established that December/January constituted the month of lowest deposit among informal lenders. This practice was linked with withdrawals for festive seasons. June was also identified as the month of least deposit by 50% of community bank operators studied. This may be due to the peculiarities of the community bank's type of clientele and may also have something to do with the planting season in which many of their clients are involved.

The estimated deposit ratio between peak and least deposit months can be substantial in the case of some banks. It is about 60% on average for community banks, 48.7% for merchant banks, 37.1% for commercial banks and 24.1% for the People's Bank. This has implications for lending and liquidity management in the various banks. Community banks, it would appear, are more susceptible to 'seasonality' problems of deposit mobilisation and perhaps lending as a result of the observed wide variation in deposit mobilisation. This is one of the structural constraints impeding the flow of investment funds to agriculture and SMEs.

There is some connection between the formal financial institutions and the informal financial sector. Some banks hold deposits for some informal/semi-formal financial institutions. Commercial banks, community banks and the People's Bank are the usual links employed. Some commercial banks located in rural areas estimated that as much as 23.4% of their deposits, on average, came from the informal and semi-formal financial sector. This is distributed as follows: 2.3% from *esusu* collectors, 7.7% from moneylenders, 5.1% from savings and loans companies, 2.1% from financial cooperatives, and 2.5% from credit unions.

For community banks, the estimated proportional contribution from the informal/semi-formal sector is even higher. Some of them indicated having as much as 9.4% of their deposits from *esusu* collectors, 2% from moneylenders, 15% from financial cooperatives, 10.5% from savings and credit associations and 6% from credit unions. From the People's Bank the estimated corresponding proportions are 15.3% for *esusu* collectors, 10% for financial and credit cooperatives and 6% for savings/credit associations. In spite of the limited number and size of the deposits involved, this finding suggests that it is possible to design innovative schemes to strengthen the link between the formal and informal financial sectors in Nigeria, thus promoting financial integration.

2.3 Analysis of savings mobilisation by finance houses

The analysis in this section is based on a survey of finance houses conducted by Soyibo (1994a). Out of about 500 members of the Finance Houses Association of Nigeria, 250 were selected at random for the study. Of these, 165 questionnaires were found usable for the analysis, representing a response rate of 66%.

There are many similarities between the operations of finance houses and banks. Both mobilise liability funds from the public. However, these funds may be collected as over-the-counter deposits in retail amounts (commercial banks) and in lumpier wholesale amounts by merchant banks (minimum of ₦25,000 in 1994; the figure was higher previously, being initially ₦100,000, later reduced to ₦50,000). By law, the investible funds generated by finance houses cannot be taken as over-the-counter deposits, but only as 'wholesale' loans from customers, with a minimum value of ₦100,000. In general, the operations of finance houses are closer to those of merchant or investment banks, in that they deliver similar services such as equipment leasing, LPO financing, project consultancy, factoring and debt management, among others.

Like banks, the liabilities of finance houses are mainly short-term in tenor. Thus, none of the finance houses surveyed by Soyibo (1994a) had liabilities with a maturity exceeding 12 months in 1990. In 1991 and 1992, only 6% of the total liabilities of the finance houses surveyed exceeded 12 months (Table 10). This is similar to the result obtained in our analysis of the aggregate deposits of merchant

Table 10 Structure of total liabilities of finance houses (%)

	1990	*1991*	*1992*
Up to 3 months	66.5	53.1	54.8
Over 3 months–6 months	23.2	26.2	23.4
Over 6 months–1 year	10.3	14.7	15.8
Over 1 year–5 years	-	5.0	5.0
Over 5 years	-	1.0	1.0
	100.0	100.0	100.0

Source: Soyibo (1994a).

banks.

Thus it will be seen that finance houses operate more or less like near-banks, and are handicapped by similar constraints in their investment pattern. In spite of the opportunities offered by the financial reforms and the springing up of new FFIs, these structural constraints remain unmitigated.

3. Structure of credit allocation in formal financial institutions

3.1 Aggregate credit allocation

Prior to the financial reforms, net credit to the government sector (i.e. minus the Federal Government's deposits in the banking system) was less than that to the private sector. When it is recognised, however, that public sector deposits in the banking system are generally high, it will be seen that credit to the government sector, including parastatals, may be quite substantial denying the private sector the much needed credit for investment and capital formation. The situation did not improve even with the financial reforms (Table 11).

With the financial reforms, the Central Bank started becoming an important supplier of credit to the economy, providing between 40.2% and 59.8% of aggregate credit between 1990 and 1992. This sudden ascendancy of the CBN in the provision of credit is related to the increasing budget deficit of the Federal Government which is often financed by money creation. Deficit financing worsened from -3% of GDP in 1990 to -10.5% in 1992. The increasing crowding-out effect of government credit puts a structural constraint on the availability of credit to the private sector in general, and to SMEs and rural people in particular. Nevertheless, the banking system has improved its lending to the private sector since the financial reforms (Table 11).

The use of directed credit was rigidly applied by the CBN prior to the financial reforms. Even with the reforms, it was not completely eliminated, but only substantially relaxed. In the early days of strict control agriculture, mining, manufacturing and construction were regarded as preferred sectors in the granting of credit. For example, in 1983 the prescribed minimum of aggregate credit to the agricultural sector was 10%; however, the actual aggregate credit allocation for the sector can easily be computed from Table 12 as 8.5%.

In most cases the banks prefer to lend to areas where they can easily recoup their investment. Thus real estate and construction, general services, commerce and others (including personal and professional credit) tend to be favoured. SMEs and indigenous enterprises are regarded as preferred sectors, but the banks shy away from them because of their perceived risk.

Some government policies also inhibit the capacity of banks to lend. As a way of protecting the depreciation of the naira with the introduction of the foreign-

Table 11 Structure of banking credit (end of period, %)

	Aggregate (Net)[a]	*Credit to Private Sector*	*Credit to Govt. Sector (Net)[b]*	*Credit from Central Bank*	*Credit from Commercial Banks*
1980	100.0	66.71	33.3	15.9	84.1
1981	100.0	59.4	40.6	33.8	66.2
1982	100.0	53.7	46.3	40.0	60.0
1983	100.0	43.8	56.2	41.1	58.9
1984	100.0	41.6	58.4	34.5	65.5
1985	100.0	41.9	58.1	31.4	68.6
1986	100.0	47.2	52.8	44.8	55.2
1987	100.0	54.3	45.7	34.6	66.4
1988	100.0	51.9	48.1	34.6	65.4
1989	---	---	---	---	---
1990	100.0	63.5	36.5	40.2	59.8
1991	100.0	54.1	45.9	41.1	58.9
1992	100.0	40.8	59.2	59.8	40.3

a. Gross credit to the domestic economy less Federal Government deposits with the banking system.
b. Gross credit to the Federal Government less Federal Government deposits with the banking system.

Source: Computed from CBN, *Statistical Bulletin*, 4(1) June 1993.

exchange market, where the exchange rate is determined by market forces, the CBN has issued from time to time stabilisation securities which it uses to mop up 'excess' liquidity in the banking system. The CBN also raised the reserve requirements of banks and prohibited them from granting loans using the proceeds of accounts denominated in foreign exchange as guarantee. In order to ensure that the banks are adequately capitalised, the banks' capital ratio was revised in 1989 to 1:10 between adjusted funds and total loans and advances, as against the previous ratio of 1:12. Merchant banks, which were previously excluded from the observance of cash-reserve requirements, were also subjected to a cash-reserve requirement of 5% of their total demand deposits (Soyibo and Adekanye, 1992). These policies make less cash available for the banks to use as loans. Thus, despite their good intentions and theoretical elegance, policies put in place to ensure the soundness of the financial system after the implementation of the financial reforms can constrain the banks in granting credit to disadvantaged groups like SMEs, agricultural enterprises and rural dwellers.

