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LITERATURE REVIEW

BANKING REGULATIONS AND LOAN PERFORMANCE OF DEPOSIT MONEY BANKS IN NIGERIA

Concept of Financial Regulation

Regulation of banks has been defined by Llewellyn (1986) as a body of specific rules or agreed behavior either imposed by some government or other external agency, or self-imposed by explicit or implicit agreement within the industry that limits the activities and business operations of financial institutions. The regulatory authorities may differ from one country to the other, but the goal of promoting and ensuring efficient, safe and sound financial system is similar and paramount to them all. (Itsede, 2000)

Supervision on the other hand, is the process of monitoring banks to ensure that they are carrying out their activities in accordance to laws, rules and regulations and in a safe and sound manner. It is a means of ensuring compliance with laid down rules and regulations and to determine their financial condition at any given time. Bench (1993) asserted that effective supervision leads to healthy industry. Dimitri Vitas (1990) also believed that good regulation and supervision will minimize the negative impacts of moral hazards and price shocks on the financial system, thereby leading to a reduction in bank failure and financial system distress.

Primary Regulatory Objectives

According to Olorunshola, 1998, the broad objectives of banking regulation and supervision are to:

1. Prevent undue concentration of economic power, and promote healthy competition in the financial system;

2. Ensure a safe and sound financial system to safeguard the public against the worst consequences of instability;
3. Encourage and promote a high level of operating efficiency and innovation in the financial system;
4. Meet the needs of the public for conveniently available credit facilities and financial services;
5. Enforce the implementation of government's monetary and credit policy guidelines; and,
6. Promote an equitable distribution of costs and benefits among the Management, stakeholders, creditors, and customers of banks and other financial institutions.

Benefits of Efficient Regulation

According to Olorunshola (1998), among the many potential benefits of an efficient financial regulatory framework are to:

a. Protect the depositors/investors;
b. Promote monetary stability;
c. Integrate the activities of the informal sector of the economy to harness their boundless economic potentials;
d. Ensure a stable, efficient and coordinated payments system;
e. Promote healthy competition among financial institutions;
f. Ensure disclosure of adequate and correct financial information to users
g. Reduce undue financial intermediation risks such as liquidity, credit, investment, interest rate and fraud risks;
h. Ensure the safety and soundness of individual institutions and, by extension, of the financial system; and
i. Reduce unprofessional practices among practitioners and thereby promoting

professionalism

Banking Regulation and Supervision in Nigeria

Regulation is necessary in the case of banks. Specifically, to maintain a safe and sound banking system that can meet its obligation without difficulty, a high solvency and liquidity level is the experience of individual banks than they would ordinarily maintain. Oloyode (1994) observed that the banking industry is highly prone to volatility and fragility, either arising from exogenous or endogenous shocks, and are therefore amenable to regulation and supervision. Tougher capital requirements may have positive benefits; they may reduce the consequences of market freezes, they may encourage banks to become smaller to avoid "systemic" capital requirements, and they may reduce contamination, but they may not be relied on to reduce the risk of bank failure (Barrell & Phillip 2011).

Theoretical Framework

Economic Theory of Regulation

The economic theory of regulation seems to have gained more acceptance among economists (Llewellyn, 1986). Specifically, in the case of banks, regulation is necessary to maintain safe and sound banking system that can meet its obligations without difficulty, hence, a high solvency and liquidity level is expected of individual banks than they would ordinarily maintain. Nwankwo (1989) argues that the historical evolution of banking in any country provides the rationale for the regulation of banks in that country. The regulatory authorities supervise the banks to ensure that they are conducting their business either in accordance with regulation or more generally, in a prudent manner in the public interest.

Ogunleye (1999) summarized the rationale for bank regulation as: efficiency, diversity of choice, competition, and stability of financial system, macroeconomic stability and developmental and social objective. He went further to identify four approaches to bank supervision as: information disclosure, self-regulation, bank examination and takeover, and finally, deposit insurance scheme.

Mishkin (1997) provides reasons why the regulatory process may not work as expected. First, the regulators and bank managers may not have sufficient resources or knowledge to do their job properly. Second, the regulators may not do their job properly because of the moral hazard problem or the principal agent problem. The principal agent problem stems from asymmetric information because the principal does not have sufficient information about what the agent is doing to make sure that the agent is operating in the principal's interest. Mishkin (1997) concludes that forging strong bank supervision system will be one way out of financial crisis.