Table 12 **Sectoral distribution of commercial bank credit (₦m., End of Period)**

Year	*Agric. Forestry & Fishery*	*Manuf.*	*Mining and Quarrying*	*Real Estate and Construc'n*	*Bills Discounted*	*Domestic Trade*	*Exports*	*Imports*	*Public Utilities*	*Transport and Comms*	*Credit and Financial Institutions*	*Government*	*Personal and Professional*	*Misc.* [a]	*Total*
1980	462.2	1956.8	50.9	1325.4	26.6	634.6	100.2	447.9	88.0	485.4	206.8	160.3	222.3	181.7	6349.1
1981	590.6	2659.9	88.0	1750.5	-	827.5	107.1	540.4	177.2	610.3	360.8	308.9	323.2	238.6	8349.1
1982	786.6	3037.6	94.3	2085.0	-	1092.3	150.5	583.7	193.1	707.0	402.1	368.1	-	774.4	10275.3
1983	940.4	3053.1	118.7	2260.2	-	1066.6	137.7	522.9	181.3	718.2	753.2	589.0	-	695.7	11093.9
1984	1052.1	3083.5	165.5	2373.8	-	1197.7	133.5	491.5	200.7	738.5	538.2	579.6	-	734.0	11503.6
1985	1310.2	3232.2	236.1	2493.7	-	1417.7	122.6	511.0	244.0	743.7	823.2	552.6	-	768.2	12170.2
1986	1830.3	4475.2	208.0	2840.4	-	1725.0	311.5	718.3	242.1	730.3	1102.0	514.8	-	1282.5	15701.6
1987	2427.1	4961.2	246.3	2892.4	-	1961.7	462.5	613.2	232.3	801.1	192.3	643.5	561.2	627.4	17531.9
1988	3066.7	6078.0	227.3	3007.9	-	2335.9	477.7	802.6	258.0	885.7	478.8	774.7	847.4	607.0	19561.2
1989	3470.5	6671.7	271.6	3226.7	-	2736.3	603.6	882.4	200.5	821.5	719.1	841.8	1151.1	651.5	22008.0
1990	4221.4	7883.7	362.4	3210.8	308.0	2761.8	747.1	1021.8	215.5	935.3	756.0	1159.0	1332.2	1122.0	26000.1
1991	5012.7	10911.3	541.8	3573.2	122.5	3035.0	942.7	1001.4	217.2	1134.4	-	997.4	1683.0	1377.6	31306.2

a. Miscellaneous includes Personal and Professional from 1982 to 1986.

Source: CBN: *Statistical Bulletin*, 3(2) December 1992.

The presence of high excess liquidity in the banking system, particularly before the financial reforms, tended to support our view that banks shift away from lending, especially to SMEs. Thus, the liquidity ratio of the commercial banks was 94.5% in 1970 dropping to 59.1% in 1976, on the eve of implementing the rural banking programme. Between 1984 and 1985 it rose to about 65.1%. For merchant banks the position is different. Since they deal with corporate customers and high networth individuals with more familiar risk profiles and who are ready to provide the necessary collateral, they exhibit a high loan-to-deposit ratio, in many cases above 100%. In 1986 and 1987, they had liquidity ratios of 14.6 and 24.5% respectively.

Even when commercial banks lend, they avoid lending to rural customers, particularly those involved in agriculture, and small-scale enterprises. In spite of the requirements of the rural banking programme that a substantial amount of the deposits mobilised by the commercial banks in rural areas should be lent to customers in those areas, the average loan-to-deposit ratio in the rural areas is generally much less than the economy-wide average (Table 13). This confirms our hypothesis that banks tend to perceive lending to small-scale enterprises in the rural areas and to agriculture as being risky, and would rather carry high liquidity than lend.

One of the results of the financial repression was that banks were forced by the government to lend to government companies and parastatals at concessionary rates. Many such loans, often called policy loans, ended up as non-performing assets. They were never appraised and usually depended only on a government guarantee. A study of one of the three largest commercial banks in Nigeria (Garba, 1994) showed that policy loans, which are yet to be recovered by the bank, amounted to ₦535 million in 1992 and that bad loans as a ratio of shareholder funds in the bank amounted to 90.2% and constituted 21.9% of total earnings.

Because of the problem which non-performing assets pose to the survival of the banking system, the CBN, as part of the financial reforms, introduced stricter prudential guidelines in November 1990. These stipulate that credit facilities are to be classified as performing and non-performing. They also contain criteria and modalities by which the banks are to recognise income and losses from credit facilities as well as various provisions for the perceived losses, so that regulators and the investing public can obtain a fairly true picture of the financial situation of the licensed banks. With the introduction of these guidelines, the banks became stricter in their evaluation of credit proposals and in granting credits. In 1991, following the introduction of the prudential guidelines, most banks declared huge losses or reported drastic falls in profit margins. Because of the ripples this caused in the industry, the CBN, in May 1991, allowed the banks to spread the burden (in terms of making provision for non-performing assets) over a period of four years. In spite of this, six banks, all of them owned by state governments, were classified as distressed.

Table 13 Loan-to-deposit ratio of rural branches of commercial banks

	Rural Branches	*All Commercial Banks*
1982	0.32	0.85
1983	0.34	0.84
1984	0.21	0.82
1985	0.37	0.67
1986	0.43	0.83
1987	0.40	0.73
1988	0.48	0.67
1989	0.65	0.80
1990	0.57	0.67
1991	0.56	0.60

Source: ibid.

Our head office interviews suggest that the after-effect of the ripples caused by the application of the prudential guidelines has tended to make banks stricter in their credit assessment and in granting credit to small-scale industries and the agricultural sector, because of the perceived high risk. In particular, this may lead to higher costs for loans.

However, one innovation of the financial reforms, the community banks, appear from initial returns to the CBN to be focusing on these neglected areas, though they are limited by a very low capital base from having an immediate appreciable impact. Given their numbers and extensive locational spread, they may, if well exploited, contribute meaningfully, in the final analysis, to the transformation of the rural sector. In 1992, for example, the community banks lent 17.9% of their total credit to agriculture, more than the 14.9% from the commercial banks and the 15.7% from the merchant banks. Moreover, whenever merchant and commercial banks lend to agriculture, it will in most cases be to large-scale agriculture. In particular, non-agricultural small-scale enterprises, which are normally neglected by the commercial and merchant banks, benefitted from community bank credit in 1992. Thus petty trading topped the list, with 33.1% of the total credit portfolio, followed by small-scale manufacturing (9.2%), transportation (7%), small-scale restaurants (6%) and cottage industries (5%) (Table 14). The 'others' category consists mainly of personal loans to civil servants, local government officials and teachers in the community, for consumption purposes.

Table 14 Sectoral distribution of community bank loans 1992 (%)

Agriculture	17.9
Petty trade	33.1
Restaurants	6.0
Manufacturing	9.2
Cottage industries	5.0
Transportation	7.0
Others	21.8
Total	100.0

Source: Computed from CBN, *Annual Report and Statement of Accounts*, 1992.

3.2 Analysis of micro-level lending operations

3.2.1 Characteristics of usual borrowers

Commercial banks and community banks tend to be patronised more than merchant banks by people living close to the bank branches. Thus the average distance of the non-resident small-scale enterprise client of the merchant banks studied was 90km, while the corresponding figure for commercial banks was 25km.

The People's Bank, though a recent creation, receives by far the largest number of loan (excluding overdraft) applications. For example, it received on average in 1990 a total of 2,559 applications from SSE operators; this declined to 2,013 in 1991, rising by 95% to 3,874 in 1992. This contrasts sharply with the average 66 applications per branch received by the commercial banks in 1990, rising to 81 in 1991 and 93 in 1992. It also contrasts with the community banks which received, on average, 18 applications per branch in 1990, 54 in 1991 and 66 in 1992 from SSE clients (Table 15). That the average number of applications received by merchant banks from all client categories exhibits a decreasing trend should not be surprising. When combined with their decreasing approval rate in 1990 and 1991, clients may have been almost certain of rejection and hence did not bother to apply.

This decreasing application rate and the low success rate (to be demonstrated later) tend to confirm allegations in the popular press, and in professional conferences, workshops and symposia, that the Nigerian banks, in particular the merchant banks, were carrying out less financial intermediation by means of lending because of other profitable opportunities that came about as a result of deregulation. In particular, they were accused of taking advantage of the arbitrage opportunities

Table 15 Average number of loan applicants per branch

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	66	76	81	49	35	28	18	654	66	2560	2013	3874
Large-scale enterprises	61	58	74	24	26	37	9	31	30	2302	2743	309
Small-scale agriculture	32	31	70	32	19	32	10	14	74	2252	2519	13537
Others	40	61	66	111	91	69	12	11	36	2010	2827	32568

Source: Survey.

resulting from the differences in the official and parallel market exchange rates. On 5 March 1992 the official and parallel market rates were merged, resulting in a devaluation of the naira by more than 40%. This may have affected the increase in lending by the merchant banks in 1992, as will be demonstrated later. Of course, this does not imply that devaluation promotes financial intermediation. Rather, it stresses the need to ensure that the policies implemented are consistent and credible and do not allow for the existence of arbitrage opportunities.

The success rate of SSE loan applicants to the merchant banks in our sample was 26.5% in 1990, dropping to 22.9% in 1991 and rising to 50% in 1992 (Table 16). Not surprisingly, the LSE success rate was better in 1990 than in 1991, at 54.2% and 26.9% respectively. The drop to 14% in 1992 when small-scale agriculture was much favoured (17.8% success rate) may be due to portfolio structuring strategy.

In general, the success rate in applications to the commercial banks appears more impressive. Thus, for SSE clients, it was 84.9% in 1990, 73.7% in 1991 and 88.9% in 1992. Corresponding values for LSEs were 63.9%, 56.9%, and 67.6%, while those of SSA enterprises were 81.3%, 80.7% and 62.9%. There appears to be a restructuring in the loan portfolios of the merchant and commercial banks based on the above results (and in the loan amounts, to be presented later). The commercial banks, it will be seen, are becoming more involved in lending to LSEs, while the merchant banks are becoming increasingly involved in lending to SSAs. This is in accordance with the spirit of the financial reforms, which emphasise the concept of *universal banking* by making the dividing line between merchant and commercial banking much fainter than it used to be.

Table 16 **Average number of loans approved**

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	56	56	72	13	8	14	9	9	9	1282	1261	1309
Large-scale enterprises	39	33	59	13	7	8	5	12	9	1273	1221	236
Small-scale agriculture	26	25	44	4	7	23	4	7	4	1275	1262	3532
Others	21	28	30	77	26	35	3	6	10	1257	1163	7537

Source: Survey.

The success rate of loan applicants to the community banks and the People's Bank is lower than that of the commercial and merchant banks. Thus, for SSEs, the success rates with the community banks were on average 50% in 1990, 16.4% in 1991 and 12.1%. The corresponding rates for the People's Bank were 50.1% in 1990, 62.6% in 1991 and 33.8% in 1992. This low success rate may be due to the low capital and deposit bases of these banks.

Some banks tend to have more male applicants. Thus in 1992, for example, the proportion of female loan applicants as compared with male applicants was 28.1% for the commercial banks, 57.1% for the merchant banks, 34.6% for the community bank and 58.4% the People's Bank.

On average, more men than women were granted loans by the various financial institutions surveyed. Thus in 1992, three times as many men as women were granted loans by the commercial banks surveyed. However, there is no significant difference between the success rate of women (57.4%) and that of men (51.8%). Among merchant banks, the success rate of male loan applicants in 1992 was estimated as 55.8%. Again no significant difference was observed between the success rate of female loan applicants (25.5%) and male applicants (16.4%) in the community banks studied.

As already noted, the lower success rate of loan applicants with the community banks may be due to the limited capital and deposit bases of these banks. This suggests that, given that the type of clientele they serve are those who are not normally served by other banks, there is a need to design ways of improving the access of this type of bank to funds, so that it can be enabled to serve its unique groups of disadvantaged clientele better.

3.2.2 Loan structure and maturities

In spite of the attempt via the financial reforms to limit the differences between commercial and merchant banking, our survey shows that the merchant banks still devote a high proportion of their loan and overdraft portfolios to LSEs (Tables 17 and 18), while the commercial banks continue to concentrate on SSEs and SSAs rather than LSEs. However, there appears to have been a subtle restructuring of portfolios between 1991 and 1992. While the merchant banks studied appeared to be moving in the direction of SSAs, the commercial banks were shifting more of their loans towards LSEs. This is not surprising, given that the merchant banks have since 1988 been improving their performance with regard to lending to the agricultural sector. While the prescribed minimum ratio of lending to the agricultural sector has remained at 10% since 1988, the actual aggregate monthly average performance was 11.5% in 1988, 14.2% in 1989, 14.5% in 1990, 14.7% in 1991 and 15.1% in 1992 (CBN, 1992).

The commercial banks have also improved their funding of LSEs through the use of overdraft facilities. In fact, they often grant more overdrafts than loans to this class of enterprise (Table 18). In general, the commercial banks appear to favour the use of overdrafts as a financing option rather than loans. This is not surprising, since their deposit liabilities are mostly short-term. The merchant banks, whose liabilities are slightly more long-term, give more loans than overdrafts (Tables 17 and 18). This shows that a greater proportion of commercial bank credit tends to be mainly for working capital and is much less long-term than that of merchant banks. Thus merchant banks will tend to provide more funds for capital-intensive projects than commercial banks. However, given that overdraft facilities can be rolled over, the contribution of commercial bank credits to developing capital formation in the long term can be seen to be more substantial than it appears on the surface. The community banks and the People's Bank, which tend to specialise in granting credit to SSEs and SSAs and attempt to reach a large number of customers, are generally hampered by the limited loan amounts they allocate. Table 15 shows that the growth rate of the average loan granted by the community banks to SSEs between 1991 and 1992 was computed at 200% and that to SSAs at 100%. However, the average loan amount was a paltry ₦0.1m. in 1991 and ₦0.3m. in 1992. Given the vast number of customers to whom these loans were distributed, it can be seen that the community banks will have only a limited impact on the operations of these sectors in the economy. This conclusion is also true of the operations of the People's Bank.

In the case of the commercial banks, the average loan amount to individual owners of enterprises (sole proprietorships) is generally about 5–10% of that to businesses and corporate bodies. For community banks, the loan amounts are in the range of 10–15% of the corresponding amounts given to corporate bodies. Among merchant banks, on the other hand, the proportion of loan amounts given to individuals and sole proprietors form, on average, a substantial part of that given to businesses and

Table 17 Average total loan amount granted (₦m.)

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	18.6	18.9	20.5	3.7	4.4	12.1	0.1	0.1	0.3	0.8	0.3	2.1
Large-scale enterprises	17.9	19.8	33.9	4.5	6.7	14.6	0.1	0.1	0.3	0.5	0.5	0.3
Small-scale agriculture	23.9	24.0	19.6	4.7	15.2	33.7	0.1	0.1	0.2	0.3	0.2	0.7
Others	23.2	16.0	15.5	4.7	14.2	8.7	0.1	0.1	0.7	0.3	0.3	0.6

Source: Survey.

Table 18 Average overdrafts given (₦m.)

	Commercial Banks			*Merchant Banks*			*Community Banks*			*People's Bank*		
	1990	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*	*1990*	*1991*	*1992*
Small-scale enterprises	8.5	22.5	24.4	1.0	2.0	6.0	0.1	1.5	0.1	0.07	0.05	0.05
Large-scale enterprises	16.3	64.5	21.4	5.7	9.7	11.5	0.1	1.8	0.1	0.05	0.07	0.09
Small-scale agriculture	10.3	19.8	16.1	1.5	6.0	8.0	0.1	1.0	0.03	0.01	0.02	0.02
Others	16.4	15.8	17.1	-	5.0	1.5	0.1	0.02	0.1	0.00	0.01	0.01

Source: Survey.

corporate bodies. For example, in 1992, the average proportion of sole proprietorship (individual) large-scale enterprise loan amounts given by merchant banks in the sample was 36.3% of that given to large-scale enterprises as a whole. This is not surprising, given that merchant banks deal with High Networth Individuals, whose repayment track record is often well-known and whose risk of default is quite low compared with SMEs or agricultural enterprises.

The maturity of loans varies according to the type of formal financial institution as well as the scale and type of business. The maturity of loans granted to SMEs is, however, the least for all financial institutions. Thus, the most frequent maturity of commercial bank loans to SMEs and SSA enterprises in 1992 was 9 months, with the longest maturity of SME loans from commercial banks averaging 14 months (Table 19). Merchant bank loans tend to have the longest maturity of the formal financial institutions studied. The most frequent maturity averaged 16 months for SMEs; for LSEs, maturities varied between 13 and 33 months. The maturity of community bank loans is shorter than that of the merchant or commercial banks; for SMEs, the most frequent maturity averaged 7 months. The maturity of People's Bank loans is the shortest. This finding agrees with our earlier conclusion regarding the relative contribution of the different financial institutions to capital formation in the economy.