Llewellyn (1986) defines prudential regulation as a body of specific rules or agreed behaviour, either imposed by the government or external agency or self-imposed by explicit or implied agreement within the industry that constrains the activities in the industry to achieve a defined goal and/or act prudently. In a nutshell, it is the codification of public policy towards banks (Ogunleye, 1999). The prudential guidelines draw theoretical backing from the anticipated income theory, which forms the basis of what is referred to as the cash flow approach to bank lending (Llewellyn, 1986). It views that the borrowers' repayment ability should be in line with his/her income generating ability, and not on sales of asset of the borrower (liquidation). Banks are expected to generate lending policies that do not emphasize reliance on securities or its realization. Llewellyn (1986) classifies prudential regulation into three: preventive, protective and supportive. Preventive regulations are designed to limit the risk incurred, while protective regulations offer protection in the event of failure. The supportive regulation is in the form of lender of last resort. Banking supervision, on the other hand, is the process of monitoring banks to ensure that they are carrying out their activities in accordance with laws, rules and in a safe and sound manner. It is a means of ensuring compliance with laid down rules and regulations and to determine their financial condition at any given time (Llewellyn, 1986).

Modern Theory of Financial Intermediation

According to Andries (2009), the modern theory of financial intermediation analyzes, mainly, the functions of financial intermediation, the way in which the financial intermediation influences the economy on the whole, and the effects of government policies on the financial intermediaries. That is, the theory of financial intermediation highlights the role of financial intermediaries in an economy, and most studies have highlighted their role in a nation's quest in achieving durable economic growth and the impact of regulations on financial intermediation, while also accentuating the role of the central bank in the regulation, supervision and control of financial intermediaries.

Historically, the theory regarding financial intermediation was developed in the 1960's with the starting point being the work of Gurley and Shaw (1960). The financial intermediation theory is based on the theory of informational asymmetry and the agency theory. In principle, the existence of financial intermediaries is explained by the existence of the following categories of factors: high cost of transaction, lack of complete information in useful time; and the method of regulation. (Andries, 2009).

Empirical review

Kandrac and Schlusche (2021) examined the effect of bank supervision and examination on risk taking: evidence from a natural experiment using from December 31, 1981, to June 30, 1985 using OLS regressions and found that financial institutions that witnessed a reduction in supervision and examination took on much more risk than their counterparts that were subject to identical regulations but unaffected by the change in supervisory attention. In addition, the study found that this expansion in risk taking resulted in more failures and these failures were more costly because failed institutions passed more bad assets to the insurance fund and because less oversight led to slower resolutions.

Kori, Muathe, and Maina (2020) examined the effect of regulatory framework in commercial banks, in Kenyan context for 40 commercial banks between 2016 – 2018 using descriptive statistics and simple regression analysis. Findings of the study showed that regulatory framework has a statistically significance on the performance of commercial banks in Kenya but not to a large extent. Moreover, both financial and non-financial measures of performance were found to be relevant in the banking sector and growth of Kenyan economy.

Asefa (2020) determined the relationship between bank regulations with bank financial performance and liquidity between 2008 and 2017 with a total of 70 observations using regression analysis. The result showed that capital adequacy and management efficiency had negative and significant effect on profitability of private commercial banks in Ethiopia and the remaining regulatory variables legal reserve requirement, capital requirement, NBE Bill Purchase and equity investment had insignificant effect on profitability of private commercial banks. While a legal reserve requirement had positive and significant effect on liquidity of private commercial banks in Ethiopia. NBE Bill Purchase and equity investment had positive and insignificant effect on liquidity of private commercial banks in Ethiopia mean the pre and post policy periods comparison revealed that a relatively better liquidity record for private commercial banks during the time of post policy restriction and the remaining two regulatory variables capital adequacy and capital requirement had negative and insignificant effect on liquidity of private commercial banks.

Wanja (2020) evaluated the effect of regulation on financial performance of commercial banks in Kenya using descriptive statistics and regression analysis. The findings indicated that capital adequacy has a positive relationship with financial performance of commercial banks while liquidity regulation has a negative relationship with performance of commercial banks in Kenya.

Almaw (2020) examined the Effect of Bank regulation on banks' performance using a literature review approach. The study found that structural bank regulation affects the performance of the banks positively or negatively in both advanced and emerging countries, and prudential regulation affects the banks' performance positively, but in case of prudential regulation effect there is different effect in different size and risk level of the banks. The study also found that mostly, it affects developed countries banks' performance positively. Finally, the study found that monetary regulation affects the bank operation and performance negatively.