Interest charged on loans varies according to the institution. Merchant banks charge the highest rates, with very high rates for SMEs in particular. The commercial and community banks do not appear to discriminate in the rates charged. Clearly the People's Bank does not discriminate in the rates charged across different sectors (Table 20). However, it is intriguing that the People's Bank charges any interest rate at all, as they are expected to charge only 5% of the loan amount to cover administrative costs. The average interest rates charged by the commercial and merchant banks in the sample compare favourably with the average economy-wide lending rates (Table 21).

The differential rates charged to SMEs may be a way of 'making up' for the perceived risk in lending to these enterprises. The high interest rate charged to this sector suggests, in part, that the spread necessary for banks to cover the perceived risk as well as the average transaction costs of SME loans, when added to the cost of funds, results in an interest rate considered 'high' for firms to pay (and may explain the fluctuating loan application success rate).

3.2.3 Investment activities of finance houses

As shown earlier, finance houses raise mainly short-term liabilities. Accordingly, their investment activities are generally short-term. While the average deposit mobilised has been on the increase in nominal terms, more resources tend to be committed to project financing than factoring. The tenor of factoring and project financing operations, not unexpectedly, tends to be rather short (Table 22). If these financing operations are rolled over, then the impact on long-term investment may be greater than it appears. Other investment activities engaged in by the finance houses surveyed were equipment leasing, LPO financing, export financing, debt management, among others. The longest tenor was an average of 8 months for equipment financing in 1992 (Table 23).

Table 19 Average maturity of loans approved in 1992 (months)

	Small-scale enterprises	*Large-scale enterprises*	*Small-scale agriculture*	*Others*
Commercial banks				
Longest	14	23	17	18
Shortest	7	10	9	8
Most frequent	9	12	10	11
Merchant Banks				
Longest	28	33	49	29
Shortest	9	13	9	5
Most frequent	16	29	17	8
Community Banks				
Longest	7	12	8	6
Shortest	5	8	7	4
Most frequent	7	10	7	5
People's Bank				
Longest	9	10	11	12
Shortest	5	6	6	5
Most frequent	6	8	8	7

Source: Survey

Table 20 Average interest charged 1992 (%)

	1992			
	Commercial Banks	*Merchant Banks*	*Community Banks*	*People's Banks*
Small-scale enterprises	29	44	32	22
Large-scale enterprises	30	39	33	22
Small-scale agriculture	29	40	32	22
Others	28	32	32	22

Source: Survey.

Finance houses use non-price competitive strategies to woo customers away from banks. Their interest rates were on average more than 5 percentage points higher than those of the banks before January 1994. This led to *adverse selection* and *adverse incentive* problems (Stiglitz, 1989), resulting in a high rate of non-

Table 21 Lending rates in commercial and merchant banks 1992 (%)

	March	*June*	*September*	*December*
Commercial Banks				
Prime	23.00	24.10	25.90	29.80
Maximum	25.20	25.90	27.60	31.20
Merchant Banks				
Prime	29.90	35.00	39.20	44.40
Maximum	34.10	35.00	38.50	48.10

Source: CBN, *Annual Report and Statement of Accounts*, 1992

Table 22 Tenor and volume of finance houses operations (Average,₦m.)

	1989	*1990*	*1991*	*1992*
1. Loans from Customers				
Up to 3 months	10.0(2)*	6.2(12)	6.4(84)	10.7(120)
Over 3 months - 6 months	5.0(1)	2.4(11)	3.6(75)	5.7(133)
Over 6 months - 1 year	-	1.3(9)	2.5(59)	4.2(108)
Over 1 year - 5 years	-	-	5.1(10)	13.1(11)
Over 5 years	-	-	3.5(3)	6.0(5)
2. Factoring				
Up to 3 months	11.7(2)	5.0(6)	5.2(17)	6.3(26)
Over 3 months - 6 months	-	1.0(3)	3.7(15)	4.4(24)
Over 6 months - 1 year	-	-	4.9(5)	4.1(9)
Over 1 year - 5 years	-	-	1.6(3)	2.4(5)
Over 5 years	-	-	-	5.0(1)
3. Project Financing				
Up to 3 months	5.5(3)	3.9(11)	6.1(74)	7.9(129)
Over 3 months - 6 months	-	2.7(7)	3.1(61)	4.3(117)
Over 6 months - 1 year	-	1.5(2)	2.4(40)	2.7(72)
Over 1 year - 5 years	-	-	3.6(9)	3.9(12)
Over 5 years	-	-	1.2(3)	1.7(2)

Note: Numbers in parenthesis are the numbers of observations reporting the average value.
Source: Soyibo (1994d)

Table 23 **Structure of assets of finance houses**

		1989			1990			1991			1992		
		Vol. (₦m)	*No.*	*Avg. Tenor (mth)*	*Vol. (₦m)*	*No.*	*Avg. Tenor (mth)*	*Vol. (₦m)*	*No.*	*Avg. Tenor (mth)*	*Vol. (₦m)*	*No.*	*Avg. Tenor (mth)*
1.	Equipment	5.3	4	3.0	1.7	12	9.5	2.5	8	7.6	4.6	5	8.0
	Leasing	(2)	(2)	(2)	(8)	(7)	(8)	(44)	(42)	(44)	(97)	(92)	(96)
2.	LPO Financing	2.3	11	3.0	2.5	8	4.3	3.9	7	4.8	5.6	7	4.9
		(2)	(2)	(2)	(10)	(9)	(10)	(60)	(56)	(59)	(123)	(116)	-
3.	Export	4.5	-	-	2.3	5	5.5	4.6	5	5.2	4.9	5	4.5
	Financing	(1)			(7)	(6)	(6)	(38)	(35)	(37)	(86)	(80)	(86)
4.	Debit	-	-	-	-	-	-	5.3	3	3.8	4.5	5	5.7
	Management							(5)	(3)	(4)	(24)	(21)	(22)
5.	Project	-	-	-	2.9	7	4.8	4.0	4	5.3	2.9	4	5.1
	Consultancy				(8)	(6)	(6)	(2.9	(26)	(26)	(54)	(47)	(46)
6.	Private Ledger	-	-	-	-	-	-	14.1	13	5.5	12.8	11	3.4
	Services							(5)	(6)	(6)	(8)	(8)	(8)

Note: In parenthesis are numbers or observations reporting the stated average value
Source: ibid.

performing loans and a high rate of default and insolvency in many finance houses in 1993. As at December 1993, the extent of default in meeting matured obligations amounted to ₦688.1m. (CBN, 1993), representing 124% of the capital and reserves of the reporting finance houses, 53.3% of their borrowing (i.e. deposits) and 28.1% of their total assets (Soyibo, 1994a).

4. Loan processing and administration

4.1 Loan screening process

Previous knowledge of potential borrowers would seem to be very important for commercial and merchant banks in Nigeria, particularly for SSE loans. Thus, among the commercial banks in our sample, 29.2% of SSE loan recipients in 1992 were first-time borrowers, while the corresponding ratio for merchant banks was 28.6%. These contracts contrast sharply with what obtains in the community banks, where 55.6% of beneficiaries of SSE loans were first-time borrowers. With fewer first-time borrowers, less screening time and costs will be incurred. It is also a way of hedging against the potential risk of default.

It is the standard practice in screening loan applicants for banks to ask for information from third parties. This is often done by seeking information from referees identified by the banks or by the applicants. Merchant banks tend to place more emphasis on referees identified by them. For other banks, banks from which the applicant had previously borrowed are the first points of call in seeking screening information. Previous indebtedness is the most important information sought by commercial and merchant banks when screening loan applicants. Personal integrity is next in order of importance, followed by an estimate of the returns from the project and the attitude of the potential borrower to debt (i.e. his willingness to settle previous obligation(s) as and when due). This shows that the commercial and merchant banks rely more on indirect assessment methods in screening loan applications. This contrasts with the direct method of screening applicants used by the informal financial sector as a way of containing the problems of moral hazard and adverse selection in granting credit (Hoff and Stiglitz, 1990). This approach is adopted by the People's Bank in seeking direct information about potential borrowers from the groups to which they belong. This is perhaps one of the major reasons why the default rate of the People's Bank has been low so far, and is an example of the linkage between formal and informal lending practices resulting from the financial reforms.

Project sites are often visited as part of the screening process, mostly by commercial and merchant banks, in particular for SSA loans. This tends to increase the cost of screening. For SME loans, projects are sometimes visited, depending on the size of the loan. Among commercial and merchant banks, some types of information must be obtained about the applicant before loans are granted, particularly for SSA and SME applicants. Thus with regard to SSA applicants, 85% of commercial bank managers would obtain some kind of information before granting a loan. Commercial banks sometimes test SME and SSA applicants with small credits before granting all the credit requested. Merchant banks usually do not get involved in such practices, particularly for LSE applicants.

While commercial banks, merchant banks and, to some extent, community banks would always ask for security before granting a loan, it is often ranked low in assessing the creditworthiness of a potential borrower. Interviews with head-office staff suggest that the complex legal procedures before a property is foreclosed and the consequent negative publicity may inform this practice. Business size, previous indebtedness, personal integrity and project returns are ranked higher by the commercial banks in our sample in assessing the creditworthiness of SME applicants.

However, our head office interviews revealed that the effect of liberalisation, in particular the implementation of the prudential guidelines in respect to making adequate provision for non-performing assets, has made banks more risk-averse in their assessment of potential borrowers. They have tightened up their credit analysis standards and many have sent a higher proportion of their officers on credit analysis courses organised by the Financial Institutions Training Centre, the Chartered Institute of Bankers of Nigeria and reputable private banking and finance training institutions in Nigeria and abroad. Thus sounder project appraisal is now becoming the rule. It is not therefore surprising that the emphasis placed on collateral by respondent banks in assessing the creditworthiness of applicants is low.

Another measure of risk-aversion on the part of banks is the fact that there have been periodic embargoes placed on branch lending by head offices as a way of ensuring the minimisation of risk of accumulating non-performing assets by almost all the banks interviewed at one time or other during the period under study. SME applicants, in particular, are disadvantaged in that they seldom have good feasibility reports or audited accounts. Some banks have business advisory services to help them out in this regard. Their effectiveness appears rather suspect, however.

4.2 Cost of loan administration and its components

The cost of administering loans is made up of screening costs, monitoring cost, and contract enforcement costs. In general, the same loan officers are used in each branch for screening, monitoring and contract enforcement *across all sectors* of business operations. The total cost of staff time, transportation and stationery used for each of these operations is included in the inputs for the costs of these different stages of credit allocation. Commercial and merchant banks have on average at least 3 loan officers per branch, while community banks have an average of 2 officers per branch.

Feasibility reviews for SMEs take on average 2 man-days in commercial and community banks, and 3 man-days in merchant banks. Credit analysis is given pride of place in merchant banks, where it takes on average 5 man-days. This contrasts sharply with 2 man-days in commercial and community banks and the People's Bank. This is not surprising, given the high risk perception of SMEs on the part of merchant banks. However, SME loan structuring takes only 2 man-days in merchant banks, about the same time as it takes in commercial banks, while, on average it takes just 1 man-day in community banks. Commercial and merchant banks devote more time to decision-making with regard to SME applicants; for commercial banks, this takes an average of 4 man-days, while for merchant banks it takes about 6 man-days. For community banks and the Peoples Bank, it is a 1 man-day job. Commercial and merchant banks spend a little more time in screening LSE loans. Thus, on average, commercial banks spend on average 2 man-days to review a LSE feasibility study, 2 man-days for the credit analysis, 2 man-days for the loan structuring and 5 man-days for decision-making.

Commercial banks tend, on average, to spend more on screening loan applications than any other banks (Table 24). It is not surprising that the People's Bank spends the least, given that the screening process has been transferred directly to the groups to which the potential borrowers belong. This innovation, borrowed from the informal sector, can be copied by other conventional banks in trying to contain the problems of moral hazard and adverse selection. The high cost of screening for the 'others' category may be due to the need to minimise the problems of the diversity of membership of the group, being made up of personal loans, loans to sectors like construction, commerce, and so on. Of interest is the relatively low screening costs for community banks and the People's Bank with regard to the SSE and SSA sectors. In contrast, apart from the 'others' category, the screening costs of SSE and SSA enterprises reported by the commercial and merchant banks tend to be relatively higher. This agrees with our hypothesis that banks tend to perceive lending to these sectors as relatively risky. Apart from the community banks, banks tend to spend relatively more on loan monitoring than on loan screening. Thus, on average, commercial banks spend 98% more on monitoring SSE loans than on screening them (Table 25). Correspondingly, merchant banks spend 135% more on monitoring than on screening. In the case of LSE loans, the comparisons are even more spectacular.

In general, merchant banks spend more on contract enforcement than other banks. Thus with regard to SSE loans, they spend over 800% more on enforcement than on screening and nearly 300% more than on monitoring. In contrast, commercial banks spend about the same amount on contract enforcement as on screening SSE loans. This suggests that, once careful screening and adequate monitoring have been ensured, the bank may have to spend less on contract enforcement. This does not appear to be the case with the merchant banks studied (Table 26). The finding here agrees with our hypothesis of high contract enforcement costs for (merchant) banks.

Table 24 **Average screening cost 1994 (Naira)**

Bank Type	*Type of Enterprise/Applicant*			
	SSE	*LSE*	*SSA*	*Others*
Commercial Bank	210,398	172,507	295,918	332,495
Merchant Bank	93,070	77,740	83,210	107,506
Community	16,974	27,759	4,309	21,936
People's Bank	10,593	13,831	6,808	27,556
Overall Mean	82,759	72,959	97,561	122,373

Source: Survey.

Table 25 **Average total cost for loan monitoring (Naira)**

	Type of Enterprise/Applicant			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	433,923	525,731	449,006	532,154
Merchant Bank	218,510	176,810	382,663	372,050
Community	18,819	18,593	13,739	25,038
People's Bank	58,600	68,000	60,500	65,400
Overall Mean	182,463	197,284	226,477	248,661

Source: Survey.

Table 26 **Average contract enforcement cost by type of bank1992 (Naira)**

Bank Type	*Type of Enterprise/Applicant*			
	SSE	*LSE*	*SSA*	*Others*
Commercial Bank	209,724	220,191	248,595	137,200
Merchant Bank	842,508	618,500	717,625	804,567
Community	83,854	67,265	39,470	16,020
People's Bank	25,356	21,434	16,727	19,548
Overall Mean	290,361	231,848	225,604	2244,344

Source: Survey.

Commercial banks have the highest total loan administration costs, compared with other banks, across most sectors (Table 27). Next in rank are the merchant banks. However, as a proportion of the total loan amount, the community banks and (in the case of LSEs) the People's Bank are relatively costly (Table 28). This is probably due to the fact that these banks are relatively new and are not yet operating at the optimum level of scale economies. Moreover, they also engage in a limited range of banking services. For commercial banks, lending to SSEs and SSAs is relatively more costly than lending to LSEs. This suggests that the high cost of loan administration may inhibit lending by commercial banks to these sectors. Merchant banks tend to spend more on loan administration than commercial banks, except in the special case of lending to SSAs in 1992. The relatively low level of lending costs in that year was due essentially to the unusual lending to that sector. It should not therefore, be interpreted as typical, but was probably due to the inability to continue cashing in on arbitrage opportunities in the foreign-exchange market. That merchant banks tend to have the highest loan administration costs for SSAs corroborates the findings of the World Bank (1995) on the relative high transaction costs of merchant banks with regard to rural people.

Analysing the various components of loan administration costs, it will be seen that in our sample the commercial banks and the People's Bank tend to spend more on loan monitoring than on any other components of loan administration (Tables 29, 30, 31). Merchant banks, on the other hand, spend more on contract enforcement; in particular, whenever they spend a little more on monitoring, they tend to do it for SSA loans. It is interesting that community banks spend a lot on contract enforcement for SSE and SSA loans. This may tend to discourage them from lending to these sectors for which they were specially created.