Yhang et al (2019) examined the role of bank regulation on bank performance in the Asia-Pacific region for the period 2005 to 2014 using double bootstrap data envelopment analysis to measure bank efficiency and employing regression analysis to examine the relationship between regulation, supervision, and state ownership in commercial banks. The study found that excluding off-balance sheet activities in efficiency estimations lead to underestimating of the pure technical efficiency, while overestimating the scale efficiency of banks in the Asia-Pacific region. Cross-country comparisons revealed that Australian banks exhibit the highest levels of technical efficiency, while Indonesian banks exhibit the lowest average. Furthermore, the bootstrap regression results suggest that bank regulation and supervision are positively related to bank technical efficiency, state ownership is not significantly related to bank efficiency, and tighter regulation and supervision are significantly related to higher efficiency for small and large-sized banks.

Hassan (2019) examined the impact of regulation and other micro- and macro-economic factors on banks' productivity growth. It investigated the impact of different regulatory reforms on banks' performance of total factor productivity (TFP) and its component efficiencies, along with their association with bank-specific variables of profitability and equity, and with macro-level variables of economy and freedom. The study found that high capital requirements enhance productivity growth in North and Latin American banks, but not in European African or Asian banks. Supervisory powers drive bank productivity growth in all regions except Europe and Central Asia.

Osano and Gekara (2018) evaluated the effect of government regulations on the performance of commercial banks in Kenya. The research adopted a descriptive research design using 42 commercial banks in Kenya and employed regression model. The results showed that that forex exposure cap negatively affects profitability of commercial banks in Kenya. On the liquidity regulation ratio, the study found that there exists a positive relationship between liquidity regulation ratio and profitability of commercial banks in Kenya.

Deli and Hasan (2016) investigated the real effect of bank capital regulation on loan growth by using bank level data in 125 countries and found that stringent capital regulation affects the growth of loan negatively in short term, mostly for low capitalized banks, however they find positive long-term effect of Capital regulation on loan growth They also revealed that compliance in international regulatory guidelines such as Basel's pillars has much less effect for growth of loan.

Bouheni, Ameur, Cheffou, and Jawadi (2016) examined the effects of regulatory and supervisory policies on profitability and risk taking for European banks over the period 2005 to 2011 using the Generalized Method of Moments (GMM) for dynamic panels to capture further heterogeneous supervision effects before and after the subprime crisis. The study found that strengthening regulations and supervision improves profitability and boosts the stability of European banking systems. Also, the study found a positive correlation between capital adequacy, deposit insurance systems, and banks' profitability. Lastly, the study found that that stepping up supervisors' powers reduces risk-taking and promotes banking stability.

Alalade, Adekunle and Oguntodu (2016) empirically investigated the effects of recapitalization on the composition of banks in Nigeria, the varying level of bank profitability since 2008, the significant relationship between recapitalization and bank profitability, and the extent at which recapitalization has affected the banking sector. The dependent variable used was bank profitability while the independent variables were Return on Assets (ROA), Return on Equity (ROE), and Non- performing loans (NPL). The research discovered that since the onset of recapitalization, banks' profitability has been on a persistent increase and recapitalization had caused greater good than harm in the banking sector.

Ikeora, Igbodika and Andabai (2016) evaluated the relationship between banking sector reforms and performance of the Nigerian economy using data spanning 1998-2013. Secondary data were used and sourced from the Central Bank of Nigeria Statistical Bulletin and National Bureau of Statistics. Hypotheses were formulated and tested using the Vector Error Correction Model (VECM). The study reveals that the variables do not have unit roots. There is also a long-run equilibrium relationship between banking sector reforms and performance of the Nigerian economy and the result confirms that there is about 76% short-run adjustment speed from long-run disequilibrium. The coefficient of determination indicated that about 55% of variations in the performance of Nigerian economy could be explained by changes in banking sector reforms variables. There is causality between banking sector reforms and performance of Nigerian economy.

Olaf and Olawuwo (2015) analyzed the impact of three financial sector sustainability regulations: the Chinese green credit guidelines, the Nigerian Sustainable Banking Principles (NSBPs) and the Bangladesh Environmental Risk Management (ERM) Guidelines. All three address the connection between financial sector activities and sustainable development, and develop guidelines for sustainable banking policies, strategies, practices, products and services. The analysis of the impact of the sustainability regulations on banks was based on literature research and an empirical analysis of sustainability reports and other data from Chinese, Nigerian and Bangladeshi banks. The results suggest that sustainability reporting and sustainability performance of banks increased in all three countries between 2010 and 2014. However, the data also demonstrate that the compliance with the regulations varies. While compliance in Nigeria is high, with 90 percent of the Nigerian banks complying, it is lower in Bangladesh and in China (30 to 60 percent).