We investigated formally whether there is any significant difference in the cost structure of loan administration and its different components across banks and their

Table 27 **Average total administration cost per branch/bank(Naira)**

	Type of Enterprise 1992			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	854,045	918,429	993,519	1001,849
Merchant Bank	115,4088	873,050	908,341	1187,323
Community Bank	119,647	113,617	57,518	62,994
People's Bank	94,549	103,365	84,035	112,504
Overall Mean	555,582	502,115	510,853	591,168

Source: Survey.

Table 28 Administration costs as percentage of loan amount by type of bank, 1992

	Type of Enterprise/Applicant			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	4.4	2.7	5.1	6.5
Merchant Bank	9.9	6.2	2.7	13.8
Community	33.3	33.3	30.0	8.6
People's Bank	4.1	33.3	11.4	16.7
Overall Mean	12.9	18.9	12.3	11.4

Source: Survey.

Table 29 Screening costs as a percentage of total administrative costs

	Type of Enterprise 1992			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	24.6	18.8	29.8	33.2
Merchant Bank	8.1	8.9	9.2	9.1
Community Bank	14.2	24.4	7.5	34.4
People's Bank	11.2	13.4	8.1	24.5
Overall Mean	14.5	16.4	13.7	25.4

Source: Survey.

Table 30 Monitoring costs as a percentage of total administrative costs by type of bank per sector

	Type of Enterprise/Applicant			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	50.8	57.2	45.2	53.1
Merchant Bank	18.9	20.3	42.2	31.3
Community	15.7	16.4	23.9	39.8
People's Bank	62.0	65.8	72.0	58.1
Overall Mean	36.9	39.9	45.8	45.6

Source: Survey.

Table 31 Contract enforcement costs as a percentage of total administrative costs per sector by type of bank

	Type of Enterprise/Applicant			
Bank Type	*SSE*	*LSE*	*SSA*	*Others*
Commercial Bank	24.6	25.0	24.0	25.0
Merchant Bank	73.0	70.8	79.0	67.8
Community	70.1	59.2	68.6	25.4
People's Bank	26.8	20.7	19.9	17.4
Overall Mean	48.6	43.7	48.17	31.1

Source: Survey.

borrowing clientele, using the F-test statistic as defined in section 1.2. All the estimated costs were found to be highly statistically significant. For example, there is a significant difference in loan administration costs as a percentage of loan amount across bank and borrower types with computed F-ratio = 16.3 > 1. Similarly the computed F ratios for Tables 28–30 are respectively 20.3, 5.1 and 18.8, each of which is greater than 1.

This finding seems to suggest that prices and terms in the formal financial market in Nigeria are different for comparable transactions and possibly comparable risks, implying the existence of possible lack of integration of the different segments of the banking system.

4.3 Loan repayment trends

Increases in the level of non-performing assets in the loan portfolios of Nigerian banks have been a source of concern to the regulatory authorities, particularly the Nigeria Deposit Insurance Corporation (NDIC). Thus, in 1990, the NDIC reported the existence of some distressed banks that were technically insolvent. Most of these banks had non-performing loans and advances in excess of 50% of their total loans and advances and 100% of their total capital and reserves. The poor performance of distressed banks was traced to a number of factors, including ineffective management, poor administration of loans and advances, undercapitalisation, interference by owners in the management of the banks, board and management instability, poor internal control systems, and fraud (NDIC, 1990).

Our head office interviews reveal that the managements of banks wholly owned by state governments cite as a major cause of the increase in non-performing assets

Table 32 Classified loans and advances as a proportion of total loans and advances by bank ownership, 1989-92

	1989	*1990*	*1991*	*1992*
State Government-owned Commercial Banks	64.3	69.0	66.3	68.3
Non-State Government-owned Commercial Banks	39.9	42.3	32.3	40.5
Merchant Banks	14.7	19.3	27.0	36.6
All Banks	40.8	44.1	39.0	45.4

Source: NDIC, *Annual Report and Statement of Accounts*, Various Issues.

interference by governments in granting loans to politicians or government parastatals that usually ended up being unpaid. In particular, commercial banks owned by state governments tend to have an unfair share of non-performing assets in their loan portfolios. Merchant banks tend to perform better than commercial banks in this regard (Table 32). It is worrying that, for all banks, over 40% of total loans and advances were non-performing between 1989 and 1992.

It is not surprising therefore that, as shown earlier, commercial banks pay more attention than merchant banks to screening loan applicants. The better performance of merchant banks in this regard may arise from the fact that, on average, they spend substantially more on contract enforcement than commercial banks. Moreover, having fewer borrowers than commercial banks, they are in an advantageous position to do more thorough monitoring and contract enforcement.

Analysis of our survey data reveals that default in repayment is more common among SSE and SSA borrowers from commercial banks. In 1991, for example, an estimated 20% of SSE loans granted by the commercial banks in our sample ended up unpaid. Among SSA beneficiaries of commercial bank loans, 28% failed to meet their repayment obligations. Among merchant banks, the corresponding default rates are estimated at 25% of SSE loans and 14.2% of SSA loans in 1991. Default rates in community banks are lower, while those in the People's Bank are lowest of all.

If we were to apply the classification of the prudential guidelines to the above data, the default rates would probably be comparable to those in Table 32. Even if this condition is not imposed, our findings will be seen to be in agreement with our earlier conclusion, using aggregated banking sector data, that default rates in merchant banks tend to be lower than those of commercial banks.

Reforms in the financial system have forced banks to take the management of non-performing assets more seriously, particularly in view of the rigid adherence of the CBN to the application of the prudential guidelines since their introduction in 1990. Our head office interviews reveal that banks now have special debt recovery units in each area or regional office as well as at head office. Moreover, a reward system is used to recognise exceptional efforts made with regard to debt recovery by branch managers and others connected with granting credit. As directed by the guidelines, the head offices of banks ensure that interest on non-performing assets is never taken into consideration in computing earnings. Full provisions are also made for such assets over the year: 25% per quarter. Most banks, and merchant banks in particular, now involve their legal departments fully in debt-recovery efforts, especially in the realisation of securities, as the case arises. This may, in part, explain why a greater proportion of administration costs is devoted to contract enforcement by merchant banks.

5. The savings – investment link

The policy of financial liberalisation in Nigeria, as in many developing countries, is premised on the McKinnon-Shaw financial intermediation hypothesis which argues that interest rates show a positive response to savings and economic growth (McKinnon, 1973; Shaw, 1973). Our analysis so far has shown that Nigeria's financial reforms have led to an increase in the number and types of financial institutions and in deposit mobilisation to some extent, but have not altered significantly the lending practices of the financial institutions. We have identified a mismatch in asset-liability maturity as one of the major factors making it difficult for banks and finance houses to commit funds to long-term investment. In this chapter, we explore further other factors which inhibit the transmission of savings mobilised by FFIs to investment in the Nigerian environment. Data used for this analysis are obtained from Soyibo (1993, 1994d). They were collected using two surveys of banks (supply-side analysis) and users of bank credit (demand-side analysis). The results of the supply-side analysis show that bankers attach a high premium to such factors (in descending order of importance) as ability of the borrower to repay; profitability of the sector of operations; the borrower's previous experience in similar projects; returns to the bank; the borrower's contribution to the project; and the opportunity costs to the bank in granting credit to its customers. SMEs and agricultural enterprises, as well as rural people, are seen not to possess these factors in abundance; hence, banks would rather retain excess liquidity than lend to them.

The structure of the micro-level composition of loan portfolios of the banks surveyed in the supply-side study shows that agricultural loans are given least priority, in spite of the fact that the agricultural sector remains a preferred sector as stipulated in the CBN's annual monetary and credit policy guidelines (Table 33). However, there has been some improvement, though marginal, since the reforms. The manufacturing sector appears to be more consistently favoured, given the fact that it is a sector dominated by LSEs whose risk profile can easily be identified by banks. The results compare favourably with our earlier micro-level analysis which showed the preference of banks for LSEs in their lending practices.

In addition to the preferences of banks as determinants of how much to lend and to whom, this study also identified some factors which tend to inhibit the transmission of savings mobilised by the banking system into investment. These include inadequate information about investment opportunities; uncertainty and unpredictability of the economic/industrial environment; high cost of funds; limited availability, or even non-availability, of viable productive ventures; and poor enabling environment and lack of adequate infrastructure. All these factors, it will be seen, affect SMEs and agricultural enterprises more than other sectors.

Table 33 Micro-level structure of loan portfolio of banks 1980-89 (average %)

	1980	*1981*	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*
Agricultural loans	5.8	6.5	8.4	9.0	14.1	11.4	17.5	15.3	17.6	12.6
Manufacturing loans	30.4	35.1	36.4	39.1	32.1	27.5	36.1	35.2	30.9	40.0
Other loans	63.8	58.1	55.2	51.9	53.8	61.1	45.8	49.5	51.5	47.4
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Soyibo (1994d).

On the demand side, Soyibo (1993, 1994d) shows the relative decline of bank credit as a source of financing productive investment, even among LSEs, with the onset of the financial reforms, when compared with the use of own-funds like retained profits, the increase in share capital and time and savings deposit draw-down. In general, bank credit accounts for less than 20% of the average total volume of investment of the organisations surveyed (Table 34). In particular, retained profits as a source of funds appeared preferable to bank credit after the financial reforms, perhaps because of the higher costs of funds. The fact that the proportion of draw-down on corporate savings increased in 1987, 1988 and 1990 gives credence to the impact of the high cost of funds on the declining preference for bank credit after the financial reforms. The fact that SMEs and agricultural enterprises lack corporate savings and have limited retained profits, corroborates and helps to explain the findings of our micro-level survey of banks relating the limited number of loan approvals and loan amounts granted to these enterprises. Of particular relevance to this paper is the identification of the determinants of choice between the different financing alternatives employed by the users of bank credit. Soyibo (1993), using discriminant analysis and logistic regression analysis, identified the significant determinants of the choice of bank credit made by Nigerian firms as total dividend paid, current asset, total asset and type of ownership (i.e. whether government or private). These determinants are weighted more in favour of LSEs than SMEs or agricultural enterprises.

To sum up, the transmission of savings to investment, through the granting of credit by financial institutions, depends on a host of factors other than the responsiveness of the real interest rate to savings. Such factors include the availability of investment opportunities at rates of return which exceed the cost of funds; the existence of private and social profitability differences; institutional constraints; and the cost of administering funds. This chapter has attempted to provide some evidence on both the supply and the demand sides of credit, to

Table 34 Structure of micro-level source of investment financing by Nigerian companies (average %)

	1981	*1982*	*1983*	*1984*	*1985*	*1986*	*1987*	*1988*	*1989*	*1990*
Bank Credit	40.04	7.79	7.35	16.72	12.83	4.98	6.21	7.98	7.98	14.50
Retained Profit	14.04	20.06	12.60	20.82	15.36	14.52	15.00	14.48	14.48	24.00
Share Capital Increase	25.80	44.80	59.91	24.69	32.06	35.65	38.85	32.28	32.28	23.25
Time and Savings Deposit Drawdown	7.74	8.24	10.67	20.13	24.41	28.17	26.43	32.02	17.40	29.07
Debentures and other Capital Market Instruments	12.38	19.11	9.57	17.63	15.35	16.68	13.50	13.24	4.30	9.18
	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Soyibo (1994d).

explain some of the results obtained from our micro-level survey of formal financial institutions in Nigeria.

6. Innovations in the formal financial system and emerging links with the informal financial sector

The financial reforms brought about an increase in the number of financial institutions in Nigeria. This is expected to promote competition and improve the efficiency of service delivery. The reforms also brought about innovations in the areas of product-packaging and methods of operations, as, for example, between commercial and merchant banking, and led to the development of some links, however tenuous, with the informal financial sector. Financial innovations involve the development of new products or services by financial institutions to facilitate their operations and the efficiency of intermediation (Oyewole, 1993). These include new financial instruments which are the objects of transactions, new financial markets where transactions take place, and new media to effect the transfer. For our purposes, we shall discuss innovations in the Nigerian financial sector since the reforms from three perspectives: (i) product and service packaging; (ii) operations and procedures including ways of promoting and planning for new products; and (iii) development of links between the formal and informal segments of the financial system.

6.1 Product and service packaging

Financial repression restricts initiative and so kills innovation. Adekanye (1990) attributed the lack of development of new financial products and services during the era of financial repression to excessive controls and regulation of the financial sector. As expected, with the financial reforms many new banking products came on to the scene. For example, Nwandike (1990) identified 151 different banking products in Nigeria, though further analysis showed that most of them were similar but some were innovative.

Banking products and services can be classified into three (Oyewole, 1993); credit instruments, deposit instruments and other instruments. The financial reforms certainly brought a phenomenal increase in the number and types of financial products in Nigeria (Table 35). From a mere 13 new products before the reforms, the total number of new products/services developed after the reforms increased by nearly 208% to 40 (Table 36).

The merchant banks developed more new products and services after the reforms than the commercial banks. This is not surprising because more merchant banks came on stream with the reforms. There is some difference in the underlying reason for the development of new products after the reforms. Before the reforms financial innovation was seen as a means of circumventing excessive regulation. After the reforms, the development of new products/services emanated mainly from the

Table 35 **Content analysis of new financial products introduced by commercial and merchant banks before and after reforms**

	Before Reforms			*After Reforms*		
	Credit Instrument	*Deposit Instrument*	*Other Instrument*	*Credit Instruments*	*Deposit Instrument*	*Other Instruments*
Commercial Banks	■Village Credit ■Special Agric. Credit ■Joint Liability Credit Finance	■Christmas Savings ■House Savings Plan ■Children Savings Account	■Trustee Service	■Discounting of promissory notes ■Commercial papers ■LPO Financing ■Rural Credit Scheme ■Bills discounting ■Credit Cards	■Investment Certificate of depositor ■Floating rate deposit account ■Current account with variable interest rates ■Cash remittance service ■Target and Special deposit account for prime customers ■Insurance deposit account ■Profit Sharing deposit account	■Automatic teller machines ■Cheque guarantee facility ■Automatic funds transfer to any part of the country ■Investment advisory service ■Weekend and flexible facility.
Merchant Banks	■Equipment Leasing ■Hire Purchase Finance ■Export Finance ■Working Capital Financing	■Certificate of Deposits	■Brokerage Service	■Export Stimulation Credit ■Venture Capital Finance ■Investment Trust ■Commercial papers ■Bills discounting ■Credit Cards ■Loan Syndication ■Debt Conversion	■Discounting Certificate of deposits ■High yield investment Certificate ■Premium Current account facilities ■Up-front interest payment on deposit ■Tax and Dividend annuity ■Forex accounts	■Mutual Funds ■Unit Trusts ■Equity Swaps ■Asset Securitisation ■Fund management service ■Risk asset trading ■Investment advisory service. ■Stockbroking service

Source: Oyewole (1993).

Table 36 Number of new financial products introduced by commercial and merchant banks in Nigeria before and after reforms

	Commercial Banks	*Merchant Banks*	*Total*
Before Reforms			
Credit Instrument	3	4	7
Deposit instrument	3	1	4
Other Instrument	1	1	2
Total	7	6	13
After Reforms			
Credit Instrument	6	8	14
Deposit instrument	7	6	13
Other Instrument	5	8	13
Total	18	22	40

Source: Derived from Table 35.

competition posed to the conventional banking sector as a result of the springing up of new and aggressive banks as well as the competition posed by NBFIs like finance houses.

6.2 New operations and procedures in banking

The reforms brought about changes in the operations and/or procedures of the banking system. There are two main types of development in this regard: those brought about by policy changes and those brought about by competition in the financial market. Within the first group are the changes that resulted in the emergence of *universal banking* in Nigeria. With changes in their operational guidelines, services and operational procedures, hitherto regarded as exclusive either to commercial or merchant banks, became common to both types of banks. For example, commercial banks were allowed to engage in equipment leasing to the tune of 15% of their total assets in 1990. This used to be a service only merchant banks could deliver. Merchant banks were also subjected to cash-reserve requirements of 5% of their total demand deposit liability, a requirement which used to apply *only* to commercial banks. Thus with the financial reforms, the dividing line between commercial and merchant banking in Nigeria became quite fluid.