Andow (2015) examined the impact of banking reforms on service delivery in the Nigerian banking sector. The study used primary and secondary source of data collection as questionnaire was administered to the staff of the banks to seek their opinion on the subject matter. Chi-square was used to measure the differences between the expected frequency and the observed frequencies and t-test was used to ascertain whether there was a significant relationship between customers' deposit and reforms, and the relationship between banking reforms and service delivery in the Nigerian banking sector comparing the pre-and post-consolidation results. The findings of the study revealed that there is increase in the customer's deposit after banking reforms as compared with before banking reforms, it was also revealed that the performance of the bank increased in terms of profitability and service delivery.

Roseline, O. O., Sikiru O. A., & Oluwafemi (2015) evaluated the effects of mergers and acquisitions on bank recapitalization in Nigeria with emphasis on the impact of the strategy on economic development. The study made use of data from the foremost eight banks in Nigeria that account for over 60% of banking transactions in the country. The research work was evaluated through regression analysis of secondary data covering ten years (2002-2011) from the sampled banks. The research focused on a study of the pre-recapitalization and post-recapitalization periods hence the sample period was divided into two. This approach assisted the authors to capture the actual effects of the latest recapitalization policy of the government during the period. The result suggests that the effect of the latest recapitalization policy was positive on the operational capability of the Nigerian banking system. There are lots of economies of scale derived from the exercise. Harnessing of resources through mergers and acquisition gave the banks the much-required funds to intermediate more effectively within the financial system.

Bernard, A.U., Obialor, & Michael, C. (2014). investigated the impact of bank recapitalization on bank performance. The Ordinary Least Square (OLS) regression analysis was used for the analysis. The results showed that bank capitalization has no significant effect on bank profitability and asset quality, whereas liquidity and financial deepening were significantly influenced by the recapitalization. The study posited that profits maximization drives of Nigerian banks have had counterproductive effect on bank capitalization. Also, efforts of banks to maintain quality assets and remain in business normally erode their capital. Strategies to increasing bank capitalization can be used to boost loans and advances to the productive sector of the economy.

Jegede (2014) investigated the implications and challenges of the banking sector reforms in Nigeria. It sought to; examine the various roles played by banking reforms in the development of the Nigerian financial system, find out the prospects and the performance of banks after reforms are implemented, determine whether reforms have achieved its aim of strengthening the capital base of banks and providing a healthy competitive environment among banks. Descriptive survey research was adopted for the study. The results showed that banking reforms in Nigeria have significantly improved the performance of the services provided in the industry and that the challenges of banking sector reforms in Nigeria will guarantee its successful future operations. The study also indicated that banking sector reforms in Nigeria has significantly strengthened a healthy competition in the industry. However, the respondents reflected that they have encountered operational problems during the reforms and most of these problems include problems of the system integration, computer failure, power failure, crash programs and policy differences.

Ajakaiye and Tella (2014) investigated the potential trade-offs between financial sector regulation and financial stability in Nigeria and implications for financial inclusion and inclusive growth. Quantitative and qualitative analyses of the financial market activities showed that the raison détre for the 2004 consolidation and the 2009 post-consolidation reforms were hinged on instability in the banking sector due to critical gaps in regulatory framework and regulations, inadequate supervision and enforcement of regulations, and instability caused by capital flows.

Obadeyi (2014) examined the effects of financial reforms on banking performance in emerging markets using the Nigerian experience. The study covered between 1992 and 2011, because the last reform in banking sub-sector was in 2005 w Prof. Charles Soludo's era as the CBN governor (Pre-Lamido era). Automated Statistical Package Technique (ASPT) was used to analyze the model and Ordinary Least Square method was adopted to analyze the existing relationship of variables and their behaviors. The study revealed that the effect of financial reform on banking performance is mixed. It was discovered that financial reform is not a causal factor for effective banking performance and development; but there is need for strong capital account policy to regulate short-term capital flow and exchange rate volatility.

Olokoyo (2013) accessed the effects of the reforms on the performance of banks in Nigeria. The data required for this study was gathered through the instrument of questionnaire. One hundred (100) copies of questionnaires were administered out of which eighty (80) copies were collated for the analysis. Analysis of Variance (ANOVA) method was used to test the hypothesis. The results of the study showed that the recapitalization and consolidation process had a significant effect on the manufacturing sector of the economy and thus on the Nigerian economy at large. The study further revealed that despite the reforms, post consolidation challenges like challenges of increased return on investment still exist.