NBFIs, or more correctly near-banks, like finance houses and primary mortgage finance institutions sprang up, offering services similar to those of the commercial and merchant banks. In particular the services of finance houses posed a considerable threat to the survival of the banking system because of the high deposit rates offered and the use of non-price competitive strategies. Of course, this led to adverse selection and adverse incentive problems in the financial houses, which resulted in distress for many of them.

In the second group of new banking operations and procedures are the use of automation to effect better delivery of services, the adoption of a marketing approach and strategic planning to improve the performance of financial institutions, in particular banks. Many new-generation commercial and merchant banks started off with computerised operations. This posed a major challenge to the older generation and the big banks. Some of them, like the Trans International Bank, adopted slogans like 'Prompt and Caring' to show the influence of computerisation on their operations. Most of the banks use 'stand-alone' computerised operations as opposed to 'networking' operations which link several branches of the same bank together. Our head office interviews suggest that the huge investment involved in networking makes it difficult for the big banks, in particular, to engage in it. A few new-generation banks like the Diamond Bank, the Citizen Bank and the Nigerian International Bank are into networking. Commercials on prime-time national television are used by these newer banks to woo customers to take advantage of the efficiency of service offered by networking. Automated teller machines are also used by some banks in selected branches.

The marketing approach and strategic management are two other operational and procedural innovations adopted by Nigerian banks to cope with the uncertainties that came about as a result of competition within the industry following the financial reforms. Our head office interviews revealed that all the market leaders (the five largest banks), some medium-sized banks and the aggressive new-generation banks adopted both innovations. It is now also fashionable for banks to display their mission statements on advertising bill boards, on television commercials and in their Annual Reports and Statements of Accounts. However, some of these statements, when subjected to rigorous content analysis, lack the basic elements and characteristics of well-defined mission statements. The importance of strategic management as an innovation in Nigerian banking since the reforms is underscored by the fact that the success story of Wema Bank plc is largely attributed to the adoption of this approach. Wema Bank is one of the three surviving indigenous commercial banks, founded in the 1940s because of alleged discrimination against Nigerians in the granting of credit by foreign-owned banks. In fact, it is the only one among these three banks, that is currently non-distressed. A new book, Adegbite (1994), chronicles how this turn-around was achieved.

6.3 Development of links between different segments of the financial system

The development of linkages between formal and informal segments of the financial system predated the financial reforms. Some semi-formal financial institutions like Savings and Loans Companies, Co-operative Savings and Credit Associations and Credit Unions provided some links which used the techniques of the informal sector in screening and monitoring clients. They also provide some direct links by depositing some of the savings mobilised in commercial banks (Soyibo, 1995).

Community banks and the People's Bank are two innovations of the financial reforms that provide direct linkages between the formal and informal financial sectors. First, they aggregate the savings of a large number of savers, including informal financial groups like *esusu* and moneylenders. Second, they use techniques similar to those of the informal sector to raise savings. In particular, community bank operators have desk officers who visit markets and shops daily to raise savings just as the *esusu* collector does. In granting credit they use a direct approach similar to that of the informal sector in screening and monitoring loan applicants. Community banks are supposed to grant credit based on personal knowledge of the creditworthiness of the borrowers. In those banks that have a strong community base, as in many rural communities, this practice is in vogue. However, urban-based community banks tend to operate like commercial banks, placing emphasis on collateral and other securities before granting credit.

In spite of its limited capital base, the People's Bank, has successfully used the mechanism of the informal sector perhaps more than any other new financial institution that came about after the reforms. It grants credit in the range of ₦50 to ₦10,000. No interest is charged on the loan, but an administrative charge of 5% is paid on the loan secured. No collateral is required, but to induce repayment loans are usually granted on the basis of group membership of cooperatives, trade associations, etc. A borrower is expected to be a member of a group of at least 15 persons. Thus, the approach adopted by the People's Bank is similar to the concept of 'peer monitoring' which Stiglitz (1990) has suggested that formal financial institutions can borrow from informal financial institutions to reduce the problems of loan default.

Finance houses also provide some links with the informal sector. They engage in less rigorous credit assessment than the banks and place less emphasis on collateral. However their risk exposure appears to be much higher than that of banks because it is easier for SMEs and traders to access funds for investment, working capital, export promotion, etc., from them than from the banks. Customers whose needs cannot be satisfied (because of size) by the informal sector and who cannot satisfy the requirements of the banks usually patronise finance houses. Finance houses employ a combination of formal and informal approaches in deposit mobilisation and granting of credit.

6.4 Potentials for financial innovation in Nigeria

Our head office interviews suggest that an area requiring the development of new products and services in the financial sector relates to the management of non-performing assets. Securitisation of government debt is one area that can help reduce the huge pile of government non-performing assets in the banking system. Securitisation is the substitution of market-oriented intermediation for institution-based intermediation. Securitisation of debt is a strategy which enables the debtor to recuse its debt burden by changing the character of its debt through the purchase of stocks and bonds in the capital market. Securitisation of bank debt enables banks to manage their total credit position as well as securing a desired portfolio of lending assets to minimise cost and risk (UBA, 1992). One of the bank managing directors interviewed suggested that Federal and State government debts to the banks should be converted into marketable securities for trading and purchase on the stock exchange, with the proceeds of the securitisation applied to the settlement of the original debt to the banks. This could be extended to individual or corporate indebtedness as well.

Another way of solving the problems of non-performing assets in the financial sector is to create a spread agency to manage the recovery of non-performing assets by converting some of the debt to bonds and writing off the debt that cannot eventually be recovered. This is similar in conception to the Non-Performing Assets Recovery Trust in Ghana and the Loans and Advances Realization Trust of Tanzania (Caskey, 1992; Bagachwa, 1995).

7. Concluding remarks

This study has shown that financial reforms brought about considerable development in the formal financial sector in Nigeria in terms of growth in the number and types of financial institutions as well as innovations in product/service delivery. There have also been changes in the procedures and operations of banks with the dividing line between commercial and merchant banking becoming increasingly faint. Thus, the concept of universal banking is becoming more popular with the financial reforms.

It has also been demonstrated that there is no considerable change in the maturities of bank liabilities even with the financial reforms. Yet the requirements of the users of long-term credit have not diminished. This shows the existence of a mismatch of asset-liability maturity in the financial sector.

Our analysis of micro-level data reveals that different units of FFIs have their different market niches. Merchant banks mobilise deposits more for LSEs and HNWIs and tend to favour them in granting credit. Community banks and the People's Bank are more grass-roots oriented, mobilising deposits from small savers and favouring SSEs and SSAs in granting credit. Commercial banks operate midway between these two groups of banks. Finance houses grant credit to SMEs and SSAs and traders who require more funds than can be provided by the People's Bank, community banks or the informal financial sector, but who cannot satisfy the stringent requirements of banks. They provide short-term to medium-term funds for commerce, export promotion, working capital and other productive purposes. We also attempt to provide an explanation for the existence of structural bottlenecks which do not allow markets to clear, even with the introduction of financial reforms.

The financial reforms resulted in some measure of linkage of the informal and formal financial sectors of the country. Formal financial institutions like the People's Bank, community banks and, to some extent, finance houses use some of the techniques of the informal sector to raise deposits, screen loan applicants and monitor credit customers. There is also some direct linkage resulting in some of the deposits of the informal sector being placed in the banking system, though they may be small in volume terms.

The study also shows that the loan default rate tends to be higher in the commercial banks than in the merchant banks. It is particularly pronounced in State government-owned commercial banks. Thus a potential financial innovation would be the securitisation of State government debt in the banking system. Across sectors, SSEs and SSAs tend to have higher default rates. However, they require adequate credit to develop. Serious consideration may need to be given to the use of credit insurance to encourage bankers to lend to SSEs and SSAs. The creation of special agencies to manage and recover non-performing loans has also been suggested. Such an agency, already in existence in Ghana and Tanzania, can convert non-performing corporate and individual loans into bonds and write off those that cannot eventually be recovered. This will improve the health and soundness of the financial system and reduce the risk of lending to SMEs and SSAs.

There is a need to exploit further the relationship of community banks with the informal sector. This can be done by developing financial products based on obtaining funds from other segments of the financial system like commercial and merchant banks for on-lending to the informal sector as well as SSEs and SSAs. Such an approach can help reduce the default risk by commercial and merchant banks in lending to SSEs and SSAs. This can help promote stronger linkages with the informal sector.

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