Omowunmi, O.F (2012) investigated the effects of bank deregulation on bank performance in Nigeria. The objective of this study was to analyze the areas that have been deregulated in the banking sector and how it has affected bank performance. To realize these objectives, the study analyzed secondary data collected from CBN statistical bulletin by employing the Ordinary Least Square (OLS) technique. This study found out that the deregulation of the banking sector has positive and significant effect on bank performance. It was recommended that bank management should embark on effective intermediation drive that will bring all the small savers to the purview of the banks, banks should improve their total asset turnover and diversify in such a way that they can generate more income on their assets, and adequate efforts should be made by banks to increase their level of investments as that will help in generating reasonable returns on their assets. Also, the banking sector regulatory authorities have a duty to perform in ensuring that good corporate governance and the best of banking practices are obtainable in the nation's banking industry.

Okpara (2011) examined the impact of banking sector reforms on the performance of the banking system in Nigeria. The researcher adopted a one sample t-statistics using the population average as the test value. The findings revealed that apart from the reform period of financial liberalization which affected significantly virtually all the banking sector performance indicators and the financial deepening, the rest of the reforms made no significant impact on the performance variables. However, with the exception of the recapitalization reform exercise that started in 2004 which deteriorated financial deepening and made insignificant impact in all but returns on equity which is drastically reduced, all other reforms exerted significantly on financial deepening.

Bakare (2011) examined the trend and the growth implications of bank capitalization in Nigeria. The secondary data used for the study were processed using sample test technique for difference between two means. The test of difference of means was used to compare the means of the variables before and after recapitalization to see if there is any significant difference between the two periods. The result indicated that post recapitalization mean at 21.58 was higher than the pre-recapitalization mean of 15.09, implying that banks are more adequately capitalized and less risky after the programme. This result also indicated that recapitalization has low but significant influence on the growth of Nigerian economy compare to other variables in the model.

Rehman (2011) conducted an empirical analysis of financial reforms in Pakistan to examine whether it affects economic growth. It explored correlation among economic growth, deposits, lending, real interest rate, savings, and inflation, taking data of thirty-six years (1973-2008). The regression analysis showed a positive impact of financial reforms on the growth of the Pakistani economy.

Mwenda and Mutoti (2011) investigated the effects of market-based financial sector reforms on the competitiveness and efficiency of commercial banks, and economic growth in Zambia. The results show that reforms adopted in Phase II and III had significant positive effects on bank cost efficiency. They also found, using an endogenous growth model, that bank cost efficiency, financial depth, Phase II and III financial sector reforms, degree of economic openness, and rate of inflation are significant determinants of economic growth. Phase II policies and inflation rate have adverse effects while the rest of the variables have positive impact on economic growth.

Literature Gap

Most reviewed studies employed series of analysis techniques like descriptive and simple percentage, (Donli, 2002; Amala, 2005; Aminu & Ologbondiyan, 2005; Ogunleye, 2005), with short insight on regression (ECM) (Onuoha, 2015, Austin, 2005) but none of these studies employed the simple regression considering the lag with which it takes for monetary policy to take effect. In this regard, this research work will examine the effect of banks regulation on banks performance in Nigeria. Onuoha (2015) also considered five selected banks in the analysis, while this research will look at the entire sector.

Conclusions

The banking industry is one of the most heavily regulated industries around the world. Regulation differs across countries and has significant effects upon the structure of the banking sector and the performance of banks. Regulatory measures include variables indicating whether securities, insurance and real estate activities are permitted. The results find that restrictions on bank activities tend to yield more government ownership, less private credit, and a larger fraction of non-performing loans. The effect on concentration is unclear, with different activity constraints yielding different results. Also, having an implicit deposit insurance scheme reduces bank concentration, foreign ownership and private credit. Stricter entry requirements reduce government ownership of banks. Restrictions on ownership only affects concentration. In particular, restricting non-financial firms from owning banks reduces concentration, while restricting banks from owning non-financial firms increases concentration.

In general, too many restrictions on banks activities, having an implicit deposit insurance system, and having loose entry requirements tend to yield a lower performing and more government owned banking system.

Suggestion for Further Studies

Future studies should examine the effects of bank regulation on loan performance of commercial banks. Additionally, future studies could consider the effect of monetary policy as a moderating tool for managing the performance of banks as well as their loan management.

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